I'm a Plastic Surgeon: How Should I Manage My Debt?

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This is the first issue for many new graduates in Plastic Surgery. The end of June brings a wave of euphoria and relief as new surgeons embark on their careers. They are now superb diagnosticians, technicians, and physicians. However, many find themselves wandering in a world filled with new financial responsibilities and challenges. For many, this represents the first time in which the accretion of debt is feasible and its diminution possible. They are understandably confused about the manner in which their debt should be managed at a time in which revenue is soaring. To compound this issue, taxation becomes an opaque labyrinth, and the management of income is confusing.

One strategy for managing debt is to reduce the amount of personal debt that is taxable and to maximize tax deductible business debt.

Different Types of Debt

Most people hold debt in various forms. Graduates will typically have 2 broad classes of debt. The first is debt that is securitized by real estate. In most cases, this type of debt is secured by a mortgage. Property is proffered as collateral against the debt. Payments include a portion that is applied to the principal borrowed and a portion applied to the cost of borrowing. Plainly speaking, this is your home mortgage.

The second type of debt is a student loan or line of credit. These are often unsecured liabilities but are supported by legislation that precludes default. This legislation ensures that trainees with the possibility of steady income stream will be legally required to pay these debts without the benefit of many types of loan forgiveness programs, the most extreme of which is personal bankruptcy. These debts are typically offered at very attractive interest rates in consideration of the high rate of repayment and low credit risk.

The above classes of debt are taken personally and relate to personal consumption. As a consequence, their payment is made in income after taxation. The revenue required to service this debt is relatively large in that it is not deductible as an expense prior to calculation of net income. Stated simply, an

individual who earns a salary will pay income tax first. After this tax is paid, interest will be paid on the after tax income. This is referred to as non-deductible interest.

Another class of debt is business debt. These are loans that are offered by financial institutions whose collateral is either the asset of a business or the revenue streams that the business is likely to generate. In these situations, a financial institution is making a risk calculation based on the value of a business at the likelihood that the business will generate sufficient revenue to service the debt. In many cases, further collateral may be required such as the personal assets of the business owner, the assets of the business, or a co-signature from another credit-worthy customer.

This debt is designed to provide the business with the capital required to operate the business. In some instances, these resources fund working capital, which is required to meet payroll and other short-term expenditures. In some instances, it is provided to procure equipment or infrastructure required to support business activities. However, in all cases, the purpose of the loan is to provide a business with funds that allow that business to produce revenue. In other words, the loan is required to allow the business to make money.

The diverging purpose of business debts creates different treatments in taxation. Taxation is levied at the level of net income that is defined as revenue from which expenses have been calculated. As such, all expenses must be deducted prior to calculation of net income. The purpose of a business loan is to allow the business to earn income and as such this is a

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business expense. As a consequence, the interest on a business loan is deducted from the calculation of net income. This means that the interest on a business loan is tax deductible as an interest expense. This is in contrast to the interest on loans for personal consumption, which are not tax deductible.

For new graduates, most will have a large amount of personal debt either in the form of mortgages or personal lines of credit. Very few will have business debt. This means that many will have a large amount of non-tax deductible debt. Completion of training and the ability to start a business offer the opportunity to convert this debt into tax deductible debt, thus effectively reducing interest payments by about half.

Why Is Business Debt Preferable?

There are several reasons to consider the substitution of corporate debt for personal debt. The tax benefit is certainly an important consideration and the mechanisms of this conversion will be discussed below. However, corporate debt also has several other benefits.

In many cases, the rates offered to businesses are lower than those which have been offered to individuals for personal consumption. This is a consequence of the risk calculations performed at financial institutions and may not be applicable in all cases. Most financial institutions calculate the interest rate on various loans as a function of expected profit and the risk of default. Although the risk for residents is low, the risk is often lower once that resident has graduated and is earning money. Furthermore, businesses can often purchase insurance against these liabilities thus securing the loan to a greater extent.

Another issue is the source of collateral. A business may have assets or goodwill which can be valuable to a financial institution and can be reflected in lower interest rates. Finally, corporate debt may be safer to the individual. Depending on the nature of the loan, the liability may only extend to the corporation and not be transferred to the underlying owner of the business. Furthermore, such debt is susceptible to the debt protection mechanisms provided by law including bankruptcy protection. Although this is clearly not a desirable outcome, student debt is often not amenable to this treatment under the law.

Maximizing Business Debt

There are several mechanisms to reduce debt. However, one option is to pay all personal debt as quickly as possible in order

to rapidly decrease the amount of non-deductible interest. All revenue from the business can be employed for this purpose. Under this scenario, all revenues are taken as income. No revenue is employed to finance the expenses of the business. Income tax is then paid, and the remainder is used to dramatically reduce the principal owing in personal debt. This would include all student loans, lines of credit, and mortgages. For most people, this would be mitigated to some extent by investing some of this income in a tax-shielded way, such as an RRSP or TFSA. However, the majority of the income would be used to dramatically reduce the amount of non-deductible interest.

The business would still require financing for ongoing operations. Payments for equipment, payroll, leasehold improvements, education, and conferences would be incurred in order to operate the business. There are 2 alternatives to finance these activities. The first is that the revenue from the business can be employed thus reducing the net income to the business. However, this strategy requires a decrease in the funds available to diminish the non-deductible interest. The second option is to finance operations using a business loan. In this scenario, the debt incurred by the business will escalate rapidly as equity will remain low. However, the interest on this debt is entirely deductible and thus preferable. In fact, the net interest rate is almost half of that paid on non-deductible interest.

This requires a shift in psychology and an understanding that business debt is preferable to personal debt. This shift in psychology is critical. It is often the barrier to the assumption of business debt and a driver in continued payments of non-deductible personal debt.

As new graduates start their business lives, it is important to consider new tools that become available as they become proprietors of a small business. The assumption of debt within a business has several advantages and can mitigate larger costs associated with interest payments. Such a strategy may have benefits that allow new surgeons to decrease the overall debt burden and increase net worth over a shorter time span.

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