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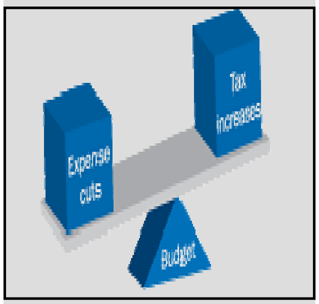
Back from the Fiscal Cliff - Sort Of

Congress Passes Cliff Legislation But Largely Ignores Spending Cuts

January 2, 2013 | By William L. Pittenger, MAI, SRA

Both the House and the Senate have now passed Fiscal Cliff legislation which will become law with the President's signature. The Senate passed it 89-8 New Years Eve and the House passed the same version 257-167 late last night. Both versions of the bill were passed with virtually no open debate. Most discussion occurred behind closed doors with none of the traditional mark ups, amendments or floor debate. Indeed, it seems unlikely that most even read the 157 page bill instead relying on mere assurances of its content by the leadership. Nevertheless, the President is expected to sign it quickly.



Here is a simplified summary of the legislation plus the preliminary CBO assessment as well as key observations from the non-partisan Tax Policy Center.

The act will raise taxes by about $600 billion over 10 years and delay for two months across-the-board spending cuts otherwise set to begin slashing the budgets of the Pentagon and numerous domestic agencies.

Preliminary scoring by the non-partisan Congressional Budget Office (CBO) however suggests that the law would add $3.9 trillion to the deficit over the next decade. The addition would result from $3.6 trillion in the Alternative Minimum Tax (AMT) patch plus extension of lower tax rates. The remainder would be about $330 billion in miscellaneous spending including a 12 month extension of emergency unemployment benefits. The CBO preliminary assessment could change as it was given insufficient time to finalize its work before the vote.

Highlights of the law

- **Income tax rates.** Extends tax cuts on incomes up to $400,000 for individuals, $450,000 for couples. Earnings above those amounts would be taxed at a rate of 39.6%, up from the current 35%. Extends Clinton-era caps on itemized deductions and the phase-out of the personal exemption for individuals making more than $250,000 and couples earning more than $300,000.

- **Estate tax.** Estates would be taxed at a top rate of 40%, with the first $5 million in value exempted for individual estates and $10 million for family estates. In 2012, such estates were subject to a top rate of 35%.

The author is Senior Director, Economic and Consulting Services at Focus Valuation Advisors in Orlando, Florida. Contact Mr. Pittenger at Bill.pittenger@focusvaluation.net

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- **Capital gains, dividends.** Taxes on capital gains and dividend income exceeding $400,000 for individuals and $450,000 for families would increase from 15% to 20%.

- **Alternative minimum tax:** Permanently addresses the alternative minimum tax and indexes it for inflation to prevent nearly 30 million middle and upper-middle income taxpayers from being hit with higher tax bills which would have averaged nearly $3,000.

- **Other tax changes:** Extends for five years Obama-sought expansions of the child tax credit, earned income tax credit, and an up to $2,500 tax credit for college tuition.

- **Unemployment benefits:** Extends jobless benefits by one year for the long-term unemployed.

- **Cuts in Medicare reimbursements to doctors:** Blocks a 27% cut in Medicare payments to doctors for one year. The cut is the product of an obsolete 1997 budget formula.

- **Social Security payroll tax cut:** Allows a 2-percentage point cut in the payroll tax first enacted two years ago to lapse, which restores the payroll tax to 6.2%.

- **Across-the-board cuts:** Delays for two months $109 billion worth of across-the-board spending cuts set to start striking the Pentagon and domestic agencies this week. Cost of $24 billion is divided between spending cuts and new revenues from rules changes on converting traditional individual retirement accounts into Roth IRAs.

According to the Tax Policy Center, the law results in $41 in tax increases for every $1 in expense reduction. It will actually raise taxes on 77.1% of U.S. households as a result of expiration of payroll tax cuts. Approximately 80% of Americans with incomes between $50,000 and $200,000 will see an average tax increase of $1,635.

My Observations. In my view, Congress and the President earned a huge incomplete grade on this one.

Once again (with few exceptions) the can has been kicked farther down the road. An extraordinary debt problem still remains and little has been done to cure the fundamental spending problem. Indeed **spending cuts and the debt ceiling were put off for another two months.** That leaves enormous uncertainty in general but among federal workers and defense contractors in particular as they wait to see what sequestration might ultimately hold.

Although smaller than they might have been, the tax increases are widespread. Add those to the various health care taxes currently going into effect and a huge amount of consumer discretionary spending is removed from the economy. That is certain to have an adverse effect on consumer spending, employment, housing and the broader economy. Indeed, the U.S. may face another unwelcome credit rating downgrade and the action also moves the nation's economy another step closer to recession.

It will take a few weeks or months for the real effects and the unintended consequences to become apparent.