

## **Learning Objectives**

After reading Chapter 1, participants will be able to:

- 1.** Determine what constitutes building an estate, preserving wealth, and distributing assets in the context of financial fundamentals and tax planning elements.
- 2.** Identify types of income, from a financial and tax perspective, to be budgeted into cash so that income-producing assets can be acquired and managed for an effective investment plan.
- 3.** Recognize the types of fringe benefits that employers can provide to employees tax-free.
- 4.** Specify budget rules, ways that cash can be used, guidelines that should be applied when purchasing assets, and money management rules.

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# CHAPTER 1

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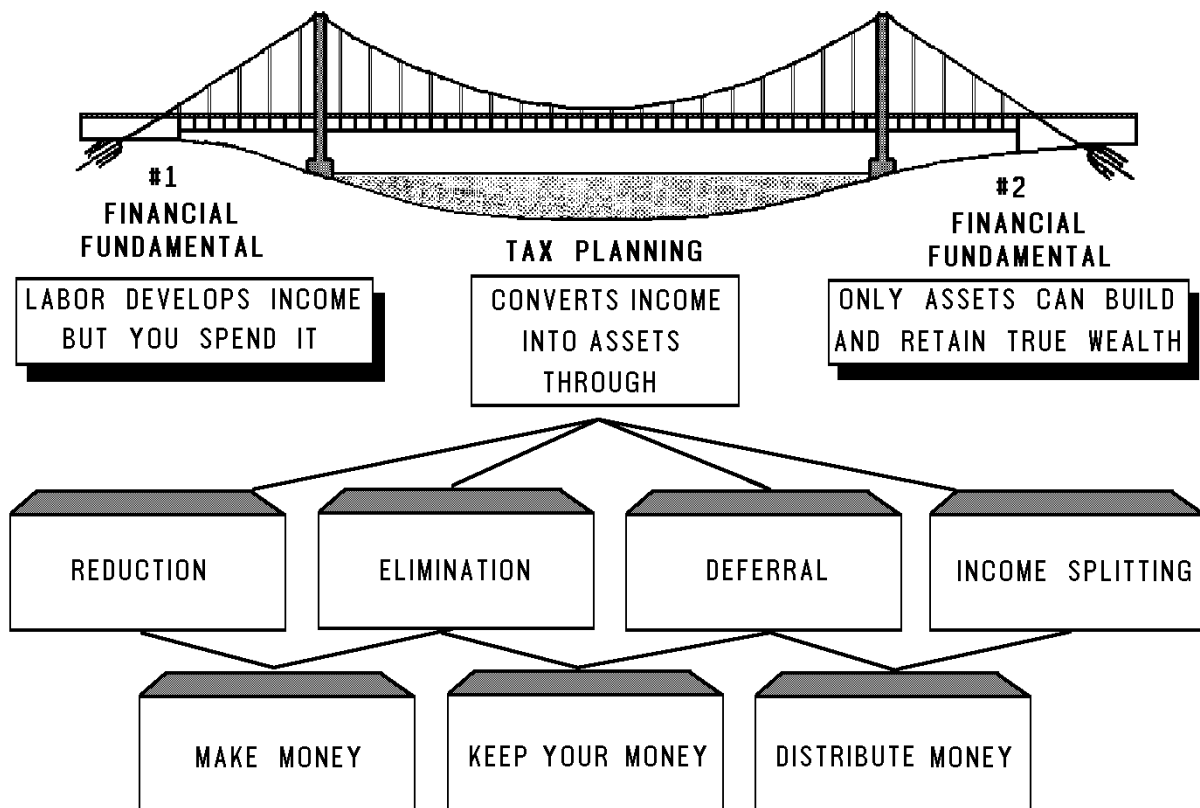
## Tax Economics

### Financial Fundamentals

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There are three financial fundamentals:

1. *Labor* develops income, but you spend it.
2. Only *assets* create true wealth.
3. *Tax planning* converts income into assets.



