Statement

On Behalf of the
National Association of Home Builders

Committee on Ways and Means
Tax Reform Working Group on Small Business

<u>Tax Reform: Implications for Small Businesses in Real Estate</u>

April 8, 2013

Introduction

The National Association of Home Builders is a Washington-based trade association representing more than 140,000 members involved in home building, remodeling, multifamily construction, property management, subcontracting, design, housing finance, building product manufacturing and other aspects of residential and light commercial construction. NAHB is affiliated with 800 state and local home builders associations around the country.

Small businesses and pass-thru entities, such as S Corporations and Limited Liability Corporations, play a critical role in the U.S. economy and are the dominant players for the U.S. home building and construction sectors. Housing plays a central role in the economy. Housing contributes to gross domestic product (GDP) in two basic ways: through private residential investment and consumption spending on housing services. Historically, residential investment has averaged roughly 5 percent of GDP while housing services have averaged between 12 and 13 percent, for a combined 17 to 18 percent of GDP. These shares tend to vary over the business cycle.

Currently, because of the impacts of the Great Recession, housing's total contribution to GDP stands at 15.1 percent. While lower than historical averages, the share has been rising over the last year. Housing starts stand at a 917,000 annualized pace as of Feb 2013, and NAHB expects to reach the one million starts a year pace near the end of 2013. Home builders are also adding jobs, after losing more than 1.4 million positions as result of the Great Recession. In fact, over the last four months, home builders have added nearly 60,000 positions, and shortages of skilled labor are now more commonly reported.

And the industry has much room to grow. Given the growth in population and the need to replace older housing stock, the normal housing starts rate lies between 1.5 million and 1.8 million starts a year. Until the nation's housing markets fully recover, there can be no robust economic recovery for the economy at large. Housing is linked to household wealth, consumer confidence, a healthy labor market (by enabling people to locate from city to city), and the direct jobs impact connected to the housing industry. Future tax policy should not harm an emerging recovery in this sector, and should recognize the important role of small businesses and pass-thrus in this industry.

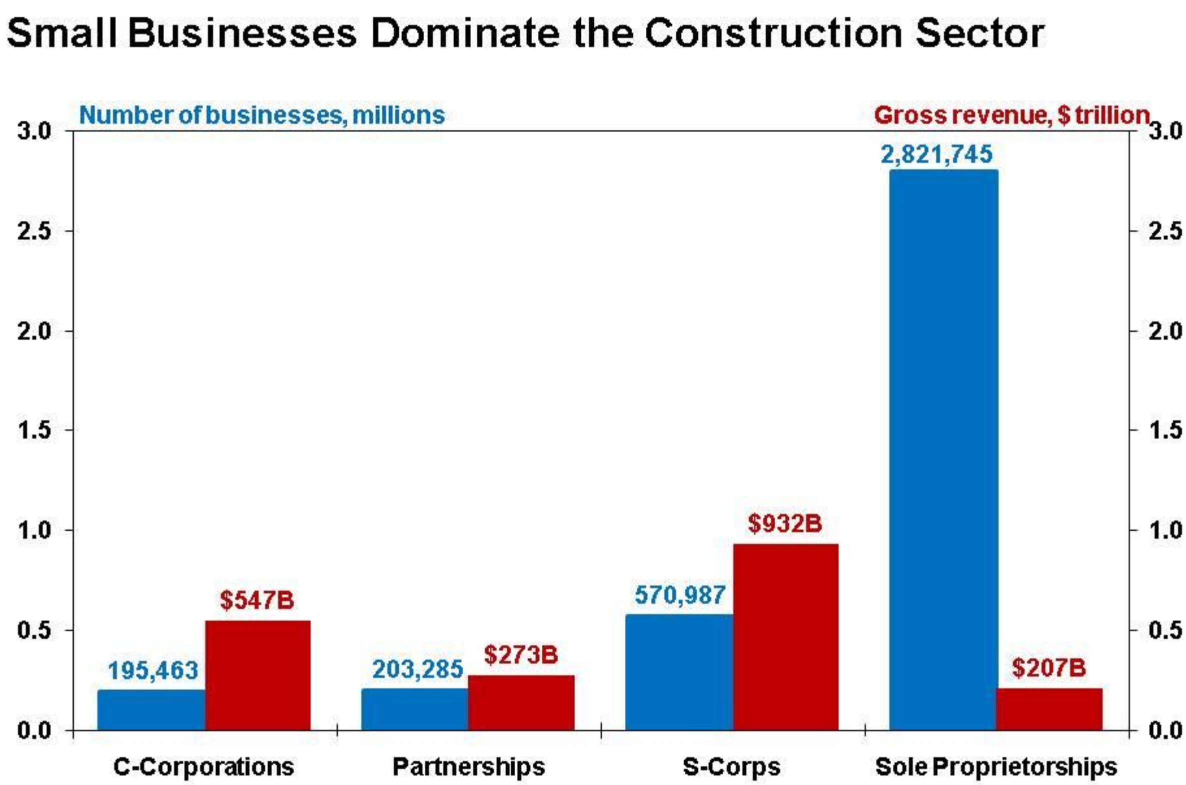
Importance of Small Businesses for the Residential Construction Sector

