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Family Offices Allow (Some) Taxpayers to Deduct Investment Related Expenses

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WHAT IS A FAMILY OFFICE?

Family offices have been a very popular topic for articles, conferences and discussions with high net worth families for a number of good reasons.

These include: (1) customizing a private and high quality concierge style investment, business, financial and educational management system for a particular family; (2) providing competitive pricing by directly hiring talented and skilled advisors by a family entity to "skip the middle man" of law firms, CPA firms, and investment houses that might otherwise add to costs incurred; (3) use and develop the talents of family members and close family friends who might not have involvement or participation in a traditional arrangement; (4) more significantly involve family members who may have an interest in helping to run a family office and provide professional and investment services, as opposed to relying upon separate professional and investment advisory entities that would otherwise "handle everything"; and (5) last but not least, facilitate deductibility of expenses associated with the operation of a family office, most notably including costs incurred with professional investment advisors that are deductible under §162[1] as active trade or business expenses, and would not be deductible after the Tax Reform Act of 2017, if they are merely "investment expenses" under §212.

Because of reason number (5) above, the Tax Cuts and Jobs Act[2] has propelled the proliferation of family offices, given that §212 no longer provides a deduction for expenses incurred in the collection and production of income, unless they arise to the level of an "active trade or business."

Under prior law, §212 provided a deduction for expenses incurred in the collection and production of income to the extent that such expenses exceeded 2% of the taxpayer's adjusted gross income. Before 2018,

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[1] All section references herein are to the Internal Revenue Code of 1986, as amended (the "Code"), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

[2] Pub. L. No. 115-97, §11045 (effective from 2018 through 2025).

expenses incurred in the collection and production of income were deductible to the extent exceeding 2% of the taxpayer's adjusted gross income.

As relevant here, adjusted gross income includes certain items ''attributable to a trade or business carried on by the taxpayer.'' If an expense is not incurred in a trade or business, or excepted elsewhere in §62(a), it will not be part of adjusted gross income, and will be disallowed as a miscellaneous itemized deduction. Thus, individual taxpayers generally cannot enjoy the deduction in §212 for nonbusiness income, which is the best candidate for deducting investment expenses. The same is generally true of trusts.[3]

As described in IRS Publication 529, *Miscellaneous Deductions*, miscellaneous itemized deductions include functions which are typically performed by family offices—such as legal fees related to producing or collecting taxable income or getting tax advice; investment fees and expenses, and clerical help and office rent in caring for investments. However, the problem is not unique to a formal office. The same is true when an individual uses the services of an investment advisor. His CPA will report these expenses on Schedule A as an investment expense, rather than on Schedule C as a trade or business expense. As such, the deduction will be disallowed.

Because of the factors set forth above, many families have and will set up family offices that will hire professional investment advisors to manage investment accounts, and will deduct the expenses incurred with respect thereto. Affluent taxpayers will look for ways to deduct such expenses and may consider creating a family office to manage their family's investments. While these entities may work for some, this strategy will mainly appeal to very wealthy families. Families can set up a family office and hire a professional investor to manage their accounts with the goal being the ability to deduct expenses associated with the investment management and conducting the family office.

When setting up a family office, it is important to consider the tax effects of the office's own activities. It will incur payroll, rent, and other expenses. To pay these expenses, income must first be earned. If a taxpayer cannot deduct the expenses, the result could be a tax disaster—minor or major, depending on the size of the office, and the wealth of the family.

Some families may hire a relative to manage their investments, but most hire one or more professionals that they are already using, and wish to deduct at least part of the investment manager's salary, or other compensation and benefits paid.

There are a number of requirements that must be met in order to create a successful family office. The main requirement is that the business qualifies as a trade or business under §162. A trade or business under §162 is not defined under the I.R.C., but there is significant case law which provides guidance as to what will constitute a ''trade or business'' for the purposes of §162.

A successful family office arrangement was achieved in a recent case, *Lender Management, LLC vs. Commissioner*,[4] involved a family office that was owned 99% by one individual and 1% by another individual from the same family. The LLC (Lender Management, LLC) provided investment management services for a number of different LLCs owned by various family members.[5] Most of the owners of the LLC that held investments for the Lender family were individuals who did not own an interest in Lender Management, LLC, but were members of the same family.

