PHILOSOPHY OF WEALTH BUILDING

There are a lot of books that will tell you how to become wealthy. Do they work? Yes, IF your temperament matches the strategy the book puts forth. There are different roads to wealth. Some may be faster than others, but riskier. Other ways may be slower, but surer. In any case, there is no substitute for a good foundation on which to build your wealth.

1. Live – First, you must determine what your financial needs are on an ongoing basis. What would it take for you to live comfortably (not lavishly) and have your bills met each month. Be sure not to forget taxes. Any income you will receive is subject to income taxes which can not only be significant, but will cut into what you have to invest. This is the first step you would take in determining a budget, but I want you to make the determination for a different purpose as you will see.

Therefore, you should begin your wealth building by finding a way to generate the income you need to live comfortably. You may accomplish this first step by working for someone else or working for yourself. It doesn’t matter, this is only the beginning.

2. Replace – Next, you need to figure out a way to replace that income based on hours worked, with income that is automatic. This is known as “passive income.” When you have built your passive income up to a point that it equals or exceeds your working income, you can quit your job—whether you work for someone else or for yourself. Once put into place, this passive income requires much less ongoing effort to maintain and frees up your time to begin true wealth building.

At this point, you can truly consider yourself “Financially Independent,” even though your assets may be small. Up to this time your focus was to get your cash flow up to met your monthly needs. But once that is done, each additional dollar received above what you need (determined above) will be taxed and you then only have the after tax amount to invest.

3. Build – During the wealth building stage, you should structure investments such that they produce minimal additional (immediate) income that will be taxed. Rather, you should seek to keep the money invested tax deferred if possible and any current income should be tax advantaged. One of the best ways to build at this point is to use your IRA to invest in real estate. If this is a Roth IRA, qualified distributions will never be taxed.

There are three forms of income - immediate (present), cash flow stream over time and future cash. Some ventures generate cash immediately, such as selling widgets or quick-turning a property for cash sale. Other ventures produce a cash flow stream, such as the interest from a loan or the discount earned on a discount note. Still others produce future income, such as timber cut several years from now. Of course, there are those ventures that generate any combination of the three; for instance, you could sell an investment property you own for a good down payment, a mortgage for five years with a balloon at the end.
Need - So, how much assets do you really need? Well, once you have your annual budget as discussed above including income taxes, multiply it by 25. This will be the value you need in working investment assets to live for the rest of your life without having to work for additional income. If you think about it, this would mean that if your investments yielded 0% and there was no inflation, you would be able to live 25 years before exhausting your investments. But there will be inflation and your investments certainly should continue earning a return, plus an increase in the value of the investments themselves. Considering these factors, you should be able to live off these investments for the rest of your life, be it 25 years or 70 years.

No "Costing Assets" – By the way, do not include your home, furniture, vehicles or any other assets you would need or are not willing to sell in the value of your assets. These items do not normally generate income (they are actually costing assets) and are necessities for your lifestyle.

Beyond this value of investments, you may just be building an estate tax and inheritance problem. Depending on what Congress finally settles, you may only have a couple of million dollar exemption. Your gross estate, including the value of your investments, home, furniture, clothes, vehicles, etc. are considered for the estate tax. Over the exemption, your estate will pay roughly 50% in tax. You may be willing to do this to benefit the government, most of us are not.

Inheritance – Inheritance is another issue. A study was done of lottery winners where those winning five thousand dollars or more were tracked for five years. After that time, 85% of them were in worse financial condition than when they won five years earlier. It is a fact of human nature that we appreciate money more if we earn it than when it is just given to us. Also, we are much more disciplined with earned money. This is true of inheritances as well. I am sure you know more than one person personally who has squandered an inheritance, no matter how small or large.

The best thing you can do is to begin helping those around you that would like to have an inheritance, to begin building their portfolio while you are still around. This sidesteps the estate tax and any income will be in their tax bracket, probably lower than yours. This also helps train the person in financial matters and generates more self-respect. You will be more fondly remembered by taking this approach than if you just leave them money and their wealth will last longer. They have also gained expertise they can pass on to future generations. You can even structure deals so your church or a charity gains the benefits, now and in the future—all outside your estate.

So, consider your own situation and plot a roadmap to provide for both yourself and those you wish to help.