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I. INTRODUCTION

In 2017, two tax developments sent shockwaves throughout the family office community. First, the Tax Court, in *Lender Management v. Commissioner*, held that a multi-generational family office was a trade or business and could take above-the-line deductions for operating expenses it incurred.[1] Second, Congress passed the 2017 Tax Act (commonly known as "TCJA"[2]) which disallowed operating expenses for taxpayers engaged in a profit-seeking activity like investing.[3] Before the TCJA, taxpayers had an incentive to argue they were engaged in a trade or business: expenses would be fully deductible if they were and limited if they were only engaged in a profit-seeking activity.[4] But the combination of *Lender* and the 2017 Tax Act made that incentive even greater for family offices.[5]

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1 Lender Mgmt., LLC v. Comm'r, T.C. Memo. 2017-246, 114 T.C.M. (CCH) 638 (2017).

2 That said, TCJA was not the Bill's official name. *See* Pub. L. No. 115-97, 131 Stat. 2054 (2017) (noting that the official name of the bill is "An Act to provide for reconciliation pursuant to titles II and V of the concurrent resolution on the budget for fiscal year 2018").

3 *See id.* § 11045 (disallowing a taxpayer from taking a section 67(a) miscellaneous itemized deduction, which included section 212 deductions for a taxpayer incurred expenses in connection with a profit-seeking activity).

4 *Compare* I.R.C. § 162 ("There shall be allowed as a deduction all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business . . . ."), *with* I.R.C. § 67(a) ("In the case of an individual, the miscellaneous itemized deductions for any taxable year shall be allowed only to the extent that the aggregate of such deductions exceeds 2 percent of adjusted gross income.").

5 *See* Farhad Aghdami & Michelle L. Harris, *IRS Gets "Bageled" in Tax Court Over Family Office Expenses*, WILLIAMS MULLEN (Sept. 28, 2018), https://www.williamsmullen.com/news/irs-gets-%E2%80%9Cbageled%E2%80%9D-tax-court-over-family-office-expenses-1 ("[The *Lender*] decision is particularly notable because it affirms the ability of a family office to be respected as a trade or business for federal income tax purposes—an ability that is particularly important under the new tax reform legislation."); Mark Leeds, *New Tax Case Provides Guidance on Deductions for Fees Incurred by Family Offices*, MAYER BROWN (2018), https://www.mayerbrown.com/-/media/files/perspectives-events/publications/2018/01/new-tax-case-provides-guidance-on-deductions-for-f/files/update-guidance-deductions-family-offices/fileattachment/update-guidance-deductions-family-offices.pdf (noting that The TCJA (i.e., the Section 11045 repeal of the miscellaneous itemized deductions) puts "an even more important significance" on "the distinction between business expenses and investment expenses.").

In response to this incentive, law firms and accounting firms have encouraged clients to create structures like the taxpayer's structure in *Lender*.[6] The cost savings associated with a *Lender* structure were and remain substantial.[7] Family members investing through a family office structure now can take immediate ordinary income tax deductions yet pay tax at the preferential long-term capital gains rate.[8] Because family offices are implementing this structure at a rapid pace, a thorough understanding of the core issues in *Lender* is timely and necessary.

The theoretical starting point for this discussion is an analysis of whether a family office is a trade or business. The Supreme Court long ago established "[n]o matter how large the estate or how continuous or extended the work required may be," a taxpayer who solely manages investments for himself will not be engaged in the trade or business of investing.[9] Courts have since only drawn two exceptions: when the taxpayer acts as a conduit for investors (dealer) or derives profits from active trading (trader).[10] Some courts have created a third exception for private equity and venture capital funds even though these taxpayers fall somewhere between the dealer and investor label. The *Lender* court eschewed the traditional trade or business test, finding instead that the family office was a trade or business because it operated like a traditional investment fund and received a profits interest for the services it performed.

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6 *See, e.g.*, Aghdami & Harris, *supra* note 5; Leeds, *supra* note 5; Amy E. Heller & Ivan Taback, *Impact of New US Tax Law on High Net Worth Individuals, Trusts and Family Offices*, SKADDEN (Jan. 23, 2018), https://www.skadden.com/insights/publications/2018/01/2018-insights/impact-of-new-us-tax-law; Anchin Alert, *Tax Court Ruling That Family Office Carried on a Trade or Business May Offer Tax Planning Opportunities*, ANCHIN, BLOCK & ANCHIN LLP (Feb. 5, 2018), https://www.anchin.com/uploads/1413/doc/Alert_02052018_Tax-FamilyOffice-FS.pdf; Newsletter: Private Investment & Family Office Insights, *The Profits Interest Family Office Structure*, KIRKLAND & ELLIS LLP (Sept. 25, 2018), https://www.kirkland.com/-/media/publications/newsletter/2018/09/private-investment-family-office-insights/privateinvestmentfamilyofficeinsights92518.pdf.

