



Staff Report

City of Manhattan Beach

TO: Honorable Mayor Ward and Members of the City Council

THROUGH: Richard Thompson, Interim City Manager

FROM: Bruce Moe, Finance Director
Robert V. Wadden, Jr., City Attorney
Steve Charelian, Revenue Services Manager

DATE: September 21, 2010

SUBJECT: Consideration of Collection of Existing Business License Tax on Real Estate Agents

RECOMMENDATION:

Staff recommends that City Council discuss and provide direction on the collection of the Business License Tax on Real Estate Agents.

FISCAL IMPLICATIONS:

Based on the City's current taxing structure, if the City were to license all real estate agents, staff estimates a minimum collection of approximately \$20,468 annually. The business license taxes are based on the real estate agent's calendar year gross receipts (commissions). The formula for the calculation is \$204.68 base tax for the first \$59,800 of gross receipts plus \$1.88 per \$1,000 in excess thereof (not to exceed \$7,923.00). The annual figure stated above is based on 100 agents paying a base tax of \$204.68.

BACKGROUND:

Earlier this year, staff determined, with a few exceptions, that real estate agents operating in Manhattan Beach were not licensed by the City (brokers are licensed). A letter noticing those agents of the need to comply with the City's tax laws was issued (see Attachment "A"). As a result of that notice, the South Bay Association of Realtors (SBAR) contacted the City Council and staff inquiring into the validity of the collection of the tax. Subsequently, the issue was discussed with the Finance Subcommittee at their July 6, 2010 meeting.

The Finance Subcommittee reviewed materials provided by the City Attorney (see attached memo) addressing the validity of the tax and our authority to collect it. After discussion, the Finance Subcommittee directed staff to collect the tax from the agents based upon their gross receipts (mainly from commissions), but to also modify the brokers' business license tax gross receipts lower to account for the funds used to pay commissions to the agents (the agents would then report those commissions themselves under their individual business licenses). After the Finance Subcommittee meeting direction was received, staff contacted SBAR to advise them of

the outcome. Further SBAR communications to Council and staff followed, asking for more information and consideration on the issue. As a result, the item has been placed on tonight's agenda.

DISCUSSION:

Currently, the City's business license tax applies to both real estate brokers (Shorewood, South Bay Brokers, etc.) and agents. However, the tax has not been uniformly collected from the agents. The City considers agents self employed independent contractors (not employees of the brokers). This determination is based on the following facts:

- Most agents do not receive salary and benefits from brokers. The brokers receive a commission from the sale of real property which they then share with the agents involved in the transaction
- Agents do not have an employer pay social security taxes for them or provide unemployment insurance or any other payroll tax. They are not considered employees for the purpose of State and Federal payroll taxes
- Brokers issue a 1099 year end tax form to the agents with regard to commission payments (not a W2 which indicates an employer-employee relationship). This is typically the sole compensation received by agents from brokers
- In some cases agents pay rent to the broker for their office space in the broker's office
- Brokers do not supervise the day to day activities of agents or provide them with tools or materials
- Agents pay self employment taxes and file quarterly tax returns with an I.R.S. schedule C with their annual tax return, just as any self employed individual would.

State law requires that the relationship between a broker and agent be established by contract (Business and Professions Code Section 10032(b).) The broker-agent relationship is specifically characterized as not being considered employment and not being subject to the requirement for employer-provided unemployment insurance (Unemployment Insurance Code Section 650.). The agents' position on this issue is that that relationship of being dependent upon the broker to effect sales means the agent can not enter into a transaction or conduct business without the broker. This makes them somewhat of a hybrid since they cannot act independently. Agents have also stated that they are covered under the brokers' workers compensation insurance – an arrangement that clearly would not be the case with independent contractors.

Staff conducted surveys of other cities, and the results of those responding indicates that most cities recognize Real Estate Agents as independent contractors and charge a business license tax in addition to that charged the broker:

City	Do you charge real estate agents separate from their broker?	Do you charge real estate agents on Gross Receipts?	Fee schedule notes
Beverly Hills	Yes	Yes	They charge a business license to both brokers and the agents that work as independent contractors.
El Segundo	→	N/A	<i>They charge each real estate office per head count not gross receipts. Each agent in the office is calculated in the business license tax.</i>
Hermosa Beach	→	N/A	<i>They charge each real estate office per head count not gross receipts. Each agent in the office is calculated in the business license tax.</i>
Huntington Beach	Yes	No	They consider real estate agents to be independent contractors and do require each individual to have a business license. They charge a flat tax.
Long Beach	Yes	Yes	They charge a business license for both brokers and the agents that work as independent contractors.
Los Angeles	Yes	Yes	They consider real estate agents and any persons receiving an IRS form 1099 to be independent contractors and do charge each individual agent to have a business license.
Newport Beach	Yes	Yes	They charge a business license for both brokers and the agents that work as independent contractors.
Redondo Beach	→	N/A	<i>They charge each real estate office per head count not gross receipts. Each agent in the office is calculated in the business license tax.</i>
Santa Barbara	Yes	No	They consider real estate agents to be a 1099 independent contractors and require each individual agent to have a business license. Each agent is charged a flat fee in addition to the fee that the
Torrance	Yes	No	They charge each individual agent and broker a flat fee.