Lender Management, LLC received a profits-based payment from the LLCs that managed investments and provided direct advisory and financial planning services.[6] Having a performance-based compensation model is important because it shows that the entity must operate like a trade or business to make a profit, and provides an incentive for active management and positive results.

It is important to note that Lender Management, LLC engaged outside experts, exercised ultimate authority over the investment LLCs, and did not always follow the advice of its outside experts. Such actions evidenced that the LLC was acting independently and was not merely created to obtain a tax deduction.

It appears that a substantial amount of work was performed by the individuals managing Lender Management, LLC. Given the activities conducted by the LLC in actively managing the investment LLCs and providing investment services, the Tax Court found that Lender Management, LLC satisfied the requirements of §162 to be classified as an active trade or business.[7]

Another Tax Court case that is usually referenced in relation to family offices is *Hellmann v. Commissioner.*[8] In this case, a family office was created to manage investments for four family members. Those

[3] *See* §67(e); Reg. §1.67-4(b) (result depends on whether the costs would have been incurred by an individual); Notice 2018-71 (clarifying that the Tax Cuts and Jobs Act does not impact these rules).

[4] T.C. Memo 2017-246.

[5] T.C. Memo 2017-246.

[6] T.C. Memo 2017-246.

[7] T.C. Memo 2017-246.

[8] *Hellman v. Commissioner*, United States Tax Court Order

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same four family members owned the entity that was providing the investment-related services. This case did not reach a final decision and was settled outside of court, but it appears that the Tax Court was more concerned with the facts of this case because:

a. the family was reimbursing the entity for its services rather than allowing it to earn revenues that would have resulted in profits, if it had performed appropriately; and

b. the entities had the same owners, and the profits from the family office were being allocated to the family members in a similar proportion to their ownership interests in the underlying funds.

Due to the above, the allocation of profits for the investment management entity was identical to the allocation of profits associated with the entities that owned the investments. This negates the economic substance of the family office and is a distinguishing fact from *Lender Management*.

Although the §162 trade or business classification must be determined on the facts and circumstances basis,[9] it is fairly clear that a family office should be structured to resemble the structure in place in the *Lender* case.

If the family is large enough, and the money manager's job is complicated enough, there may a solution. That solution is to assert that the family office really is engaged in a trade or business—namely, the trade or business of managing other people's money. While it is hard to draw a bright line, common sense helps. The trade or business is more likely to be respected if the family is large and diverse, owning different shares of different assets, thus placing diverse demands on the money manager. Also, the profits earned by the family office should not flow pro rata to every family member, instead they should flow to those members of the family who are involved in running the family office.

Based upon the above, it appears that the following structure would likely work, if implemented for sound business reasons, and not as a contrivance to facilitate the deductibility of investment advisory expenses that would not otherwise be deductible:

1. The LLC or corporation that will manage investments (the Family Office Entity) should have some level of control over the investment decisions made by the various investment entities made by the entities owning the investments (the Investment Entities), and preferably would have final authority as to investment management decisions.

2. The owners of the Family Office Entity should be different than the owners of the Investment Entities. This has the effect of shifting income among the family members and shows the intent of the family office to actively conduct a trade or business. This arrangement should be structured based upon arm's-length terms in order to support the existence of the family office for non-tax purposes.

3. Having a profits-based compensation model for the Family Office Entity is important in order to show that the Investment Entities are not merely shifting expenses to the family office to try to make its expenses tax deductible. Thus, the taxpayer should be able to show an incentive and non-tax purpose for operating the Family Office Entity other than for tax avoidance purposes. Further, the Family Office Entity should refrain from arranging the investments manager's fee to be paid by the entity which holds the underlying investment, in the form of a ''guaranteed payment.'' Because the services provided by the investment manager are for the benefit of the investor and not the investment, the deductions would be disallowed under §67(c) and Reg. §1.67-2T which disallow deductions that are assigned to a pass through nearly to obtain the deductibility of miscellaneous itemized expenses.

