Ep #66: Your Biggest Expense

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: Good day, everybody. Evan Harris on the mike. I've got my fellow DJ, Dr. David Phelps on the line. Dr. David, are you there?

David: Evan, I am here. I'm going to go ahead and make a note for people that are listening that this is happy tax day. It's actually April 18th. We normally don't give dates but I thought for this episode maybe I'll just mention it. It's happy tax day.

I don't know how happy you are or how happy our listeners are, I'm being a little bit factious of course because nobody likes to pay taxes. It's part of life and part of what we deal with. Anyway, that's where I thought we'd go today since it was kind of top of mind for me. Is that okay with you?

Evan: That's okay with me. I've got a buddy of mine that says if he's paying a lot of taxes, his belief is either he's incredibly lazy and hasn't done the right planning or he's made a whole lot of money. So I hope for all of you out there that you have not been lazy, you've taken some of the things that we've said and I'm sure that countless other people have shared. You've taken action on whatever taxes you're paying. You're thankful because you have made a good amount. We hope to help you make even more so you can live better and give more.

David, you had a blog post just recently here. It says, "your biggest expense." My belief is that if you had taken a survey and offered a prize for people to share their biggest expense, my belief is I think you would have heard things like, "In my practice, payroll." Or, "Within my life, it would be my mortgage." I believe that people miss the biggest, the biggest, expense in their life. Not just today, but in their whole life, because they can pay off their house. They could be able to pay off a practice debt but they've got an expense that is going to likely continue all the way until the grave. David, if you could kick that off and share what this big expense is that you'd like to talk about.

David: You're exactly right, Evan. I think for many of us, I think I've been in the same mindset as well in the past, is that we all know that taxes are something that we have to pay. As you said, it's not necessarily a bad thing if you're paying taxes because it means you're producing some income, some revenue. The more tax you pay, then you think, well, then I'm probably doing pretty well in life.

The problem is there's a lot of different kinds of taxes, Evan, typically people think on tax day, on April 15th, or this year it's April 18th, that we think in terms of the federal tax because that's the big one. But there's a lot of other taxes. When you start to add them all up, the top rate today I think is 39.6 percent, but when you start to add up state, local, property taxes, payroll taxes. We've got the Obamacare, Medicare taxes, that is an additional 3.8 percent on investment income over a certain price point.

When you start adding all those taxes up depending on what state you're in, you could pay well over 50 percent in taxes. That's a heavy load to carry. What I want people to understand about taxes is that—well, let's turn it around.

Let’s say this Evan, most people understand that there’s the law of compounding. I think that Albert Einstein said that compounding is the eighth wonder of the world.

We know if you take a dollar bill and you double that dollar bill every year for 20 years, that dollar bill will turn into a million dollars. That’s the magic effect of compounding. One dollar, twenty times, turns into a million dollars. That’s huge, isn’t it?

Now let’s just add in a very modest 15 percent federal tax rate. We call that interim taxation. So every year as you grow your wealth, or in this case every year when we double the dollar from one dollar to two, two to four, four to eight, etcetera. We have to subtract out interim taxation. If we just do 15 percent each year for that 20 years, instead of reaching a million dollars, Evan, that dollar bill doubling with only reach $250,000. That’s a reduction or a decline of four times the amount of wealth building without taxes. Think about that. That’s only at15 percent.

Evan, if we jump to a 28 percent tax bracket, then that doubling effect to a million dollars drops all the way down to $51,000. That’s a decline up to over 20 times, 20 times reduction, in a 28 percent tax bracket.

Let’s jump it one more time, Evan, let’s go to 39.6, the top federal bracket. Again, we’re not even looking at all the other ancillary taxes but just the federal level. That doubling of that dollar instead of reaching a million, only grows to $13,000. I’ll say it again. That’s not a mistake. That’s $13,000. That is the effect of interim taxation, the negative compounding effect on one’s wealth building. Now think about how you feel about taxes as an expense.

Evan: I'd say that anything pales to the comparison of that. I think a lot of people just kind of throw up their hands and actually years ago I did the same thing. I just thought well what can I do? That's just is what is unless I want to leave this country, that's just what I signed up for so I might as well just buck up, pay my share, and just ride it out. Just make more.

My guess, David, is that you have some more things in store for us that we could take legal, not tax avoidance, but tax efficient moves today that can be able to help our next year a whole lot better.

David: Exactly. You know the famous judge Learned Hand, famous quote—and I'm paraphrasing this—but essentially he said you shouldn't pay more tax than you are obligated to pay. Let me say this also, Evan, you and I are not tax accountants, CPAs, or tax professionals. We don't give legal advice. So we're talking in general frameworks here. Always take any information that we give you back to your professional advisor before you implement anything. But I'm going to talk in frameworks.

Evan: Ask your doctor, right?

David: Yeah, ask your doctor, ask your tax doctor.

Evan: May cause dizziness.

David: Yeah, exactly. Don't stand up too fast after you write that check to the IRS. You might definitely get dizzy.

