STROOCK
SPECIAL BULLETIN

The *Lender* Case: Potential Avenue for Family Offices to Obtain Trade or Business Expense Deductions for Rendering Investment Management Services

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Lender Management, LLC v. Commissioner of Internal Revenue, T.C. Memo. 2017-246 (2017), provides family offices with a potential avenue for obtaining trade or business expense deductions under section 162 of the Internal Revenue Code ("IRC") in connection with rendering investment management services. In this **Stroock Special Bulletin**, we summarize the key aspects of the *Lender* case and address certain additional relevant considerations that were not discussed in that case but which could potentially be highly relevant in determining whether the result in *Lender* may be applied successfully in other family office contexts.

The principal issue in *Lender* was whether the family office ("Lender Management") carried on a trade or business. Lender Management provided direct investment management services to three separate limited liability companies ("LLCs"), the beneficial owners of which were entirely Lender family members. Each of the LLCs was treated as a partnership for federal income tax purposes. *Lender Management also managed certain "downstream entities" in which one of the investment partnerships had a controlling interest, and investors in some of these downstream entities included persons who were not members of the Lender family.* (Slip op. at 11) Lender Management's operating agreement permitted it "to engage in the business of managing the Lender Family Office and to provide management services to Lender family members, related entities and other third-party nonfamily members."

If the name "Lender" sounds familiar, there is a good reason for it. The family patriarch, Harry Lender, founded "Lender's Bagels," which was the font of the family's wealth. The Lender family members here were in some cases grandchildren and great-grandchildren of Harry. They were both geographically, and in temperament, very much dispersed. So although it was an extended family by pedigree, the Tax Court's memorandum

decision[1] made it very clear that, for all intents and purposes, the relationships between Lender Management and its "clients" were effectively at arm's length and that Lender Management could have been terminated as an investment advisor at any time by the investment partnerships.

Among other key facts:

- More than 50% of the assets under management were invested in private equity;
- Lender Management also provided individual investors in the investment LLCs with one-on-one investment advisory and financial planning services;
- Compensation was paid to Lender Management for the investment management services that it provided in the form of profits interests (or carried interests) in the various investment partnerships that it advised;
- The taxpayer (Lender Management) therefore received not just a return on its investment, but compensation attributable to its services provided to others;
- Lender Management employed five employees during each of the tax years at issue; and
- The key person at Lender Management (Keith Lender, who was Harry Lender's grandson) worked approximately fifty hours per week in Lender Management, had a business degree from Cornell University and an MBA from Northwestern University, and prior to joining Lender Management worked for several years in marketing and brand management for major corporations.

The Tax Court determined that the activities of Lender Management – which involved providing investment management services **to others for profit** (although the others were all part of the Lender extended family or their related entities) – were sufficient to constitute a trade or business, which can give rise to fully deductible trade or business expenses under IRC section 162.

The Internal Revenue Service had contended that these expenses were not trade or business expense deductions under IRC section 162, but instead were deductible under IRC section 212 -- which meant that, as miscellaneous itemized deductions, they were subject to the 2% of adjusted gross income ("AGI") floor and the alternative minimum tax. (Importantly, under the new tax law, IRC section 212 expenses are no longer tax deductible.) The Internal Revenue Service basically asserted that the family was managing its own money, and that family attribution rules should apply where the clients are family members.

The critical distinction that the Tax Court drew in *Lender* was between **[A]** trade or business expenses and **[B]** investment expenses. Commenting on this distinction, the Tax Court observed that "[n]o matter how large the estate or how continuous or extended the work required may be, overseeing the management of one's own investments is generally regarded as the work of a mere investor." (Slip op. at 25, quoting *Higgins v. Comm'r*, 312 U.S. 212, 218 (1941)) In addition, "[e]xpenses incurred by the taxpayer in trading securities or performing other investment-related activities strictly for his own account generally may not be deducted under section 162 as expenses incurred in carrying on a trade or business." (Slip op. at 25 (citing *Higgins*, 312 U.S. at 218)) The Tax Court further observed that transactions within a family group are generally subject to heightened scrutiny.

Notwithstanding this heightened scrutiny due to the family group relationship, the Tax Court concluded that the record before it demonstrated that Lender Management provided investment management services **to others for profit**. According to the Tax Court, "selling one's investment expertise **to others** is as much a business as selling one's legal expertise or medical expertise. Investment advisory, financial

[1] It should be noted that a Tax Court memorandum is ***not*** entitled to full precedential effect.

planning, and other asset management services provided **to others** may constitute a trade or business." (Slip op. at 27) As such, Lender Management's activities were sufficient to constitute a trade or business and therefore gave rise to fully deductible trade or business expenses under IRC section 162.

Thus, the use of a family office management company in *Lender* under the facts presented effectively converted non-deductible expenses (miscellaneous itemized deductions) into above-the-line fully deductible trade or business expenses. Lender Management's profits interests in the investment partnerships, in turn, reduced income for those partnerships.

Commentators have observed that, under Rev. Rul. 78-195, 1978-1 C.B. 39, the ability of the family office to deduct its general office expenses under IRC section 162 may be further enhanced if the family office entity is instead structured as a "C corporation." In that Revenue Ruling, a C Corporation that was formed for the express purpose of investing in real property purchased a tract of unimproved, non-income-producing real property, which it held for two years and sold without having made any substantial improvements. The corporation did not make any significant efforts to sell the property and did not engage in any other transactions in real or personal property or in other commercial activities. During the period that it held the property, the corporation incurred expenses for interest, real property taxes, accounting fees, and general office costs. The Internal Revenue Service held that the accounting fees and general office costs were expenses related to investment property of the C Corporation and, as such, were deductible by the C Corporation under IRC section 162 in the year paid or incurred (except to the extent that such expenses may need to be capitalized).

Some caveats should be noted, however. Importantly, the *Lender* case solely involved the question of income tax deductions under IRC section 162. It does **not** address any other issues, such as whether the transfer of a carried interest – which was a junior class of equity under these facts, as other classes of equity were preferred to it in receiving distributions from the investment partnerships that Lender Management advised – may constitute a **"distribution right in a controlled entity"** so as to potentially trigger the application of the deemed gift rules of Section 2701 of the Internal Revenue Code. That issue needs to be carefully considered as well.

In addition, being deemed engaged in a trade or business could potentially trigger certain collateral tax consequences. Depending upon the circumstances, this could potentially include ordinary income treatment on certain trading profits and potential exposure to additional state, local and unincorporated business taxes.

Moreover, a family office needs to carefully consider securities law restrictions on managing others' financial assets. Accordingly, securities law counsel should be consulted as well in connection with the establishment of a family office that seeks to follow the *Lender* model.

Stroock's Private Client Services Practice Group continues to monitor all developments in the family office space and in planning for wealthy individuals and their families, and will provide updates, including with respect to the U.S. Department of Treasury's and the Internal Revenue Service's issuance of guidance to address open points in the 2017 Tax Reform Legislation.

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