In looking at other similar situations when reviewing this issue, the hair salon-stylist relationship seems most analogous to the real estate broker-agent relationship. The City does require the operator of a hair salon to be licensed, as well as the independent stylists who perform the work within the salon. The stylists are independent contractors who typically rent space from the salon owner.

Staff believes, and the City Attorney has concluded, that the current business license tax does apply to any Real Estate Agent who is an independent contractor and files their State and Federal tax returns as a self employed individual. It should be noted, however, that for many years the City has not collected this tax from Real Estate Agents. The City Council may wish to discuss this issue and determine if the City should pursue the collection of this tax, seek alternative methods of licensing the agents or exempt them as being covered under the license obtained by the broker for which the agent performs his or her services in the broker-agent relationship.

Attachments:

- A – Sample letter to Real Estate Agents
- B – City Attorney Opinion on Collection of Tax



City Hall 1400 Highland Avenue Manhattan Beach, CA 90266-4795
Telephone (310) 802-5000 FAX (310) 802-5001 TDD (310) 546-3501

April 12, 2010

[REDACTED]
[REDACTED]
[REDACTED]

Dear Business Owner:

Re: Notice of Non-Compliance

While we welcome your business to Manhattan Beach, it has come to our attention that you may be conducting business in the city without a business license.

Our records indicate you may be conducting business from one or more of the following sources:

- State Board of Equalization to obtain a Seller's Permit
- County Clerk of Los Angeles County to file a Fictitious Business Name Statement
- An inquiry or inspection of Non-Compliance

Pursuant to Manhattan Beach Municipal Code Section 6.01.020, "It shall be unlawful for any person to commence or conduct in the City any business...without first having procured a license from the City."

Please call or apply for the appropriate License within ten (10) days from the receipt of this letter. The City of Manhattan Beach City Hall is open Monday – Friday 8am to 5pm.

Not responding to this notice of non-compliance can result in a violation of the City's Municipal Code. If you have any questions, please feel free to contact the Business License Division at (310) 802-5557. Thank you.

Sincerely,

City of Manhattan Beach
Licensing Division

cc: Code Enforcement

Fire Department Address: 400 15th St., Manhattan Beach, CA 90266 FAX (310) 802-5201
Police Department Address: 420 15th St., Manhattan Beach, CA 90266 FAX (310) 802-5101
Public Works Department Address: 3621 Bell Avenue, Manhattan Beach, CA 90266 FAX (310) 802-5301
Visit the City of Manhattan Beach Web Site at www.cityymb.info

**CITY OF MANHATTAN BEACH
MEMORANDUM
CONFIDENTIAL ATTORNEY/CLIENT PRIVILEGE**

TO: Bruce Moe, Finance Director, Steve Charelian, Revenue Services
Manager

FROM: Robert V. Wadden Jr., City Attorney

DATE: April 22, 2010

SUBJECT: Imposition of City Business License Tax on Real Estate Agents

I. Introduction

Presently the city's business license tax is imposed on real estate brokers but not on real estate agents affiliated with those brokers. In most cases agents are independent contractors who are technically self-employed. Most agents do not receive salary and benefits from brokers and are not considered employees for purposes of State and Federal payroll taxes or unemployment insurance. Brokers receive a commission from the sale of real property which they share with the agent involved in the transaction. Brokers submit a 1099 to the IRS with regard to such payments. This is the sole compensation received by agents from brokers. In some cases agents may even pay rent on the office space they use in the broker's office. Presumably, however, brokers declare the entire sums they receive in commissions (before paying the share to agents) as gross receipts for purposes of the City's business license tax.

II. Issues

- a.) Are real estate agents conducting business for purposes of being subject to the City business license tax?
 - b.) Would the current scope of the business license tax apply to real estate agents without need for amendment?
 - c.) Does the State real estate license requirement preempt a local business license requirement?
 - d.) Would taxing the proceeds of commissions received by real estate agents be considered illegal double taxation since the entire commission has already been taxed pursuant to the gross receipts tax on real estate brokers?
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III. Brief Answers

- a.) Yes, it is clear that for all tax purposes real estate agents are not employees and would be considered as in business for themselves as separate taxable entities.
- b.) Yes, Manhattan Beach Municipal Code Section 6.01.010 contains extremely broad definitions of “business” and “engaged in business” which would clearly encompass selling real estate. Section 6.01.020 imposes the license tax on any entity or person doing business in the City.
- c.) No, while it is true that the State real estate licensing scheme is regulatory in nature and would clearly preempt any local regulatory ordinance, the Manhattan Beach business license ordinance is not regulatory but simply a tax and would not be preempted by State law.
- d.) No, while Article XIII Section 1 of the California constitution prohibits double taxation it is only with regard to taxes on property. Case law clearly permits double taxation with regard to other types of taxes.

