Statement Submitted

By

The National Association of Home Builders

Committee on Ways and Means

Subcommittee on Select Revenue Measures

Hearing on Small Businesses and Tax Reform

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Introduction

The National Association of Home Builders is a Washington-based trade association representing more than 160,000 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. NAHB's builder members will construct about 80 percent of the new housing units this year.

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. The home building industry has been hit hard by the impacts of the Great Recession, with the construction sector currently experiencing a 21% unemployment rate and more than one million jobs lost in the residential construction sector, which includes single-family and multifamily construction, land development and remodeling. In normal economic times, housing constitutes approximately 15% of Gross Domestic Product and is an important generator of jobs. 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. NAHB Census of Membership data for 2009 reveals that 80% of businesses that belong to NAHB are organized as pass-thru entities or sole proprietorships. In particular, 47% of businesses are organized as S Corporations and 25% are LLCs.

Overall, approximately one-third of NAHB's membership is made up of dedicated builders. The remaining share of its membership consists of associate members who also work within the residential construction sector.

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, the most recent available, indicate that there were 781,000 C Corporations in the construction business. On the other hand, there were approximately 570,000 S Corporations, 209,000 partnerships, and 2.9 million sole proprietorships. 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 actively loss restrictions and AMT issues due to the reporting business tax items.

Tax Policy Considerations

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. For example, NAHB analysis shows that the construction of an average single-family home creates three jobs, $90,000 in federal, state and local taxes, $145,000 in wage income, and $86,000 in business income. [1]

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 non-corporate, 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.

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[1] The Direct Impact and Remodeling on the U.S. Economy. NAHB. 2007. (http://www.nahb.org/generic.aspx?sectionID=734&genericContentID=103543&channelID=311)

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 large, corporate entities.

Regulatory Flexibility Act—An Underutilized Tool

The Regulatory Flexibility Act (RFA), as amended by the Small Business Regulatory Enforcement Act (SBREFA), requires agencies, including the IRS, to consider the potential impact of regulations on small businesses and other small entities.[2] NAHB believes that the RFA, in certain circumstances, can be utilized more effectively by the IRS to minimize the burden imposed on small businesses. Unfortunately, the IRS, like many agencies, avoids the RFA requirements by issuing guidance. Issuing guidance—rather than a notice-and-comment rulemaking—avoids any serious analysis or consideration of the impact that the new reporting requirements will have on small businesses.

The IRS' avoidance of the RFA motivated Congress to amend the Act with SBREFA in the mid-nineties.[3] SBREFA expressly expanded the scope of the RFA to include interpretive rules involving the internal revenue laws, so long as they are published in the federal register and impose a collection of information requirement on small entities.[4] When issuing informal guidance, however, the IRS can do an end run around the RFA.

NAHB acknowledges that the IRS, when implementing tax provisions, often lacks the authority to exercise discretion and regulatory flexibility. However, the IRS has successfully worked through the RFA process in the past. For example, in 2006 the IRS partially withdrew regulations and submitted a revised regulatory flexibility analysis to proposed regulations that would change like-kind exchanges.[5] These changes occurred following a slew of adverse comments from stakeholders after the initial regulatory flexibility analysis was conducted. The impacts would never have been meaningfully considered if the IRS had merely issued guidance.

Of course, there are also circumstances where it is appropriate for the IRS to implement policy through informal guidance. Even in cases where the IRS lacks discretion, NAHB believes that Congress and the

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[2] Pub. L. No. 104-121, Title II, 110 Stat. 857 (1996).

[3] The Impact of Regulation on Small Business, Joint Hearing Before the S. Comm. On Small Business and the H. Comm. on Small Business, 104th Cong. 13 (1995) (statement of Jere W. Glover, Chief Counsel for Advocacy, U.S. Small Bus. Admin.).

[4] The legislative history associated with SBREFA explains: "One of the primary purposes of the RFA is to reduce the compliance burdens whenever possible under the statute. To accomplish this purpose, the IRS should take an expansive approach in interpreting the phrase 'collection of information' when considering whether to conduct a regulatory flexibility analysis. " 142 Congr. Rec. S3242-02 (March 29, 1996) (Joint Managers' Statement of Legislative History and Congressional Intent).

[5] 71 FR 6231.

Administration would benefit from RFA analyses in order to effectively determine the impact of tax changes on small businesses. NAHB would encourage the committee to look further into this issue.

Conclusion

Putting the federal government on a sustainable fiscal path is critical, especially for an industry like home building that depends on debt finance for business and homebuyers. The federal government should strive to constrain the growth of government spending so that tax increases – particularly tax increases that disproportionately affect particular sectors of the economy – are not required. And policymakers should be certain to not increase tax on certain businesses, like small businesses organized as pass-thru entities, in order to achieve other policy goals.