Ep #9: Dealing with Expenses and Taxes

Full Episode Transcript

With Your Hosts

Dr. David Phelps and Evan Harris

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You are listening to the *Dentist Freedom Blueprint* podcast, with David Phelps and Evan Harris. Navigating you through the uncharted waters of a turbulent economy with straight-forward advice to, transform your practice into a self-sufficient cash machine, compound your net worth assets, and multiply, multiply, multiply your passive cash flow streams.

Evan: This is Evan Harris with the Dentist Freedom Podcast, along with my good friend, David Phelps. David, how are you today?

David: Evan, I am doing great. So glad to be back with you again. I am excited about the topic we are going to talk about today.

Evan: Indeed. So, David, we've been talking a lot about production from the practices that our clients and our audience is in, as well as revenues and growing capital. Today, I'd like to talk a little bit more about expenses, something that can kind of be a negative, but yet when controlled and harnessed, my belief is it can be really a powerful, powerful benefit to our listeners. David, question number one for you, what would you say is our number one expense in our lives and our listeners' lives?

David: Well, Evan, I think this is going to surprise a lot of people today, and you're right. Expenses are something we need to look at, but this is an expense that most people don't even count as an expense. In fact, on most P&L, profit and loss statements, it doesn't really show up as an expense, per se. That is taxes, and I'm talking about federal taxes, including social security and Medicare. But if you think about it, and you go back and look at literature P&L, and see what you are paying in taxes every year, that number is pretty significant, and I would bet that for most of our listeners, their effective tax rate, that means the average amount of tax that they pay on their net profits, so net profits, is about 25% to 28%. So that's a quarter of your profit.

So let's say you're running a practice, and you're netting after all of your expenses, $250,000. That's what you can take home and spend on your lifestyle, and hopefully you're investing some of that money, but you're already going to take off 25 to 28% of that and pay that to Uncle Sam. Now, if you combined some of your other living expenses, Evan, let's say your housing cost. Let's say you have a mortgage, and you have obviously food and entertainment and cars, and maybe some private education, school tuition, that kind of thing. If you combine those other basic costs of living, it's not going to add up to as much as what you pay in taxes. So that's why I say the number one expense is taxes, and there are some things we can do about taxes and some things we can't, but if we learn the things that we can do about taxes and how we can mitigate, reduce some of the taxes – I'm going to show an example in a couple of minutes here, why that's so important. See, the problem, Evan, is that most people just default to the fact that you know what, taxes are just a part of life, get over it, get used to it. And they are. I'm not talking about tactics here to evade paying taxes. That's illegal. That will get you ten years in the pen. So I'm talking about legal ways to offset taxes, and the reason why that's important is just not so you have enough money left to buy a bigger lifestyle, Evan, but I'm talking about money here that's so important to have, to save to keep from paying taxes so that you now have something you can put into proper investments, the other piece of the Dentist Freedom Blueprint we talk about, so now you have that capital that you can invest, you can leverage, and you can grow it, but the key here is how do you reduce the taxes.

Evan: Wow, yeah. Most people, I think if I would ask what the biggest expense was, they would typically say their mortgage, their rent, and those types of lifestyle expenses, but you're right. I guess when I put the pencil to it, taxes really are the largest cost of any business and of anyone. Yeah, we talked a lot about compounding wealth, and we talked about some of the investments and having that capital continue to build and build and build. What would you say the effective taxes would be on compounding wealth building?

David: Well, if people understand the basic concept, the value of compounding by itself, then this will make a lot of sense. So here's the example. If you take a dollar bill, and you double it every year for 20 years, so we're going to go $1 and then $2 and then $4 and $8, $16, $32. We do that 20 times, Evan, so we do it over 20 years, that one dollar bill will double over that 20-year period of time to a million dollars. That's just basic math compounding. Now, if we add in a very conservative 15% tax rate, then that doubling effect of that dollar every year – so if you go from $1 to $2, and you pull out 50% to pay Uncle Sam, if you do that every time over 20 years, that doubling will not reach a million dollars. In fact, Evan, it will only reach $250,000. You've reduced –

Evan: Really? A quarter?

David: Well, yes. Well, you discount four times, so yes, you only reach a quarter of what that original dollar would do without the effect of taxes at all. Now, remember, that's only at a 15% tax rate. Let's bump it up to what I just said was more realistic for most of our listeners, and that's the 28%, 25% to 28% bracket. If we add that tax effect to that doubling, we only grow that doubling of that dollar to $51,000. That's only a tenth of what it would have grown to without the factor of taxation, and let's take it one more level. The top tax bracket rate today, not including state and local, is about 39.6%. If we throw that tax rate in, our doubling effect only reaches $13,000 – $13,000, Evan, when we were at a million dollars without any taxes. Does that give you any idea what the effect of that expense of taxes is doing to your wealth-building?

Evan: I'm feeling sick, David. We may have to end this podcast right now.

David: Well, but [inaudible] –

Evan: But I'm guessing there are some other listeners out there who might have some good news to be told. Is that right?

