President Donald J. Trump's Proposed Tax Reforms:

Real Estate Agents and Associate Brokers Could Benefit by Receiving Commissions Through "Pass-Through" Business Entities

By John Dolgetta, Esq.

On April 26, 2017, the President's long-awaited proposed changes to the Internal Revenue Service Tax Code appeared to be delivered in an anti-climactic manner, and appeared to be more of a policy statement than a detailed tax plan, when a one-page outline entitled *"2017 Tax Reform for Economic Growth and American Jobs"* was revealed to the press and to the American people. (*See* http://cnn.it/2u3QbZ9).

More particularly, the outline was announced and discussed in a press briefing led by the Secretary of the Treasury, Steve Mnuchin, and the Director of the National Economic Council, Gary Cohn. And, while it seems to lack specificity, if a particular provision therein contained nonetheless comes to pass after the text of a proposed bill goes through congressional scrutiny, it could mean significant tax savings for small businesses such as real estate brokerages and agents, as more particularly discussed below.

The proposed tax policy is part of President Trump's overall economic growth plan, and the real estate industry, along with the American people, still await more significant details. Secretary Mnuchin stated at the press conference that *"[t]he President's objective is creating economic growth. And as we've said before, we believe we can get back to 3 percent or higher GDP that is sustainable in this country. The overall economic plan consists of massive tax cuts and tax reform, regulatory relief, and renegotiating trade deals. And with that, we will unlock the economic growth that's been held back for too long in this country."* (*See* http://bit.ly/2p4Lqsu). While there are certain aspects of the tax plan that lack specificity, one clear element is that "pass-through" business entities would stand to benefit tremendously if a lower tax bracket of 15% is made to apply to such business entities.

What the Tax Plan Stands for and How it may Benefit Real Estate Agents in New York

Among the various topics covered by the tax reform, such as doubling the standard deduction and eliminating the estate tax, the two important takeaways from the outline presented by Secretary Mnuchin and Director Cohn that affect small business, including licensed real estate salespersons, associate brokers and brokers who are currently doing business as sole proprietorships, are (i) lower individual income tax rates; and (ii) lower business tax rates (which will likely include "*pass-through*" entities).

With regard to lower individual income tax rates, the proposal calls for reducing the number of tax brackets for individuals from currently seven brackets, which are taxed at the rates of 10%, 15%, 25%, 28%, 33%, 35% and 39.6%, to only three tax brackets, which would be set at 10%, 25% and 35%. (See: http://cnnmon.ie/2tdGrHg).

The Trump Tax Plan also proposes that the top tax rate for all businesses be reduced to 15%, from the current rate of 35% for corporations today. And, although many believe the 15% rate is more likely to settle in at 20% or 25%, it would still be a significant tax cut for businesses. Most importantly, this tax cut to 15% would mean a significant savings by owners and shareholders of "pass-through" businesses. (See: http://bit.ly/2u90tGQ). In a "pass-through" business (for tax purposes), such as partnerships, limited liability companies ("LLCs") and Subchapter S Corporations ("S-Corps"), the owners, members and shareholders of such entities report profits on their personal tax returns at their personal income tax rate levels and do not pay a corporate tax rate. This allows these entities, and individuals who own these companies, to avoid double taxation.

Most small businesses in America are "pass-through" entities, which allow small business owners to be taxed at their individual tax bracket rate, instead of the 35% flat corporate rate under today's tax code. Among these businesses are real estate brokerage firms. However, many agents and associate brokers are ***not*** set up as "pass-through" entities, but rather operate as independent contractors on an individual basis. Currently, "pass-through" business entities are a useful tool for those individuals who find themselves in a tax bracket with a rate less than 35%. A significant downfall, however, is that the highest tax rate of a "pass-through" entity could be as high as 39.6%, which is the top tax rate paid by individuals.

Essentially, the vast majority of real estate agents currently pay income tax at their personal tax rates, depending on which of the seven current tax brackets the individual falls into, and based on adjusted gross income after all deductions and expenses are taken into account. Whether or not they are set up as a sole proprietor, or a "pass-through" business entity, the personal tax rate still applies. However, if President Trump's tax plan comes into effect, then significant tax savings could be realized. If an agent's commission profits end up moving that individual into a tax bracket that is greater than the 15% tax rate threshold, they will benefit from being able to claim such commissions at 15% (provided they set up a "pass-through" entity to receive commissions), instead of paying a potentially much higher personal tax rate.

