0 (2s):

This is the passive income investor podcast hosted by Matt Dorn and Aaron Merriman. This is 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. Hi, this is Aaron Merriman and Matt Dorn, and we are officially launching our first podcast here. Many of you may know Matt and I have done a number of videos that are currently on the LMD DG YouTube channel, but we've had such great response over the years that we've been doing this, that we wanted to take it to the next level. So we are very, very excited. This is our maiden voyage, so to speak with the podcast, but I know we're very much looking forward to it and helping when we can a little bit about me, Aaron Merriman.

0 (51s):

I'm one of the managing directors here at Lu Han Merriman development group or LMDG we're based here in orange county, Southern California. And we are multifamily apartment investors. We focus on five to 15 unit buildings in coastal Southern California. We're looking at buildings as far south as Laguna beach in orange county, hugging the coastline up to Santa Monica, and then we'll go inland through the wheelchair corridor. We invest for value and cashflow focusing on these smaller buildings. We will go in there typically 75 to a hundred years old. We're renovating a really to compete with new construction.

0 (1m 32s):

And so, but we're maintaining that character, creating a really nice micro-community experience for our tenants. And because we operate in low cap rate environments, it allows us to really add a lot of value with the rent creation or the rent increases that we're able to achieve. So a little bit about me, Matt, let us, let us hear about you and, and Sage wealth planning.

1 (1m 54s):

Yes. Excited for this first episode. And thank you. My name is Matt Doran and I'm a certified financial planner and also the owner of a registered investment advisory firm headquartered in Northern Michigan called Sage wealth planning. Sage is planning centric and tax focused, and we pride ourselves on being comprehensive financial planners. So we do the traditional things that you might expect. We, you know, we manage investment assets, but we really work hard to coordinate all the pieces of a person's financial life and add efficiencies wherever we can.

1 (2m 36s):

And it just so happens that tax is that space where efficiencies are relatively easy to find and often unexplored. So I'm excited to be here today.

0 (2m 50s):

Awesome. Well, you know, as, as, as we were brainstorming about our first topic and you know, what people ask about a lot to you or I, with our different backgrounds, you know, the tax tax and the IRS is always a topic that comes up. And one of my favorite sayings that we've discussed in prior discussions and videos is the IRS is your partner. And that sounds completely ridiculous and crazy to most people I'm sure. But talk to us a little bit about that and what that means to you and how it impacts how people invest.

1 (3m 29s):
Yeah. I think it's a, it's a very engaging concept. Yes. The tax laws are complex very complex, but there are also powerful incentives. And if you understand what they're incentivizing you to do, there's often a more efficient path to achieving any particular goal by putting the tax laws on your side. So rather than seeing them as constraints, think of them as incentives. So, so Aaron, you know, that the way that we give the way that we save the way that we spend invest structure, our businesses, leave things to the next generation, all have powerful tax incentives built in and around those things that we're going to do anyway.

1 (4m 15s):
So, so why not do all we can to understand how the tax rules work and do those things in the most efficient manner. You know, th the tax laws are a moving target, frequent changes and including some pretty big proposed changes that were announced yesterday morning and, and adding tax planning can add tremendous efficiencies that make it easier to achieve goals.

0 (4m 41s):
Yeah, no, that, that makes a lot of sense. And you know, that the IRS has different tax rates for different activities, right? And if I think about my own business and real estate and how we invest, you know, we're never going to sell a building in under 12 months of Holt because now you're triggering ordinary income tax versus capital gains tax. And that's a big, that's a big, big difference. And it's something that I think a lot of people don't think about inherently. You know, if you take a typical ordinary income tax rate of 32% versus a capital gains, you know, average rate of 20%, and you start looking at investments, you have to achieve a 17 and a half percent higher rate of return to net the same amount of money.

0 (5m 37s):
And so inherently you don't get something for nothing. So if you have to obtain that much higher of a rate of return, you now have to take more risk. And so more risk means more volatility. And, and that's really something that a lot of people don't think about when they're looking at investments, w how is it going to be taxed? And, you know, what is the risk that they're, you know, obviously tax is an easy thing to quantify, but risk is not. And if you are just looking at, you know, projected rates of returns on things, you're, you're really, really missing a lot with real estate also.

0 (6m 18s):
And, you know, we talk about this all the time, but there are some inherent things that are nice depreciation, accelerated depreciation, you know, different things that create paper losses early that can really help you down the road. You know, w when people invest with us, we operate as a fund structure. We're not doing single deal syndications. And so when you operate as a fund, and, you know, for example, our current fund

fund three, you know, we're about a year and a half or so when we bought some buildings early on, and then we just bought some buildings most recently, a couple months ago, these buildings are in different stages.

