Aaron Merriman: This is the Passive Income Investor Podcast hosted by Matt Doran and Aaron Merriman. This podcast features discussions and interviews related to conservative passive income investing. We focus on long term wealth building and tax efficient income strategies.

Thank you for joining us today everybody on this third episode of the Passive Investor Podcast. Today we're going to touch on tax efficient retirement income. It’s something in our space as a real estate investment company that isn't thought of a lot. I think it's something that is really important that people need to think about, and I know Matt is going to touch on that as well with his expertise and what he does in his practice. Lujan Merriman Development Group, we are a real estate investment company based here in Southern California in Orange County. We focus on multifamily apartment buildings five to 15 units in really desirable areas here in Southern California. It’s primarily coastal property, we're buying buildings that are 75 to 100 years old, and really renovating them to compete with new construction.

We love to keep as much character as we can, but renovate and add air conditioning in unit, washer, dryers, all the things that the astute tenant would look for if they were renting in a large, brand new building, but they're looking for that micro community experience that we provide. Sage Wealth Planning, Matt, tell us about it.

Matt Doran: Yeah, so Sage Wealth Planning is a registered investment advisory firm, domiciled in northern Michigan. We are a planning centric and tax focused firm. We pride ourselves on being comprehensive financial planners. We have it. I wouldn't call it unique, but it's not as mainstream as the other pricing structures are, we are a fee only pricing structure, which means that we only get paid directly from our clients. We don't have revenue streams that come from mutual funds or custodians or insurance companies. We only get paid directly from our clients and we have multiple pricing structures for serving them.

We like to think our job is to be great listeners and while we have technical expertise and experience in doing what we do, what we really like to do is listen intently for what our clients are trying to do, and what are the things that they really value, and then pull up alongside them and collaborate with them on how to do what they're trying to do in the most efficient way. That gives us a lot of joy and it gives us deep relationships that we very much enjoy. I say that we are planning centric, because for us, it's not about investments. Although investments are part of the equation, they're fuel for what people are trying to accomplish.

Aaron Merriman: Great. Let’s jump into it. Tax efficient retirement income, from a real estate investment sponsor and our side, I feel like it's definitely one of those things where people will ask, “Hey, what is the tax treatment of what you do?” Sometimes, if it's a K-1, what kind of tax document did they get, but I feel like a lot of folks aren't really thinking about the tax implications, whether they're retired or not, when they're making investment decisions. And I say that because I'm certainly not a CPA or a tax aficionado, but I do recognize the difference between ordinary income, capital gains, and some of the things that you need to be thinking about.

Unfortunately, it feels like a lot of folks, they really don't, they're just looking at what is the projected return of something and what's the highest one. When you really take a step back and look at that to net the same amount of money, you don't need to -- if something's a capital gains treated investment versus ordinary, you don't need the same top line return to net the same amount of money. One of the big things that people have, just such a hard time quantifying is risk. It's very, very difficult. There's people that are paid a lot of money to try to measure risk

and it's not a perfect science. Inevitably you can't get something for nothing. If you are trying to achieve x return and it's ordinary income, you're going to take a lot of risk that I think is just not measured well or thought about well.

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Touch on this, and then we can kind of really drill in Matt, but talk about what this means for somebody that is getting close to retirement in retirement and planning, because that's one of the things that I think you guys do a great job. It’s not about paying zero tax, and you and I talked about that a lot. I'm excited about this episode, because you bring a lot of expertise in this area.

Matt Doran: Yeah. I'll just clarify that I'm not a CPA either. I'm a CFP and there's a big difference, obviously. There's also a big difference between tax preparation, which is what tax professionals do, and tax planning, which is what financial planners do. My goal is not to necessarily help someone reduce to the minimal level their tax liability in any given year. My goal is to help them reduce their lifetime tax liability. There are some very specific strategies that will result in the ladder that if we were focused on the former would be lost. Why do you talk about tax efficiency and retirement planning together? Well, two reasons.

Number one, retirement planning is the biggest and most important financial planning goal that people have. Walking away from work and relying upon the assets you've amassed is a big, big decision. Is not one that people want to have an oops on and have to go back to work 15 years in. Retirement Planning is the biggest of the financial planning goals that people have. Tax efficiency is the biggest opportunity to gain alpha. We see more opportunity lost in not being tech smart than we actually see in the investment landscape. Lots of mistakes are made in any behavioral endeavor, but we see in general, a real lack of awareness on tax treatment that could improve the outcomes. So that's why they go so well together.