## Tax Planning Elements

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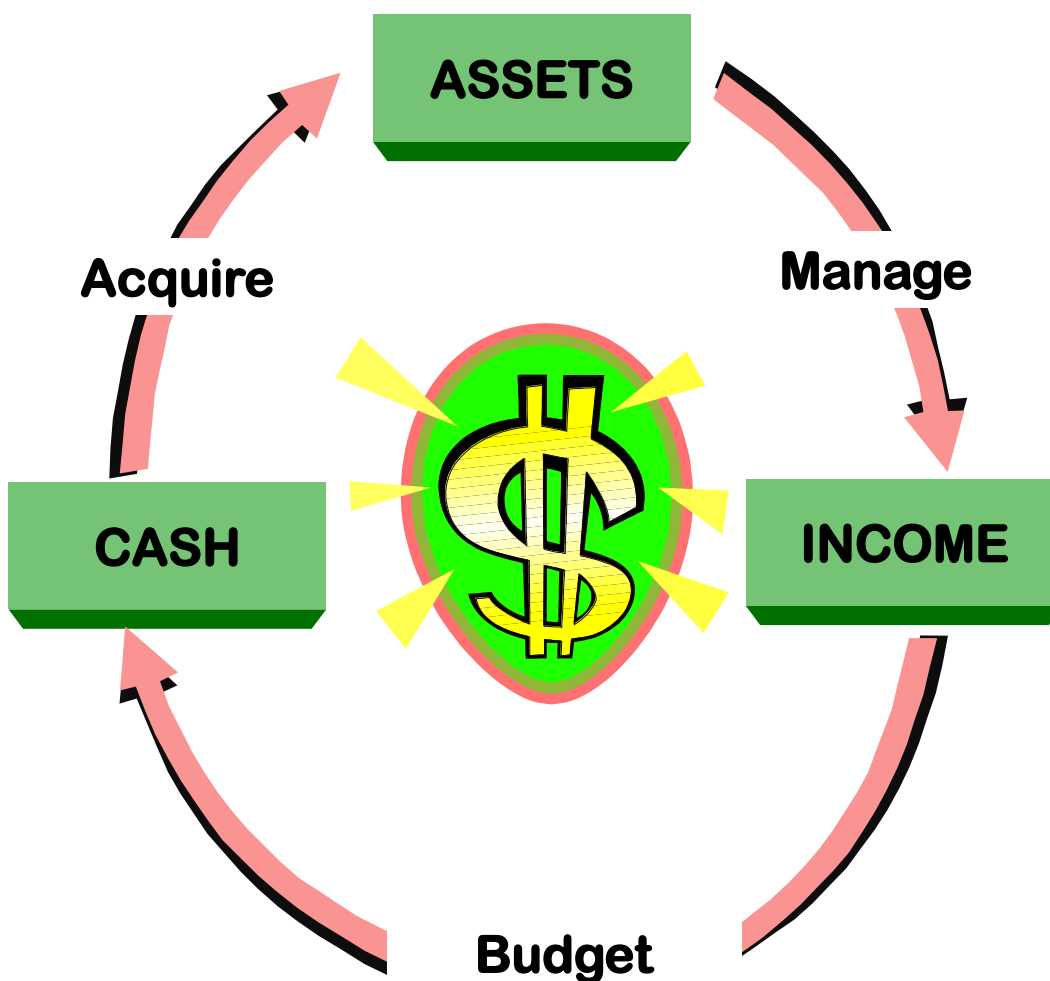
Investment planning has three basic elements:

- 1. Building an Estate & Creating Wealth.** Before you learn how to shelter or distribute money you obviously need to know how to make it;
- 2. Preserving Wealth.** Once you have a little money the next move is to discover how to keep it; *and*
- 3. Distributing Wealth to Heirs.** Providing for the smooth, thoughtful, and tax-free transfer of your assets to your family and heirs completes the plan.

## Assets, Income, & Cash

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Constructing a plan involves a dynamic relationship among assets, income, and cash.