7 KIRKLAND & ELLIS, *supra* note 6 ("Depending on the size of the family office and number of existing entities, implementing the profits interest family office structure can be complicated, although the benefits usually well outweigh the cost.").

8 A third prong of the *Lender* decision is that by putting assets into a family partnership structure, the estates of the individuals who own a beneficial interest in the family partnerships will pay less in estate tax. Lender Mgmt., LLC v. Comm'r, T.C. Memo. 2017-246, 114 T.C.M. (CCH) 638 (2017). A discount of 10-20% is common in these situations. *See generally* Louis A. Mezzullo, *Wealth Planning with Family Limited Partnerships and Limited Liability Companies*, 722 TAX MGMT. PORTFOLIOS (BNA), at I.C. (acknowledging the potential estate tax benefit of putting assets in an investment LLC, similar to what the Lender family did, but not discussing this potential benefit).

9 Higgins v. Comm'r, 312 U.S. 212, 218 (1941).

10 *See infra* Part II.A.

While the *Lender* decision was no doubt a positive one for taxpayers, some family offices may not celebrate that decision as much as one would expect. First, a few aspects of the Tax Court's decision are not persuasive. Future courts may find the court's analysis of the family office's profit interest structure was lacking relative to the varied ways in which a family office can create a profits interest. Courts may also adopt a different standard from which to evaluate the trade or business question. These points are even more important because *Lender* is a memorandum opinion and has no precedential value.

Second, the *Lender* decision was narrow. This paper lists four reasons why the *Lender* structure may not be the panacea for every family office: some family offices don't have as favorable facts as the *Lender* taxpayer; some family offices will be unable to fall under an exemption from securities registration; a family office's profits interest may create other unintended tax consequences; and family investment partnerships will still be unable to deduct investment expenses. These reasons do not diminish the benefit of the *Lender* structure. Instead, these issues reflect significant concerns that every lawyer and family office executive needs to consider before jumping into the fray with their own *Lender* structure.

This paper proceeds as follows. Part II describes the sometimes-amorphous distinction between dealers, investors, and traders. It also provides a brief case study of private equity funds. Part III discusses the Lender family office structure and the *Lender* decision. Part IV discusses the implications of the case for future family offices and courts looking at the issue. Part V concludes.

II. Background

A. Dealer, Trader, Investor

Lots of people buy, sell, and hold investments for many purposes and in many roles. Tax law separates these people into three categories: dealers, taxpayers like stockbrokers who help facilitate investments; investors, people with other jobs who invest their own money for personal gain; and traders, people in the profession of trading because they trade with more frequency and exploit short-term gains.[11] Though not found in the Code, these labels provide a useful shorthand for the tax consequences of the activities of the taxpayer.[12] This distinction is not pedagogical. As this section explores, whether a taxpayer is a dealer, trader,

[11] Shu-Yi Oei, *A Structural Critique of Trader Taxation*, 8 Fla. Tax Rev. 1013, 1016–17 (2008).

[12] Boris Bittker I. & Lawrence Loken, Federal Taxation of Income, Estates and Gifts ¶ 47.2 (Thomson Reuters/Tax & Acct. eds., 2d/3d ed. 2019) (discussing

or investor may have significant consequences on whether the person can deduct investment expenses incurred in generating the income.

1. *Dealer—A Merchant of Securities*

A dealer is a "a merchant of securities" who "buys securities and sells them to customers with a view to the gains and profits that may be derived therefrom."[13] Essentially, the dealer "seek[s] to profit on the resale of those securities at marked up prices."[14] For example, a dealer is a business that, in its "ordinary course," may offer interest rate or currency swaps to customers.[15] As the next sub-section will show, some argue that private equity and venture capital funds are also "dealers" because they act as a party who buys securities on behalf of investors in hopes that the funds will sell the investments at a higher price in the future.[16]

There are three primary tax characteristics of this label. First, because dealers sell securities "to customers," the securities in which they deal are not capital assets under section 1221(a)(1), and the dealers therefore need to pay tax at an ordinary income tax rate. Second, dealers need "to recognize gain or loss annually on a mark-to-market basis on their securities inventories and other securities not held for investment."[17] Third, dealers are in the trade or business of dealing securities and can deduct business expenses under section 162, which means that these losses can offset ordinary tax income and are not limited.