4. The Family Office Entity should customize its investment strategy and advice for each of the Investment Entities that employ it. This shows that the Family Office Entity is actively conducting a trade or business, and that it must take the time to analyze the investment objectives of each investment entity and to customize an investment program for each entity.

5. It is also important to look at the expertise and level of sophistication of the parties controlling and operating the Family Office Entity. It would be good to have a party who is financially savvy and has a finance, accounting, or similar degree that would indicate some level of financial expertise, or may have experience in the financial industry.

6. It would be a good idea to include provisions in the agreement with the Family Office Entity that allow the Investment Entities to fire and replace the Family Office Entity in order to help provide evidence that the Family Office Entity is acting as a real trade or business and independent of the Investment Entities.

STRUCTURING A FAMILY OFFICE

A family office can be structured in several different ways. The first choice that has to be made is what

dated Oct. 1, 2018, Docket No. 8486-17, 8489-17, 8494-17, 8497-17, available at https://aboutbtax.com/O7X.

[9] *See, e.g.*, *Spermacet Whaling & Shipping Co. v. Commissioner*, 30 T.C. 618 (1958), *aff'd*, 281 F.2d 646 (6th Cir. 1960).

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form of entity will be used for federal income tax purposes. A family office could be structured as a partnership, S corporation, C corporation, or other form of entity. In most cases, the family office will be a partnership, an S corporation or a C corporation.

When determining whether to use a partnership, an S corporation, or a C corporation, the tax implications involved must be considered. One consideration is planning for net operating loss carryforwards. C corporations generally can carry forward net operating losses and deduct all of such expenses, but if the entity is taxed as a partnership or S corporation then §461(l) generally provides that a partner or shareholder can only deduct the expenses associated with his or her share of the family office against other trade or business income, plus up to $250,000 for single taxpayers and $500,000 for taxpayers that are married and filing jointly.

Another advantage of the C corporation is that it is taxed directly. Therefore, due to its structure, it may more easily overcome the trade or business hurdle in the event that is ever in question. Some practitioners believe that operating under a C corporation would make it easier to meet the trade or business exception, but the authors are skeptical.[10] Nevertheless, it is unclear whether operating under a C corporation would really make it easier to meet the trade or business exception.

Further, when determining whether to operate as a partnership, an S corporation, or a C corporation, the degree of activity of the owners of the family office is a consideration. If the owners do not meet certain threshold levels of activity, then losses will be considered passive and will only be deductible against passive gains.

Section 469 will apply to determine whether the taxpayer is engaging in an active trade or business, which will require him or her to expend at least 100 hours on the activity each year, with some exceptions that allow a taxpayer to qualify by being active for three out of six years, or five out of 10 years, depending on the circumstances.[11]

Due to the §469 concerns, it is likely that many taxpayers will prefer to create a C corporation because the §469 restriction generally should not apply. The issue with creating a C corporation is that any net operating losses will not be passed through to the individual taxpayer owners and will only be deductible against C corporation net income in future years. Additionally, income of a C corporation is subject to double taxation, which makes the C corporations structure generally less preferable than an S corporation or partnership.

Even with a C corporation, there can be a §469 issue if it is deemed to be a personal service corporation. This is generally the case when any employee providing substantial family office services owns stock of the C corporation and more than 10% of the stock is owned by one or more of its employees, after accounting for attribution through family members pursuant to §318. One way around this is to have an individual own over 50% of the stock and materially participate in the family office business. This means that such individual must actively participate in the operations of the Family Office Entity for at least 100 hours per year.

Section 469 is a facts and circumstances based test so the only clear way to meet the test is to participate for at least 100 hours per year, with no other person providing more hours of service to the entity.[12] This means that the owner who wants to materially participate must work more than any other employee, independent contractor, child, or other person working for the entity. Alternatively, the taxpayer can be deemed as *per se* active by spending at least 500 hours a year working in the Family Office Entity.

This raises additional issues, as activities that are generally conducted by investors do not count towards the material participation requirement. However, it is likely that investment related activities would qualify in the event that the materially participating owner is analyzing and reviewing investment strategies in order to provide services to the Investment Entities.