Small businesses are the heart of the residential construction sector, which includes single family and multifamily construction, land development and home remodeling: 80% of businesses that belong to NAHB are organized as pass-thru entities or sole proprietorships. Specifically, 47% of businesses are organized as S Corporations and 25% are LLCs.

As measured by workers, 80% of NAHB builder members have less than ten employees, with the average member have approximately 11 employees. Only 1% of NAHB builder members have more than 100 employees. For NAHB's associate members, nearly 90% of such members have less than 50 employees.

Approximately 50% of NAHB builder members have less than $1 million in gross receipts, and 86% have less than $5 million in gross receipts. Approximately 80% of NAHB builder members built 10 or fewer homes in 2010. NAHB's associated members are very similar to its builder members with respect to dollar size of business, with 77% having less than $5 million in gross receipts.

Statistics of Income data from the Internal Revenue Service provide a similar story for the construction sector as a whole. Data for tax year 2007 that matches the last Economic Census, indicate that there were 781,000 C Corporations in the construction business. On the other hand, there were approximately 2.9 million sole proprietorships, 570,000 S Corporations, and 209,000 partnerships.



Although sole proprietorships are the most common business form in construction, they may only represent a single individual working as an independent contractor, such as an electrician. S-corporations are actually the largest source of business income for the sector, and represent many family-owned businesses. All of these non-C Corporation taxpayers in the construction industry pay their business income taxes on the individual income tax forms. They also face certain restrictions and complications that C Corporations do not face, including but not limited to, certain passive activity loss restrictions and AMT issues due to the reporting business tax items.

Tax Reform Must Be Comprehensive

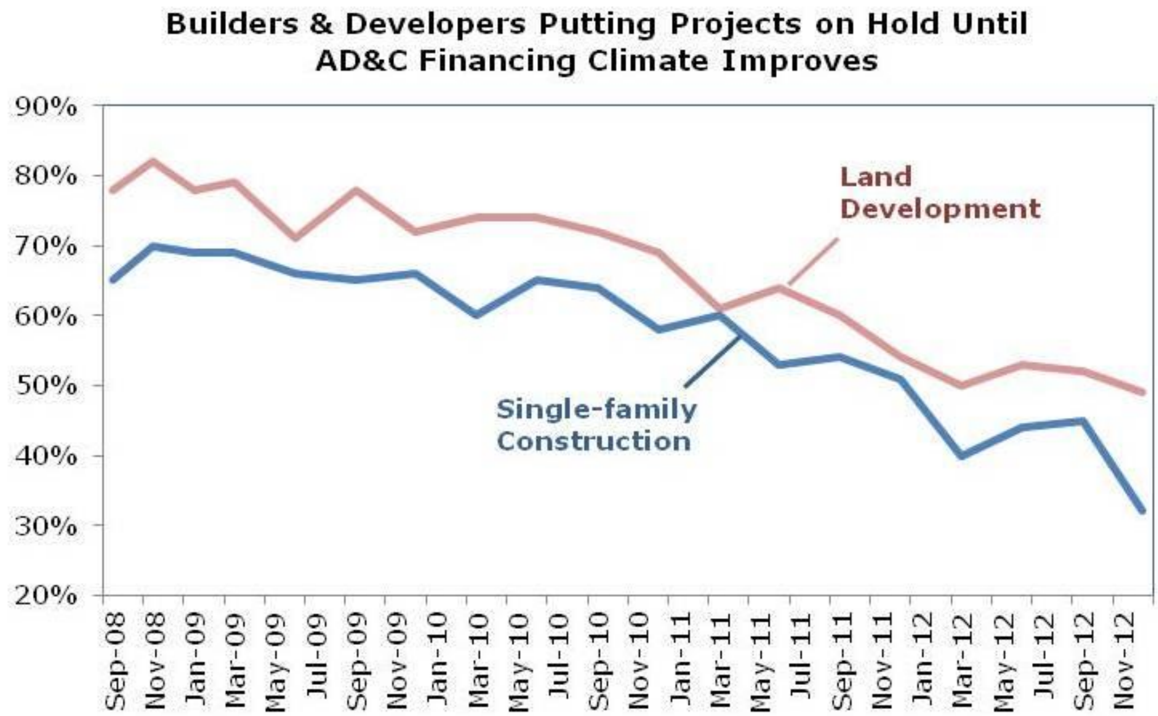
Given the large and important role played by small firms in the residential construction industry, it is critical that future tax policies do not harm these job creators. Some analysts have proposed doing away with certain business tax expenditures in exchange for corporate tax rate cuts. While reducing the tax burden on business will certainly help foster a more robust economic recovery, a subset of businesses should not face tax increases to accomplish this goal. If tax rules that currently are used by both corporate and pass-thru businesses are eliminated, and rates are reduced only for C Corporations, then pass-thru businesses will realize tax increases. Tax increases on small business will consequently result in jobs losses and lost spillover economic activity in areas of the country where small businesses play a larger role.

