



STATE OF CALIFORNIA
FRANCHISE TAX BOARD
PO Box 1720
Rancho Cordova, CA 95741-1720
Telephone (916) 845-7266
FAX (916) 845-0140

STEVE WESTLY
Chair

JOHN CHIANG
Member

TOM CAMPBELL
Member

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Requested By: Marie Gott
Architecture and Data Management Bureau
Requested Date: 07/19/2005
TAM Author: Christine Roloff
Phone Number: (916) 845-7266
Fax Number: (916) 845-0140

SUBJECT: Reporting Real Estate Commissions

QUESTION(S) PRESENTED

1. Whether a listing broker has an obligation to file an information return for commissions paid to the buyer's broker.
2. Whether the listing broker and the buyer's broker have an obligation to file an information return for commissions paid to their agents.

CONCLUSION(S)

1. The listing broker is obligated to file information returns for commissions paid to the buyer's broker. General authority requiring information returns for payments to non-corporate recipients comes from Internal Revenue Code § 6041. But even if the recipient is a corporation or treated as a corporation, information returns are required under IRC § 6041A because the payment is for a "service rendered"
2. Brokers are obligated to report commissions paid to their own agents, under both IRC sections 6041 and 6041A. The escrow company is obligated to report only the gross proceeds of the sale, under IRC section 6045 and so is not required to report commissions paid to agents.

FACTS

A listing broker, through its listing agent, contracts with the owner of property (the seller), to sell real property located in California. The listing agreement is signed by both the seller and by the

listing agent who signs on behalf of the listing broker. The listing agreement is called an "Exclusive Right to Sell Listing Agreement" (ERSLA). An ERSLA is a commonly used agreement, pursuant to which the seller obligates herself to pay the listing broker a full commission regardless of who finds the buyer. The ERSLA authorizes the listing broker to compensate the cooperating broker who represents the buyer ("buyer's broker"). The buyer's broker provides services to the listing broker by formulating offers and counteroffers on behalf of the buyer, and by assisting the buyer and the listing broker with inspections and the completion of other legal requirements.

The seller authorizes the listing broker to submit the ERSLA to the escrow company as instructions to pay the listing broker the total commission. Typically, the seller also authorizes the listing broker to use a Multiple Listing Service (MLS) of the listing broker's choice. An MLS is a means by which authorized MLS participants make blanket unilateral contractual offers of compensation and cooperation to other broker participants. Even if a listing broker does not participate in a MLS, the custom and practice of the real estate industry is that a listing broker pays part of the commission to the buyer's broker.

The listing broker is the person making the payment of commission to the buyer's broker. The fact that the escrow company writes commission checks to a number of people does not change the fact that the listing broker is the payor. The escrow company is just assisting the listing broker in making his payments.

Both the listing broker and the buyer's broker have contracts with their agents, who are either employees or independent contractors, pursuant to which the brokers are obligated to share a portion of the commission with their agents. Therefore, the brokers are obligated by contract to make payments to their agents.

APPLICABLE LAW

IRC § 6041 requires payers of over \$600 in the course of a trade or business during a tax year to file information returns (generally IRS Forms in the 1099 series) reporting those payments in certain situations.

IRC § 6041A requires information returns for remuneration for services of \$600 or more.

IRC § 6045 requires brokers to file information returns showing gross proceeds of certain sales.

Treas. Reg. § 1.604-1 sets forth specific situations where information returns are required, including the general rule that information returns are required for all salaries, wages, fees, commissions and other forms of compensation for services (1099-MISC).

Treas. Reg. § 1.6041-3 provides exceptions for various payments, including payments made to a corporation. (§ 1.6041-3(p).)

Treas. Reg. § 1.6045-4 sets forth specific requirements for reporting real estate transactions (1099-S.)

ANALYSIS AND DISCUSSION

SELLER'S OBLIGATION

The seller is obligated to pay the listing broker. However, often the seller will not have a reporting obligation under Section 6041 for two reasons. First, the seller often is not selling the property and therefore making the payment as part of his "trade or business"; consequently, Section 6041 does not cover the payment. When the seller is selling the property and making the payment "in the course" of his trade or business, a reporting obligation will arise, so long as the payment is not to a corporation. Second, as explained more fully below, payments made to corporations are exempt from the reporting requirement unless they are payments for services rendered. Therefore, the seller generally does not have an information reporting requirement in this type of transaction.

