Statement Submitted

By

The National Association of Home Builders

Committee on Small Business

Hearing on the Tax Outlook for Small Business:

What's on the Horizon

April 18, 2012

Introduction

The National Association of Home Builders is a Washington, DC-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 builder 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 17% unemployment rate and nearly 1.5 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 17% to 18% of Gross Domestic Product and is an important source of job creation.

As the economy emerges from the Great Recession, NAHB strongly urges Congress to extend the 2001/2003 tax reductions. Small businesses organized as pass-thru entities pay individual income tax rates on their net business income. Thus, for small businesses, traditionally the nation's foremost job creators, individual income tax rates are business tax rates.

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 2010 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, 79% of NAHB builder members have less than ten employees, with the average member supporting approximately 12 employees. Only 2% of NAHB builder members have more than 100 employees. For NAHB's associate members, 87% of such members have less than 50 employees.

Approximately 52% of NAHB builder members have less than $1 million in gross receipts, and 84% have less than $5 million in gross receipts. Approximately 76% 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 2008, the most recent complete data available, indicate that there were about 767,000 corporations in the construction business. Of this total, approximately 571,000 were S Corporations. Additionally, there were 203,000 partnerships and 2.8 million sole proprietorships in the sector. All of these non-C Corporation taxpayers in the construction industry pay their business income taxes on individual income tax forms. They also face certain restrictions and complications that C Corporations do not face, including but not limited to, certain passive loss restrictions and AMT issues that arise from reporting business tax items on an individual income tax return.

Role of Housing and Home Building for the Economy

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] In normal periods, housing's share of Gross Domestic Product stands at 17% to 18%. As of the end of 2011, housing's share of the economy was only 14.9%. The direct impact of home building, which typically stands at 5%, is now at 2.5%.

Home building typically leads the economy out of recessions, but clearly the housing sector today remains at very low levels of economic activity. Housing starts in February 2012 were reported at a nearly 700,000 seasonally-adjusted annualized rate. This is a significant reduction from annualized rates of more than 2 million housing units just a few years ago. Based on growth in population and need for replacement of housing stock, the normal level of production for housing starts should be 1.5 million to 1.8 million starts a year.

There is some local improvement. For example, the NAHB/First American Improving Markets Index now stands at 101. That is, 101 metropolitan areas, representing one-quarter of all metropolitan areas, are now ranked as improving under a conservative evaluation of local job markets, home prices and housing construction permit activity. To make the list, a metropolitan area must show 6 consecutive months of improvement in each of the above listed categories.

But until more of the nation's housing markets 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. Due to declines in housing prices of more than 30%, households have had to deleverage or repair balance sheets. To do so, savings have had to increase, which results in reduced spending. This is one cause of the weak recovery we are experiencing.

NAHB is forecasting improvement for single-family and multifamily starts. The multifamily sector has improved already. Multifamily starts were up 55% in 2011 over 2010 totals. NAHB is forecasting an additional 22% increase in 2012. Single-family starts will follow the improvement in the multifamily

[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)

sector. NAHB is forecasting a 17% increase in single-family starts for 2012 and an additional 30% growth in 2013.

In the meantime, business conditions for the nation's home builders remain challenging. Access to lending, even in markets where housing demand is recovering, is tight. Many builders cannot get access to lending for Acquisition, Development and Construction (AD&C) purposes. In fact, according to FDIC data, lending for AD&C for home building is down 77% from levels of a few years ago. However, over the same period, the dollar value of permitted housing construction is down 58%. This means a lending gap has opened for home builders between available business lending and available credit. Tight conditions for mortgage lending for responsible homebuyers are also holding back a robust recovery for the nation's housing markets.

NAHB survey data of builder's financial status reveals what these economic conditions have caused. On average, single-family builders in fiscal year 2010 made $7.1 million in revenue, had $6.0 million go towards cost of sales, and slightly over $1 million towards operating expenses, which left them with an average net profit of $39,000 before taxes. In terms of percentages of revenue, cost of sales represented 84.7% of total revenue, which translates into a gross profit margin of 15.3%. Operating expenses ate up another 14.7%, leaving builders with a net profit margin of only 0.5%.

Tax Policy Considerations

With these economic issues in mind, it is clear that tax policy can have a dramatic impact for a sector like home building that is dominated by small businesses. Because most home builders pay income tax on their business income through the individual side of the Internal Revenue Code, individual income tax rates are business tax rates for the residential construction sector. And because profit margins are so low, even small tax increases can have serious consequences for an enterprise. The following discusses several tax issues of concern for the nation's home builders.