There’s a big difference, again, between tax preparation and tax planning and why these things go so well together is because it takes a really large amount of assets in general, to support somebody through decades of retirement. The more tax efficient we are in drawing from those assets, the longer they last.

Aaron Merriman: That's one of the things that I like about in the conversations that we've had about thinking about the whole lifetime tax obligation versus grinding it to zero right now. One of the things that we come up against fairly often, in real estate, the 1031 exchange is a big thing. A few years ago, opportunity's own investing was a hot topic. Now, there's some accelerated depreciation laws that are on the books for a few more years and that's created this kind of sub industry. From my perspective, I feel like a lot of people get really sucked into doing really an unnatural act. They’re investing in something that really isn't a very good deal, in my opinion, solely for tax purposes. That’s can be very scary, because if it goes bad, I've seen people lose a lot of money because they went into a 1031 that didn't work. It was just a bad investment.

You saw that with opportunity zones a few years ago, we actually own a property that is in an opportunity zone, and we've run the numbers a million times, and it's better to develop the property, standalone and pay tax than to develop it as an opportunity zone and wait the 10 years and not pay tax and do all these things. It’s a lot of the tail wagging the dog I feel like, at least from the real estate side of things.

Matt Doran: Yeah, and people are inundated with messages about do this, do that and lacking a North star and a vision for what they're trying to do and how all the many pieces fit into that vision, it's tempting to react instead of plan.

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I would back up and say that being tax smart means optimizing the whole system to reduce lifetime tax liability. That means looking at how all the pieces interact with one another, and how they affect one another and being intentional about order, timing, amount, both in terms of how we're building our asset base, and how we're drawing from an asset base. The key factor in being tax smart is to recognize that there are various tax treatments in play, and then harmonizing them. One of the key aspects of good planning is what I would call managing adjusted gross income. So many things are tied to adjusted gross income, that not planning for how to manage it results in bad outcomes that you could never see coming.

We often get this argument about, should I pay tax on the seed or the harvest, which is a tremendously oversimplified and silly way of looking at things? Because what's really being said there is should I invest in Roth, pay the tax now and not pay anything in the future? Or should I invest pretax in my retirement account at work, take a tax break now, and knowing I'll pay tax in the future. It’s not about whether you pay tax now or pay tax later. It's about when you'll pay the least tax. One of the things to be thinking about is retirement accounts are not just places where we save for retirement. They're also very powerful tools for tax planning. If I'm bumping up against the eligibility for things like my ability to deduct student loan interest, contribute to a Roth IRA outside of work, get a child tax credit. The way that I contribute my retirement dollars at work, could really help me to preserve those other items.

That’s often just lost in this sort of cedar harvest argument. One of the things that has to be considered is, how can I use the retirement accounts that I have available to me to maintain my eligibility for other things, which could be very valuable? Child tax credits, for example, are credits. They're not deductions, they're real dollars that are coming back to the taxpayer as long as they're eligible. I think we started off talking about retirement income, but before we can even get to retirement income, we have to build a diversified base of assets. When I say diversified in this case, I mean, tax diversified so that we have the freedom and flexibility to pull money when we need it from a place that is most efficient.

Aaron Merriman: Yeah, that's a good point. You're listening to the Passive Investor Podcast with Matt Doran and Aaron Merriman. Today we're discussing the importance of tax efficient retirement income. To your points there, Matt, thinking back to episode one of our series, the topic was, the IRS is your partner, and hearing you talk, it really harkens back to that because in thinking about, the IRS has this system, it's set up in a way to drive certain behaviors. What you're talking about right now, is really about optimizing the system that's in play because if you grind down your tax to nothing, you could really be missing out on some legitimate opportunities, just because you've overcorrected on one specific thing. We’ve chatted offline a few times, about just some different things that you've seen over the years and some corrections you've made. I'd love to hear some more of those kind of real world examples that you've seen in the real world and the impact that it's had for folks.

Matt Doran: Yeah, so tax efficiency is about flexibility.

