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In This Issue

Tax Law: Preparing for the New Tax on Investment Income.....Page 1

Old Law Wins a New Case.....Page 2

Meet Our Attorneys: Ashley R. Dobbs.....Page 3

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TAX LAW:
PREPARING FOR THE NEW TAX ON INVESTMENT INCOME

BY RONALD A. FEUERSTEIN, ESQUIRE

As part of the 2010 Reconciliation Act, Congress enacted new Internal Revenue Code ("Code") section 1411. The Code provision imposes on "unearned" income a new Medicare contribution tax on individuals (U.S. citizens and resident aliens), estates and trusts. This new tax comes into effect January 1, 2013 for taxable years beginning after December 31, 2012.

The new levy applies to income from interest, dividends, annuities, royalties, rents and capital gains. It is a new tax on investment income. Code section 1411 is not a tax on business income.

"Investment income" is the sum of (i) gross income from interest, dividends, annuities, royalties and rents (other than such income derived in the ordinary course of trade or business to which the Medicare contribution tax does not otherwise apply), (ii) other gross income derived from any business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply.

Code section 1411's tax rate is 3.8 percent. As applied to individuals, the tax is levied on the *lesser of "net investment income" or the excess of "modified adjusted gross income" over the "threshold amount."*

The term "net investment income" is investment income reduced by the deductions properly allocable to such income.

The term "modified adjusted gross income" is adjusted gross income increased by the amount excluded from income as foreign earned income under Code section 911(a)(1) (net of the deductions and exclusions disallowed with respect to the foreign earned income).

Under Code section 1411, the "threshold amount" is $250,000 for joint returns or surviving spouses. It is $125,000 in the case of a married individual filing separately and $200,000 for all other taxpayers. Note that the threshold amounts are not indexed for inflation. As a result, it is possible that the new tax will affect more taxpayers each year.

In the case of an estate or trust, the tax is 3.8 percent of the lesser of undistributed

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net investment income or the excess of adjusted gross income over the dollar amount at which the highest income tax bracket applicable to an estate or trust begins.

The new tax does not apply to a non-resident alien or to a trust in which all the unexpired interests are devoted to charitable purposes. This new tax will also not apply to a trust that is exempt from tax under Code section 501 or to a charitable remainder trust exempt from tax under Code section 664.

It is significant to note that the new tax is subject to the individual estimated tax provisions. The new tax is not deductible in computing any tax imposed by Subtitle A of the Code (relating to income taxes).

Since the new Code section 1411 will not tax what is presently excluded from the scope of gross income, it will not apply to items such as, by way of examples only, tax-exempt bond interest, Veteran's benefits or capital gains from the sale of a principal residence to the extent excluded from gross income.

In the case of a trade or business, the new tax will apply if the trade or business is a passive activity with respect to the particular taxpayer or if the business consists of trading financial instruments or commodities as defined in Code section 475(e)(2). The tax does not apply to other trades or businesses conducted by a sole proprietor, partnership or S corporation.

The new levy will apply to dispositions of a partnership interest or stock in an S corporation, but only to the extent gain or loss would be taken into account by the partner or shareholder if the entity had sold all its properties for fair market value immediately before the disposition. Consequently, only net gain or loss attributable to property held by the entity which is not property attributed to an active trade or business is taken into account. Significantly, income, gain or loss on working capital is not treated as derived from a trade or business.

Investment income does not include amounts that are subject to self-employment tax or distributions from qualified retirement plans. "Net investment income" does not include any distributions from Code section 403(a) qualified annuity plans, Code section 403(b) annuities, Code section 408 individual retirement accounts (IRA's), Code section 408A (Roth IRAs), or Code section 457(b) deferred compensation plans of tax-exempt organizations and state and local governments.

New Code section 1411 probably will not apply to either simple trusts or grantor trusts.

The new tax or investment income raises some planning opportunities for well-advised clients and will doubtlessly catch some taxpayers unaware of its enactment.

Ronald A. Feuerstein practices tax law and is a Shareholder with Bean, Kinney & Korman, P.C. in Arlington, Virginia. He can be reached at 703.525.4000 or rfeuerstein@beankinney.com.

OLD LAW WINS A NEW CASE

BY JAMES V. IRVING, ESQUIRE

The Fourth Circuit Court of Appeals has reversed the 2010 ruling of an Eastern District of Virginia District Court Judge in a non-competition case. In July 2010, Judge Leonie Brinkema granted summary judgment to a defendant who contended that the non-competition agreement contained in a restrictive covenant he had signed was unenforceable. Judge Brinkema's decision in *BP Products v. Stanley* was reviewed in the September 2010 edition of this newsletter.