2001/2003 Tax Law

NAHB strongly supports extending the 2001/2003 income tax reductions, now scheduled to expire at the end of 2012. This includes extending the present set of marginal income tax rates, with a top rate of 35%. Absent extension, the top rate will rise to 39.6% along with rate increases at the lower brackets. Absent extension, these scheduled changes will result in income tax increases for those home builders in markets that are now recovering.

NAHB also supports extension of the 15% dividends and capital gains tax rate, which is important for small business owners. A higher capital gains tax rate could also affect the multifamily sector as the sale of apartment buildings can give rise to capital gains as part of the development and operation process.

Many home building companies are family-owned, thus NAHB also supports extension of the reduced rates and higher exemption amounts for the federal estate tax. The 2003 tax legislation also temporarily fixed the marriage penalty.

Tax Issues Related to the Patient Protection and Affordable Care Act

It is worth noting that several tax issues arose as a result of enactment of the 2010 health care legislation. Beginning in 2013, a new 3.8% capital gains tax will be added to the existing capital gains tax system for certain taxpayers. This will have a negative effect on small businesses, particularly multifamily developers for whom capital gains may arise from developing and operating residential rental property. Furthermore, the new 0.9% Medicare payroll tax will also add to tax burdens in 2013.

The 2013 tax increases has also had an unintended but important negative effect on the nation's housing markets as it is commonly, but incorrectly, believed that the 3.8% sales tax is a sales tax on home sales. This is not correct, but unfortunately due to the complexity of the new law, many participants in the housing market believe it to be true. NAHB along with other stakeholders in the housing industry have been attempting to educate homebuyers, home sellers and businesses in the real estate industry the facts concerning this tax.[2]

Tax Reform Principles

NAHB supports simplifying the tax code as part of a comprehensive tax reform process. Comprehensive tax reform should only occur after a thoughtful and deliberate vetting process that examines proposed changes, necessary transition rules, and economic impacts.

This process should involve making many temporary features of the income tax permanent, including the 2001/2003 income tax rates. It would also involve permanently patching or repealing the Alternative Minimum Tax (AMT). The AMT is a particular administrative burden for small business organized as pass-thru entities because it both raises tax liability and disallows certain tax incentives that business may claim. For example, in the home building sector, businesses caught in the AMT may not be able to claim the new energy efficient home tax credit (section 45L). This complicates tax and business planning, as well as increasing the tax administrative burden on small firms.

NAHB believes that the 1986 Tax Reform Act should act as a guide for tax reform. The 1986 Act reduced rates while protecting long-standing provisions of the tax code. For home builders, homeowners, and prospective homebuyers, it is critical that the mortgage interest deduction (MID) not be curtailed or eliminated as part of a tax reform effort.

---

[2] http://eyeonhousing.wordpress.com/2011/06/22/the-facts-on-that-rumored-3-8-sales-tax-on-homes/

Weakening or eliminating the MID would hurt the housing market, just as signs are beginning to appear that the housing market is once again contributing to economic growth. Unfortunately, many tax reform plans would severely weaken the MID. Such changes would serve as a tax increase on the more than 30 million taxpayers who benefit from the MID, and who made home financing decisions based on long-standing tax rules. It would be unfair and economically destructive to make changes to the MID.

Additionally, tax reform plans that would reduce corporate tax rates and leave individual income tax rates the same would place small businesses at a competitive disadvantage to their larger peers. This would be harmful to the small business sector, which traditionally has been a robust source of job creation. Any reduction in corporate tax rates must be accompanied by similar reductions in rates for small businesses that pay income taxes through the individual side of the tax code.

Further, 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.

Tax Issues Concerning Business Debt

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. 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.

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. 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.

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 for such events occurring in 2009 and 2010. NAHB recommends that the committee examine extending this deferral to tax years after 2010 and making the deferral an exclusion. Absent such action, many small businesses will be forced to declare bankruptcy to avoid a tax bill that cannot be paid.

Tax Accounting Issues

Finally, for home builders, an important tax accounting rule 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 spillover 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 the home only once the home is sold, rather than during the construction period, which would require additional up-front financing.

Conclusion

Putting the federal government on a sustainable fiscal path is critical, especially for an interest-rate sensitive 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 taxes on certain businesses, like small businesses organized as pass-thru entities, in order to achieve other policy goals. Absent extension of expiring tax rules, most prominently the 2001/2003 tax cuts, many small businesses will be facing tax increases just as the economy is once again showing hopeful signs of growth.