Single family office operations 2018: Recent case law and coordination with legislative developments

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December 2017 brought with it two important developments for single family offices. The first was from the US Tax Court's decision in *Lender Management v. Commissioner ("Lender")* released on December 15, 2017 which held that a family office, Lender Management, LLC ("Lender Management"), carried on a trade or business and therefore was entitled to deduct operating and investment management expenses under Section 162. The second important development was the well-publicized Tax Cuts and Jobs Act, H.R. 1, signed into law on December 22, 2017 (the "2017 Tax Act"). The 2017 Tax Act makes the *Lender* decision all the more valuable in light of new limitations on tax deductions as discussed below.

Lender is an important case for family offices because it acknowledges the professionalism that can exist within a family office context which can rise to the level of a trade or business entitled to income tax deductions like any other active business.

Briefly putting the single family office into context

Family offices take many forms, sizes and shapes. They vary with respect to ownership, management, and scope of operations. However, one key distinction is whether a family office is structured for tax purposes as a corporation or a partnership. Both are viable in the right circumstances. We have previously discussed how US tax reform changed the landscape of many tax provisions that could impact family offices, whether organized as a partnership (the "Partnership Model") or as a C corporation (the "Corporate Model"). (See the Withers Bergman LLP client alert link here).

The Partnership Model

Partnership Model family offices must determine whether operational expenses are deductible under Section 162 as "trade or business expenses", or instead deductible under Section 212 as expenses relating to the "production of income." Prior to the 2017 Tax Act, the benefits of Section 212 deductions were restricted because of AGI limitations and the alternative minimum tax, making Section 162 characterization more desirable. However, under the 2017 Tax Act, Section 212 expenses are no longer deductible for tax years beginning 2018 through 2025, making Section 162 characterization all the more important for family offices.

The Corporate Model

There has long been a presumption in US tax law that C corporations are deemed to be engaged in a trade or business. Therefore, C corporations are generally entitled to deduct all of their operating expenses under Section 162. However, choosing to form as a C corporation presents other challenges. For example, personal holding company tax may be triggered if the majority of a family office's income is from passive sources. Additionally, a C corporation family office may be subject to accumulated earnings tax to the extent the family office is deemed to have "unreasonable" retained earnings.

Case law prior to *Lender*

A recurring question in the Partnership Model family office context is whether a family office is merely providing investment oversight for the benefit of its owners, rather than carrying on an active trade or business with continuous, regular, and substantial activities entitled to Section 162 deductions. (See *Commissioner v. Groetzinger* (1987)). The IRS will often argue that a family office performs mere clerical and administrative duties in connection with managing the investment portfolios of its owners. (See *Commissioner v. Scottish American Investment Co., Ltd.,* (1944)). The IRS's clerical and administrative argument is particularly successful in the real estate sector when a family office is merely receiving rental income through a triple-net lease. (See *Neill v. Commissioner* (1942)).

To counter the IRS's scrutiny, family offices have often analogized their operations to those of a general partner in a private placement investment fund. Just as a general partner of a fund can be characterized as actively engaging in a trade or business while managing fund assets, so too a family office can be viewed as engaged in an active business while managing the assets of a dynastic family.

Factual summary of *Lender*

In 1927 Harry Lender founded Lender's Bagels, a company that was originally from New Haven, Connecticut, which would grow to become one of the world's biggest bagel producers. Harry Lender had two sons who worked in the family business. Eventually, Lender Management was formed as a tax partnership to provide direct management services to three limited liability companies (the "Investment LLCs"), which were in each case owned beneficially by Harry Lender's children, grandchildren, and great-grandchildren. Although Lender Management provided services to Harry Lender's lineal descendants, Harry Lender's grandchildren and great-grandchildren were not particularly close and were rarely in contact with one another, which is not unusual for families with multi-generational wealth.

