Handout # 9: The Three (3) Types of Income[1]

1. Earned Income

Earned income is any income that is generated by working. Your salary or money made from hourly employment (regardless of whether that salary or hourly income came from working for someone else or from your own "consulting") is considered earned income.

Some activities that generate earned income include:

- Working a job
- Owning a small business
- Consulting
- Gambling
- Any other activity that pays based on time/effort spent

While earned income is the most common mechanism for making money, its obvious downside is that once you stop working, you stop making money. Additionally, because the amount of money that is made through earned income is directly proportional to the time and effort you spend working, it's difficult for someone to make more earned income without either learning a new (or more valuable) skill or working longer hours. Additionally, earned income is taxed at a higher rate than any other type of income.

One huge benefit of earned income over the other income types is that you generally don't need any startup capital in order to make earned income, which explains why most people rely on earned income from the start of their working life. In fact, earned income is a great way to start your investing career, as it allows you to save up cash that will help you generate the other two types of income…

2. Portfolio Income

Portfolio income is any income generated by selling an investment at a higher price than you paid for it. Some people refer to portfolio income as "capital gains," because that's how the money is taxed by the federal government.

Some activities that generate portfolio income include:

- Trading (buying/selling) Paper Assets — Paper assets refer to things like stocks, bonds, mutual funds, exchange-traded funds (ETFs), certificate of deposits (CDs),

[1] Source: E. Kiyosaki & S. Lechter, 2000. Rich Dad Poor Dad. Warner Books Ed.

treasurybills, currencies or other types of futures/derivatives. Stock market investing is the most common generator of portfolio income

- Buying and Selling Real Estate (specifically the profit from the sale)
- Buying and Selling of any other Assets — Antiques or cars, for example, or other types of collectibles that have appreciated in value

There are a number of downsides to portfolio income; for example:

- It often takes a good bit of knowledge and experience to learn how to make money trading paper assets. Unless you have inside knowledge of the companies you're trading, you must learn to read financial statements or how to analyze market trends if you hope to beat the market
- You often have little control over your investments, other than your ability to buy or sell. For example, buying stock in a company still affords you no day-to-day control over the operation of the company, and therefore little day-to-day control over your investment
- Generating portfolio income generally requires you to have money to invest upfront. Even large gains are inconsequential when the investing amounts are very small
- Portfolio income is often taxed at very high rates — equivalent to earned income in many cases

Portfolio income certainly has some advantages over earned income. Once you have the knowledge and experience to generate portfolio income on a consistent basis, you can continually reap the benefits (compound your return) by reinvesting after each sale. Additionally, any portfolio assets held long-term are generally taxed at a lower rate.

3. <u>Passive Income</u>

Passive income is money you get from assets you have purchased or created. For example, if you were to buy a house and rent it out for more money than it costs you to pay your mortgage and other expenses, the profit you make would be considered passive income. As another example, if you owned a business that could operate independently of your working for it, any money that you make from the business would be considered passive income (of course, if the businesses success was limited by the number of hours you worked, the income you made would be considered "earned income").

Some activities that generate passive income include:

- Rental Income or Note Income from Real Estate
- Business Income (assuming it's not earned based on amount of time/effort spent — that would be Earned Income)
- Creating and Selling Intellectual Property — Books, Patents, Internet Content, etc.

- Affiliate or Multi-Level Marketing

There are some major benefits to passive income over the other two types of income:

- Passive income is generally recurring income; once the investment is made, and assuming it is a good investment, the income will continue to come in month-after-month or year-after-year, with little additional work by you. This means that you can essentially “retire” and still continue to grow your net worth;

- Investments that generate passive income usually allow the owners active control over the investment. For example, if you owned an apartment building or a corporation, you would have a say in the day-to-day operations that would ultimately impact the success of your investment;

- Passive income investments often allow for the most favorable tax treatment. Corporations can use profits to invest in other passive investments (real estate, for example), and take tax deductions in the process. And real estate can be “traded” for larger real estate, with taxes deferred indefinitely;

- Because it is generally possible to closely approximate the return (or at least the risk) you can expect from passive investments, these investments can often be funded using borrowed money. For example, a good business plan can attract angel funding or venture capital money. And real estate can often be acquired with a small down payment (20% or less in some cases) with the majority of the money borrowed

As you might suspect from the above overview, many people consider passive income the holy grail of investing, and the key to long-term wealth.