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'Taxmageddon:' Prepare to Potentially Pay More on Investment Income

On January 1, 2013, an array of tax increases will kick in and leave Americans with significantly larger tax bills -- unless Congress acts. Increases are scheduled on capital gains, dividends and the tax rates on wages. That's not all. More people will be liable for the estate tax, the alternative minimum tax and the marriage penalty. The payroll tax cut expires, which means employees will see smaller paychecks, and many other taxpayer-friendly provisions will end. The result has been dubbed "Taxmageddon." This article looks at what might happen to investment income rates and how you can prepare in the coming months.

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DC's First Source Law Imposes Unattainable Hiring Mandates

DC's First Source Law mandates that all projects funded in whole or in part with District of Columbia funds, or other funds which the District administers, shall provide for increased employment opportunities for District residents. However, with the current economic slowdown, a lawsuit has been filed by seven construction-related organizations and businesses to find the law unconstitutional.

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ASAE Standards of Conduct

ASAE recently adopted an ethics policy to help guide members and organizations. ASAE has made a commitment to ethical standards that promote the goal of transforming society for the better.

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Commercial/ Rental Real Estate

Subdivide and Save Taxes with a 'Section 1237' Exception

Do you own appreciated land that you want to subdivide and then sell off for a large profit? There might be a way to save a significant amount on the tax bill. Click "Full Article" for the details.

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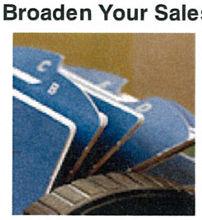
Broaden Your Sales Circle with 4 Simple Steps



Stop wasting time with chit-chat at professional functions. Those events are an opportunity to network and expand your circle of contacts and potential customers. Click "Full Article" for a smart four-step plan that can help you get the most out of the next professional get-together you attend.

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Learn Your Business From Your Customers

Customer satisfaction leads to repeat business and a robust bottom line. Here's how to teach your entire staff to unlock the mysteries of what your clientele wants.

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'Taxmageddon:' Prepare to Potentially Pay More on Investment Income

Through the end of this year, the so-called Bush tax cuts are cast in stone, and investment income will be taxed at relatively favorable rates. But next year could be a much different story. That's because the various tax cuts will automatically expire at year end unless Congress takes action.

In addition, a new 3.8 percent Medicare surtax on investment income earned by higher-income individuals is scheduled to take effect next year. The new surtax is part of the 2010 healthcare legislation that was recently upheld by the Supreme Court.

The combined tax impact of the expiration of the Bush tax cuts and the 3.8 percent Medicare surtax has been dubbed "Taxmageddon" for higher-income investors. Here's what you need to know to be prepared.

For more information about the changes in the estate tax scheduled for next year, click here to read our previous article.

Year	Highest bracket tax rate
1993-2000	39.6%
2001	39.1%
2002	38.6%
2003-2012	35%
2013	**39.6%** unless Congress acts

Impact of Expiring Investment Tax Cuts

For 2013 and beyond, the *maximum* federal income tax rate on most long-term capital gains is scheduled to rise to 20 percent (up from the current 15 percent). However, an 18 percent maximum rate will apply to most long-term gains from selling investments that were acquired after December 31, 2000 and held for more than five years.

Starting next year, dividends will once again be treated as ordinary income and taxed at regular rates -- as was the case before the Bush tax cuts. This is really bad news because the maximum federal rate on ordinary income, including dividends, for 2013 and beyond is scheduled to be 39.6 percent. For 2012, qualified dividends are taxed at a maximum rate of only 15 percent.

For 2013 and beyond, the top federal rate on short-term capital gains, taxable interest income, rental income, royalties, and income from annuities will increase to 39.6 percent because these types of investment income are taxed at ordinary rates. For 2012, the maximum rate on ordinary income is 35 percent.

Starting next year, the phase-out rules for personal and dependent exemption deductions and itemized deductions are scheduled to return with full force. These disguised tax increases can reduce or even eliminate exemption deductions and wipe out up to 80 percent of certain itemized deductions -- including the ones for home mortgage interest, state and local income and property taxes, and charitable donations. For higher-income investors, these deduction phase-out rules can make your federal income tax bill just that much higher.

Impact of the New 3.8 Percent Medicare Surtax

Starting next year, higher-income individuals may also be hit with a new 3.8 percent Medicare surtax on all or part of their net investment income. For purposes of this surtax, net investment income is calculated in two steps.

