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New Tax Case Provides Guidance on Deductions for Fees Incurred by Family Offices

By Mark Leeds[1]

It is said that every culture has a variant on the adage, “Rags to rags in three generations.” Whether wealth is new or old, however, affluent families understand that avoiding this fate means that successfully managing investments is as important as the initial wealth creation. For this reason, many families create and staff family offices whose mission it is to invest and manage family capital. A recent case, *Lender Management, LLC v. Comm’r*, left the US Internal Revenue Service (“IRS”) with the hole in the bagel after it challenged a family office’s position that the costs of running the office were deductible for federal income tax purposes. This Legal Update explores the implications of that case for family office managers.

Background

The US Tax Code has always drawn a distinction between expenses incurred in connection with a trade or business, which are generally deductible, and investment expenses. Prior to a 1942 legislative change,[2] the US Tax Code did not permit a deduction for investment investments. In that year, Congress amended the Tax Code to provide that investment expenses were deductible as either expenses for the production or collection of income or for the management, conservation or maintenance of property held for the production of income.[3] Even when such expenses were available as a deduction, in recent years, the deduction was limited by the rules applicable to miscellaneous itemized deductions.[4] In many cases, these limitations resulted in virtual prohibitions on the ability of taxpayers to claim advantage of such deductions. In addition, net operating loss (“NOL”) carryovers can only arise from trade or business activities.[5]

In December 2017, Congress passed and President Trump signed into law, the “Tax Cuts and Jobs Act” (the “Tax Act”).[6] Section 11045 of the Tax Act suspends the rules that permitted deductions for expenses incurred for the production of income (as well as for other miscellaneous itemized deductions) for 2018 through 2025. Accordingly, for 2018 and the next seven years (at least), the Tax Code once again denies deductions for investment expenses. Accordingly, the distinction between business expenses and investment expenses has assumed an even more important significance.

The case that started it all was *Higgins v. Comm’r*, 312 US 212, 218 (1941). In that case, the taxpayer managed his own investments, with the assistance of what would now be known as a family office, before the Tax Code permitted a deduction for expenses incurred for the production of income. The taxpayer incurred significant family office expenses in managing his investments. These expenses included rent, salaries and other expenses. The management of the investment portfolio did not constitute the

conduct of a trade or business. The taxpayer, however, sought to deduct the family office expenses as ordinary and necessary business expenses. The Court disallowed deductions for salaries and other expenses incurred in hiring others to assist him in offices rented for the purpose of overseeing his extensive investments because his activities – including keeping records and collecting interest and dividends from his securities –were not connected to the conduct of a trade or business. The fact that the taxpayer maintained the family office did not convert the activities into a trade or business.

Courts have generally employed the same analysis for determining the existence of a trade or business under the various Code sections in which the term appears. Cases arising in the foreign context have been cited with approval in cases arising in various domestic contexts, and *vice versa*. *Liang v. Commissioner*, 23 T.C. 1040 (1955), acq. 1955-1 C.B. 4, which involves whether investment activities attributable to a foreign investor constituted a trade or business, for example, cites *Higgins*. Also, Liang has been cited for support in a number of cases determining the existence of a trade or business for domestic tax purposes.[7] *Whipple v. Comm'r*, 373 US 193 (1963) held that an investor was not in a trade or business for the purpose of claiming a bad debt deduction because his activities were limited to overseeing his own investments.[8]

In *Neill v. Comm'r*, 46 B.T.A. 197, 198 (1942), a nonresident alien whose only US source income was rents paid on a net lease (*i.e.*, the lessee was obligated under the lease to pay taxes and insurance and to maintain the property) was held not to be engaged in the conduct of a US trade or business by virtue of the net lease. The lease was monitored by an agent who also collected rent and disbursed interest payments on a loan securing the property. The court, relying on *Higgins*, *supra*, held that since there was no US trade or business, the taxpayer was not entitled to deductions for interest and expenses incurred in connection with her ownership of the building. The fact that she maintained an agent in the US did not cause the taxpayer to be considered to be engaged in the conduct of a US trade or business.

In *Scottish American Investment Co., Ltd.*, 12 T.C. 49 (1949), a foreign taxpayer was engaged in the business of investing funds in securities where a substantial portion of its investment activity took place within the United States. Specifically, an employee was located in the United States and office space was rented. The US office maintained records and kept a general ledger, collected dividends, prepared and sent reports to the home office, voted certain proxies and performed extensive clerical and routine services for the taxpayer. All business decisions relating to the purchase and sale of securities were made outside of the United States and all such purchases and sales were handled by US resident brokers with confirmations being sent to the US office. The activities of the taxpayer rose above the investment activities considered in *Higgins* and *Neill*, *supra*. Nonetheless, the activities of the US office did not cause the taxpayers to be considered to be engaged in a US trade or business because "the US office functioned primarily as a clerical department performing a number of useful routine and incidental services for [the taxpayer]."[9]