0 (6m 59s):
And so if you're getting gains on one earlier building, let's say, either you sold it or there's cash flows or something like that, but you have other stuff that you're renovating or is, you know, gives you more opportunity for depreciation. There is, you know, different ways to kind of smooth the whole thing. So to speak on the T on the tax side.

1 (7m 22s):
Yeah. And it's the same with stocks. You know what I mean? If somebody has a large portfolio of individual securities and they're diversified, I mean, by, by nature of being diversified, they won't all perform the same way at the same time. And that's by design. But if you, if you have your money in a package product that gives you X percent return, no, that inside that package product, not everything was performing well. If you had a big basket of individual securities that gave you the same overall return, but had some laggards in there at the end of the year, you might consider selling the laggards and capturing what we call a paper loss. As you, as you mentioned already, that's called tax loss, harvesting.

1 (8m 5s):
You had the same return, but having the securities in a way that you could manage them more tax efficiently, could give you that return with, with, with a text coupon to go with it. And so I think it's just important to understand that the tax laws are about choice, right? They're not dictating how we do anything, their incentives and understanding which way is best for your personal circumstances is where the heavy lifting is. So just to give you an example, the, the government has incentivized us to save for our retirement, right? And there are tax advantages for doing so they're not saying you need to save on a pretax basis, or you need to save on our after tax basis in a Roth.

1 (8m 55s):
They're not telling you where to take the tax break. They're offering a tax break on the front end, or the back end, the choice is yours, right? So which way is going to benefit you most? Should I invest pre-tax now and reduce my current tax liabilities, knowing that all owed tax on the growth in the future, or should I forgo that tax advantage right now, knowing that I won't, and it's a much more complex question than it appears, but the government is in dictating which way to do it. They're making either choice available. And that's how 401k and 4 0 3 B structures work, you know, pre-tax or Roth, the choice is which one is going to benefit you.

1 (9m 42s):
And, and, and there's a lot more that goes into that. Then the oversimplification I just made of, do you want to pay tax now or later? It's, it's a lot different than that. So I'll give you an example. If you're in a relatively high tax bracket now, and you contribute pre-tax dollars to a employer sponsored plan, it helps you to

manage your adjusted gross income. And that matters a lot because adjusted gross income is what dictates your eligibility to do a whole bunch of other things like qualify for child tax credits or American opportunity tax credit, or the ability to deduct student loan interest or eligibility to contribute to Roth IRAs or things outside of work.

1 (10m 24s):
Right? So the employer sponsored plan is not just saving for retirement. It's a tax tool. And whether you put money in pre-tax or Roth, it's going to grow the same once it gets in the account. So the idea is to manage the tax arbitrage of when is the tax advantage greatest to me, and that's where the really heavy lifting occurs.

0 (10m 51s):
No, that's it, that's a good point. And I, and I know we've talked in the past the government and it's, it's a, it's a valid, you know, it's a valid observation and a good observation when they are giving you a tax rate that is, you know, quite a bit lower. If you are investing for the long-term are investing for retirement, you have to, you have to look at that and you have to think that, what, what are they, what behavior are they wanting me to do? And then, and then take advantage of that. You know, you just touched on it a little bit right now, and I know, you know, people ask all the time about, you know, pretax or Roth and, you know, there's all these snippets that you see on the internet, or, you know, article grabbers about, you know, and they just try to quantify it to a certain age.

0 (11m 44s):
Well, if you're over this age, don't do a Roth. If you're under do a Roth. And what I'm hearing from you now is it's, it's not that simple. There's more to think about when it comes to looking at that future tax obligation in capital gains and ordinary income and that kind of thing.

1 (12m 3s):
Yeah. There's a lot more to think about and managing your adjusted gross income is just one of those things, right? There are a whole bunch of others, but it's a pretty common pattern that someone's marginal tax bracket rises as their career progression moves, moves on, and then they leave work. And it's particularly more relevant. Now that pensions are, are less prevalent in our society, but they leave work and their tax bracket drops pretty dramatically. And then they've been conditioned to defer taxes as long as possible, which in many cases is a mistake because if you delay too long and you reached the age where required minimum distributions are required.