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We have a pretty massive tax proposal on the table right now. It has the potential to change capital gains rates for some people and marginal income tax brackets for some people, it's changing the estate tax exemption, and so on. In my work, where I see people being most impacted by either a change in the law, or the need to seize an opportunity is that if they haven't taken the time, and it takes many years generally to do this, if they haven't taken the time and opportunity to build assets with different tax treatments, when it comes time to pull income from somewhere, they lose control.

In retirement, I often see that the clients who have the highest marginal tax bracket, contrary to popular belief, are not the people with the most money. They're the people who were W2 employees, maybe even have a pension and social security and the money was primarily saved in a pretax retirement account. Which again, I'm a big fan of as long as it's optimized. But if you have a pension and Social Security, which is never fully taxable, but when it is, I mean, that part that is, is ordinary income. If you have a pension, that's ordinary income, Social Security on top of it, and then it's time to take a vacation, pay for a wedding, buy a new car, and that money is pulled from an account that holds only pretax dollars, then it merely adds to the ordinary income burden and pushes us further along the schedule of marginal tax brackets.

That's very different than if some assets are capital gain, some assets are Roth, some are tax free, completely like HAS, some are offset by depreciation, like real estate. The bottom line here is there are multiple buckets of assets where wealth can be built, and income can be produced, that will then give more control when it's time to create an income stream to the individual who's doing it, rather than only one place to pull it from. It takes planning and forethought and a commitment to build that, but it minimizes the risk and improves the control when things change.

Aaron Merriman: Yeah, so what I'm hearing is really kind of the strategy side of this right? Whether you're already retired, ideally, I would assume, as you're getting closer to retirement, or even, if you catch someone young enough when they're just getting started with investing, but really looking for these strategies that are these different tax buckets so that when that time comes, you are pulling from the optimal bucket, so to speak, for that income or that cash that you need to live on,

Matt Doran: Before we even get there Aaron, I'm glad you set it up that way, because before we even get there, let's not lose sight of the fact that life events which are happening along the path to retirement present opportunities as well, opportunities to top off tax brackets, influence the way we contribute or withdraw, performed conversions. It’s quite common when a young family begins having children and somebody stays home even if only temporarily that their earnings landscape changes a little bit. It might be an opportunity to either contribute differently or convert to take advantage of a temporary lower tax bracket, transitions like job changes or going into retirement offer similar opportunities, the early retirement years. Generally speaking, to tax landscape, for a person who's leaving active employment and going into retirement provides an immediate drop in taxable income.

We can enjoy those years of paying almost no tax or we can say, “Hey, how do we optimize these years, maybe even pulling some future income into the present by accelerating withdrawals because we're going to pay less to do it?” Why would we want to optimize the tax treatment, which then means we'll pay less tax over the long haul?

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That can happen in terms of small withdrawals or conversions, but it requires some planning.

Aaron Merriman: Yeah, this is good stuff and I think I'm really enjoying this topic, just because of the strategy side of it, the optimization, it's almost like a chess match with the IRS.

Matt Doran: Yes, it is. And how we give to our favorite charities or gift to our family members is important too. Optimizing how we're doing what we're doing is the name of the game. It's not about telling anybody what they should do. It's about listening for what they want to do, and then designing an efficient path for doing it.

Aaron Merriman: Definitely. I'm sure for most people, it's just about awareness. At least in my business, when I'm talking to folks, it's a lot of education, which is great, because we want people to be fully informed and absolutely in your business. So, this is great stuff, great topic this episode, as we wind down here, any parting thoughts?

Matt Doran: I think that individuals and families have a lot more responsibility for the outcomes they seek than at any point in history. At least in modern history, they've got a lot more responsibility and a lot more moving parts in trying to produce those outcomes. It should make perfect sense that harmonizing those things presents a tremendous opportunity to improve the outcomes.

Aaron Merriman: Absolutely. Well, thank you, everybody, for joining us today as Matt and I discussed tax efficient retirement income. We hope you join us going forward on future episodes. Thanks again.

For more information on LMDG, you can visit lmdg.net, and for examples of some of our projects or see more videos from Matt and I, you can also visit youtube.com/lmdgre, or you can email me directly at aaronmerriman@lmdg.net. For more information on Sage Wealth Planning, you can visit sagewealthplans.com, or you can email Matt directly at mdoran@sagewealthplans.com.