Linen Thread Co. involved a foreign corporation engaged in the sale of manufactured goods.[10] The Tax Court held that delivery of goods, handling of paperwork, and collection of payment by the US office did not rise to the level of a trade or business, since all the pivotal profit-generating activity—i.e., sale of manufactured goods—was conducted abroad. The US office did not solicit or otherwise participate in arrangement of the associated sales. Similarly, in *Spermacet Whaling and Shipping Co. v. Comr*., the Tax Court held that receiving monthly statements and correspondence and making certain payments were "ministerial and clerical in nature" and involved little exercise of the

discretion or business judgment "necessary to the production of the income in question."[11] The fact that board meetings were held in the United States was of "no particular consequence," since all management activities were conducted from abroad.[12]

In *Moller v. United States*, 721 F.2d 810 (1983), the taxpayers managed their investments through two home offices. They devoted their full time to their investment activities, kept regular office hours and monitored the stock market on a daily basis. The taxpayers incurred significant expenses including the expenses attributable to maintaining the two home offices. The court denied business expense deductions claimed by the taxpayers for expenses associated with their home offices because their activities – including keeping regular office hours, maintaining a list of all stock they considered as potential purchase, keeping detailed records and subscribing to financial publications – were not connected to the conduct of a trade or business. The court found the fact that their profits were not derived from the direct management of purchasing and selling was indicative of investment activity. The taxpayers were primarily interested in long-term growth potential and the receipt of interest and dividends.

In *Frick v. Comm'r*, 56 T.C. 1368 (1989), the taxpayer derived his income from a wide range of personal investments and sought to deduct various expenses related to his investments. The court, relying on *Higgins*, *supra*, held that the taxpayer's keeping of records and collecting of investment do not constitute carrying on of a trade or business. Therefore, the court disallowed business expenses with respect to an automobile and home office. The fact that the taxpayer maintained the home did not convert the activities into a trade or business.

The Lender Management Case

The *Lender Management* case involved the Lender family. The family patriarch (Harry) was the founder and operator of a food manufacturer and distributor known as Lender's Bagels. Harry's two sons, Murray and Marvin, worked in the family business. Marvin had three children and four grandchildren. Murray also had three children but had six grandchildren.

Lender Management ("Management") was formed in 1992 and was taxable as a partnership. It maintained offices in New Jersey. The Marvin Lender Trust owned 99 percent of Management and the Helene Lender Trust owned 1 percent of Management. Marvin, acting through the trust, acted as the managing member of Management. In 2011 and 2012, as a result of assignments of the interests in Management, the Keith Lender Trust owned 99 percent of Management and the Marvin Lender Trust held the remaining 1 percent. In 2010 and 2011, Management incurred net losses, and in 2012 and 2013, Management earned net income.

The Management operating agreement provided that its business included managing the Lender Family Office and providing management services to the Lender family and "other third-party nonfamily members." (It did not appear, however, that investment advisory services were provided to non-family members.) It had five employees and paid over $300,000 in payroll in each year. Keith Lender, a hard-working MBA with an Ivy League education and family member, served as the chief investment officer of Management. He reviewed over 150 hedge fund and private equity offerings each year. A substantial portion of the compensation paid in 2011 and 2012 was paid to Keith Lender. Management hired a non-family member to serve as its chief financial officer. She managed borrowings and the cash positions of the family. Management also hired other third-party professionals to recommend and evaluate investment opportunities.

Management provided management services to three limited liability companies taxable as partnerships (the "Investment LLCs") that had been formed in 2005. The owners of the Investment LLCs were the Lender family

members at the Marvin and Murray level and below. The Investment LLCs had been formed to accommodate asset diversification and flexible allocations among family members. One Investment LLC invested in private equity, a second in hedge funds and the third in public equities. The family members held interests in the Investment LLCs in different proportions. Marvin and Keith (the beneficiaries of the trusts with their names and the owners of Management) also held minority interests in the Investment LLCs. No family member was required to keep his or her assets in two of the three Investment LLCs. One LLC required the consent of Management to withdraw.

Management received a straight fee for managing the private equity Investment LLC. It received a carried interest for managing the hedge fund and public equities Investment LLCs, but did not receive fees from these entities. It held annual meetings with its clients, that is, the members of the extended Lender family, to discuss strategy and performance.

For US federal income tax purposes, Management consistently reported itself as being engaged in the conduct of a trade or business. It treated all of its expenses as deductible trade or business expenses. The IRS challenged this treatment of the expenses. The IRS asserted that Management's expenses were expenses incurred for the production of income and, accordingly, were subject to the limitations applicable to such expenses.

The court first focused on the fact that Management earned fee income: "If the taxpayer receives not just a return on his or her own investment but compensation attributable to his or her services provided to others, then the fact tends to show that he or she is in a trade or business." The court held that the fact that taxpayer may invest with those he or she serves does not distract from the fact that trade or business activity is supported by the receipt of compensation.

