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Distinguishing Investment and Business Expenses - Family Office Structuring After *Lender*

Structuring a family's investment activities can be complex. Across assets, activities, relationships and the particular circumstances of each family member-investor, a family office will typically provide a spectrum of services. While the role of the family office is, in part, to substitute the range of independent advisors needed, structuring a family office in a tax-efficient manner can be difficult due to the limitations that the tax law places on related persons and managing one's own investments. One such limitation has been the inability to deduct trade or business expenses related to the family office. However, recent court cases offer new guidance to family offices that may entitle taxpayers to a deduction for trade or business expenses if the family office is structured properly.

Background

Lender Management, LLC v. Commissioner of Internal Revenue, T.C. Memo. 2017-246 (2017), provides family offices with a potential way to obtain trade or business expense deductions under Internal Revenue Code (the "Code") Section 162 in connection with rendering investment management services.

Prior to tax reform legislation enacted in December of 2017 (the "2017 Tax Act"), Code Section 212 allowed taxpayers to deduct expenses incurred for the production or collection of income, to the extent such expenses exceeded 2% of the taxpayer's adjusted gross income. The 2017 Tax Act suspended miscellaneous itemized deductions under Code Section 212 from 2018 through 2025.

Code Section 162, on the other hand, has not been suspended. Section 162 allows a taxpayer to claim as a deduction all of the ordinary and necessary expenses paid or incurred by the taxpayer during the taxable year in carrying on a "trade or business." For example, payment of salaries and other compensation is deductible as a trade or business expense. However, it has long been held that an investor is not, by virtue of activities undertaken to manage and monitor his or her *own* investments, engaged in a trade or business.

Therefore, given the suspension of deductions under Section 212, it would be beneficial for the owners of income-producing activities if those activities were treated as a trade or business expense for tax purposes rather than as an investment activity engaged in for the production and collection of income.

***Lender* Facts**

A recent case that many taxpayers and practitioners have been relying on to work around the suspension of Code Section 212 is *Lender Management, LLC v. Commissioner*. The Lender case involved a family business consisting of multiple LLCs. Every LLC at issue in Lender was co-owned, whether individually or through an entity, by the child, grandchild or great-grandchild of the family patriarch, or by the spouse of one of those people. Lender Management, LLC ("Management LLC") directed the investment and management of assets owned by three investment LLCs, each of which were owned by Lender family members. Management LLC was also owned indirectly by two Lender family members. Management LLC owned only a minority interest in the investment LLCs.

The operating agreements of the investment LLCs provided Management LLC with a profits interest as compensation for its services to the extent that it successfully managed its clients' investments. While Management LLC was owned by, and provided services to, Lender family members, it also held itself out as an active management entity to various governmental authorities, clients, investment banks, hedge funds and private equity funds. While each investor in the investment LLCs was in some way a member of the Lender family, Management LLC's clients did not act collectively. The Tax Court noted that they were geographically dispersed, and some of them were even in conflict with each other. Thus, it did not simply make investments on behalf of the Lender family group. It provided investment advisory services and managed investments for each of its clients individually, regardless of the clients' relationship to each other.

The Tax Court found that Management LLC was engaged in a trade or business for purposes of the deduction under Code Section 162. The Tax Court focused its attention on the activities of Management LLC and the family relationship among the investors. While family relationships are generally subject to heightened scrutiny, Lender Management's activities and the positive facts in this case satisfied the Tax Court and the deduction under Section 162 was allowed.

Hellmann

About a year after the *Lender* decision, the Hellmann family petitioned the Tax Court for a similar issue. However, the Hellmann family had less favorable facts.

The Hellmanns were a group of family members who owned and operated GF Family Management, LLC ("GFM"). Like *Lender*, the issue raised in *Hellmann* was whether GFM was engaged in a trade or business within the meaning of Section 162, which would entitle it to claim ordinary business expense deductions for its operating costs. The IRS, as it did in Lender, argued that GFM was not engaged in a trade or business.

The *Hellmann* case eventually settled without a ruling, so it cannot be certain how the Court would have ruled. Prior to settlement, however, the Tax Court issued an order outlining some of its preliminary thoughts, which highlighted the differences between Hellmann and Lender:

- There were four Hellmann family members related to the court case; they all resided in the same city, had a good relationship, and the family office made investment decisions for the group as a whole. While the Lender family members, on the other hand, were geographically dispersed, in some cases did not get along or did not know each other at all, and the family office made decisions for each family member separately.

- The Hellman family members owned 99% of the relevant investment partnerships, and each of the four family members held a 25% interest in the family office. In contrast, the Lender family office did not own a significant portion of the LLCs it managed, and most of the family members who invested in the LLCs did not have an ownership interest in the family office.

Concluding Thoughts

While the *Lender* case does provide a helpful look at what the Tax Court views as a valid trade or business for purposes of deducting expenses under Code Section 162, it is important to keep in mind that the facts are key. The structure in *Lender* may not be the typical family office structure, but for clients with the appropriate expertise and family structure, *Lender* potentially provides an avenue for deducting family office expenses under Section 162.

Each family office attempting to deduct expenses under Section 162 should analyze its unique circumstances in connection with these cases. This article was authored by Jessica Wilson. If you are interested in establishing a family office, restructuring an existing family office to fit within this guidance, or would like to learn more about ways to maximize value to your family, please contact Jessica Wilson at jwilson@coblentzlaw.com or James Mitchell at jmitchell@coblentzlaw.com.

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