## Income

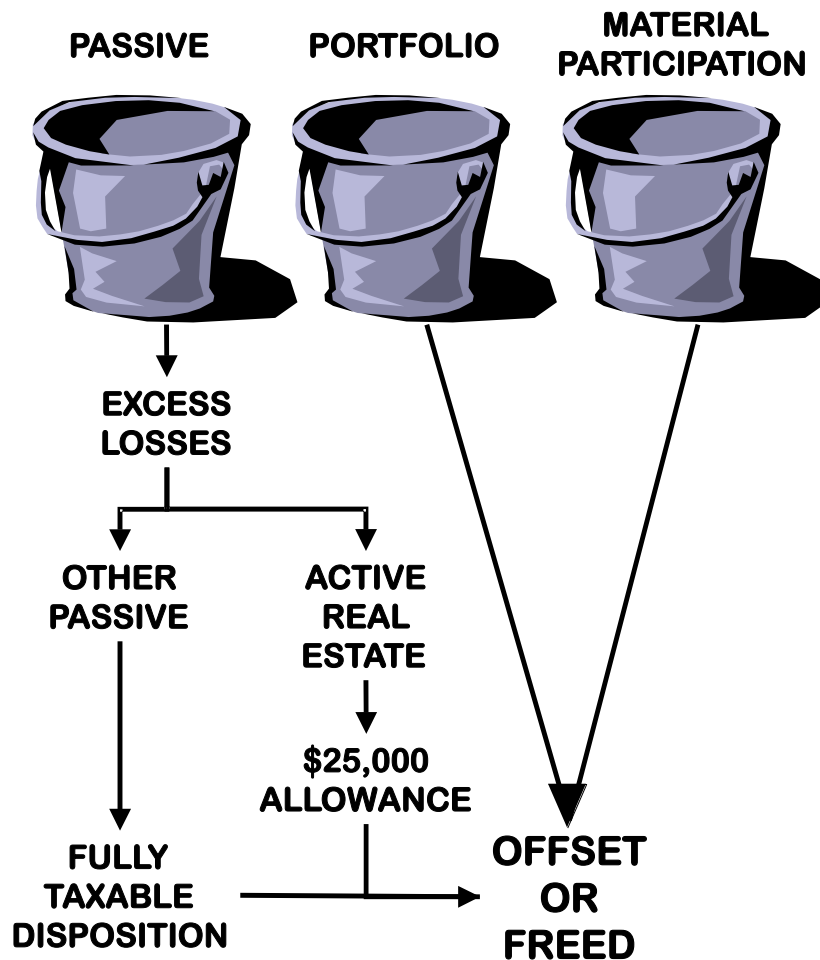
The *four* types of income are:

### Taxable

Taxable income is wages, salary, commissions, rents, interest, dividends, and royalties. The recent tax legislation has made major changes to taxable income including:

- (1) Reducing income tax rates but not taxes;
- (2) Eliminating numerous deductions;
- (3) Widening the gap between capital gains and ordinary income; *and*
- (4) Separating many surviving deductions from income under the passive loss rules.

## Passive Loss Big Picture

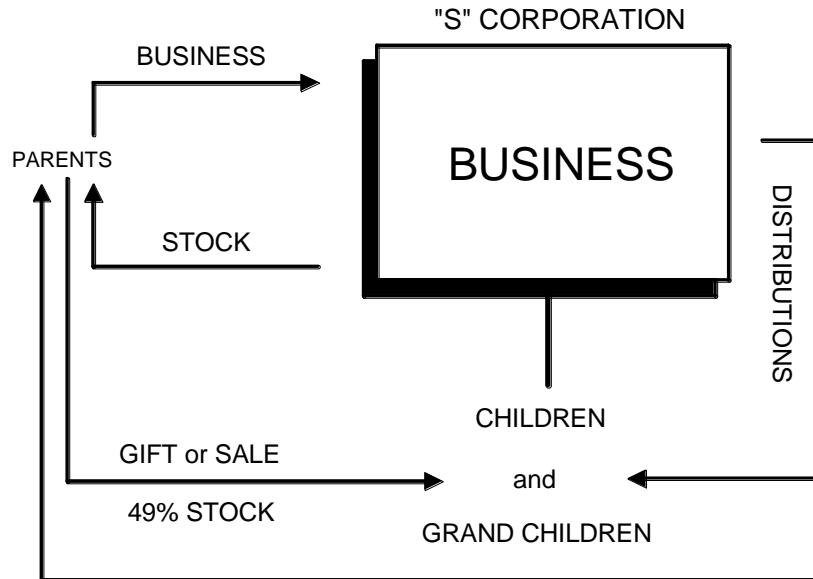


## Income Splitting/Matching

There are three major formats for income splitting:

