In the wake of federal tax reform, Family Offices should consider restructuring

Private Trust Company Research
Welcome

The sweeping federal tax reform legislation enacted in December 2017 eliminated the deduction of certain expenses that have historically been permissible under Internal Revenue Code (IRC) Section 212. Consequently, for tax years 2018 through 2025, deductions a family office generally would take under IRC Section 212 will be lost unless the family office qualifies as a “trade or business” and can deduct those expenses under IRC Section 162. Expenses deducted under IRC Section 162(a) generally are subtracted in full from gross income to arrive at adjusted gross income.

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Guidance

The IRC does not define the term “trade or business.” Hence, deciding whether the activities of a family office constitute a trade or business requires a careful examination of the facts. Managing one’s own investments, no matter how businesslike the operation is, will not constitute a trade or business. Despite the lack of guidance from the IRC, family offices can find direction in a recent decision by the United States Tax Court. On December 13, 2017, the Tax Court concluded the taxpayer (Lender Management, LLC, a family office) was operating a trade or business and could deduct its expenses under IRC Section 162 instead of Section 212. Therefore, family offices desiring to deduct expenses under IRC Section 162 may want their facts to closely mirror those of Lender Management, LLC.

Key Facts

According to the Tax Court and previous rulings, “to be engaged in a trade or business the taxpayer must be involved in the activity with continuity and regularity, and the taxpayer’s primary purpose for engaging in the activity must be for income or profit.”

Lender Management, LLC (LM) operated as a fund manager by providing direct management services to three limited liability companies (investment LLCs) and directing the investment and management of assets held by the investment LLCs for the benefit of their multiple owners. The ultimate owners in each case were all children, grandchildren or great-grandchildren. Each investment LLC held different classes of assets. Based on these facts, the Internal Revenue Service contended the taxpayer’s primary activity was managing the Lender family fortune for members of the Lender family. The Court, however, focused on several facts or attributes of LM that led to the conclusion that it was engaged in a trade or business.

First, its employees worked full-time and were involved in researching investment opportunities, executing new investments, monitoring existing positions, and working with individual clients to understand their investment needs. LM also engaged the services of an outside firm to supplement its ability to provide its clients a complete set of investment management services. The services LM provided were comparable to the services that hedge fund managers generally provide, including the responsibility to provide clients with sound investments with growth potential and investments tailored to their specific financial needs. Consequently, the Court concluded that LM’s activities went far beyond those of an investor managing the investor’s assets.

Second, LM was entitled to a profits interest as compensation for its services. LM and its managing members held minority interests in the investment LLCs. LM did not receive a fee but rather held a profits interest and received compensation for its services only if the investment LLCs earned net profits. The absence of fees motivated LM to increase the net values of the investment LLCs. To the extent that the net assets of the investment LLCs increased in value, the operating agreements provided that LM could receive compensation separate from, and in addition to, the amounts it received for its investment membership interests. According to the Court, the profits interest provided substantial incentive to deliver high-quality management services. Additionally, LM’s compensation structure revealed its predominant activity was providing investment management services to others, rather than passive investing for itself.

Third, although each investor in the investment LLCs was in some way a member of the Lender family, LM’s clients did not act collectively or with a single mindset. LM’s clients were geographically dispersed, many did not know each other, and some were in such conflict with others that they refused to attend the same business meetings. Their needs as investors did not necessarily coincide. Hence, LM did not simply make investments on behalf of the Lender family as a single, collective entity, but provided investment advisory services and managed investments for each of its clients individually, regardless of the clients’ relationship to each other or to the managing member of LM. The Court noted that there were no attribution rules that would require the Court to treat LM or its managing member as owning all of the interests in the investment LLCs.

Conclusion

Federal tax reform has potentially and perhaps unexpectedly increased the tax liability for families by destroying the deduction for investment expenses. The Lender Management case, however, may provide an opportunity for family offices to maintain deductibility for legitimate business expenses. If your family office desires to follow the precedent and direction of Lender Management, your facts should be carefully reviewed by qualified counsel to determine the necessary operational and legal restructuring required to obtain the desired outcome.

Our Team

For nearly 30 years, large, family-owned and closely held businesses, high net worth individuals, family offices including their private trust companies, and tax-exempt organizations around the world have sought out our team to provide practical tax, business, and estate and trust planning solutions.

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