Secretary Mnuchin stated at the press conference of April 26, 2017 that *"Under the Trump plan, we will have a massive tax cut for businesses and massive tax reform and simplification. As the President said during the campaign, we will lower the business rate to 15 percent."* (*See* http://bit.ly/2p4Lqsu). Therefore, in summary, in order to take advantage of the proposed tax provision, a real estate salesperson or associate broker must clearly be set up as a "pass-through" business entity through which to be paid his or her commissions from the principal broker.

A Brief Primer on Popular "Pass-Through" Business Entities

The two most common vehicles used as "pass-through" business entities are the S-Corp and the LLC. Generally, a corporation is a separate legal entity created under State Law. A corporation has shareholders who are the owners of the stock interests in the corporation. The primary advantage of incorporating is "limited liability." An S-Corp is the same entity as any other corporation except that, as mentioned above, it is an entity which elects under the Internal

Revenue Code to be a "pass-through" entity in which the shareholders pay all taxes on the profits and are able to reflect on their personal tax returns any losses of the business enterprise. There is no double taxation. Other limited tax advantages may be that corporations are entitled to establish defined benefit pension plans. Furthermore, S-Corps can often divide income between salary and Subchapter S distributions. Salary is subject to payroll taxes, Subchapter S distributions are deemed to be dividends to which self-employment taxes and Medicare taxes do not apply.

LLCs enjoy the same type of limited liability enjoyed by corporate shareholders, and have been permitted under New York law since the early 1990's. Notwithstanding the fact that the entity has limited liability, the LLC is taxed as a "Partnership." Partnership income is deemed to pass-through to the partners for purposes of taxation, therefore, the members of a LLC pay all taxes on the profits and are able to reflect on their personal tax returns any losses of the business enterprise, as are shareholders of an S-Corp. While there are similarities to S-Corps, there are fewer restrictions on the formation of LLCs and much greater flexibility under the Partnership Tax Rules.

Setting up "Pass-Through" Business Entities for Tax Purposes is not a new Concept to Real Estate Salespersons and Associate Brokers

As mentioned above, in order to take advantage of President Trump's business tax proposal, a licensed real estate salesperson or associate broker must clearly have set up a "pass-through" business entity through which to be paid his or her commissions from the principal broker. The question of whether a real estate salesperson should incorporate or form a LLC in order to take advantage for tax purposes is not a new one.

Principal brokers have been legally able to pay a commission to a real estate salesperson or associate broker through business entities since 2004. In fact, on August 10, 2004, then Governor George Pataki signed into law certain provisions of Section 442 of the Real Property Law granting to real estate salespersons the right to receive and the right of the real estate broker to pay any part of a "…fee, commission or other compensation received by the broker to any person for any service, help or aid rendered…" to an "…unlicensed corporation or an unlicensed limited liability company if each of its shareholders or members, respectively, is associated as an individual with the broker as a duly licensed associate broker or sales[person]." (*See* http://on.ny.gov/2u470mE).

A "pass-through" business entity, whether an LLC or S-Corp, established by a salesperson or an associate broker cannot itself hold a real estate license. The license is held by the individual licensed real estate salesperson or associate broker, who can then request the principal broker or brokerage firm to designate his or her business entity as the recipient of commission income. Two important requirements set forth in the law must be met:

- The individual associate broker or salesperson must remain licensed to the brokerage firm; and

- The principal broker can make payment to a personally owned corporation or LLC owned by that salesperson or associate broker.

Planning for the Trump Tax Plan

Everyone's personal situation is different and the decision as whether to incorporate or set up a limited liability company should be made with the advice of a tax and/or corporate attorney and tax advisor. However, based on the recently proposed tax reforms, it may be advisable to revisit the question as to what the added advantage is to setting up a legal entity to receive one's commission. Indeed, if President Trump's tax plan goes into effect, even at least partially for purposes of the 15% flat business tax rate to "pass-through" business entities, it would certainly be a benefit worthy of further exploration.

At the press briefing of April 26, 2017, Director Cohn stated, in part, that *"[w]e have a once-in-a-generation opportunity to do something really big. President Trump has made tax reform a priority…because it's good for the American people. The President is going to seize this opportunity by leading the most significant tax reform legislation since 1986, and one of the biggest tax cuts in the American history."* (*See* http://bit.ly/2p4Lqsu). If this is the case, let us hope that it is for the best and that real estate professionals just might be able to reap some of its benefits by utilizing "pass-through" business entities.

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