Anchin Alert

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Accountants and Advisors

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Tax Court Ruling That Family Office Carried on a Trade or Business May Offer Tax Planning Opportunities

On December 13, 2017, in Lender Management, LLC v. Commissioner, the U.S. Tax Court ruled that a family office, Lender Management, LLC ("Lender Management"), carried on a trade or business as an investment manager rather than as a passive investor and was therefore entitled to deduct expenses under §162 ("deductible above-the-line with no income limitation") vs. §212 ("miscellaneous itemized deductions subject to the 2% of adjusted gross income (AGI) floor").

As part of the Tax Cuts and Jobs Act (the "Act") signed into law on December 22, 2017, miscellaneous itemized deductions (or §212 deductions) are no longer deductible and are suspended from 2018 through 2025. As a result of the Act and the timing and result of the Lender Management decision, this case could be a favorable outcome for family offices and the deductibility of expenses they incur. Historically, case law has denied taxpayers who managed their own investments the ability to deduct as ordinary and necessary trade or business expenses but instead required that they be treated as investment expenses. Determining whether a taxpayer is engaged in a trade or business or investment activity is based on the facts and circumstances. The Lender Management decision sheds light on how a family office may be able to modify their operations so as to be deemed engaged in a trade or business rather than in an investment activity.

Facts of the Lender Management Case

Lender Management (a partnership), is an operating management company that managed the affairs of the Lender family office, whose founder, Harry Lender, was the operator of Lender's Bagels. His sons, Marvin and Murray, worked with their father in the family business. Lender Management is owned by two revocable trusts -- 99% by Keith Lender Trust (Harry Lender's grandson and son of Marvin Lender) and 1% by Marvin Lender Trust. Marvin Lender, through the Marvin Lender Trust, acted as Lender Management's managing member until December 23, 2010, and Keith Lender, through the Keith Lender Trust, acted as Lender Management's managing member after December 23, 2010.

Lender Management was structured in the hedge fund manager model and provided investment management services to three family investment limited liability companies ("Investment LLCs"), each taxable as a partnership and each owning a different class of assets; hedge funds, private equity and public equities. The Investment LLCs were established via a reorganization in order to provide greater diversification and more flexible asset allocations for the varying interests of the Lender family. While Keith Lender and Marvin Lender indirectly owned a minor portion of the Investment LLCs, the majority of the ownership was spread among other members of the Lender family; children, grandchildren and great grandchildren of Harry Lender.

The operating agreement for each Investment LLC provided that Lender Management was the sole manager and had the exclusive right to direct and engage in the business affairs of the Investment LLCs. Lender Management received a profits interest ("carried interest") in each of the investment LLCs, designated as Class A interests. The profits interest was different for each investment LLC, but each was structured as a percentage of net asset value or realized profits/receipts, plus a percentage of the increase in net asset value from the prior fiscal period. While it is not clear if said profits interests were fees or allocations or some combination thereof, this aspect was not a factor in the tax court's decision. It is important to note that the carried interest portion of the compensation for services was only triggered if those Investment LLCs generated profits. Members could withdraw their capital at any time (subject to liquidity constraints) if the investment was not performing well and could seek out other advisors as well. In addition, because Lender Management owned a minor percentage in the investment LLCs (as mentioned above), was further proof that their intent was not investment but to make a profit. The Tax Court cited the disproportion between the capital and the profits interests as a reason for concluding that the predominant activity of the management entities was management of investments for others rather than investing for their own account.

Keith Lender spent significant time in his role as managing member of Lender Management. His role included, but was not limited to, researching and pursuing new investment opportunities and monitoring and managing existing positions. In addition, Keith Lender spent significant time meeting with the other owners of the Investment LLCs to report on the performance of their investments, discuss their cash flow needs and to determine their risk tolerance on investments. Keith Lender received a guaranteed payment for the services he provided. He worked 50 hours a week, which included evenings and weekends, referring to members of the investment LLCs as clients. He reviewed approximately 150 private equity and hedge fund proposals per year on behalf of the investment LLCs. Lender Management also managed lines of credit for the Investment LLCs, had employees, external consultants and office space.

Tax Court Opinion

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.