Here's the deal, there's two pathways. There's the pathway that I think everybody listening today would definitely feel that they're a part of. That is, we're not afraid of working hard. I don't know any hardworking dentist who says, “I’m just lazy. I don’t want to do it.” I know every one of my colleagues works very, very hard.

So it’s not about working harder because you can't—I’ll tell you this, you cannot outrun the taxation. It’s only going to get worse. I'm not trying to be negative here. Let’s just face facts, it’s going to get worse but there are some frameworks in which any one of you listening can do some things to mitigate, not avoid, certainly no fraud here, but to mitigate taxation.

If you could get into an environment where you could reduce your taxes by 20 percent, you could increase your ability to get free sooner. That is real freedom. So you don’t have to go to work every day or you can decide when you want to transition out of your practice. You could do that so much faster just by the methodology I described in the negative compounding effect of interim taxation.

So how do you do that? The one thing I would say that most accounting reporting is done historically. So most business owners, most practice owners, don’t really have a grip on any strategies. Most CPAs, not because they don’t know what they're doing, that’s not it at all. It’s just their practice is more on a tax-reporting basis. You give them your numbers, you give them the books, they run the P&Ls, they run the balance sheet, and they tell you how much to tax to pay.

When typically you go and ask them, “What else can I do?” After the fact, after you’ve written a big check. Most of them say, “You’re expensing just about everything you can expense in a practice. There’s maybe some gray areas we’re going to, they're not illegal, but really we’re about tapped out.” That’s usually what you get.

One of the smartest CPAs that I know and has been my CPA for over 30 years, John Groom, who comes to our Freedom Founders mastermind, what he says is that he can do a lot more for people, business owners, if they have more moving parts. Well that sounds kind of complicated doesn't it? What's moving parts?

He says if you have a practice, a business, there's the typically business expenses and there's depreciation for your tangible assets and depreciation for your office building and that sort of thing, basic stuff. Everybody takes it, or should take it, but that's not nearly enough.

What he says by having more moving parts is, he says if you have other capital assets, and of course, Evan, the capital asset that you and I both really enjoy being a part of it. That's real estate. When have more moving parts, more asset classes within your umbrella of investments, he says, "There's a lot more I can do with that than a standard doctor who has his practice and the normal expenses." So that's one framework.

The other one I want to bring out and then we'll have more discussion here is that people also don't realize that there's the opportunity to use retirement accounts, whether you do a 401K or you have a self-directed—I'll go to self-directed in a minute. But you have IRAs, Individual Retirement Accounts. We know that there's traditional, there's Roth, there's Coverdells, there's Health Savings Accounts.

Any one of those can be self-directed, meaning you don't have to simply invest in the menu of the day from a Fidelity or a Schwab who lets you invest in Wall Street assets, which I'm not demeaning those. But I'm saying, again, you don't have the ability to do some of the things you can do in real estate. With self-direction, you can be involved in any type of real estate investment.

With the right type of account, you can not only mitigate taxes through tax deferral but if it's the right account like a Roth IRA or an HSA or a 401k, the distributions can come out tax free. Now that's huge in and of itself. So there's some different things that can be done, Evan, but you have to be purposeful about it.

Evan: Without a doubt. I find that once people find that there are ways that they can be able to leverage these accounts, then the sky is the limit. One thing begets the next thing, begets the next thing. They're able to receive income through the entities that are the most tax efficient. It's completely legit. They could be audited, any of that, and it totally stands up. It's solid.

But to just find the streams of income and have them come through the most efficient channels and to be involved in some type of mastermind, whatever it may be. Be around people that have already done what they've wanted to do. There's not one mastermind that's the mastermind. But if you happen to be a dentist and you want to be around other successful dentists, I would encourage find a mastermind that has that.

I belong to a mastermind on the real estate side. I also belong to a mastermind on the dentistry side. There are people that I feel are more advanced than me, more knowledgeable than me. I believe that everyone is more knowledgeable than me in some area. So I can always learn. I also feel like I can also add value. There may be exposure that I've had that I can add value to them.

My encouragement is please don't be a silo. There's more power I believe in multiple eyes and multiple brains on a topic. David happens to run, I believe, one of the very best masterminds really in the country that bring doctors together from multiple disciplines, not just dentistry. But brings multiple disciplines to the table and enables them to keep more of what they're working so hard to earn.

David: That's a key right there what you said, Evan, is keeping more of what you earn. I like what you said, I love masterminds, not just Freedom Founders which obviously I'm biased towards. But I'm part of other masterminds as well. Here's the key component is that you get to get together with other like-minded entrepreneurs or professional practice owners and realize that these concerns, in this case taxes, is common to all of us.

You don't have to take the advice or the direction of just one person who might, again, be your CPA. Again, not demeaning that person. We need them in our lives. But what if you were around other people and other professionals who also had experience in their own lives and what they've done. Does it mean you believe everything everybody says? Or you go do exactly what they say? No.