1 (12m 46s):
In other words, you're forced to start taking withdrawals based on a life expectancy factor. You lose the tax control. So you deferred for a really long time, but you could effectively take the money out at a higher rate than, than you've ever been in before. And so the idea is to recognize the pattern of when tax rates might be

higher or lower and use those periods of low tax rates to your advantage. It could be when you're young or earning a smaller amount of money, but it could also be after you've retired and your tax bracket has dropped precipitously. Right? So, so why give away a really valuable tax advantage in your higher earnings years when you could withdraw or convert in a lower tax bracket shortly after you leave work.

0 (13m 38s):
And, and that's really kind of the strategy and the planning side of it, right? So you're thinking about timing, the timing of it, because, you know, for people that have done a good job through their work career of investing in saving, they're growing their net worth year over a year, and depending on how they're investing will dictate what their taxable income is in those retirement years. Correct. And then, and then now you're thinking about, okay, let's pay some tax now, you know, we, we talk about 10 30 ones all the time because I'm in real estate obviously.

0 (14m 19s):
And that's, that's, you know, that's one of those things that I feel like people get really wrapped up in them and they're, they're deferring tax at all costs sometimes to their detriment. So it sounds like it's a little bit of that where you need to be thinking about what, what is the next 10, 15, 20 years going to look like? What is my tax obligation gonna look like? And should I be doing some things now to lessen my tax in the future,

1 (14m 47s):
Right. That that's, our job is to reduce lifetime tax liability, right? It's tax deferral is wonderful. But if you defer to the point where you lose control of the rate you pay, that can work against you. Right. So the idea is to pay the tax when it's least costly to do so. And that requires planning because circumstances change. So, so let's give another example, right? I mean, if you did a, if you did a poll of, you know, what are your top three concerns about retirement planning among any large group of people? I mean, certainly healthcare is going to be one of them, right? That's going to be a top concern that people have. Well, in 2003, the health savings account was introduced as a part of a big sweeping piece of legislation to make healthcare more consumer-driven.

1 (15m 37s):
And the intent was to replace the FSA and the medical savings account with a more robust option that would encourage people to save and invest for future healthcare expenses. Well, the health savings account, in my opinion, is one of the most powerful financial instruments available to people, but it's still vastly underutilized. It's not maximized when it is utilized. And it's still being used as a reimbursement account because the flex spending account and the medical savings accounts encouraged that, and sort of embedded that behavior that, you know, it had, those accounts had a use it or lose it, provision what we call forfeiture, but in HSA doesn't have that.

1 (16m 18s):

So if you're young and healthy, you don't want to be paying any more healthcare premiums than you need to. So it might be advantageous to have a high deductible plan, right? A high deductible plan then means you're paying less than premium, but it also makes you eligible for a health savings account, which can allow you to put money away with a triple tax advantage. So triple tax advantage money goes in before it's taxed grows tax deferred. Whilst there comes out. Tax-free, if it's used for a qualified reason, that's a powerful incentive to take those actions. And that's what I meant before about the government gives us choices, right? It's providing incentives to act in our own best interest.

1 (17m 0s):
And the HSA has some other advantages that aren't obvious that unlike other tax deferred vehicles, it doesn't have a requirement for earned income. So theoretically, you can contribute to an HSA if you have a high deductible health plan up until the point where you sign up for Medicare. So let's say we retired from our job in our late fifties or 60 years old, but we don't sign up for Medicare till 65. That's five more years of contributing to an HSA that we didn't have to have earned income to do it. The opportunity is not lost just because we've retired. Okay. Secondly, it's an above the line deduction. The fact that it's above the line is really important in the environment we're in because so few people itemize now, once the tax cuts and jobs act of 2000 implemented a higher standard deduction, it made it so that 95 plus percent of people no longer itemize.

1 (17m 57s):
So the ability to reduce our taxable income above the line, instead of having to do so below the line through schedule a deductions is really, really powerful. So the HSA is one of those things where incentives have been put in place to act in our own best interest and save and invest for one of the primary concerns we have. And there are tax advantages for doing it.

0 (18m 23s):
That's yeah, that's really good points. And I, and I'm absolutely guilty of the HSA neglect as well because in our, their income, can you get income barred on the HSA or however you call it, I mean, is there is everybody's eligible for HSA. And then you said, once you retire, you can still, you don't have to have internet income.

1 (18m 46s):
Yeah. The eligibility is just that you have to have a high deductible health plan, right. And then you pair that with, with an HSA, which has some tremendous tax advantages. And so let me, let me give you one other one, Aaron, cause this kind of relates to what you were saying about 10 31 and some of those things, the capital gains laws. And I know this is a highly debated topic. It's in the news right now for potential changes, but let's just deal with the laws. It is. Okay. One of the reasons that capital assets are so attractive is that they bring with them a natural tax deferral. So let's say I bought XYZ stock for 10 grand and it's grown to be worth a hundred grand. I haven't paid any taxes on that, except maybe if it kicked out a dividend along the

way, but even if it kicked out a dividend along the way, it was a tax preferred item and texted a lower rate.