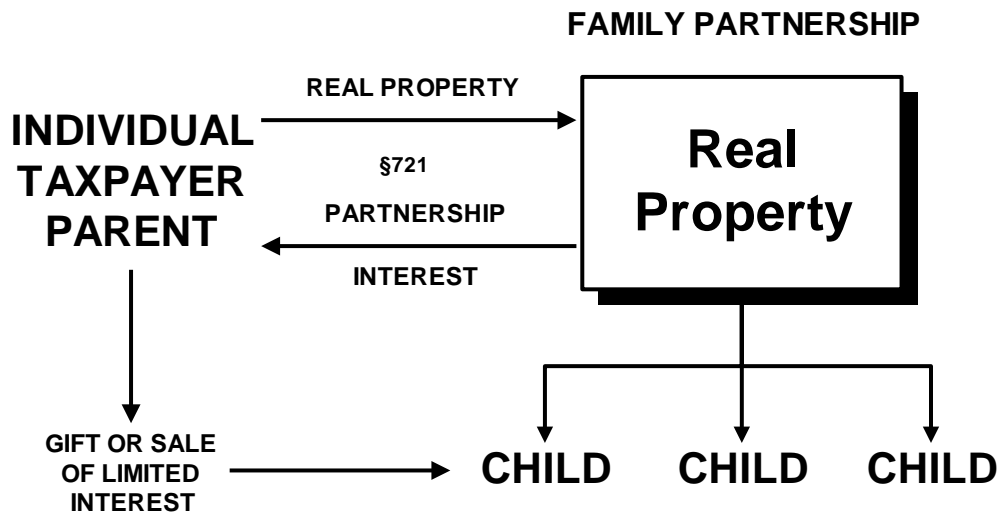
### "S" Corporation

## "S" CORPORATION

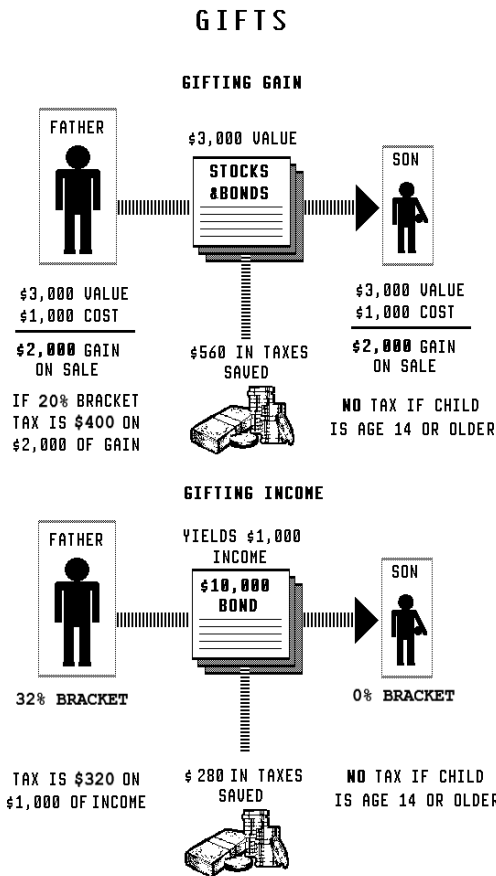


Family Limited Partnership Under §704(e)