David: There is some good news here, because there are answers to this. There are definite answers, and it was one of the keys that I didn't stumble into, but Goode and Danforth (?) (5:46) and people showed me early on, and really it was the real estate that brought it to my attention, but I'm going to take this down a particular road here, so let's go with this, but that's the key to what the effect of taxation will do to your ability to build wealth, if you were just paying taxes on your money as it comes in.

Evan: Wow. Now, how about the professional that says, "Look, David, I have a CPA. The CPA does the best that he can for me, and I've just got to pay what I've got to pay."

David: Evan, that's a great question, because I think most of our docs have a CPA, and I'm not here to bash CPAs at all. I have a CPA myself. I have one that I've had for 28 years, and he's a little different than most. He doesn't have the big box, what I call a CPA office with multiple people in there. He really is a strategic guy. He's different, but he's taught me a lot of these principles. The problem with most rank-and-file CPAs, even though they are well-trained, and they really do care. They want to do the best they can for the client. Number one, they really don't work for us, most of them. Here's why. You think, "Well, what are you talking about, David? I mean, you hire them, you engage them to provide you tax reporting services. What do you mean they don't work for me when I pay them?" Well, here's the problem.

The IRS has really created a liability, a real fear factor for most of them, because as licensed professionals that can appear before and sign your tax return, they have to meet certain standards, and if something happens that you get audited, and you get pulled into an audit, and then you say well, you know what, he or she told me to do that, there can be some real liability there. The IRS has really put the onus on the CPA to really become another tax-reporting device, unfortunately, for the rank and file. I'm not saying that's for everybody, but for the rank and file – so your CPA really has their hands tied. They're follow their own. Let me make that clear. They will follow their own. They have their hands tied today. So if you go to a CPA, and a typical question most docs have is I paid way too much in tax last year, how can you help me save taxes? Really, the CPA can't answer that question. Do you know why? Because it's not legal for them to say I can figure taxes. You have to do things for a business reason, so you have to turn the question around and say, "What can we do, Mr. or Mrs. CPA? What can we do in my current business arrangement that can change the amount that I pay in taxes?" Now, if you ask the question that way, they can start to give you some answers. But again, here's the problem, Evan. Most of them don't want to go on the line to do what they really probably could do, or if they took the time to research, it's too much work for too little profit. See, they work a little bit like dentists, Evan, unfortunately had to get to doing, and that's saying well, am I a commodity? Am I a commodity? Do I just go by the insurance fees, and therefore if I want to do better service for my patients, I just go well, you know what, the patient says all my insurance will pay for is this, and so you go okay, well, that's all we'll do. We have to be able to stand up and say – and the CPA has to do the same thing – and say for the right client, I can do this service. So the investment to do that is not going to be what you're used to paying, the $1,500 per year or whatever it is, but I can save you a ton. Most CPAs won't go there, because they're just like a lot of dentists. They're just in a commodity, low-margin basis, and you just can't get there with a lot of CPAs. So that's the short version. I could go into a lot of depth on that, but don't blame your CPA, but understand you may need to have a different conversation with the right CPA to move to the next level.

Evan: Yes, understood. When we talk about wealth-building, on the plus side, we've talked about the creating business entities and then creating methodologies to be able to build wealth even more, and you talked about creating a Plan B income. So I would say what is the best way to create a Plan B income and wealth-building strategy, while at the same time, legitimately reducing taxes?

David: Evan, if there was one secret, one clear way to both create that Plan B income and wealth-build at the same time while reducing taxes legitimately, it would be this: buy something – and I'm talking about a capital asset – that grows in value, and as it does, it is not taxed along the way. Just like the same thing I showed with the example of how taxes affect your wealth-building. Now, you're saying well, what is that? What is that thing, that capital asset? Well, that can be a business like a practice, like a dental practice, because think about it. If you are able to leverage other doctors or hygienists to increase your gross and therefore your net income, what have you done to the value of that practice, theoretically at least? You've increased it, right?

Evan: Yes.

David: So let's say the net income of that practice goes up $200,000 per year. Well, you've probably doubled the value of your practice by 2, maybe 2.5 times that net. So you've added maybe $400,000 or $500,000 worth of value. Now, do you pay tax on that additional value when you created it? No. The answer is no. You don't pay tax until the day you sell. All right, same thing with real estate. Real estate is the other capital asset, and you could do the same thing. We could go out in the marketplace, Evan, because we do it all of the time, and buy a property at a discount, because there are some problems with the property. We could buy it at a discount, and then by fixing it up, we would maybe increase the value of that property by 30% or 40%. Well, again, do we pay tax on that, increase the value that day? No, unless we sell it, unless we flip it. If you keep it, if you hold that property, then that value will continue to compound as the market increases as we have inflation, appreciation. You still don't pay tax until the day you sell, and guess what. With real estate, you don't even have to pay tax then, because you can actually do an M31 exchange, take that gain, and move it to another property without paying tax. That way we've eliminated that tax bite that I just showed you as an example that carves out and reduces that wealth-building component year after year. And the final tip there with the real estate – I'm going back to real estate because I love it – is that even then if you exchange and never pay the tax, and let's say you pass away, guess what. Your heirs take that property at what we call a step-up basis. They've taken it at market value, so again, no tax. We have eliminated the tax man through that whole holding period, and even exchanging from one property to another, and then giving the legacy to our heirs, no tax. Now, isn't that huge when you just saw the example I talked about a few minutes ago?