What you do is you investigate more. You get a chance to build relationships with people who have figured out either on their own or through their advisors strategies that work for them. Then you can take some of those concepts and ideas and go back and either through your professional advisor or maybe you need a new one who will be more innovative, whatever it might be.

Go back and push through and have those dialogs because if you don't do that, then you stay mired in, again, that income tax hamster wheel that makes it so hard to get off of it. The problem today is that when you don't have a chance to build any real wealth outside of your practice, the practice is producing your lifestyle, keeping your head above water.

But so many hardworking professionals, Evan, get into their late 50s and 60s and are definitely ready to start slowing down. Definitely ready to start taking some time off. Yet if they slow down at all or think about getting out of practice, then they have the problem of not only higher taxes but how does one invest their capital, their nest egg that's left over from practice sell and whatever else they've accumulated?

How do they invest that wisely? Again, in assets that will grow, that have safety, but also can mitigate the risk. We've mentioned a few already in real estate and also real estate within retirement accounts that have a lot of benefits.

The problem for most is most of your advisors out there are not well equipped to advise on that basis. When one doesn't do something or is not in that environment, then the easiest thing to tell a client is, "Well, that's not something I would do. That's not really necessary." Again, how can you go wrong telling someone no? The problem is it doesn't benefit the client.

You've got to find people that walk the talk. That's really what I'm saying. In mastermind groups that's what you find is people that walk the talk. Then you can dig deeper with those relationships and start to develop strategies that you can start to implement.

I don’t use any one person and I don’t think you do either, Evan, for all of my advice. I think you’ve got to orchestrate your own life. You’ve got to orchestrate your own plan. Part of that plan has got to be, “How do I mitigate taxes? How do I make sense out of the hard work I’m putting in every day, every week, every year? How am I adding to my net worth? Am I doing that the most efficient way with the least amount of taxes? With compounding effect?”

Real estate can give that to you. You can compound real estate. You can tax defer real estate. You can exchange rather than sell real estate and keep deferring the tax ultimately until you pass away and even at that point you can defer the tax because your heirs get a real estate at a stepped-up basis.

There’s lots of ways you could do this but it’s hard if you're on the outside looking in going, “Well, gosh, I've heard of all this stuff. I've heard people do this and that with real estate but that’s a world unbeknownst to me and how in the heck would I get involved in that?”

I think you’ve just got to find the right people. Be part of mastermind groups as you said, Evan. That’s where the creativity, the innovation, the inspiration comes from to start making strategic moves in your life that will multiply all that hard work you're doing now instead of just keeping you on that linear path that barely ticks upward and you get to 60s or 70 years old and wonder where did all the time go? What’s happened to my planning?

Evan: Yes. In closing, I had a meeting with a doctor today. He’s one of our investor clients. He invests with us on our trust deeds. So we essentially give him a deed to a house, that house is being fixed up and resold. Then he gets all his of principal back plus all his interest. He's going to get over 10 percent interest.

He's just so excited because he's never been exposed to anything like this. Just recently in the stock market I think he lost 17 percent, which any of you math whizzes out there, he has to be able to earn 34 percent just to break even. It's not what you lost. You've got to double what you lost just to get back to flat. Now he's going to get a double-digit return and it's secured by a local house here in our area.

The reason I mention that is he found us through another doctor. It's finding people that are already where you want to be then just sampling what they do. We don't have to just blindly do what they do but find people that are already ahead, have a direction that you want to travel. Know that success leaves clues.

I believe our net worth equals our network. If you have a strong network, the net worth will come as an organic byproduct. I'm honored to be on this show. I'm really not an expert. I'm really an observer. I'm just someone that walks into a lot of people's lives and if I can be able to bring more value to you all based upon what's been shared with me, then I feel like I'm leaving a positive legacy.

If you all want to hear more about a certain topic, let me know. I'm out there. I might as well just take notes and bring it back to you. Typically what interests you are going to interest other people too. If there's something I'm talking about that you find no interest in, I'm open to that too. Let me know. Say, "Hey, that doesn't apply to me." Cool. That probably doesn't apply to other people either.

But my desire is that I can bring the most relevant and straight-from-the-field information. I don't want to bring some old, antiquated way. Like I could talk to you about Yellow Pages but I don't think it's going to be incredibly relevant to you. I want to bring things that are working today. Like literally I was in the offices today and I want to share with you what is working for them. It may not work for you but a good chance, probably would if you have a practice. If you have a pulse. It's probably going to be a benefit at some level. You just decide if it fits your brand or not.

I'm honored to be with you. If you like what you hear, please rate us. Give us five stars if we rock. If we stink, then don't. If you want to hear more of something, let us know what you want to hear of. We'd love to be able to add that to the show.

This is Evan Harris and David Phelps, trying to change one person's life at a time through the power of both real estate leverage, of time, and also connections.

You've been listening to another episode of the *Dentist Freedom Blueprint* podcast with David Phelps and Evan Harris. The place to be to create your freedom lifestyle with more time off, security and peace of mind. Please subscribe, download the podcast, and share it with others who want to create real freedom in their lives and practices.