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Generations Fall 2021 - Tax-Structuring Considerations for the Modern Family Office

Structuring a family's investment activities as a family office can yield many benefits. A family office can centralize management of a family's investments and help incentivize nonfamily members to contribute to the family's success. A family office structure can also help ease family succession issues and pool assets to qualify for lucrative investment opportunities that otherwise might not be available. In addition to these benefits, a properly structured family office can also provide significant tax savings. Prior to 2018, an individual taxpayer, including a member of a family partnership, could claim tax deductions for expenses incurred for the production or collection of income to the extent those expenses exceeded 2 percent of the taxpayer's adjusted gross income. However, the 2017 Tax Cuts and Jobs Act eliminated this deduction until 2025. As a result, under current law, an individual taxpayer can only deduct investment expenses that are paid or incurred in carrying on a "trade or business." Well-established case law provides that an individual's management of his or her own investments does not constitute a trade or business. The U.S. Supreme Court reached this conclusion in a case called *Higgins*, notwithstanding that the taxpayer in that case had "regular and continuous" involvement in investment management and devoted considerable time to managing investments and hiring others to assist. Unlike individual investors, there are plenty of family offices throughout the United States that very much operate like a trade or business. In many instances, the family's assets are pooled in a partnership and then deployed at the direction of a separate management company, which receives a profits interest in the partnership's income and gain in exchange for its services to the partnership. The income allocated to the management company is not an expense and is therefore not subject to the rules disallowing deductions for investment management expenses. The management company can then pay fees to third-party investment advisers or pay other investment expenses and claim a tax deduction for those payments, taking the position that it is in the trade or business of managing other people's money. Unfortunately, there is no bright-line rule that establishes whether a family office constitutes a trade or business. Two recent U.S. Tax Court cases offer insight into some of the factors that the IRS and the Tax Court consider when making that determination. In a case called *Lender*, the Tax Court held that a management company established to direct the investment and management of assets held in three investment partnerships (formed as limited liability companies) owned by the Lender family was engaged in a trade or business for these purposes. As a result, the management company could deduct expenses (e.g., investment adviser fees, legal fees, tax preparation fees) that it incurred in managing the family's investment partnerships. As a result, *Lender* has become the blueprint that many family offices follow to try to achieve the same tax outcome. In the *Lender* decision, the Tax Court cited a variety of factors that helped it conclude that the management company was engaged in a trade or business, including:

- The management company had a profits interest in the investment partnerships.
- The management company was owned by a member of the Lender family, but he owned a very small percentage of the investment partnerships. He was also Ivy League educated and highly qualified to manage investments.
- The members of the investment partnerships could withdraw their investments at will (subject to liquidity constraints).
- The management company engaged outside experts but maintained ultimate authority on investment decisions and did not always follow the advice given by those outside experts.

In many respects, the Lender family had a highly favorable fact pattern that few family offices can match. Thus, most family offices need to make a judgment call as to how close they can get to the *Lender* facts. About a year after the *Lender* decision, the Tax Court considered another family office structure in a case called *Hellmann*. The facts in *Hellmann* were far less favorable. Notably, the Hellmann family office was structured such that the ownership of the management company and the underlying partnerships were identical. The case settled before the Tax Court issued a decision, so there is no written opinion to guide the structuring of a family office. However, prior to the settlement, the Tax Court requested additional facts about certain topics, which helps identify the factors that the IRS and the Tax Court take into account when deciding whether a family office is a trade or business:

- The manner in which the management company was compensated for its services.
- The nature and extent of the services provided by the management company and its employees.
- The amount of expertise possessed and time devoted by family office employees of the management company versus outside investment managers and consultants.
- The individualization of investment strategies for different family members with differing investment preferences and needs.
- The proportionality between the share of profits inuring to each family member in his or her capacity as an owner of the management company and the share of profits inuring to that same individual in his or her capacity as a partner in the investment partnerships.

The fact that the taxpayers in *Hellman* settled the case is widely viewed as an indication that they may have lost confidence that they were going to prevail on the merits. This creates something of a spectrum, with *Lender* on one end and *Hellmann* on the other end. In many instances, family offices find themselves somewhere in the middle of these two cases, so any family office considering implementing this type of structure should do what it can to make the structure as much like *Lender* as the circumstances will permit. Would you like to receive the *Day Pitney Generations Newsletter*? Sign up here. Day Pitney Generations Newsletter - Fall 2021 (pdf)

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