IRS Gets "Bageled" in Tax Court Over Family Office Expenses

By: Farhad Aghdami

09.28.2018

A recent case, *Lender Management LLC v. Commissioner of Internal Revenue*, T.C. Memo. 2017-246, has created a window of opportunity for family offices to restructure their affairs and potentially deduct certain family office expenses pursuant to Section 162 of the Internal Revenue Code (the ?Code?). The Tax Court determined that the family office of Harry Lender, the founder of Lender?s Bagels, was carrying on a trade or business because it engaged in activities ?far beyond those of an investor.? As a result, the family office, Lender Management, LLC (?Lender Management?), a partnership for tax purposes, could deduct its investment expenses under Section 162 of the Code, rather than as miscellaneous itemized deductions under Section 212. This distinction allowed its members to deduct investment management expenses in their entirety without regard to the floors and limitations that applied to miscellaneous itemized deductions. This decision is particularly notable because it affirms the ability of a family office to be respected as a trade or business for federal income tax purposes?an ability that is particularly important under the new tax reform legislation.

A family office is an organization that oversees the management and administration of a family?s affairs. Every family office is different and reflects the needs and preferences of a particular family. A family office can create economies of scale for a family, reduce the cost of services, open investment opportunities, help guarantee privacy, and allow for greater family control over service providers. Family office entities are often structured as partnerships, limited liability companies (?LLCs?), or as corporations (either ?C? or ?S? corporations). The entity is frequently owned by the family member who has generated the wealth in the family, although this is not always the case. The family office may have one or more employees who oversee the operations of the entity and coordinate the services being provided to the family, including the services of outside advisors such as investment advisors, lawyers, accountants, bankers, trust officers, and insurance advisors.

Typically, the family member who has generated the wealth in the family funds the family office expenses out of pocket through annual capital contributions to the entity. These capital contributions cover the expenses associated with the family office employees and related costs, such as office expenses. In some cases, as discussed below, the family office will receive a profits interest or carried

interest in the investments that it manages and is allocated a portion of the return it achieves on behalf of the family.

Prior to 2018, expenses for the production of income, such as investment management expenses, and tax-related expenses, such as tax preparation costs, were deductible as miscellaneous itemized deductions under Section 212 of the Code. These expenses were subject to a 2% floor and could only be deducted if they exceeded 2% of adjusted gross income. Section 212 expenses could not be deducted when computing any alternative minimum tax (?AMT?) due. However, under the 2017 Federal Tax Act, the Section 212 deduction is eliminated through year 2025. As a result, investment expenses and expenses for the production of income under Section 212 will not be deductible at all from 2018 through 2025.

In *Lender Management*, however, the U.S. Tax Court ruled that Lender Management, a family office, was ?carrying on a trade or business? as an investment manager rather than serving as a passive investor, and therefore was entitled to deduct expenses under Section 162 as opposed to Section 212. This meant that family office expenses could be deducted against income earned and allocated to Lender Management. This is especially important in 2018, since the Section 212 deduction is no longer available.

Some background factual information is helpful in discerning the Tax Court?s reasoning in this case. Lender Management was owned by two trusts established by Harry Lender?s son, Marvin, and Marvin?s son, Keith. Lender Management provided investment management services to three family investment limited liability companies (the ?Investment LLCs?). The Investment LLCs were established to provide for greater diversification and more flexible asset allocation, with one Investment LLC for private equity investments, another for hedge funds, and the third for public equities.

Marvin Lender, through Lender Management, initially served as the Manager of the Investment LLCs through 2010 and was succeeded by Keith. Ownership of the Investment LLCs was spread broadly among three branches of the Lender family. Keith spent significant time researching and pursuing new investment opportunities, such as private equity and hedge fund proposals, and monitoring and managing existing positions. In addition, he spent significant time meeting with the other owners of the Investment LLCs to report on the performance of their investments and to understand their cash flow needs and risk tolerances for investments. Lender Management also managed revolving lines of credit for the Investment LLCs and had employees and external consultants.

Lender Management received a profits interest in each Investment LLC that generally provided for allocations based on (i) a percentage of net asset value, plus a percentage of any increase in net asset value, (ii) a percentage of gross receipts, plus a percentage of any increase in net asset value, and (iii) a percentage of net asset value, plus a percentage of net trading profits (in each case, only to the extent the Investment LLC generated profits). To the extent that the Investment LLCs employed outside investment advisors, the investment management fees were not charged to the Investment LLCs, but billed separately to Lender Management.

The IRS argued that an individual?s management of his or her own investments is never considered a trade or business, because that individual will not earn anything other than his or her own investment

return. As a consequence, the IRS argued that the family office expenses were non-deductible under Section 162.

Lender Management, however, argued that it was engaged in an active trade or business, asserting that it aggregated the management of multiple individuals? investments through the family office and received, in return, compensation other than the normal investor?s return.

The Tax Court stated that the following three requirements must be present for purposes of determining whether a trade or business exists: (i) the taxpayer must undertake the activity intending to make a profit; (ii) the taxpayer must be regularly engaged and actively involved in the activity; and (iii) the taxpayer?s business operations must have actually commenced.

The Tax Court considered whether the investment management services provided by Lender Management could be treated as a trade or business instead of investment activities and reasoned that services provided by Lender Management were ?comparable to the services hedge fund managers provide,? going ?far beyond those of an investor.? The Tax Court further noted that Lender Management was entitled to a profits interest as compensation for its services to the Investment LLCs and could receive compensation separate from, and in addition to, the amounts received with respect to its capital interests in the Investment LLCs. In this regard, the Investment LLCs were owned 91.74% and 99.6% by family members that had no interest in Lender Management. As a result, the Tax Court found that Lender Management was providing investment management services to persons other than itself.

In addition, the Tax Court found it significant that the success-based fee paid to Lender Management did not equal the percentage ownership interests that the respective owners of Lender Management had in the underlying Investment LLCs. This fact meant that the fee paid to Lender Management represented something other than a normal investor?s return on the Investment LLCs? performance.

The Tax Court acknowledged that a familial relationship existed between the owners of Lender Management and the remaining owners of the Investment LLCs and, thus, that the transactions would be subject to heightened scrutiny. The court found, however, that Lender Management satisfied the demands of such scrutiny. In particular, Lender Management?s investment decisions and related activities were driven by the individual needs of the other owners of the Investment LLCs, which often conflicted with the needs of the owners of Lender Management. For example, the investors in the Investment LLCs were able to withdraw their investments if they became dissatisfied with Lender Management?s investment services.

In addition, the Tax Court stressed that most of the family members did not have an ownership interest in Lender Management, and distinguished the *Lender Management* case from the Supreme Court case of *Higgins v. Commissioner*, 312 U.S. 212 (1941), in which Higgins ?merely kept records and collected interest and dividends from his securities, through managerial attention for his investments.?

Not every family office will be able to (or will want to) structure its affairs to take advantage of the planning opportunities offered by *Lender Management*. However, in those cases where a family office is serving multiple families or family entities, it may be possible to restructure the investment

management function to satisfy the rather high hurdles established by the Tax Court and to deduct investment management expenses as an ordinary and necessary business expense.

Related People

- Farhad Aghdami ? 804.420.6440 ? aghdami@williamsmullen.com

Related Services

- Tax Law
- Private Client & Fiduciary Services
- Business Succession Planning
- Wealth Transfer Planning
- Tax Controversy