The court then undertook a detailed study of whether Management's activities constituted trade or business activities. In support of the conclusion that it did, the court cited to the following facts:

1. Management had full-time employees;
2. It provided investment advisory and financial planning services for the Investment LLCs;
3. The CFO oversaw financial accounting, cash management and negotiated lines of credit;
4. Management's services were comparable to the services provided by hedge fund managers; and
5. Management received the carried interests or fees as compensation for services (the court did not find any negative inference from the fact that Management did not receive fees from two of the three Investment LLCs).

The court held that these facts were sufficient to support the conclusion that Management was engaged in the conduct of a trade or business. The court distinguished these facts from the cases discussed above in which the activities were limited to oversight and general accounting functions.

The court separately considered the fact that Management was owned by certain members of the same family that were the clients of Management. The court explicitly held that Management would be evaluated as an entity and not as an aggregate of its partners.[13] It is interesting to note that, in another audit, the IRS itself reached the exact same conclusion on the issue of whether the existence of a trade or business should be determined at the partnership or partner level, albeit in another context.[14] (US tax law treats partnerships alternately as aggregates or entities, depending on the issue and the context.)

In this case, however, the court's refusal to consider whether the partners were engaged in a trade or business is significant. The partnership was overwhelmingly (99 percent) owned by the

individual who was primarily conducting the activities. The remaining 1 percent was held by his wife. The partnership anti-abuse rules would certainly have sanctioned evaluating the activities at the partner level.[15] It seems quite likely to the author that Keith Lender was engaged in the trade or business of providing investment management services, so an analysis of the issue at the partner level should not have changed the result, but the decision not to evaluate the activities at his level seems to elevate form over substance.

The court went on to hold that applicable authority demanded that related party transactions be evaluated with "heightened scrutiny." The operation of Management met this heightened scrutiny standard because of the business-like manner in which it was operated. The fact that family members were not bound to keep their assets in the Investment LLCs meant that if Management did not perform well, such family members could withdraw their capital and seek alternative investment advisory services. Even with respect to the one Investment LLC that required Management consent to withdraw, the court found that there was a "common understanding" that such consent would be granted. The court was also impressed by the fact that the family members did not act "collectively or with a single mindset." As a result, the individual family members each represented a different client rather than being members of a single client.

Last, but very important to the decision, was the fact that Management was owned by only a small subset of the family. To quote, "Most of the assets under management were owned by members of the Lender family that had no ownership interest in Lender Management." Again, the court emphasized that Management provided services similar to those of a hedge fund manager.

Concluding Observations

The fact that Management was operated in a balanced way for federal income tax purposes appears to have greatly helped the taxpayer's case. Specifically, Keith Lender, as chief investment officer, was paid a substantial salary for his services, rather than just passing through income from the carried interests as compensation for services. This fact impressed the court that Management was indeed operating a business. Management was able to benefit from the generation of long-term capital gains from the investments that it managed by holding the carried interests in two of the three Investment LLCs. But, at the same time, it received fee income from the third Investment LLC. Thus, optimal tax planning was achieved—long-term capital gains retained their character in the hands of Management and expenses were deductible against all types of income as active trade or business expenses and the only tax cost of the structure was the salary paid to the owner. In summary, the decision provides a good road map for other family offices on how to structure their operations for US federal income tax purposes.

Endnotes

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[2] *See* H.R. Rep. No. 2333, 77th Cong. 2d Sess. 46.

[3] Section 212(1), (2) of the Internal Revenue Code of 1986, as amended (the "Code").

[4] *See* Code § 67 and Code § 68.

[5] *Todd v. Comm'r*, 77 T.C. 246, 248 aff'd 682 F.2d 207 (9th Cir. 1982).

[6] P.L. 115-97 (2017).

[7] *See, e.g., Moller v. United States*, 721 F.2d 810 (Fed. Cir. 1983) (quoting *Liang* in case involving the home office deduction); *Purvis v. Commissioner*, 33 T.C.M. (CCH) 702 (1974) (citing *de Vegvar v. Commissioner*, 28 T.C. 1055 (1957), *acq.* 1958-1 C.B. 4, and the *Liang and Abegg* cases in a domestic case involving the availability of net operating loss carryovers).

[8] For a more recent example of the same principle, see *Beals v. Comm'r*, T.C. Memo. 1987-171.

[9] 12 T.C.at 59.

[10] 14 T.C. 725 (1950).

[11] 30 T.C. 618, 633-34 (1958), aff'd, 281 F.2d 646 (6th Cir. 1960).

[12] 30 T.C. at 633-34.

[13] The court cited Code § 6231(a)(3) in support of its conclusion. Before amendment, this Code section provided that "partnership items" are taken into account at the partnership level. The author did not find this citation to be helpful to the resolution of the issue discussed in text.

[14] *See* T.A.M. 200811019 (March 14, 2008). For our own musings on this TAM, please see Leeds, *Technical Advice Offers Planning Opportunities for US Branches of Foreign Banks*, Daily Tax Report (April 21, 2008).

[15] See Treas. Reg. § 1.701-2.

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