2. *Trader—Frequent, Regular, and Continuous Activity*

A trader manages a portfolio like a business with regularity and frequency. The term "refers to those individuals who actively buy and sell securities held over the short term for their own account, such as individuals who engage in online trading of stocks and securities."[18] Much like a dealer, the trader is engaged in a "trade or business" for his activities in buying and selling securities.

Traders, like dealers, can deduct business expenses under section 162 and often hold capital assets. Even so, because traders usually deal securities with great frequency—i.e., buy and sell the same security within a matter of days or weeks—they often need to recognize short-

how the dealer and trader distinction is a label associated with the expense because neither term appears in section 1221).

13 Oei, *supra* note 11, at 1017 (citing Treas. Reg. § 1.471-5).

14 *Id.*

15 *Id.* at 1064 (citing I.R.C. § 1.475).

16 *See infra* Part II.B.1.

17 Bittker & Loken, *supra* note 12, ¶ 107.8.

18 Oei, *supra* note 11, at 1017-18.

term capital gains and pay tax at the higher, ordinary income tax rates. Additionally, traders can "mark to market" their securities under section 475(f) so that the trader can recognize unrealized income and losses from their trading every year.

Although the line between trader and investor can be blurry, Professor Oei distillated the difference into two essential traits. First, traders engage in activity that is "frequent, regular, and continuous enough to so qualify" as a trade or business.[19] For example, one taxpayer in *Fuld v. Commissioner* made "about 249 sales of securities held for more than two years and about 98 sales of securities for two years or less" and "devoted an average of eight hours a day to studying texts and services, charting prices, conferring with his broker, attending meetings, and consulting corporate executives."[20] Likewise the taxpayer in *Mayer v. Commissioner* engaged in "substantial" activities where he "had over 1,100 executed sales and purchases in each of the years at issue."[21] But the taxpayer in *Chen v. Commissioner* was not a trader, in part because he made 94% of his trades "between February and April, and no transactions occurred in six of the other nine months of the tax year."[22]

Second, Professor Oei said that traders must intend to make a short-term profit from the holding, buying, or selling the securities involved.[23] In summarizing the distinction between a trader and an investor, the court in *Moller v. Commissioner* said that a trader must engage in activities "directed to short-term trading, not the long-term holding of investments, and income must be principally derived from the sale of securities rather than from dividends and interest paid on those securities."[24]

The seminal case of *Commissioner v. Groetzinger*, which held that a professional gambler—whose sole wages derived from gambling—was engaged in a trade or business, highlights the short-term aspect of the trader distinction.[25] The Supreme Court acknowledged that the tax-

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19 *Id.* at 1032.

20 *Id.* (quoting Fuld v. Comm'r, 139 F.2d 465, 485–89 (2d Cir. 1943)).

21 *Id.* (quoting Mayer v. Comm'r, T.C. Memo. 1994-209, 67 T.C.M. (CCH) 2949, 2949-4, -5 (1994)).

22 *Id.* (citing Chen v. Comm'r, T.C. Memo. 2004-132, 87 T.C.M. (CCH) 1388 (2004)).

23 *Id.* at 1035.

24 *Id.* at 1036 (citing Moller v. Comm'r, 721 F.2d 810, 813 (1983)).

25 480 U.S. 23 (1987). Although the Court did not directly adopt this dealer-trader-investor label, it implied that the distinction was relevant. *Id.* at 28 (noting that "the Court appears to have drawn a distinction between an active trader and an investor").

payer was engaged in a trade or business, despite its unconventionality.[26] The Court rationalized the case as follows:

> We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit. A sporadic activity, a hobby, or an amusement diversion does not qualify.[27]

The Court also cleared one misconception that taxpayers seemed to struggle with after Justice Frankfurter's concurring opinion in *DuPont*:[28] a trader need not trade to customers.[29] Traders need not sell securities on behalf or to another entity. What is important is that the taxpayer "must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit."[30] In other words, traders need not sell to anyone; they may be engaged in a trade or business simply by buying and selling securities using their own personal funds.

3. *Investor—Infrequently Purchasing Securities Using Your Own Money*

Someone who buys and holds securities is not a dealer or a trader, but an investor. An investor holds an investment "for investment or speculation," does not hold itself out as a merchant of securities, and does not engage in trading activities with the regularity to make himself a trader.[31] For example, a lawyer who works forty-hours a week at a law firm and spends one-hour a week "managing his portfolio" is likely an

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26 *Id.* at 33 ("If a taxpayer . . . devotes his full-time activity to gambling, and it is his intended livelihood source, it would seem that basic concepts of fairness . . . demand that his activity be regarded as a trade or business just as any other readily accepted activity . . . .").