## FAMILY LIMITED PARTNERSHIP §704(E)



## Gifts & Custodianship under UGMA & UTMA



### Tax-free

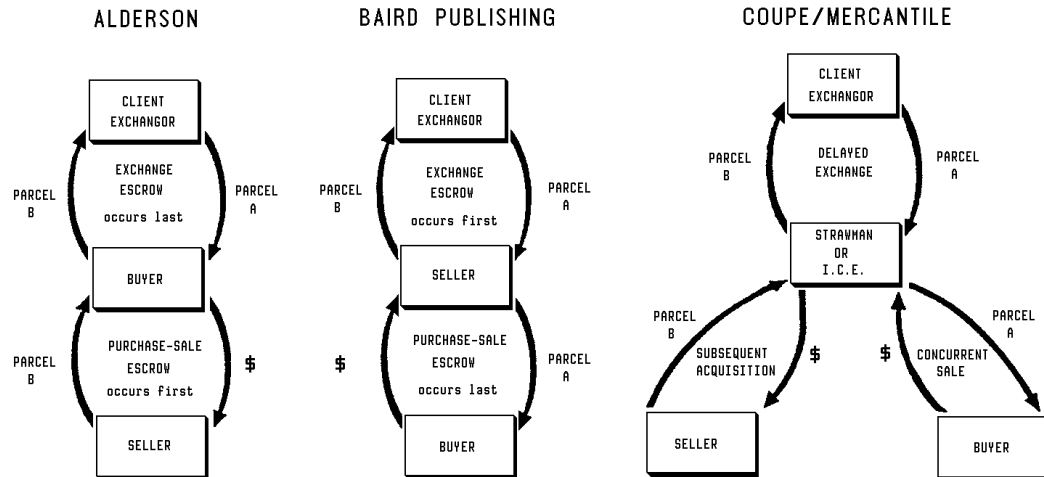
Tax-free municipal bonds are the most popularly thought of example of tax-free income. However, fringe benefits can be even better. With fringe benefits, the employer gets a deduction and the employee has no taxable income upon receipt.

### Fringe Benefits

- 1. Medical and Insurance Benefits.** Premiums paid by an employer for health and accident insurance are currently deductible (§106). This provision includes major medical and disability. There is no income to the employee.
- 2. Medical Reimbursement Plan.** A medical reimbursement plan is an arrangement whereby the employer agrees to pay directly or reimburse the employee for certain medical expenses incurred by its employees. The employer gets an immediate deduction starting with the first dollar paid or reimbursed.
- 3. Group Term Life Insurance.** Life insurance premiums are not deductible. Section 79 is an exception for \$50,000 of group term life insurance.



2. Taxpayer must structure the exchange such that the property he or she puts into the transaction and the property he or she takes out of the transaction is held by him or her as the same taxpayer for productive use in trade or business, or investment.
3. Properties traded must be of "like-kind."



## Options

Tax deferral does not have to be complicated. In fact, it can be affected very simply, with the use of an option.

## Deferred Compensation

Under R.R. 60-31 there are *three* basic types of deferred compensation agreements:

1. A mere contractual promise to pay.
2. Contract plus guarantees.
3. Segregated funds with substantial restriction.

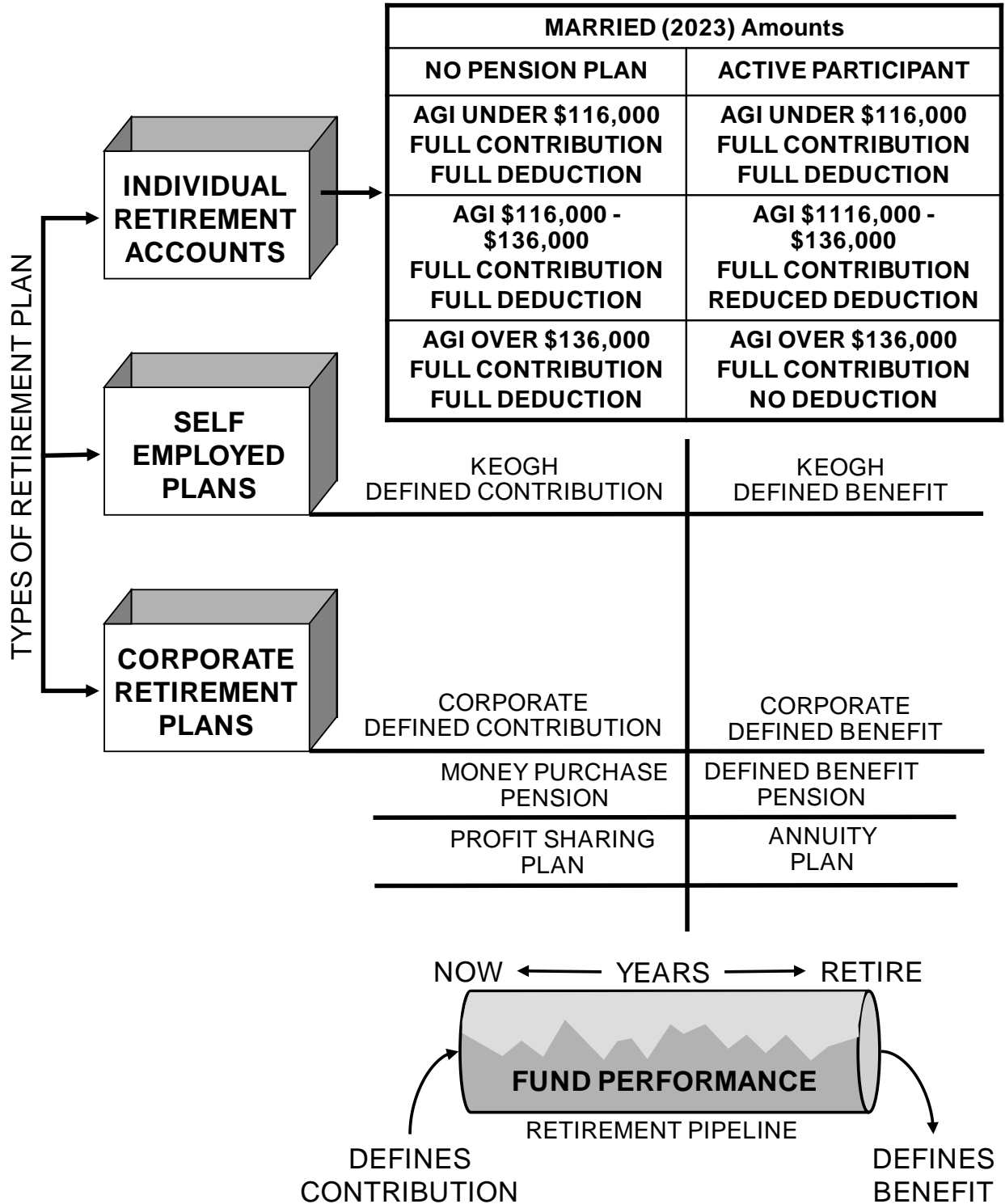
## Qualified Corporate Retirement Plans

Qualified corporate retirement plans divide themselves into two basic categories. The first is defined contribution plans. These plans are primarily designed and structured from a standpoint of what contribution is to be made to the plan. The company does not bear responsibility for any growth in the plan assets or any determinable benefit at age retirement. There are several basic types of such plans:

1. Profit-sharing plan;
2. Money purchase pension plan;
3. Stock bonus plan; *and*
4. Employee stock ownership plan.



# Retirement Plans



The second basic type of qualified corporate retirement plan is the defined benefit plan. The two most popular variations of this type of plan are the:

1. Defined Benefit Pension; *and*
2. Annuity Plan.

### **Self-employed Plans**

If you operate a business as a sole proprietor or a partner, either full-time or part-time, you could establish a Keogh plan. Since 1984, KEOGH plans have been made roughly equal to qualified corporate retirement plans in terms of contribution levels.

### **Individual Retirement Accounts**

All individuals, employees, and the self-employed can annually contribute to an individual retirement account. The contribution amount can either be \$6,500 (in 2023) or the entire earned income, whichever is less. Even someone who is a member of a qualified corporate plan can maintain an IRA. If you or your spouse is a participant in a company plan, Keogh, SEP, or government plan, your ability to set up a deductible IRA is phased out above certain income amounts.

