March 5, 2018

Tax Planning Opportunities for Single Family Offices

In *Lender Management, LLC v. Commissioner*, a memorandum decision[1] issued on December 13, 2017, the U.S. Tax Court ruled that expenses incurred by a single family office were deductible as trade or business expenses under Internal Revenue Code Section 162. In its challenge of the taxpayer's position, the Internal Revenue Service argued unsuccessfully that the expenses should have been deducted under Code Section 212.[2] Unlike deductions that were previously allowed under Code Section 212, Code Section 162 deductions constitute "above the line" deductions and are not subject to the 2% floor limitation, which means that they are generally more advantageous to taxpayers.

In *Lender*, the single family office at issue managed the investments of three closely held LLCs, each of which was owned by various members of one family as well as related trusts. While the IRS focused on the fact that all the LLC owners were members of a single family, its family members spanned three different generations and lived around the United States as well as abroad, and many did not know each other or, if they did, had very limited contact. The manager of the family office also was a member of the family and held minority interests (between 0.4% and 8.2%) of the related LLCs. As part of his duties for the family office, he provided investment management and advisory services on a full-time basis. The manager was paid a guaranteed sum from the family office and also was entitled to a percentage of profits of the related LLCs based on the investment returns he generated. The manager referred to the LLCs as "clients"; provided investment materials, models, forecasts and other advice to each family member/entity tailored to meet their individual investment goals; held annual investor meetings for all investors; and interacted with each investor directly and on a frequent basis. The family office also employed a full-time Chief Financial Officer and an office manager, hired consultants and rented its own dedicated office space.

Finding in favor of the taxpayer, the Tax Court held that in light of the manager's activities and other surrounding facts and circumstances, the family office was operated as a bona fide trade or business for profit. Consequently, expenses incurred by the family office for salaries and wages, repairs and maintenance, rent, taxes and licenses, depreciation, retirement plans, employee benefit plans and other items were properly deductible under Code Section 162. *Notably, the Tax Court did not comment as to whether fiduciary or trustee fees incurred by the related LLCs or the trusts that owned the family office vehicle were similarly deductible.*

Overall, this case is favorable to family offices as it evidences the Tax Court's willingness to acknowledge that a single family office can be operated as a bona fide trade or business for purposes of taking deductions under Code Section 162. Also, as a result of the TCJA, to contest these types of deductions in the future, the IRS will need to argue that the deductions should be disallowed entirely, as Code Section 212 deductions are no longer an available alternative.

While *Lender* is clearly a taxpayer victory, we note that the facts of this case were particularly taxpayer-favorable, including (among other things) that the family was large and geographically dispersed, and operated completely independently of one another; that the manager had no other source of employment, and his compensation included performance incentives beyond what was available to other investors; that the family office had full-time employees and hired external consultants; and that each family member had his or her own investment goals. In other words, although it served only members of the same family, the family office in *Lender* operated more like a multifamily office than like a single family office. As a result, the Tax Court may be unlikely to follow *Lender* in a case where the facts are more consistent with a typical single family office structure.

Family office and investment professionals are encouraged to contact a member of the Day Pitney Family Office team with questions regarding this case or assistance with related tax planning.

[1] TC Memo 2017-246. Notably, the U.S. Tax Court issues a “memorandum” decision when the chief judge believes that the issue before the court is primarily concerned with the application of existing, well-settled law or merely an interpretation of the facts.

[2] Prior to enactment of the Tax Cuts and Jobs Act (TCJA), signed into law on December 22, 2017, Code Section 212 allowed for the deduction of expenses incurred in the “production of income,” with such deductions limited to the excess of 2% of the taxpayer's adjusted gross income (the so-called 2% floor). Deductions under Code Section 212, along with all other miscellaneous itemized deductions subject to the 2% floor, were suspended by the TCJA through December 31, 2025.

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