

*You can't avoid death or taxes.  
Or can you?*

# Can Real Estate Practitioners Avoid Taxable Income From Commission Rebates? They Can Now!

BY MARK LEE LEVINE

Most tax practitioners are well aware of a fundamental point in the tax law regarding taxable income. Under 26 U.S.C.A. §61(a), *gross income* is very broadly defined.<sup>1</sup> Because of this broad definition in the Internal Revenue Code, real estate practitioners must be concerned with the issue as to whether they have taxable income when they receive a commission and then rebate part of that commission to a buyer, seller or other broker involved in the transaction.

In most instances, real estate practitioners want to receive all of the commission in a transaction. However, to encourage additional business, especially in a slower market, many licensees have agreed in some circumstances to pay part





of the commission that was otherwise due to the broker to another party, often a buyer.<sup>2</sup>

When Congress wrote Code §61, the general idea was to include most activities within the definition of income and then to allow for deductions, exemptions, and other adjustments, before the actual tax rate was levied against the taxable amount. Because of this approach,

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Code §61(a) states: “Except as otherwise provided in this subtitle, gross income means all income from whatever source derived...” Thus, the simple use of the word *all* makes clear the intent of Congress in enacting Code §61. In fact, if that word were not sufficient to make most sources of revenue coming to a taxpayer taxable, Code §61(a) provides that all income includes income from whatever sources derived. This section goes on to state: “including (but not limited to) the following items: (1) compensation for services, including fees, commissions, fringe benefits and similar items...”<sup>3</sup> Thus, the language makes it apparent that

commissions are in fact income, and anything that is similar to commissions, such as other payments for services, advice, referral fees, and the like, would also be income. Code §61(a) further provides that gross income includes earnings derived from businesses, from dealings in property, interest, rents, royalties, dividends, and much more.

**This issue is relevant in the real estate field because taxpayers have been concerned as to whether there is income generated when a taxpaying broker receives a commission but distributes that commission to other parties, such as a buyer, seller, or other broker.**

As mentioned in my text, *Real Estate Transactions: Tax Planning*, the Internal Revenue Service (IRS) has successfully argued in a tax court case, *Patch v. CIR, T.C. Memo 1995-449*, that even monies received by a bank robber actually constituted taxable income to the bank robber! (The fact that the bank robber must surrender such monies that were not his did not change the outcome.)<sup>4</sup> This simple case illustrated the position that the IRS, interpreting what Congress wrote in Code §61, clearly intends

that *all* sources of monies, unless otherwise shown to be a specific exception, constitutes income.

This issue is relevant in the real estate field because taxpayers have been concerned as to whether there is income generated when a taxpaying broker receives a commission but distributes that commission to other parties, such as a buyer, seller, or other broker. The issue is: "Does the distributed commission amount constitute *income* to the taxpayer?"

It is worthwhile to note that in some instances, it might be assumed that receiving the total amount of *income* and paying it out, with the corresponding deduction, would result in no net difference to the taxpayer who received a gross amount. For example, if a taxpayer received \$100,000 and distributed that \$100,000, under contractual agreement, to others who were to share in that amount, the question would be whether the taxpayer must report the \$100,000; or, the taxpayer would report the net amount, such as paying \$40,000 to another person, netting only \$60,000 for the given taxpayer. This issue is very important where a full deduction is not allowed of the \$40,000 in the above-noted example. This issue is also very important for other purposes, such as computing the Alternative Minimum Tax (AMT), which is another form of tax calculation that applies to some taxpayers under federal income tax law.<sup>5</sup>

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then, is whether the part paid to another party allows the real estate practitioner to receive the whole commission, reduce the amount that is paid to a third party, and report the net amount, as noted above.

As many taxpayers know, the IRS often issues guidance, general or specific, for taxpayers on important issues. General guidance from the IRS may be issued in the form of a broad *Revenue Ruling or Revenue Procedure*. A specific guideline may come as a *Private Letter Ruling* (PLR).

On the specific question as to whether there was taxable income for real estate brokers who rebated part of their commissions to a seller or buyer, the IRS issued PLR 200721013.<sup>6</sup> This PLR noted a factual setting where the taxpayer, a broker, received a real estate commission. The broker signed an agreement to act as an agent for the buyer, which is referred to as *buyer's agency*.