### **Installment Sales**

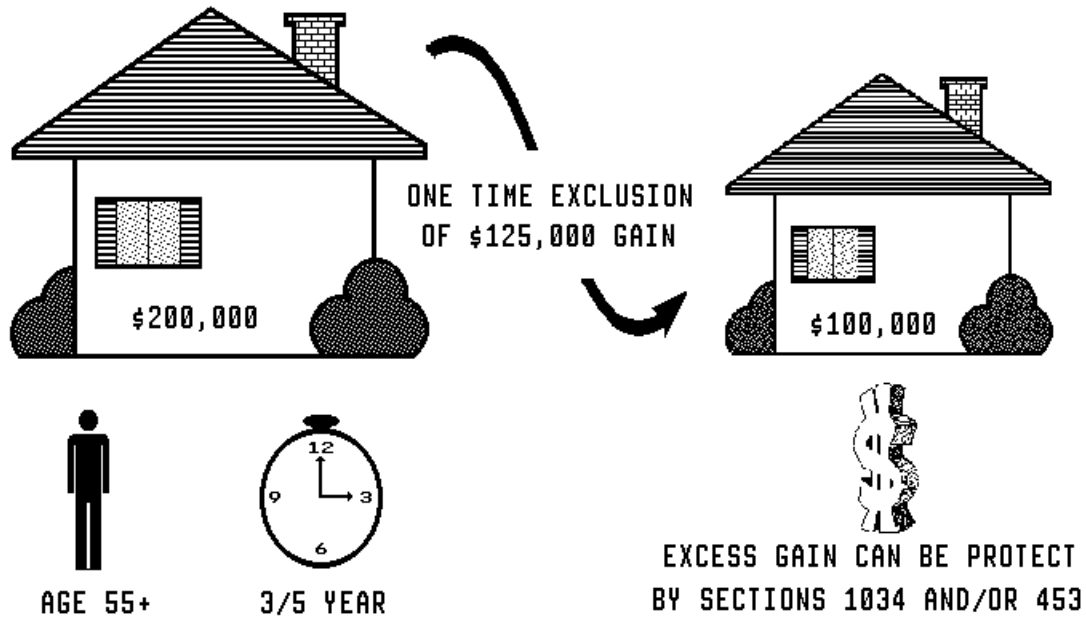
An installment sale can permit a taxpayer to pay his or her taxes on the disposition of property as he or she receives the payments. This deferral can result in huge tax savings.

However, installment sales have been severely impacted in several ways:

- (1) Sales between related parties are restricted under the two-year rule;
- (2) Certain taxpayers, including dealers, cannot use the installment method;
- (3) “At-risk” rules now apply to seller carry back installment obligations;
- (4) Imputed interest rate rules apply if the interest charged is not sufficient;
- (5) Mortgage in excess of basis is a deemed downpayment; *and*
- (6) Pledging rules make loan proceeds a payment on the collateralized installment note.

## Tax-sheltered

Tax-sheltered income is where you escape the system and never pay the tax. The \$500,000 home sale exclusion is an example. So are gifts, insurance, and certain forms of estate planning.



## Age 55 Exclusion - Repealed

Under former §121, a taxpayer (or their spouse) who was age 55 or over could sell their principal residence and exclude up to \$125,000 in gain. This was a once in a lifetime shot. The residence sold must have been the taxpayer's residence for 3 of the 5 years preceding the sale.

**Note:** Although there are certain transition rules, the TRA '97 repealed old §121 and replaced it with the home sale exclusion under new §121, effective May 6, 1997.

## Home Sale Exclusion - §121

Current rules for gains on the sale of a personal residence are replaced with a \$500,000 exclusion for joint filers (\$250,000 for single filers), effective generally for sales after May 6, 1997. This exclusion can be used once every two years.

**Note:** This exclusion does not apply to any gain attributable to depreciation deductions taken in connection with the rental or business use of the property for periods after May 6, 1997.

**Municipal Bonds**

Municipal bonds are issued by a state or its subdivisions or its agencies. The investment importance of such bonds is that their interest is tax-free, both federally and in the state where they are issued.

**Gifts & Inheritances**

Amounts received in the form of gifts or inheritances are not included in taxable income.

**Life Insurance**

Taxable income does not include any amounts a taxpayer receives from a life insurance policy.

