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Fiscal Cliff Agreement: Impact on Real Estate

After a chaotic 23 hour struggle regarding the fiscal cliff, the drama in Washington came to a close late Tuesday, January 1, as the fiscal cliff deal passed the U.S. House of Representatives and Senate. The legislation, entitled *The American Taxpayer Relief Act*, was signed into law by President Obama the next day. Though the deal averts an immediate budget crisis, it sets the stage for months of renewed confrontations between Republicans and Democrats over the debt-ceiling, entitlement reforms, spending cuts beyond a two-month delay of massive budget cuts, and a long-term plan for deficit reduction.

While the new law provides many benefits for the commercial real estate industry (listed below), abrupt and complicated changes to the capital gains and personal income tax rates could hamper the sector's recent recovery. Specifically, the law raises the top capital gains and dividend rate to 20 percent for taxable income exceeding $450,000 for couples and $400,000 for individuals. However, the 15 percent rate is preserved for those with taxable incomes below the $450,000/$400,000 threshold. Additionally, the law permanently extends Bush-era personal income tax rates for taxable income up to $450,000 for couples and $400,000 for individuals. Taxpayers earning more than these thresholds will see their top marginal rate rise to at 39.6 percent, up from 35 percent.

Furthermore, the law may create some confusion for taxpayers that have both ordinary income and capital gains income. For example, how would a married couple calculate their capital gains rate if they earned, say, $300,000 in ordinary income and $500,000 in capital gains?

Summary of Other Key Real Estate Provisions

- **Carried interest** will continue to track the capital gains rate.
- **Estate tax:** The current $5 million per-person estate tax exemption remains (with the $5 million indexed for inflation), but the rate is increased to 40 percent from the current 35 percent.
- **Bonus depreciation:** This provision extends the current 50 percent expensing provision for qualifying property purchased and placed in service before January 1, 2014 (before January 1, 2015 for certain longer-lived and transportation assets) and also allow taxpayers to elect to accelerate some AMT credits in lieu of bonus depreciation.
- **15-year straight-line cost recovery for qualified leasehold improvements** on commercial properties is extended through 2013 and made retroactive to cover 2012.
- **7-year recovery period for motorsports racetrack property:** The law extends for two years, through 2013, the special seven year cost recovery period for property used for land improvements and support facilities at motorsports entertainment complexes.
- **Alternative Minimum Tax (AMT)** is patched permanently.

Looking Forward

Because the deal simply moved the trigger date for the sequester of automatic spending cuts totaling $1.2 trillion over nearly a decade from January 1 to March 1, expect renewed debate to begin with the start of the 113th Congress on a long-term plan for deficit reduction. By most estimates, the U.S. government will reach its $16.4 trillion borrowing limit by the end of February – so wrangling will also renew the debt ceiling, entitlement reforms, and spending cuts. Additionally, the federal government is set to shut down on March 27 unless Congress authorizes a continuing spending resolution. This could set up either an additional catalyst for a broader brinksmanship scenario or yet another moment in a series of showdowns that continues from last year.

Prospects for comprehensive tax reform and entitlement reform remain uncertain, with both sides appearing unwilling to reach meaningful compromises without an imminent deadline with severe consequences. Since Congress is now likely to be consumed by a series of short-term budget battles, such partisan bickering may distract lawmakers from the complicated process of achieving comprehensive tax and entitlement reform.