There are many examples of business tax rules that benefit both C Corporations and pass-thru entities, such as the Section 199 Domestic Production Activity deduction. For home builders, an important tax accounting mechanism is the Section 460(e) home construction contract rule. The tax code's long-term tax accounting rules require pre-payment of some expected tax revenue for contracts that spill over from one tax year to another. Home construction can last months or a year or more. Hence, the 460(e) rule allows home builders to pay taxes on homes once the home is sold, rather than during the construction period, which would require additional up-front financing. Elimination of this rule would negatively affect home builders of all sizes and increase the cost of housing for homebuyers.

Importance of Debt to Finance Small Business Expansion

Access to affordable credit is the lynchpin to the success of small business. In general, the tax code currently allows businesses to deduct interest as a necessary and ordinary business expense. This has the effect of lowering the cost of carrying debt, and for many small businesses, makes their operations financially practical. In many parts of the country, home builders have found they are completely cut off from access to credit. This is due, in part, to the difficult economic environment facing residential construction in many parts of the country, but also due to inflexible regulatory policies. As the housing market enters its recovery phase, without access to credit, small builders and small product suppliers will find themselves at a disadvantage to larger, corporate entities who can turn Wall Street to finance their business activities.

Although the availability of credit has eased since the height of the housing crisis, small business lending remains in a state of crisis, particularly for those firms in the residential construction industry. NAHB's membership survey shows that builders and developers continue to put projects on hold due to a lack of credit.



In the near term, a troubling development is that financing for land development is improving at a slower pace than construction. In many areas, buildable lots are growing scarce, which will translate into both higher prices until new lots are brought online, and will also result in stalled economic growth as customers are turned away. Lot development has a lengthy time horizon, often several years, so we should already be experiencing a greater uptick in lot development to respond to expected growth in the coming years. This does not appear to be occurring due to the lack of financing, which again, will result in a drag on the housing recovery.

Some tax reform proponents have suggested that the tax code carries a bias in favor of debt rather than equity, and this bias should be eliminated. NAHB urges the committee to consider that small businesses lack the access to equity capital that corporations often have. For small home builders and nearly any other small business, their sole source of financing may be limited to lending by community banks and other sources of debt. If Congress eliminates the present-law tax treatment for debt, small businesses will face significantly higher costs to raise capital, placing them at a distinct disadvantage to larger, corporate entities.

Section 108 Debt Forgiveness

As noted above with respect to AD&C lending, small businesses, and home builders in particular, also rely on debt proportionally more than their publicly-traded corporate peers. It is worth noting that as the economy emerges from the Great Recession, many home builders are dealing with tax issues arising from prior or ongoing debt mitigation efforts. Small business may be working with lenders to restructure debt due to land and home price declines in recent years. These efforts may result in interest rate reductions, term extensions, or even principal reduction. Under present law (section 108), these market-based workouts can give rise to tax liability. In 2009, the American Recovery and Reinvestment Act (ARRA) allowed an up to 10-year deferral, but only for such events occurring in 2009 and 2010.

