

**Statement from the  
National Association of Home Builders**

**For the  
United States House Committee on Ways and Means  
Subcommittee on Select Revenue Measures  
and  
Subcommittee Income Security and Family Support**

**on**

**The Effects of Misclassifying Workers as Independent Contractors**

**May 8, 2007**

## **Introduction**

The 235,000 members of the National Association of Home Builders (NAHB) appreciate the opportunity to submit this statement for the House Ways and Means Committee, Subcommittee on Select Revenue Measures and Subcommittee on Income Security and Family Support regarding the effects of misclassifying workers as independent contractors. 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. At the same time, entrepreneurship only succeeds when all participants in the market play by the same rules and one entity cannot have an unfair advantage over others. NAHB supports enforcement of the current rules on the classification of workers, but would also support clarification of those rules to improve compliance across all industries.

This statement focuses on the economics surrounding the decision by home builders to contract with independent contractors as well as the motivations for employees to act as independent contractors. Further, it examines present law rules for the classification of workers and how they ensure a fair and equal marketplace for business. Finally, the statement identifies some potential enhancements to the current law that could improve compliance.

## **Economics of Independent Contracting**

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 contract 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 business begin operation as a self-employed independent trade worker.<sup>1</sup>

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.<sup>2</sup>

### **Present Law Rules**

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

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<sup>1</sup> 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.

<sup>2</sup> Builders' Economics Council Survey: Special Analysis. May 2005.

## **Policy Recommendations**

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 as they would be 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.

As a general principle, NAHB opposes tax proposals and policies that impose increased administrative burdens on businesses that play by the rules. For example, increasing information reporting requirements beyond present law rules would increase paperwork burdens on business, and small business in particular. Indeed, such small businesses are those firms that, due to the economics of utilizing specialists, rely on independent contractors the most and thus would shoulder the largest burden from increased paperwork requirements.

## **Conclusion**

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. NAHB looks forward to working with the Committee and the Congress to achieve both of these goals.