Having found that these requirements were met, the Tax Court then considered whether (1) the investment management services provided by Lender Management could be deemed as trade or business instead of investment activities and (2) the familial connections between Lender Management and the Investment LLCs could preclude trade or business treatment.

The Tax Court reasoned that the investment management services provided by Lender Management were comparable to the services hedge fund managers provide and went far beyond those of an investor. The Tax Court also noted that Lender Management was entitled to a carried interest as compensation for services to the Investment LLCs only if profits were generated, in addition to earnings on Lender Management's minor capital interest. The fact that Lender family members owned the majority of the Investment LLCs and had no interest in Lender Management further demonstrated that Lender Management was providing investment management services to persons other than itself.

While the Tax Court notes that due to the familial relationship, the transactions would be subjected to heightened scrutiny, they found that Lender Management satisfied such additional scrutiny. Lender Management's investment decisions were in essence driven by the needs of the owners of the Investment LLCs and often conflicted with the needs of Lender Management whereby such owners were able to withdraw their investments if they became dissatisfied with Lender Management's investment services. Despite each owner being part of the Lender Family, they did not act collectively with a single mindset, they were geographically dispersed; many did not know each other and did not attend business meetings.

In the end, the Tax Court found that the breadth of services Lender Management provided to its clients was analogous to the services hedge fund managers provide to their clients and went well beyond those of an investor.

Anchin Observations

As a result of this decision, family offices may be able to structure operations in a manner consistent with the Lender Management case in order to deduct expenses as trade or business expenses and to avoid the negative result of the

Act’s suspension of miscellaneous itemized deductions.
It is important to note that this case relates to an investment manager and not to the (family) investment vehicle (or vehicles). Therefore, the Tax Court analyzed the activities of the investment manager in relation to the Investment LLCs and the Lender Family and not the activities of the Investment LLCs. The deductibility of the expenses at the Investment LLC level is a separate facts and circumstances determination that should be independently discussed and planned for in order to determine the appropriate deductibility of such expenses.

Family office investment vehicles generally have many trading and investing activities which need to be examined to determine appropriate deductibility of expenses at this level. Whether the vehicle is investing in other pass-through vehicles, sourcing and investing in private equity deals or trading/investing in securities, said fund level expenses may not all be deductible as trade or business expenses.

If investing in other pass-through partnerships such as trader funds or investor funds, one needs to revisit Revenue Ruling 2008-39 which addressed the deductibility of expenses in a fund of funds structure. Fund of funds are tiered partnership arrangements in which securities trading and investing is undertaken by other lower-tier partnerships where investors participate by acquiring interests in the upper-tier partnership (or fund-of-funds) that holds the interests in the lower-tier partnerships. In these structures, the fund-of-funds charges a management fee at its level for asset allocation services while the lower-tier partnership also charges a fee at its level for managing the lower-tier partnership. While each lower-tier partnership may be engaged in the trade or business of trading stocks and securities, the fund-of-funds itself is not engaged in a trade or business. Expenses incurred outside of a trade or business for the purposes of producing income are no longer deductible under §212 (miscellaneous itemized deductions) and are suspended until January 1, 2026. Revenue Ruling 2008-39 concluded that the activities of the upper-tier partnership (or fund-of-funds), should be addressed without regard to the activities of the lower-tier partnerships, and do not constitute a trade or business within the meaning of §162. Instead, the upper-tier partnership’s activities consist of holding limited partnership interests in lower-tier partnership interests for the production of income under §212.

Given the suspension of §212 expenses, the conclusion of Revenue Ruling 2008-39 and certain aspect of the Lender Management decision, it may be possible to conclude that a family investment vehicle is itself actively engaged in the trade or business of trading securities, like the lower-tier partnerships themselves. It is unclear if such a determination would be respected by the IRS. However, since this is a facts and circumstances determination, each case should be carefully addressed, discussed and analyzed to determine the proper deductibility of such expenses.

If you would like to discuss this alert, potential planning opportunities or have any specific questions, please contact E. George Teixeira or your Anchin relationship partner. We stand ready as ***Your Expert Partner*** to help you plan effectively and to navigate through the various tax rules that may apply to you, your family and your fund.

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