Ultimately, small businesses face few options when dealing with the tax fallout from debt forgiveness. When a home builder takes out a loan, they will make a personal guarantee to the bank, placing their own home, car, savings accounts, children's college fund, and so forth as collateral. Increasingly, banks require the builder's spouse to cosign to ensure assets are not hidden in a spousal account. For a financial institution to agree to forgive a debt, the home builder's financial situation is, in many cases, rather bleak. Builders who have faced a situation where principal debt is forgiven simply will not have the assets to pay taxes on their so-called phantom income, forcing the builder into bankruptcy. The tax liability is literally the last straw from these small business owners who were desperately trying to survive the downturn.

There are two means through which the tax liability can be removed: bankruptcy or insolvency. Both options, however, result in the loss of the business financing. Because a home builder's access to credit depends on their personal creditworthiness, bankruptcy can tarnish their credit records. While they are now free from their tax liability, their careers as a home builder are over. In contrast, corporations can often go through bankruptcy and emerge to find willing investors on Wall Street. NAHB believes that this is unfair for small businesses, and in a tax reform rewrite, would urge Congress to consider a limited exclusion for debt forgiveness targeted to small businesses.

Independent Contractors—Section 530 of the Revenue Act of 1978

This issue is of great importance to the home building industry, which thrives on the efficiency and entrepreneurship that comes from both home builders and their workers being able to freely choose the form of their business relationship. There are important business-related reasons why a home builder would want to use an independent contractor as part of a home construction project. Economic theory dictates that firms employ labor in-house only when the costs of doing so are less than the cost of contracting with another firm. In general, labor costs are lower for businesses that specialize in a particular activity compared to a business that attempts to do all tasks in-house. Consequently, it may be more efficient to contract with a business consisting of dedicated specialists than housing a single or few employees within the firm. This effect is also known as economies of scale and is likely to occur in industries associated with large fixed costs, low marginal costs and learning-by-doing, such as residential construction or the technology sector.

In addition to certain professional duties, such as management and administration, home building requires a large number of specialized tasks. The Census identifies some of these roles, including but by no means limited to: construction supervisor, brick mason, carpenter, flooring contractor, cement worker, general laborer, pile driver, engineer, drywaller, electrician, glazier, insulation contractor, painter, paperhanger, pipe plumber, plaster contractor, rebar worker, roofer, metalworker, quality inspector, fencer, hazmat removal contractor, and septic and sewer specialist.

For a small home builder, who may only construct a few homes a year, there is not sufficient internal demand to justify hiring an employee for each of these specialized roles. For example, the total internal demand for an electrician may only be for one-half of a position per year. Consequently, it makes more economic sense to contract with an electrician who acts as an independent contractor. This contractor will likely own his own equipment, provide for his own training, and contracts with other businesses. He may also employ his own staff. Therefore, working with an independent contractor has the potential for significant efficiency gains. Proposals that would artificially alter the decision between hiring an employee and working with an independent contractor would increase overall construction costs and therefore result in higher prices for home buyers.

Furthermore, there are advantages for specialty trade workers to adopt independent contractor status. Data from the Census Bureau's Survey of Population demonstrates that independent contractors in the construction industry tend to be higher skilled than their employed counterparts. Not surprisingly given the demand issue discussed above, self-employed construction trades workers are more common in rural areas and smaller cities, where home building occurs at a smaller scale. Finally, independent contractor status affords the opportunity of growth and expansion, whereby a successful contractor hires his own staff to meet the increasing needs of his business. Indeed, many contracting businesses begin operation as a self-employed independent trade worker.[1]

The result of the economic setting described above is a vibrant subcontractor market within the residential construction industry. NAHB survey data indicate that 80% of home builders subcontract at least three-quarters of their total work. The average home builder uses 24 subcontractors for the construction of a single-family home. For example, 53% of home builders subcontract their sales operations.[2]

The prevailing tax and regulatory system reflects the economic importance of allowing businesses to determine how services are provided. Under present law, the determination of whether a specialist is an independent contractor or an employee is made by a facts and circumstances evaluation. This evaluation examines the nature of the work completed, the means and control of the work, and the circumstances under which the work is performed, among other factors. Internal Revenue Service Ruling 87-41 provides 20 such factors that may be considered in performing this evaluation. These factors include training, payment by job/time status, tool/material provision, and whether the specialist works for more than one business. Further, Section 530 of the Revenue Act of 1978 allows a business to treat a worker as an independent contractor if the IRS or past industry practice has accorded such status to similar workers in the past. Section 530 is an important policy tool for ensuring that inappropriate tax policy considerations do not interfere with efficient market operation and established business practice.

