



Your Bottom Line

PUBLISHED QUARTERLY BY: MACKENSEN & COMPANY, INC. FEE-ONLY FINANCIAL PLANNERS
Navigating a clear course toward your financial security.



David T. Mayes

Managing Your Money Amidst Higher Taxes

The race for “revenue enhancement” has begun in Congress. Although most of the tax changes designed to pay for healthcare reform don’t take effect immediately (aside from the new 10% tax on indoor tanning that starts July 1), 2011 will likely bring higher tax rates when the Bush tax cuts expire.

True, many of the tax increases are targeted toward high income taxpayers. But other changes, like the \$2,500 limit on pretax contributions to flexible spending accounts and the higher limit for medical expense itemized deductions, will ensnare middle-income taxpayers as well. Here is a brief look at what is on the horizon and some planning techniques to minimize the impact of these higher taxes on your wallet.

The most notable of the funding items in the healthcare law is the Medicare Surtax, which will create some confusing tax scenarios for high income earners and investors. This new levy expands the Medicare tax base to include investment income as well as wages.

Wage earners will see their Medicare tax rate increase from the current 2.9% to 3.8% on earnings in excess of \$250,000 for a married couple (\$200,000 for single filers).

Couples in this income category will need to do some planning to determine if estimated tax payments should be made to cover the additional tax.

Investors will also be affected as the 3.8% rate will also apply to net investment income (interest, dividends, capital gains, royalties, rental income, and annuity payments) for couples whose income exceeds \$250,000 (\$200,000 for single taxpayers). Investment income earned in retirement accounts will continue to grow tax deferred, but may fall prey to the new tax when withdrawn. Although distributions from IRAs, 401(k)s and other retirement plans are not considered investment income, these distributions will increase overall income, effectively making them subject to the surtax if they push total income over the threshold amount.

Thankfully, the Medicare Surtax is not slated to take effect until 2013. However, we may not need to wait that long for higher tax rates to surface. The Obama administration’s proposed budget calls for allowing the Bush tax cuts to expire as planned in 2011. This would re-instate the top tax rate of 39.6% and increase the current 33% rate to its 2001 level of 36%. When combined with the Medicare Surtax, top bracket taxpayers would be subject to a 43.4% levy on income over \$250,000. The favorable tax treatment of long-

term capital gains and qualified dividends would also be eliminated. Currently, these income sources are taxed at a maximum 15% rate. After the tax cuts expire, the capital gains tax rate will revert to 20%, while dividend income would be taxed as ordinary income at your highest marginal rate.

So, what steps can you take to minimize the drain of these new taxes on your cash flow and investment returns? First, if you expect to need cash for spending in 2011, consider realizing investment gains in 2010 to lock in today’s lower tax rates. If your portfolio is still showing some losses, you may want to recognize these before year-end as well. These losses can be carried over to future years to offset gains that will be taxed at higher rates. If you have a traditional IRA, converting part or all of it to a Roth IRA in 2010 may also be advantageous. You will pay taxes on the converted amount at today’s lower rates and potentially avoid the Medicare Surtax when you withdraw funds from the Roth because these distributions are not taxable income. Adding municipal bonds to your portfolio may also prove beneficial as another source of tax-free income. Maximizing contributions to 401(k)s and other deferred compensation plans will also help lessen the tax bite because these contributions reduce taxable income and may keep you below the surtax threshold. ♦



David A. Batchelder

Private Foundations Create a Legacy of Giving

For many people retirement is an opportunity to create a new career that combines their entrepreneurial and philanthropic drives. Armed with skills from their first career, these social entrepreneurs strike out in retirement to improve the world around them by starting their own private foundations. For these entrepreneurial spirits, establishing a private foundation offers an opportunity to stay personally engaged and productive later in life.

Similar to public charities, private foundations are tax-exempt entities established exclusively for charitable, educational, religious, scientific and literary purposes. However, instead of soliciting donations from the public, they are funded and controlled by an individual, family, or business. Warren Buffet and Bill Gates both have foundations, but you do not have to be on the Forbes wealthiest-in-the-world list to create and run your own private foundation. According to statistics from the Urban Institute's National Center for Charitable Statistics, there are currently 484 private foundations in New Hampshire, more than half of which have less than \$1 million in assets. The number of private foundations in the state has increased nearly 34% over the past decade and together, these philanthropic organizations currently have over \$950 million in their charitable coffers.

Most private foundations are set up as non-operating foundations.

That is, they do not provide services directly. Instead, they fulfill their tax-exempt purpose by making grants to public charities, or to individuals in the form of scholarships, awards, or emergency assistance. To maintain their tax-exempt status, the foundation must donate 5% of its average net assets each year. IRS rules allow a tax deduction for donations to the foundation in the year they are made, up to a maximum of 30% of adjusted gross income. Unused deductions can be carried forward to offset income for up to five years.

Starting a foundation involves some initial legal work, such as establishing by-laws, appointing a board, and obtaining IRS status as a tax-exempt organization. Ongoing management of the foundation, however, can remain a family affair. Children and other family members can be appointed as officers and directors of the foundation or serve in a staff role, providing a way to unite the family and pass important values, and management skills, on to younger generations. Family members can be compensated for their service as long as IRS rules are strictly followed.

Operating a foundation involves establishing a mission, researching charities, setting grant-making rules, reviewing and approving grant requests, as well as overseeing the foundation's investment strategy. The board of directors has ultimate responsibility for each of these functions, allowing for the greatest level of control. Creating a charitable legacy requires a hands-on approach, which is well suited to an entrepreneurial personality.

Still, the administrative burden need not be overwhelming even for those less adept at management. For smaller foundations which cannot afford a staff, many of the administrative functions (accounting, tax, legal, investment) can be outsourced, allowing the donor and board to focus on their charitable objectives.

For those with the desire to create a charitable legacy without the drive toward social entrepreneurship, establishing a donor-advised fund may be a good option. Donor-advised funds offer less control and flexibility, but avoid the administrative requirements of a private foundation. Using a donor-advised fund, you make an irrevocable gift to a fund that pools contributions from many donors and manages the investment and disbursement of the funds to public charities. While you can give direction as to which charities you would like to receive your donations, these funds are managed by a board that ultimately decides where grants are to be placed. ❖

Mackensen & Company, Inc., is a fee-only financial planning and investment management firm. No commissioned products are sold. For further information, call:

MACKENSEN & COMPANY, INC.
FEE-ONLY FINANCIAL PLANNERS

6 Merrill Drive
Hampton, NH 03842-1970
603-926-1775
800-927-7365
fax: 603-926-1249

web address: www.mackensen.com
email: info@mackensen.com