IV. Analysis

a.) Independent Contractor Real Estate Agents Are Not Employees.

Most real estate agents are not treated as employees for any purpose. They do not receive salaries or benefits, they do not have an employer pay social security taxes for them or provide unemployment insurance or any other payroll tax. In fact the only time most agents receive money from a broker with whom they are affiliated is when there is a real property sale involving a commission. In some cases agents pay brokers for the privilege of using office space. Brokers do not supervise the day to day activities of agents or provide them with tools or materials. When brokers do pay agents they file 1099 forms with the IRS reporting the payment as if it were a payment to an independent entity. In fact, typically agents have almost none of the usual characteristics of employees and function clearly as independent contractors paying self employment taxes and filing quarterly tax returns and a schedule C with their annual tax return just as any self employed individual would. State law requires that the relationship between a broker and agent be established by contract. (Business and Professions Code Section 10032(b).) The broker agent relationship is specifically characterized as not being considered employment and not being subject to the requirement for employer provided unemployment insurance. (Unemployment Insurance Code Section 650.)

A Franchise Tax Board Publication, *Franchise Tax Board – Sole Proprietorships*, defines a “sole proprietorship” as an unincorporated business that is owned by one person with income expenses of the business reported on the personal income tax return. As

employees agents would not be subject to a City business license requirement. However, as sole proprietors they would be.

Business and Professions Code Section 16300 clarifies that a city may rely on the tax filing status of an individual (i.e. as an employee or sole proprietor) in determining whether or not to impose a local license tax.

b.) The Manhattan Beach Business License Ordinance Imposes A Tax on All Businesses Operating In The City.

As currently written Manhattan Beach Municipal Code Section 6.01.020 provides “It shall be unlawful for any person to commence or conduct in the City any business activity of any kind without first having procured a license from the City.” The term “business” is defined as including “. . .any type of commerce, business, trade, calling, vocation, profession, exhibition, show, enterprise, provision of service, activity and occupation, including, for example but not limited to, the sale of goods, contracting for labor, renting or leasing commercial real property, manufacturing, maintaining or repairing any goods or premises, provision of entertainment or refreshment or any other service or activity for which remuneration is provided whether or not carried on for profit.” (Manhattan Beach Municipal Code Section 6.01.010B.)

Given this language it would appear that real estate agents operating as sole proprietors have always been subject to the imposition of the license tax whether or not it has ever actually been collected.

c.) Preemption.

Generally when the State fully occupies an area of law any local attempt at regulation within that area is preempted by the State regulatory scheme. Since real estate agents are subject to a State licensing requirement how can the City impose its own license requirement? “. . .state preemption does not preclude city from taxing state licensed businesses which are carried on within its boundaries and enforcing such taxes by requiring business licenses for revenue and by criminal penalties, revenue provisions of this nature cannot be upheld if they are an inseparable part of a regulatory scheme excluded by state law.” (*Verner, Hilby and Dunn v City of Monte Sereno* (1966) 245 Cal.App.2nd 29, 33.) Thus, if the licensing requirement is for revenue purposes only with no regulatory element there would be no preemption. In addition, of course, Business and Professions Code 16300 specifically contemplates imposition of local business licenses on real estate agents.

d.) Double Taxation.

Article XIII Section 2 of the State Constitution prohibits double taxation of property. However the courts have consistently ruled that “[c]umulative taxes are not necessarily unconstitutional on the ground of double taxation . . .” (*Redwood Theatres v. City of Modesto* (1948) 86 Cal.App.2nd 907, 920; *Pesola v. City of Los Angeles* (1975) 54 Cal.App.3rd 479, 486.) “Taxation, other than of property, upon the same activity or incident for the same purpose by the same taxing agency, more than once in the same period, sometimes called double taxation, standing alone, is not forbidden by the Constitutions, state or federal.” (*Fox etc. Corp. v. City of Bakersfield* (1950) 36 Cal.2nd 136, 140-141.)

Thus, the fact that the gross commission revenue from a particular transaction might be subject to taxation twice (at the broker and then the agent level) would not invalidate imposition of the tax on real estate agents.

V. Recommendations

From a strictly legal point of view it is clear that the City’s current business license tax applies to any real estate agent who is an independent contractor and files their state and federal tax returns as a self employed individual (in cases where an agent is actually employed by a broker, receives a salary and reports it as earned income and not self-employment income the City’s tax would not apply). State law expressly acknowledges this and neither preemption nor double taxation issues appear to present legitimate objections to imposition of the tax.

It should be noted, however, that for many years the City has never collected this tax and, if the city chooses to pursue future collection, it might be prudent to allow an orientation or adjustment period to taxpayers with fair warning of its impending collection and the City’s rationale for imposing it. Nothing, of course, obligates the City to pursue collection of this tax even though to do so would be legally permissible. Issues of practicality and fairness may be reasonably considered in crafting a policy regarding imposition and interpretation of the City’s business license code.

cc: Richard Thompson, Interim City Manager