It is also important to assure that the Family Office Entity is being compensated based upon performance in amounts and upon terms which are commensurate with fair market value. This shows that entity as actually operating a trade or business, rather than simply reimbursing the family office for expenses. This also shows that the efforts exerted by the materially participating owner would be in effort to make the family office profitable.

PARTNERSHIP

Many taxpayers use an LLC taxed as a partnership to run a family office. The benefit of using an LLC taxed as a partnership is that the net operating losses will be passed directly through to the owners.

One of the main problems with using an entity taxable as a partnership is that the net operating losses that are passed through to the individual owners will only be allowed to offset other sources of passive in-

[10] For an example supporting their view, see Rev. Rul. 78-195; for a counterexample, see Reg. §1.864-3(b), *Ex.* (2).

[11] §469(c).

[12] Reg. §1.469-5T.

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come unless the other owners materially participate. It is likely easy for the managing partner to materially participate due to the 100 hour requirement, but in order for any other owner to be treated as active, all of the owners would have to meet the 500 hour requirement.

CARRIED INTEREST CONSIDERATIONS

A family office entity may be paid based upon a percentage of capital gains and other income earned by the family related entities that it manages. Under the carried interest rules, such income could be taxed in the same manner as capital gains, if the family office is structured as a partnership and if the income attributable to capital gains is realized from the appreciation of assets that have been owned by the Investment Entity at least three years before they are sold.[13] Discussion of the requirements and factors that apply to structuring carry interest arrangements is beyond the scope of this article, but reviewing such rules is warranted in the context of structuring family offices.

Management agreements should take this into consideration, in the same manner that hedge fund managers satisfy active trade or business balance sheet requirements.

A C corporation can also be structured as a §1202 company which could provide significant tax benefits if and when the entity is ever sold.[14] A C corporation that is actively engaged as a management company may invest its earnings in active business assets, that can include computers, office furniture and equipment, and assets used in other active trade or businesses. This could include, by means of example, billboards, if the company is also in billboard advertising business, thoroughbred horses, if the company is also in the horse breeding and/or racing business, or a factory established or engaged in manufacturing and selling proprietary products.

A family office can also provide pension benefits for employed family members, and fringe benefits that can include tax-free medical insurance, disability insurance, and travel and entertainment expenses that are reasonably related to the activities of the company.

DOWNSIDES

Families and their advisors should consider whether a family office is in the best interests of the family itself, taking into consideration the following factors:

1. The very best lawyers, accountants, and investment advisors will commonly want to work for law firms, CPA firms, and investment firms where they can provide services for a number of different families in order to enjoy an economy of scale for their skills, continuing education, and teams.

2. Family members who rely upon the family office for employment or become the family office managers, may not be the most experienced, objectively selected, or trained professionals for the position. That may reduce the level of service to the family office, increase the risk of problems, and the possibility that results will not be as advantageous as would apply in a traditional competitive law firm/CPA firm/investment advisory house model.

3. Family members that become more involved with one another and their applicable business, investment, and personal situations may have relationship issues, lack of confidentiality within the family, and issues that arise when in-laws (who may become outlaws) become more involved with one another's business, investment and personal affairs.

CONCLUSION

Notwithstanding the above concerns, family offices can provide valuable services and benefits to many affluent individuals and families, while permitting them to deduct directly or indirectly deduct expenses associated with investment advisory services that are provided thereto. Care must be given to structuring such arrangement in order to achieve expected goals and to avoid causing the arrangement to become more trouble than it is worth.

Affluent families should consider the advantages and disadvantages of having involvement with a family office entity, taking into consideration both the tax and practical aspects thereof. The decision should be made only after careful evaluation of what quality and quantity of professional services and advice the family will receive from the arrangement, what this will cost, and how the family office entity and its professional employees and contractors will be held accountable for providing the same or a better level of services and professionalism that would otherwise be available and expected by similarly situated traditional service providers.

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[13] §1061.

[14] Alan S. Gassman, *et al.*, The Section 199A (and 1202) Handbook (2019), Chapter 8.

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