1 (19m 34s):
But my 10,000 that says now worth a hundred thousand, I have not triggered any tax on it because I haven't sold it. So capital assets give you that opportunity to get natural tax deferral without the limits of like a retirement account. Right. But let's take that one step further. Under the current law, there's a provision that we call step up in cost basis. So if somebody does have a capital asset, that's appreciated a lot and they own it for their lifetime, they pass away with it. The basis of that asset resets to the fair market value at that time, which means my $10,000 investment, that's now worth a hundred. If I pass away with it, the basis now becomes a hundred.

1 (20m 17s):
Well, what does that mean for my children? It means the capital gain goes away, right? And so it's quite common where people build a portfolio of income producing securities that because they've been diligent savers, and they've been long-term investors, they live off the income from the portfolio, but the capitalists continuing to grow in the background. And it's a super efficient mechanism to get both tax deferral during life and a step up for the efficient transfer at your, no, again, I know this law's always highly debated including right now, but that's the law. So when you have something that can give you growth and income potential both at a lower tax rate and the potential for forgiveness of the tax, you can't ignore that.

1 (21m 8s):
It's very powerful.

0 (21m 11s):
No, it is. And, and that's, you know, whether it's stocks or real estate, it's one thing that Aaron Lou, hunter and I are constantly debating or, you know, discussing, you know, with real estate, especially in the market that we're in right now. It's really easy to just want to sell everything, but you're triggering tax. You have to go replace the capital with a new asset. And what is the market look like to do that? And, you know, you're disrupting cash flows and all these other things and, and your, you know, your personal balance sheet and with real estate, it's, you know, it's different, right? It's, it's harder for people to feel it when they can look at a stock and a stock went from 10 to 15 or 20 or whatever it did, they can really easily quantify.

0 (21m 60s):
But if a piece of real estate you own goes up 30%, it's hard to kind of, it's hard to feel that, right? You, you have to be really diligent and disciplined around understanding your personal balance sheet and calculating your net worth and capturing that appreciation and all those kinds of things. So that, that, but you know, the, if you're sitting on it and not selling, you're, you're deferring that tax like you talked about

1 (22m 26s):

Well, and it's one of the reasons why investing in, you know, your space and mind goes so well together, right? Is because people are constantly confronted with what the value of their stock portfolio is. Right? And then you can check at any minute of any day, but to be an investor means to be, you know, have faith in the future. And you're an owner, not a trader, you know, you're not speculating. I mean, an investment that's too short term is not an investment. It's a speculation. And so one of the things I like about people having both liquid and illiquid assets is it encourages better behavior, right?

1 (23m 6s):
You can't mark to market, so to speak, you're ill liquid assets. You don't go and update their values every day, nor should you. And so they, they work well together because they encourage the right mindset.

0 (23m 20s):
That's a, that's a great point. That's a great point.

1 (23m 24s):
So, I mean, we could go on and on and on about, you know, that where tax planning really adds value. I mean, it's, it's, it's obviously way, way, way too much for, for this episode. But the point that I think can't be stressed enough is the rules incentivize certain behaviors. And if you just get some altitude on what's happening, it's clear to see that the capital markets raise capital, right? They raise capital that benefits the whole of society, right? It creates opportunities for growth and infrastructure improvement and innovation and people who live below their means and make capital available for those things improve the standard of living for everyone.

1 (24m 17s):
Even if you're not the investor, you benefit from that investment activity. And so the rules are there to incentivize it. And as you mentioned earlier, long-term investing is incentivized and favored over. Short-term investing. No one's saying you can't be a short-term investor. There's just advantages for staying with it for longer periods and the tax rules reflect that.

0 (24m 43s):
Absolutely. Absolutely. Well, this has been a great first episode and, you know, I hope everybody enjoys it or, or excited to put this content out there for you and, and Matt, I'm really looking forward to this, this next venture for us. So for everybody out there, you've been listening to the passive income investor podcast with Matt Dorn and Aaron Merriman. And this is Aaron Marmon. Thank you for joining Matt and I, as we launch this podcast for more information on L and D G you can visit LMD g.net. And for examples of some of our projects, or see more videos from Matt and I, you can also visit youtube.com backslash L N D G R E.

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