Step 1: Add up the following:

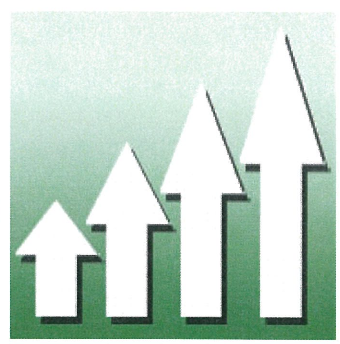
- Gain from selling assets held for investment -- including gain from selling investment real estate and the taxable portion of gain from selling a personal residence.

  Note: Gain from selling a principal residence is federal-income-tax-free to the extent of the allowable home sale gain exclusion (up to $250,000 for an unmarried taxpayer and up to $500,000 for a married joint-filing couple). Such tax-free principal residence gains are exempt from the surtax. However, to the extent a principal residence gain exceeds the exclusion, the excess is potentially subject to the surtax. Gain from selling a vacation property is also potentially subject to the surtax.
- Gross income from dividends.
- Gross income from interest (not including tax-free interest such as municipal bond interest).
- Gross income from rental activities.
- Gross income from royalties.
- Gross income from annuities.
- Gross income and gains from passive business activities (as opposed to business activities in which you actively participate) and gross income and gains from the business of trading in financial instruments or commodities (whether you actively participate or not).

Step 2: Reduce the total from Step 1 by deductions properly allocable to the types of income listed in Step 1. The result is your net investment income amount.

Gains and Income from Businesses: In general, gains from selling assets used in a business in which you actively participate are apparently outside the definition of net investment income and are therefore exempt from the Medicare surtax. (As indicated above, an unfavorable exception to the preceding general rule applies to gains from the business of trading in financial instruments or commodities. Such gains are included in the definition of net investment income--whether you actively participate or not--and are therefore potentially subject to the surtax.)

Income from dividends, interest, rents, royalties, and annuities earned in the ordinary course of a business in which you actively participate are also apparently outside the definition of net investment income and are therefore exempt from the surtax.



However, gains and income attributable to a passive business activity such as rental real estate or a partnership or S corporation in which you do not actively participate are potentially subject to the surtax.

Retirement Plan Distributions: Distributions from tax-favored retirement plans and accounts such as 401(k) plans, pension plans, traditional IRAs, and Roth IRAs are exempt from the surtax. Social Security benefits are also exempt.

Income Threshold and Tax Base: You will not be hit with the 3.8 percent Medicare surtax on net investment income unless your modified adjusted gross income (MAGI) exceeds:

- $200,000 if you are unmarried.
- $250,000 if you are a married joint filer.
- $125,000 if you are married, and you and your spouse file separately.

The amount subject to the 3.8 percent Medicare surtax is the *lesser* of:

- Your net investment income or
- The amount by which your MAGI exceeds the applicable threshold. For this purpose, MAGI is defined as regular AGI from the bottom of page 1 of your Form 1040 plus

certain tax-free income from foreign sources (relatively few taxpayers have such income).

Example 1: In 2013, you and your spouse file jointly. You have $310,000 of MAGI that includes $90,000 of net investment income. You will owe the 3.8 percent Medicare surtax on $60,000 (the lesser of your excess MAGI of $60,000 or your net investment income of $90,000).

Example 2: In 2013, you file as an unmarried individual. You have $310,000 of MAGI, which includes $90,000 of net investment income. You will owe the 3.8 percent Medicare surtax on $90,000 (the lesser of your excess MAGI of $110,000 or your net investment income of $90,000).

Example 3: In 2013, you and your spouse file jointly. You have $240,000 of MAGI. You are exempt from the 3.8 percent Medicare surtax because your MAGI is below the $250,000 threshold for joint filers. Therefore, it doesn't matter how much of your income is from investments.

Example 4: In 2013, you file as an unmarried individual. You have $190,000 of MAGI. You are exempt from the 3.8 percent Medicare surtax because your MAGI is below the $200,000 threshold for singles. Therefore, it doesn't matter how much of your income is from investments.