NAHB supports enforcement of these present law rules. Businesses or individuals that are in violation of these rules, either through wrongful misclassification of workers or through failure to pay taxes in full,

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[1] For more information, consult "Construction Workers: Settling In." Michael Carliner. Housing Economics, October 2003; and "Self Employment in Construction." Elliot Eisenberg. Housing Economics, January, 2001.

[2] Builders' Economics Council Survey: Special Analysis. May 2005.

can achieve an unfair competitive advantage in the marketplace. This hurts law abiding businesses and individuals in the industry.

Nonetheless, the present law system is complex and potentially confusing. In some cases, misclassification of employees can occur due to unfamiliarity with the rules. This is due in part to the nature of the facts and circumstances test that is available to businesses. Section 530 is useful because it establishes a safe harbor, thereby providing certainty to potential employers. NAHB recommends that compliance in this area could be improved by establishing additional safe harbors for common scenarios involving subcontractors that provide specialized services to businesses. Further, additional education efforts by the appropriate tax authorities concerning the benefits and responsibilities of being an independent contractor would be helpful. This would be useful for individuals who are new to the experience of being a subcontractor, and thus would prevent surprises concerning tax treatment at the end of the year.

However, NAHB opposes any attempt to legislate the particular circumstances under which professionals must be defined as employees or independent contractors. Such efforts would be damaging to the marketplace, particularly if they are driven by tax policy considerations and not the economics of the marketplace. Furthermore, such policies would be complex and administratively difficult to enforce. Consider the example of a specialist who theoretically would be required by statute to be classified as an employee, despite the fact that the specialist may work for several employers in a given year. Each employer would be required to withhold payroll taxes for FICA purposes, but no accounting could be made for withholding made by other employers. This would create an administratively difficult task to resolve for both the IRS and the employers, which would result in higher business costs and cash flow challenges. Indeed, this example illustrates one of the merits of the existing system.

The classification of workers as either employees or independent contractors is important for all small businesses, but it is especially so for home builders. NAHB supports maintaining the efficiency and flexibility of the marketplace by continuing to allow employers to classify their workers as independent contractors, as merited. At the same time, we support enforcement of present law to ensure a level playing field for all small businesses.

Home Equity Loans as a Source of Start-Up Funding

Present tax law also permits homeowners to deduct interest allocable to up to $100,000 of home equity loan debt. Such loans are defined as mortgages that are either used for purchase, construction or improvement purposes or as a means to access equity. The type of use of the home equity loan is important in the rules for the Alternative Minimum Tax. In general, deductions for mortgage interest may be claimed against AMT taxable income. However, interest on home equity loans **not** used for home improvement purposes may not be claimed against AMT tax liability.

According to the 2009 American Housing Survey, half of all home equity loans are used for remodeling purposes. Remodeling is, of course, another form of housing investment which creates jobs and improves the nation’s housing stock, particularly with respect to energy efficiency. Disallowing a deduction for interest for home remodeling provides a disincentive for homeowners to improve the nation's existing housing stock and hurts job creation in the remodeling industry.

There is no data that indicates with certainty what the remaining half of home equity loans are used for, but anecdotal evidence suggests that those purposes include college expenses, health emergencies and some consumption purposes. In addition, the smallest businesses tend to use home equity as a source for start-up funding. Of small business owners (construction or otherwise) who have reported tapping their housing equity for their business, 92 percent employed fewer than 20 workers. This is another example of how housing wealth impacts the ability of Americans to move up economically in society.

Improving the Tax Code for Small Business

Many small businesses experience good years and bad. This is particularly the case in real estate, which is notoriously cyclical. A developer may see a project come to fruition after years of work and struggle financially, but in the year the project is finally sold, their tax liability is based only on that one year and does not reflect the years of development going into the project. Given the progressive income tax system, there can be harm done to small business arising from this "king of the day" effect, when that long-term project comes to fruition and in that year, income spikes.

Real estate is not the only industry that experiences volatility in revenue on an annual basis. NAHB believes that the small business climate would be significantly enhanced and fairness in the tax improved if small businesses were able to use income averaging. Such an approach would provide a more balanced approach to taxing small businesses that see significant changes in revenue from year to year. Admittedly, income averaging would add to complexity, but that cost would be offset by the potential benefit for small enterprises. NAHB believes that the committee should examine income averaging as part of its deliberations.