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Tax Court Provides Clarity for Family Offices Seeking to Deduct Business Expenses

Proceedings in the Tax Court case of *Hellmann v. Commissioner* provided additional clarity on whether expenses incurred by a single family office are deductible as trade or business expenses under Section 162 of the Internal Revenue Code (the Code).

Last December, the U.S. Tax Court issued its decision in *Lender Management, LLC v. Commissioner*, where it held that these expenses were deductible as trade or business expenses. In that case, the IRS argued unsuccessfully that the relevant deductions were "below the line," miscellaneous itemized deductions under Section 212 of the Code subject to several prohibitive limitations.[1] Notably, *Lender* showcased the Tax Court's willingness to treat a single family office as a bona fide trade or business that can deduct its operating expenses under Section 162 as trade or business expenses, even if it does not manage assets for anyone outside the extended family.

The family office at issue in *Lender* was not a typical single family office, and the facts in that case were generally taxpayer-friendly (we discussed the *Lender* case in greater detail in our March alert available here). While the Tax Court did not hold that any particular fact was dispositive, the decision gave significant weight to the family's size, geographic diversity and varying investment goals; the manager's qualifications as an investment professional; and the manager's compensation structure (which included income based on capital and also an incentive-derived component, or "carry"). While *Lender* provided a useful blueprint, family offices that lacked the particular facts present in *Lender* were left uncertain as to whether the Tax Court's favorable decision would apply to them.

In the *Hellmann* case, petitioners were a group of family members who owned and operated GF Family Management, LLC (GFM). As in *Lender*, the issue raised in *Hellmann* was whether GFM was engaged in a trade or business within the meaning of Section 162 and could therefore 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 and therefore its operating costs were instead subject to limited deductibility under Section 212.

On October 1, 2018, the Tax Court in *Hellmann* issued an order in response to both parties' motions for summary judgment requesting further development of the relevant facts by both parties. Clearly, merely issuing an order requesting further information by the Tax Court is by no means a determination that GFM would or would not have successfully argued at trial that it was engaged in a bona fide trade or business.[2] However, the order indicates that the Tax Court may be inclined to compare certain specific factors from *Lender* to facts in other cases, thereby providing additional guidance to single family offices.

The Tax Court in *Hellmann* seemed particularly interested in the family's percentage ownership interest in its investment assets versus its percentage ownership interest in the management company's profits (i.e., "proportionality"). In *Lender*, the Tax Court noted that a common way to distinguish a trade or business from mere management of one's own investments is through compensation beyond an investor's expected return. Indeed, the management company in *Lender* earned a profits interest based on its performance managing the family's underlying investments; meanwhile, the 99 percent owner of the management company owned only a minority interest in the assets under management. Consequently, the manager's compensation (income derived from the profits interest) exceeded his expected return as a minority equity owner, apparently indicating to the Tax Court that the management company was engaged in a bona fide trade or business.

Conversely, in *Hellmann*, each of the same four family members who owned 100 percent of the family's investment assets owned 25 percent of GFM. In one of its orders, the Tax Court suggested that a profits interest allocated proportionately among the four family members would *not* be evidence of a trade or business, since the family members would essentially be receiving the same investment return they would otherwise be entitled to as fractional equity investors. The Tax Court also contrasted the facts in *Hellmann* with those in *Lender* by highlighting that GFM managed investment assets for fewer family members than in *Lender* and that those family members were close to one another both geographically and personally, whereas the family members in *Lender* were geographically dispersed and, in some instances, not on speaking terms with one another.

Ultimately, the *Hellmann* order should *not* be viewed as a negative development. Rather, *Hellmann* provides helpful considerations and guideposts for families in the process of evaluating whether restructuring their family offices would be tax-efficient. Importantly, family offices considering ways to enhance deductibility of operating expenses should consult with an experienced tax adviser before attempting to navigate the substantial gray area between *Lender* and *Hellmann*.

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[1] *Lender* was decided prior to the Tax Cuts and Jobs Act (the TCJA), signed into law on December 22, 2017, which, among other things, suspended Section 212 deductions through 2025 for individuals and trusts, while leaving Section 162 deductions intact. Therefore, the result of *Lender* is even more significant for tax periods after the enactment of the TCJA.

[2] Orders cannot be treated as precedent but often are helpful in showing how a court may rule in future cases with similar facts. The parties ultimately reached a settlement in the *Hellmann* case, so there will be no subsequent Tax Court decision.

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