Keith Lender, Harry Lender's grandson, was the manager and 99% owner of Lender Management through a trust. Consequently, most of the assets under management were owned by members of the Lender family that had no ownership interest in Lender Management (Keith Lender held a small indirect interest in the Investment LLCs). As chief investment officer, Keith Lender retained the ultimate authority to make all investment decisions on behalf of Lender Management with respect to assets held within the Investment LLCs. Most of his time was dedicated to researching and pursuing new investment opportunities and monitoring and managing existing positions. The Tax Court observed that Keith Lender personally reviewed approximately 150 private equity and hedge fund proposals per year on behalf of the Investment LLCs.

Lender holding

Hedge fund comparison

In holding that Lender Management did carry on a trade or business, and was therefore entitled to deduct its expenses under Section 162, the court emphasized that Lender Management's structure was akin to a "fund of funds," with Lender Management's role analogous to the general partner of such fund of funds. The Tax Court noted that Lender Management employed five employees, including a full-time CFO who was not a member of the Lender family, and regularly engaged accounting and investment firms to assist with various family office functions. For example, Lender Management retained a hedge fund consultant to help assist with structuring its operations. Additionally, similar to a hedge fund structure, Lender Management received carried interests or fees as compensation from the Investment LLCs, and was the manager of each Investment LLC.

Bona fide service relationship

The Tax Court emphasized numerous facts which indicated that a bona fide service provider/client relationship existed between Lender Management and the Investment LLC investors. The Tax Court noted that in his capacity as Lender Management's chief investment officer, Keith Lender regularly met with the Investment LLC investors to discuss their particular risk tolerances and cash flow needs, in addition to holding annual "face-to-face" meetings with investors to collectively review investment returns and performances. As highlighted by the Tax Court, Lender Management's investment choices and related activities were driven by the needs of the investors. The investors were able to withdraw their investments if they became dissatisfied with Lender Management's services, thereby leading the Tax Court to conclude that the Lender family members did not act "collectively" or with a "single mindset." The foregoing led the Tax Court to rule that Lender Management did substantially more than "keeping records and collecting interest and dividends," activities which would have fallen short of a "trade or business" for Section 162 purposes.

Compensation type

The Tax Court's decision in *Lender* was not contingent on the type of compensation received by Lender Management, whether as or fee income or from carried profits interests from the Investment LLCs. This is significant because carried interests are preferable over fees on the Investment LLC level as carry interest allocations reduce taxable income of the Investment LLCs, whereas fees are not deductible under the 2017 Tax Act.

Structuring family offices post- *Lender*

Lender illustrates that multi-generational centralized management and control structures can be organized and operated in a manner that rises to the level of a bona fide trade or business, especially where the extended family can demonstrate that the various family branches are not acting with a "single mindset." Families for whom *Lender* will be instructive include those who create bona fide business relationships between and among the family members and the entities within the family enterprise. *Lender* illustrates the importance of managing entities and relationships in a professional and legally distinct manner.

For smaller, first generation wealth families, a Corporate Model family office may still be preferable over a Partnership Model because of family dynamics, notwithstanding *Lender's* taxpayer friendly ruling. Although Section 162 deductions are readily available to corporate vehicles, certain mechanisms should be in place to mitigate the risk of personal holding company tax and accumulated earning tax exposure. For example, with bespoke allocations for carried profits incorporated into underlying investment vehicles, a Corporate Model family office may be able to minimize, if not altogether eliminate, personal holding company tax and accumulated earning tax exposure.

It is likely that many families fall somewhere in the middle, where the right choice between a Partnership Model versus a Corporate Model family office is not obvious. For these families, careful planning is essential. Proper documentation and legal formalities to memorialize the relationships between the family office and underlying family investment vehicles could be determinative, especially if a Partnership Model is implemented. No two fact patterns are identical. Family offices take many forms, sizes and shapes; indeed, family office structures are as diverse as the families they serve. Nonetheless, *Lender* will provide much need clarity going forward with respect to family office structuring and Section 162 deductibility.

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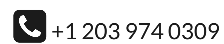

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