Evan: Wow.

David: Make sense?

Evan: It does. It really does.

David: I don't want to beat this up, but I sort of do need to beat it up, because it's a key, key concept, and the problem that most of us have is that we are so myopic with our loupes on, and we're down in the mouth doing that precision, detailed work that is so important, that we can't see that bigger picture. You've got to enlarge your operating arena. This is the $10,000-per-hour bucket. This is one of those, by learning how to leverage into assets that will grow and compound in their growth without the tax fight. This is a $10,000-per-hour project. I've got to get more doctors to understand this concept.

Evan: I think you've got a lot of listeners right now that are thinking how can they do it in their own practice, and if this is one way, what other ways – if there was maybe one or two more, not diving deep – we can do that on another podcast – but if there were a couple of other strategies, could you give us just kind of a brief list of other things just to kind of pique some interest?

David: I think the secondary, the overriding concept I just gave, Evan, is you've got to have a team. You've got to have the right team, and I'm talking about professional team. I mentioned the CPA. That's part of the team. But you've got to be around other people that can be strategic, and it's so hard for us as professionals, as doctors – I know I went through this problem many times when I was younger in practice – and that is how do you find these professionals that can help you orchestrate this? Well, it's very difficult. You find the CPA, and then you go to the attorney for estate planning or business planning, and then you go to a financial planner, and they all have different ideas and perspectives, and you end up as a doctor, frustrated because no one will speak to each other, and it's just all so convoluted that you just say, "You know what, I'm confused. I'm going to let you do nothing. I'm just going to go back and work harder." That's the typical default position. What I've done with the Freedom Founders, and what we love to do, Evan, is we like to create the network of people that already know, like, and trust, who have the same philosophy, who understand these powerful concepts, and now you can start to have conversations with real people, real time without going in and paying $300, $400, $500-per-hour consult fees. You've got to have people around you that will embrace where you want to go and will do so without always feeling they've got to put their hand in your back pocket and be extracting money, because I don't like that formula. I don't like that at all.

Evan: And to be able to – if people wanted to learn more about Freedom Founders and see the overall picture, where would they go to find out more?

David: Well, the Freedom Founders Mastermind, and Evan, you're going to be out at, I think one of our next ones is simply at the freedomfounders.com website, and that's where we pull it all together. That's where the relationships – and we've talked about relationships on every podcast we've done so far – but the relationships are key. As dentists, we've got to get outside the box, and the box is our practice, and that's what we've been trained to look at, and that's what we've been trained to focus on, no question about it. And that's the first engine that we've got to run, and we've got to make that operate, but as quickly as possible, we've got to start looking at the bigger picture, and that goes back to leverage again. So how do I leverage the practice, and then how do I leverage the income, the discretionary income that I have that I need to start investing outside the practice, both in the practice and outside, but outside, then how do I do it so that I'm not being killed by taxes? This is a key, key fundamental, but where the roadblock hits so many people again is where someone will say, "Hey, Mr. CPA, I heard this great podcast the other day driving down the road, and these two guys that are in the dental industry love what they do, they're talking about how if I set things up right, typically I can build wealth both in my practice and even outside in real estate and not pay tax."

And you know what the CPA is going to do? He's going to go, "Well, what are you talking about?" Because again, they don't want to go there. The conversation for most of them, it's way beyond what they even think about day to day. It's like going to a dentist, Evan, who has never seen the ability to change lives through doing more than fill, fill, and bill. That's the best example I can give. It's what you know, what you're passionate about, and if you only know a certain level, like when we come out of dental school, that's all we know, fill, fill, and bill. We don't know how to really change lives and fix TMJ and change smile lines and all of that cool stuff. Well, most CPAs are in that same mode. They've never even gone there in their minds as to how they could really get strategic, because you know what? It's hard work. Think about the hard work that our best dentists go through, Evan, in training and education, and see I did it year after year after year, because I wanted to be the best. That's a lot of work and a lot of investment of time. Again, most CPAs, they're so busy in their practice like we are as dentists, they can't develop a big, strategic picture. They're just like us in so many ways, so you've got to get a different group. You've got to change your mindset. You've got to give yourself permission to get outside that box and find people who are like-minded who are going down the same road and face the same challenges, but who have also broken through and then say to you, you can do this. It's okay. It's within your realm.

Evan: Absolutely. Well, David, I am honored to have been a part of this podcast, and I feel like we've got a lot more information to be able to share, going even deeper on some of these concepts. If you are listening to us on iTunes, please like us, leave a review so we can add even more content, and if you have questions, if there are things that you want to know more about so we can go even deeper on one of these topics, please leave that information. We will definitely respond to that. This has been Evan Harris and David Phelps, two men on a mission to help practice professionals grow and have the lifestyle of their dreams.

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