<u>IRS Defines 3 Types of Income</u>

"Money is only a tool. It will take you wherever you wish, but it will not replace you as the driver."
Ayn Rand

As you may have derived from the title of this chapter, not all income is created equal. In fact, the Internal Revenue Service categorizes income into three broad types, *Earned Income*, *Passive Income*, and *Portfolio Income*. While passive and portfolio are income is generated via investments, earned income is either employment (W2) or self-employment (1099) income. The principals and methods governing the three are substantially different and, **most importantly,** the rules relative to taxation are different as well. In my opinion, knowing these distinctions holds the key to financial freedom.

<u>*Earned Income*</u>

Most people live in the world of *Earned Income*, which is to say that the vast majority of us generate income in exchange for our labor and/or services. Simply put, earned income is what you get paid by working at a job as either an employee or an independent contractor. If you are an employee, your earned income comes to you in the form of paycheck, usually at regular intervals like weekly or bi-weekly and in set amount. In this arrangement, the majority of taxes have already been taken out of your check by the time you receive it.

This works a little differently for those who are self-employed, like contractors or freelance musicians. First of all, while employees count on regular paychecks from their employers, self-employed earners often experience significant variances in their paydays depending on the terms negotiated with their customers and their ability to find work in the first place. Also, a contractor may do a room addition and two roof replacements during one month, earning him $25,000, but have no significant business during the next three months. This reality requires that self-employed people become good money managers. Furthermore, in the world of the self-employed no one withholds taxes from our paychecks on our behalf. It is our responsibility to figure out who and what we money for, and to file the proper returns with the IRS.

However, regardless of whether you are self-employed or an employee at a company, your income most likely falls under the category of earned income, because you literally had to earn it with your labor!

<u>*Passive Income – The Magic Wallet*</u>

In direct opposition to the idea that you have to be employed in order to earn income, is the notion of *passive income*. The concept of earning income without work is quite difficult for most of us to comprehend since we've all been conditioned by our parents and teachers that we must "work hard" in order to achieve. What they didn't tell us is that by working <u>*smart*</u>, we can greatly diminish the amount of effort required to achieve our goals.

The Internal Revenue Service defines passive income as income from "*trade or business activities in which you do not materially participate*…" If it seems to you that this definition implies a possibility of earning income without working for it – without *your material participation*, you are right! This is, in fact, the implication. I like to illustrate passive income in the following way. Imagine you have a wallet with $3,000 in it. On the first day of the month you open your wallet and take out $3,000 to spend on whatever you wish, leaving the wallet completely empty. But by the first of the next month another $3,000 magically appears inside the wallet, ready to be spent all over again. I call this metaphor *The Magic Wallet,* and it is my financial goal in life. Now, if you want to have a little fun, try imagining $20,000 instead of $3,000. Welcome to the life of the financially free!

Don't misunderstand me. I am not at all suggesting that you shouldn't work hard. I simply want to draw a distinction between working hard at trading dollars for hours, verses working hard at educating yourself how to work smart!

Some examples of passive income are rents from real estate, business income (which does not require the owner's direct involvement), royalties from a patent or a book, pension income, etc.

Portfolio Income

Portfolio income is income resulting from paper investments like capital gains, dividend, and interest income that you might receive from ownership of stocks and bonds.

Discussion Points

As I mentioned previously, the IRS tax code treats the three types of income very differently. Earned income is the highest taxed income of the three. With the current individual tax rates ranging from 10% to 35%, and the top rate likely to soon go up to 39%, the tax bill can really add up quickly. In addition, earned income is subject to other taxes, such as Social Security and Medicare, which add up to 15.3%. What's more, while a W2 employee benefits from their employer paying half of these taxes, the self-employed earner pays the entire 15%.

Portfolio income, at least as it relates to dividends, interest, and capital gains resulting from the sale of investments held for longer than twelve months, is currently taxed at no more than 20%. Furthermore, this income is not subject to Social Security and Medicare taxes.

Passive income from investment activities such as rental of real property is the least taxed of the three. It offers even more advantages, and it is not uncommon for an investor to pay only a 10% to 15% effective tax rate.

This is so important because the burden of taxes can be one of the largest obstacles standing in the way of wealth accumulation. But it doesn't have to be – it is a matter of perspective. I have come to realize that the tax code is how our government communicates with the citizens. We live in a free society in which our politicians can not arbitrarily tell us what to do and how to make money. However, it is completely understandable that the government would want to try enticing us to do what they want us to do, which is achieved through lowering tax burden on income resulting from those activities in which they want us to participate. This is what makes it feasible to lower your tax liabilities legally, by simply following the instructions inside the tax code itself.

As such, the reality that investment income is taxed at a much lower level than earned income tells me that our politicians would like to incentivize people to become investors. Through the tax code they effectively communicate the message – if you earn money as an investor, you will be able to keep more of it. I say - O.K.

Consider this in terms of numbers. Suppose this year you earn $150,000. If you've earned it as an employee, then you will lose about 50% of it to taxes, leaving you with $75,000 of net income. If, however, you earn this money by way of investing, then you will only lose 20%, or less, of it to taxes. This would leave you with $120,000 of net income, which is $55,000 more. This is the advantage of earning income through investments. (*Note – these numbers are for example purposes only. Consult your CPA professional*.)

Here is another way of thinking about this. Suppose you've decided that you need to net $75,000 per year in order to maintain your lifestyle. If you decide to achieve this goal by way of earned income, you will need to gross $150,000 so that after you pay taxes there is $75,000 left for you to live on. However, you will only need to generate $93,750 of investment income in order to net the same amount.

There are two questions you must ask yourself around this reality. First, if you are going to be able to earn $150,000 this year, would you rather lose $75,000 of it to taxes or $18,000? Also, if $75,000 is what you need to live on, do you think that you would have an easier time getting there by way of $150,000 of earned income or $93,750 of investment income? I'll give you a clue: Both require knowledge, but it's very different types of knowledge. In my opinion, it is considerably easier to acquire the type of knowledge which would allow you to generate investment income rather than earned income. Information is readily available and no college degree is necessary!

Realizing that taxes are at the very top of the list of things that could cost you a lot of money, and therefore get in the way of wealth creation, I think it pays to try to pick a mode of income-generation with the least exposure to taxation. When I mentioned at the outset that understanding the above distinctions holds the key to financial freedom, I did so because it is extraordinarily unlikely to achieve financial freedom through earned income since it is taxed so heavily. Sure, there are professions which offer such high pay that makes it possible to lose 50% of it to taxes and still be left with very comfortable net income. But very few of us are in one of those professions; certainly not me. The alternative is to learn how to invest.

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