In 2005, BP Products North America, Incorporated ("BP") decided to sell its Virginia, Maryland and District of Columbia station properties to Eastern Petroleum, one of its major fuel suppliers. The agreement was subject to an opportunity given to each retailer to match Eastern's offer for the retailer's station property. Charles V. Stanley Jr. matched the bid for his station and acquired the Alexandria, Virginia property where for years he'd operated an automotive repair shop and sold BP fuel under BP's Amoco banner. The purchase and sale agreement by which he acquired the property included a special warranty deed containing restrictions on the property's use, among them that Stanley would not sell non-BP fuel products and that he would enter into a supply agreement with Eastern.

The relationship did not go smoothly. By July 2008, Stanley had become so dissatisfied with Eastern's prices that he stopped selling gas and in April 2009 accused Eastern of materially breaching their agreement by failing to offer fuel at commercially reasonable prices. When he received no response from BP, Stanley began selling AmeriGO fuel, a non-BP product. BP demanded that Stanley stop selling the non-conforming fuel and when he refused, BP sued him.

In granting Stanley's 2010 Motion for Summary Judgment, Judge Brinkema found that the restrictive covenant was unenforceable because it barred Stanley from offering for sale non-BP brand petroleum products that did not compete with BP. Because the restriction was beyond what was reasonably necessary to protect BP's legitimate interests, she found it to be overbroad under the test enunciated by the Virginia Supreme Court in *Omniplex World Services Corp. v. U.S. Investigations Services, Inc.* in 2005.

On February 14, 2012, a panel of three judges of the Fourth Circuit held by a two to one vote that Brinkema had applied an incorrect test of enforceability and reversed and remanded the case for further proceedings.

The noncompetition provision at issue in *Stanley* was contained in a land use restriction in the Purchase and Sale Agreement by which Stanley acquired the station property. Nonetheless, Judge Brinkema had measured the enforceability of the covenant against the test used for noncompetition agreements contained in employment contracts. This, said the Fourth Circuit, was an error. Instead, the trial judge should have applied the more liberal test employed in an analysis of an arm's length sales of assets transaction. The Fourth Circuit held that under that test, the provision was enforceable because it was "perhaps slightly broader than necessary to achieve its purpose [but] on the whole affords a fair protection to BP's interests."

The Virginia law on non-competition agreements contained in employment contracts continues to evolve through periodic opinions refining the law in this area. In support of their position, Stanley relied principally on *Omniplex,* a 2005 Supreme Court of Virginia decision. In support of their position, BP Products cited *Merriman v. Cover, Drayton & Leonard*, a case decided in 1905. The Fourth Circuit may or may not have properly interpreted Virginia law, but considering the volume of non-competition litigation in the Old Dominion, it may be time for the Virginia Supreme Court to take a new look at this old issue.

James V. Irving is a Shareholder with Bean, Kinney & Korman, P.C. in Arlington, Virginia practicing in the areas of corporate and business law and commercial and general litigation. He can be reached at 703.525.4000 or jirving@beankinney.com.

MEET OUR ATTORNEYS

ASHLEY R. DOBBS

Ashley R. Dobbs is an associate with Bean, Kinney & Korman practicing in the areas of intellectual property and business transactions. Her practice focuses on helping clients protect, grow and benefit from their ideas and assets through corporate formation, business transactions and by protecting their intellectual property.

Ashley helps clients protect and profit from their corporate brand, through trademark and copyright protection, licensing and franchising agreements, and compliance with advertising laws. Ashley also advises clients on the acquisition, protection and commercialization of intellectual property; and software, media and technology licensing and assignment agreements. She advises clients on all types of business agreements and contracts. In addition, she advises clients on web site terms of use, privacy policies and domain name use and protection.

Ashley's blend of business and legal background makes her suited to understand the intersection of business and law and keeps her focused on the client's business objectives.

Ashley also actively represents clients in a variety of

(Continued to next page)

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animal-related matters, including transactional matters and providing for their pets through estate planning.

Before attending law school, Ashley worked for 15 years in business with a large consulting company and with several of her own entrepreneurial ventures, including the Dobbs Group. While in those positions, she worked with corporate leaders on strategic planning, brand marketing, business process improvement and employee communication.

Ashley maintains a deep commitment to community service while volunteering with local charities and community organizations. She has served as a board member, volunteer and fundraiser for a long list of community organizations throughout her career. She chaired the committee that supported the Northern Virginia Pro Bono Hotline from 2005 to 2008, serves as a legal advisor to several local and national animal welfare organizations, and chairs the ABA's Animal Law Committee team developing continuing education programs.

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