Trusts: Trusts can also be hit with the 3.8 percent Medicare surtax. The surtax will apply to the *lesser* of:

- The trust's undistributed net investment income or
- The trust's AGI in excess of the threshold for the top trust federal income tax bracket. For 2013, that threshold is expected be around $12,000. As you can see, many trusts could be affected.

Impact on Maximum Federal Rates on Investment Income

Unless something changes, the demise of the Bush tax cuts in conjunction with the 3.8 percent Medicare surtax will result in the following maximum federal rates on investment gains and income recognized by individuals and trusts in 2013 and beyond.

- 23.8 percent (20 percent plus 3.8 percent) on long-term capital gains (versus 15 percent for 2012).
- 43.4 percent (39.6 percent plus 3.8 percent) on short-term capital gains (versus 35 percent for 2012).
- 43.4 percent (39.6 percent plus 3.8 percent) on income from dividends, interest, rental activities, royalties, and annuities (versus 15 percent on qualified dividends for 2012 and 35 percent on these other types of income for 2012).
- 43.4 percent (39.6 percent plus 3.8 percent) on ordinary income from passive business activities and ordinary income from the business of trading in financial instruments or commodities (versus 35 percent for 2012).

Tax Planning Considerations

If you think you will be affected by these tax rate increases on investment income for 2013 and beyond, you may want to take some steps this year to decrease your exposure. For instance, investment gains that are recognized this year instead of next year will be taxed at today's favorable rates. However, triggering gains this year will generally result in an accelerated tax bill. If you have 2012 capital losses or a capital loss carryover from before this year, things get more complicated (these losses can potentially be used to shelter capital gains recognized this year or capital gains recognized in future years when tax rates are scheduled to be higher).

Finally, depending on how the November 6th election turns out, it's possible that *none* of the aforementioned tax increases will take effect. However, the prudent approach is to:

- Plan for the worst while hoping for the best and
- Be prepared to make some tax planning moves after the November election results are known, but before year end. Contact your adviser for assistance in determining the best action plan for your specific circumstances.

Disclaimer: There are many unanswered questions about exactly how the new 3.8 percent Medicare surtax on net investment income will work. The information in this article is general in nature and based on what we think are reasonable interpretations of the statutory language and legislative history. Some of what we say here could be contradicted by future IRS guidance.

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DC's First Source Law Imposes Unattainable Hiring Mandates

First passed by the DC City Council in 1984, a statute known as the "First Source Law" requires that any projects that are funded by the municipal financing and development programs require that DC residents are given hiring preference. First Source mandates that all projects funded in whole or in part with District of Columbia funds, or other funds which the District administers, shall provide for increased employment opportunities for District residents.

With the current economic slowdown, one of the hardest hit industries is construction. In an effort to overturn First Source, a lawsuit has been filed by seven construction-related organizations and businesses to find the law unconstitutional.

The lawsuit claims that the First Source is discriminatory and has unreachable goals. they say is will cost employees their jobs and employers the opportunity to bid on work. The argument is that the First Source law discriminates on where an employee lives. The lawsuit states: "Under the Constitution, a jurisdiction cannot erect barriers that prevent qualified construction workers who live in another jurisdiction from practicing their trades. The District's First Source Employment Act imposes on employers harmful discriminatory requirements."

The lawsuit also points out that small contractors would be limited to the number of government jobs that they could bis on at one time based on the shortage of qualified DC residents. Contractors argue that the District should focus its attention and resources on vocational training, workforce development and basic public education to expand the pool of skilled workers

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ASAE Standards of Conduct

Robert Uttenweiler, Senior Consultant for McQuadeBrennan, LLP, has been appointed to serve as a member of the American Society of Association Executives (ASAE) Ethics Committee for 2012-2013. The committee is composed of more than 20 high level executives from across the United States from associations and service providers.

ASAE recently adopted an ethics policy to help guide members and organizations. Since associations serve a large number of members throughout the United States, ASAE has made a commitment to ethical standards that promote the goal of transforming society for the better.

The Standards of Conduct embody aspirational ethical standards. The aspirational ethical standards describe the conduct that individuals strive to uphold as ASAE members. Adherence to the aspirational ethical standards is not easily measured. conducting one's self in accordance with the Standards is an expectation that members have of themselves as professionals. The four main concepts described in the Standards are those of respect, responsibility, fairness and honesty.

ASAE is considering a set of enforceable rules that will apply to those applying for or who have received the organizations Certified Association Executive (CAE) designation.

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