In this agency agreement, the taxpayer/broker agreed to pay the purchaser/buyer a given amount of commission that was received from the seller. Apparently, there were

several transactions undertaken by this taxpayer/broker in this fashion. In some instances, the broker would receive the commission and write a check to the purchaser, consistent with the above-noted agreement. In other settings, the purchaser would receive a credit on the closing statement for an amount that would equate to the agreed-upon portion of commission that the taxpayer was to pay to the buyer. In any event, the buyer benefited by reducing the amount of cash needed at closing.

The first issue addressed by Private Letter Ruling 200721013 was to determine whether the payments were taxable income. The Ruling cited Code §61, which generally supports the position that almost any payment received is *gross income*, unless the taxpayer can show some authority to the contrary, such as receiving a gift, which is not income.<sup>7</sup>

The Ruling also cited Revenue Ruling 2006-27. That Revenue Ruling supported the position that when a nonprofit corporation provided down payments for purchasers who had low income, such payments did not constitute

income to the purchasers.<sup>8</sup>

The IRS cited another *Revenue Ruling*, showing that when the manufacturer of an automobile rebated monies to the purchaser of a car, such rebate was *not* counted as *taxable income*; rather, the rebate was considered as a reduction in the purchase price.<sup>9</sup> In looking to the authorities noted, the PLR concluded that the *payment* to the purchaser (taxpayer) was an *adjustment* to the purchase price. It reduced the purchase price; as such, it was not taxable income.

On the second issue addressed, the IRS looked to the question as to whether reporting (regarding tax return information) was required of the parties because of the transactions where the broker paid part of the commission to a buyer. That PLR cited 26 U.S.C.A. §6041, which requires taxpayers engaged in a trade or business to report such tax information and to file an information return with the Internal Revenue Service.<sup>10</sup> However, this Ruling concluded that Code §6041 does *not* require the reporting of the return information *if* what is received is not includable in *income*. The above

discussion noted that such amount received by the buyer was not income; therefore, the tax return information was not required to be filed under Code §6041.

This PLR 200721013 is good news to buyers and brokers. With a good deal of negative news recently reported regarding the residential marketplace, at least in this instance there was *no income* generated in the above-referenced scenario when a broker paid part of the commission to a buyer. There is the added benefit that the buyer is not required to file a separate information return under these circumstances.

Thus, in this limited setting, in some cases, a real estate broker can rest more comfortably knowing that the IRS supports the ability of a broker to pay part of the commission to a third party and to be taxed *only on the net amount* received by the broker. Of course, a PLR is only valid authority for the person that requested the Ruling. But, this *Ruling* does show the inclination of the IRS on this issue of taxable commissions.

## ENDNOTES

- <sup>1</sup> Internal Revenue Code, 26 U.S.C.A. §61 (1986).
- <sup>2</sup> Editor's note: The practice of commission rebating is increasingly common. Rebating to a party to the transaction is a lawful practice in many U.S. jurisdictions.
- <sup>3</sup> Internal Revenue Code, 26 U.S.C.A. §61 (1986).
- <sup>4</sup> Levine, M. L. (2007). Real estate transactions, tax planning. Eagan, MN: Thomson-West.
- <sup>5</sup> Author's note: A discussion of this issue is beyond the scope of this examination. However, for more detail on this topic, see the text cited earlier.
- <sup>6</sup> Internal Revenue Service. Private Letter Ruling 200721023-61.00-00: Gross income v. net gross income. (2007, May 25).
- <sup>7</sup> Internal Revenue Code, 26 U.S.C.A. §61 (1986).
- <sup>8</sup> Internal Revenue Service. Revenue ruling 2006-27, 2006-21 I.R.B. 915. (2006, May 22).
- <sup>9</sup> Internal Revenue Service. Revenue Ruling 76-96, 1976-1 C.B. 23, modified by Revenue Ruling 2005-28, 2005-1 C.B. 997. (2005, May 9). See also the authority in endnote 4, *supra*, text section 3.
- <sup>10</sup> Internal Revenue Code, 26 U.S.C.A. §6041 (1988).

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