The Bipartisan Congressional Plan to Squeeze the Middle Class in 2014 Takes Shape

December 16, 2013 - There has been a lot of talk in Congress about reducing marginal tax rates next year. The effort is bipartisan and the plan is to sell the deal as a tax cut. After all, who doesn't like cutting taxes, especially in an election year? But nothing in life is free, and that includes tax cuts. So to pay for the reduction, there is a push to shift the cost of the reduction onto the backs of middle class tax payers. It is nothing more than a dirty political trick that will reduce real estate prices, force landlords to increase rents, hurt job growth and put the dream of home ownership out of reach for millions of Americans.

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There is no doubt that the United States needs to restructure tax laws. There are thousands of pages of tax code and it is absolutely impossible for anyone to know the entire code. Americans waste millions of hours and spend billions of dollars annually to comply with the current code. There simply has to be a better way. The tax rate for American businesses is the highest in the developed world; chasing many businesses to other countries.

Enter House Ways and Means Committee Chairman, Dave Camp (R-MI). He's at the center of a proposal to reduce the top corporate and individual income tax rate to 25%. He's proposing a "comprehensive" overhaul to the current code. According to the Washington Post, he's keeping the details of his proposal secret but there are certain aspects of his bill which are widely expected. And from what we can gather, none of those things will help anyone living in a house that costs less than $3 million and they will hurt many small businesses.

The bill is expected to call for large reductions and possible elimination of the mortgage tax deduction. Under current law, the first million dollars of interest paid on a mortgage can be claimed as a tax deduction. This deduction is one of the primary reasons that many people purchase homes. Banks also factor the deduction into loan approvals. If the deduction is eliminated, it reduces the amount of money that people can borrow. In turn, that means fewer home buyers in the market which will reduce the value of home prices.

Eliminating the deduction would have little impact for people purchasing homes of $3 million or more. That's because under current law, anyone financing this amount of mortgage debt is already prohibited from writing off a large amount of the interest they pay. In fact, the more expensive the home, the lower the impact of the proposal. The new law is a clear attempt to shift more of the nation's tax burden to middle class buyers.

Depending upon where you live in the country, you may think that a one million dollar mortgage is excessive. But if you live in a place like Manhattan or San Francisco, one million dollars may not pay for 1,000 square feet of living space.

These buyers are not living high on the hog. The new law could very easily force them out of the market or into long commute times.

Another item expected to be included in the proposal is elimination of property tax deductions. Current law allows homeowners to deduct the amount they pay for property taxes from their federal income tax. Again, banks take this into account when deciding how much money they will lend to borrowers. Eliminating this deduction has an effect that is nearly identical to elimination of the mortgage interest deduction.

Not wanting to be left out of the mix, the Senate is also working on tax issues that it would like to have included in any tax overhaul. Senate Finance Committee Chairman, Max Baucus (D-MT) wants to eliminate something called a 1031 exchange in real estate transactions. These exchanges allow people to defer payment of taxes on the sales of property when they purchase a new property within certain time frames. The taxes eventually come due when the property owner makes a final sale of their property.

The likely impact of this change would be to chase many property investors out of the market; leading to reduced real estate prices. Many investors would likely move their money out of the United States into areas with more favorable tax laws.

Not wanting to leave anyone out of this mess, Baucus also wants to increase the number of years landlords use to depreciate property. Right now, owners of rental or commercial property can depreciate it over 27.5 years. Baucus wasnâ€™t to increase that period of 43 years. Since depreciation is a tax deduction, the increase means expenses for landlords would go up.

If you are a renter, you might think that his doesn't affect you. Nothing could be farther from the truth. Increased costs for landlords will be passed on to renters. Many landlords will have to act very quickly on this because depreciation is a large factor in the profitable operation of rental property. As with the proposal from Rep. Camp, the one by Sen. Baucus would shift the burden of paying for marginal tax cuts directly onto the backs of middle class Americans.

The most disturbing aspect of these proposals - other than the fact that they are being positioned as tax cutsâ€¦ which they are not - is that over the past thirty years the United States has gone through two major economic calamities which were led by real estate collapses.

In May, 1985, the system of Savings and Loan institutions across the United States began to fall apart. In 1986, Congress passed a tax reform which included many of the proposals above. One of the key items in that act was an increase in the amount of time that property owners needed to use to depreciate their property; from 15 year to 37.5 years. Another was change the way that property owners could apply tax deductions associated with their investments.

Once the law was passed, many property owners found that it simply wasn't profitable to remain in their investments. But when they tried to sell their investments, nobody wanted to pay the amount of money they were asking. The new law had significantly reduced the value of their investments.

Since many of these investments were financed with money borrowed from S & L's, investors began to walk away. They stopped paying their mortgages and the savings and loans began to foreclose on their properties. Many of the S & L's who owned the loans became insolvent and the FSLIC (similar to the FDIC) had to step in and take the institutions over.

More than 23% of the S & L's in the US were taken over by the government and their doors were closed. Others were forced into mergers. It took ten years for the crisis to run its course. By the time it was over, the number of S & L's operating in the United States had been reduced from 3,234 to 1,645; a 50% reduction.

Property foreclosures also went through the roof. At the height of the crisis, newspapers were forced to ad sections to their publications with foreclosure listings. In the Sunday Denver Post alone, that section exceeded 50 pages at times. The GAO estimated the total cost of the crisis to be $370 Billion in 1996 dollars. Adjusted for inflation, that comes to more than $550 billion today.

More recently, we have the Great Recession of 2008. While not caused by the same things, the recession was precipitated by a collapse in real estate markets in 2007. We're just at a point now where homeowners who purchased at the top of the market are able to break even in some markets.

These new proposals would likely bring any recovery to a grinding halt if they ever become law. If either of the cases above proves anything, it is that when real estate markets collapse so does the rest of the economy. New construction comes to a halt. People begin to hold onto their money rather than spend it. Companies are then forced to lay off employees and reduce their operating costs. It is a vicious spiral and it is completely foreseeable. All anyone needs to do is take an hour or two and study a little history.

Whether you rent or own your home, you should be very concerned about these proposals. If you are an owner, the value of your investment is in jeopardy. And if you ever hope to own, these proposals are likely to mean that you will have to settle for less when you buy. They could even mean that you are permanently priced out of the market.

For the economy as a whole, if these proposal ever do become law you should expect to see an increase in unemployment and a reduction in the countries standard of living. You are also likely to see a rapid increase in the number of people facing foreclosure and short sales. It is likely to look like a do-over of 2008 to 2012, impacting primarily the middle class. And it is can be all yours courtesy of a legislator near you!

byJim Malmberg
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