LISTING BROKER'S OBLIGATION RE COMMISSIONS PAID TO BUYER'S BROKER

The listing broker is obligated, through the ERS LA, through the custom and practice of the industry, and sometimes also by his participation in an MLS service, to pay the buyer's broker. Real estate brokerages are engaged in the trade/business of acting on behalf of buyers and sellers of real estate, in order that sellers can sell, and buyers can buy, real property. The real estate agents, with the support of the brokerages, effectuate the sales. To the extent that the listing broker pays part of the commission to the buyer's broker, the listing broker is making the payment "in the course of its business".

Therefore, if the payee is not a corporation, the listing broker has an obligation to file an information return because the payment is being made in the course of a trade or business. Again, if the buyer's broker is a corporation, this section does not apply since payments to corporations are exempt from the reporting requirements of Section 6041. (Treas. Reg. § 1.6041-3(p)(1)).

However, IRC § 6041A requires information returns for remuneration for services of \$600 or more, and applies to corporations as well as to individuals.

In order for a reporting obligation to arise for the listing broker's payment to the buyer's broker under Section 6041A, the buyer's broker would have to be "performing a service" for the listing broker. The buyer's broker provides services by advising the buyer and by preparing offers and counteroffers on behalf of the buyer, as well as by recommending and lining up other businesses to prepare documents (e.g. title search) and conduct inspections. The rules of Sacramento's MLS, the MetroList, state "In filing a property with the MLS, the Broker Participant makes a blanket unilateral contractual offer of compensation to the other MLS Broker Participants *for their services in selling the property.*" However, the buyer's broker is providing services primarily to the buyer, which in turn, is helpful to the listing broker. Therefore, the listing broker has an obligation to report payments to the buyer's broker under Section 6041A.

BROKERS' PAYMENTS TO AGENTS

The broker has a relationship to his sales agents, either as employees or as independent contractors. For employees, the broker must issue W-2s. For independent contractors, the broker must file information returns under IRC §§ 6041 and 6041A.

The brokers are making payments of \$600 or more to the agents "in the course of their business" and the agents are not corporations, therefore, the brokers are obligated to report payments of commission to their agents, under Treas. Reg. § 1.6041-1¹.

The brokers' payments to their agents are also reportable under Section 6041A, since the agents are providing their services to their respective brokers. The agents meet with and assist the seller or buyer, explaining the process and the forms, showing the properties, formulating, presenting, and evaluating offers, analyzing the contingencies, and recommending inspectors and other businesses to assist in the sales process.

ESCROW COMPANY'S OBLIGATION

IRC § 6045 requires brokers to file information returns showing gross proceeds of certain sales. Treas. Reg. § 1.6045-4 sets forth specific requirements for reporting real estate transactions (1099-S.)

The "real estate reporting person" is obligated to file a return for real estate transactions except those involving "sales or exchanges of certain principal residences". The exemption arises when the sale price is \$250,000 or less for an individual or \$500,000 or less for a married couple and the seller(s) put in writing: (1) that the residence is a "principal residence" under 26 USC Section 121, (2) that there is federally subsidized mortgage financing assistance (only if the IRS requires this on its form), and (3) the gain from the sale or exchange is excludable from gross income under 26 USC Section 121. The "real estate reporting person" is usually the escrow company. The regulation provides a list of persons who can be the "real estate reporting person"². The regulations require only that the gross proceeds from the sale be reported. The term "gross proceeds" includes expenses and commissions.

Therefore, escrow agents are only required to report the gross sale proceeds of the transaction on an information return. They are not required to issue separate information returns for payments to agents or real estate brokers.

¹ Note that the escrow company may write separate checks to brokers and to their agents, but will usually not have a reporting obligation for real estate commissions because they do not "perform management or oversight functions in connection with the payment" nor do they have a "significant economic interest in the payment" under Treas. Reg. § 1.6041-1.

² "... real estate reporting person" means any of the following persons involved in a real estate transaction in the following order: (A) the person (including any attorney or title company) responsible for closing the transaction, (B) the mortgage lender, (C) the seller's broker, (D) the buyer's broker, (E) ..."

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Tax Counsel III