27 *Id.* at 36.

28 *Id.* at 29 (citing Deputy v. Du Pont, 308 U.S. 488, 499 (1940) (Frankfurter, J., concurring)); *see also* F. Ladson Boyle, *What Is A Trade or Business?,* 39 TAX LAW. 737, 762 (1986) (noting that in the pre-*Groetzinger* context, "the goods or services test of Justice Frankfurter is the hardest to justify" because although it is "reasonably objective, in operation, it has little effect and can produce unfair results").

29 *Groetzinger*, 480 U.S. at 34 ("We are not satisfied that the Frankfurter gloss would add any helpful dimension to the resolution of cases such as this one, or that it provides a 'sensible test. . . .' It might assist now and then, when the answer is obvious and positive, but it surely is capable of breeding litigation over the meaning of 'goods,' the meaning of 'services,' or the meaning of 'holding one's self out.' And we suspect that—apart from gambling—almost every activity would satisfy the gloss.").

30 *Id.* at 35.

31 Treas. Reg. § 1.471-5(c).

investor when he manages his portfolio.[32] Unlike dealers and traders, investors do not have a trade or business.

Investors' tax characteristics are both better and worse of that of a dealer or trader. First, investors hold capital assets because the investor does not sell "to customers." Because section 1221 works as an exclusionary rule (saying a capital asset is any asset not explicitly listed in the statute) and because none of the exceptions under the rule apply, investors will pay income tax at a preferential capital gains tax rate. Second, although the tax treatment of income is more beneficial to investors, investors have a worse tax treatment for losses. Individuals and corporations are limited in the investment losses that they can deduct.[33] Third, investors are typically not in the trade or business of investing securities and thus cannot deduct business expenses under section 162. Investors can deduct expenses under section 212, but the TCJA limited the ability of investors to deduct these expenses until 2026.[34]

The prototypical investor is the taxpayer in *Higgins v. Commissioner*,[35] a case that held that someone managing investments for his own family does not have a trade or business.[36] The Court noted that the investor had "extensive investments in real estate, bonds and stocks, devoted a considerable portion of his time to the oversight of his interests and hired others to assist him in offices rented for that purpose."[37] The taxpayer argued that his actions were more like a trader—that "'elements of continuity, constant repetition, regularity and extent' differentiate his activities from the occasional like actions of the small investor."[38] The Court rejected his argument: "[n]o matter how large the estate or how continuous or extended the work required may be," an investor does not have a trade or business when he "merely kept records and collected interest and dividends from his securities, through managerial attention for his investments."[39]

32 GREGG POLSKY, *Income Tax*, *in* STAY AHEAD OF THE PACK: YOUR COMPREHENSIVE GUIDE TO THE UPPER LEVEL CURRICULUM 443 (2018).

33 *See* I.R.C. § 1211.

34 *See* Pub. L. No. 115-97, § 11045, 131 Stat. 2054 (2017); I.R.C. § 67(g).

35 312 U.S. 212, 216-17 (1941). The taxpayer in *Synder* also exemplifies a typical investor. The taxpayer in that case was a "salaried secretary" who made a series of margin trades and tried to argue that he was in a trade or business. *See* Snyder v. Comm'r, 295 U.S. 134, 139 (1935). The Court rejected his argument, noting that he did not "make a living in buying and selling securities" and only tried to take "advantage of the turns of the market" by increasing his margin "as great an extent as the margin of his account permitted." *Id.* In other words, the taxpayer in *Synder* was not a trader because he did not engage in enough regular activity to gain the trader label.

36 *Higgins*, 312 U.S. at 218.

37 *Id.* at 213.

38 *Id.* at 215.

39 *Id.* at 218.

The Court reaffirmed its position in *Whipple*, in which it denied a taxpayer from taking certain business losses because the taxpayer was not engaged in a trade or business.[40] There, the Court explained that

> devoting one's time and energies to the affairs of a corporation is not of itself, and without more, a trade or business of the person so engaged. Though such activities may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation's business as distinguished from the trade or business of the taxpayer himself. *When the only return is that of an investor, the taxpayer has not satisfied his burden of demonstrating that he is engaged in a trade or business* since investing is not a trade or business and the return to the taxpayer, though substantially the product of his services, legally arises not from his own trade or business but from that of the corporation.[41]

Even though the Supreme Court decided *Higgins* over eighty years ago and before the enactment of section 212, the Court highlighted its significance in *Groetzinger*. There, the Court did

> not overrule or cut back on the Court's holding in *Higgins* when we conclude that if one's gambling activity is pursued full time, in good faith, and with regularity, to the production of income for a livelihood, and is not a mere hobby, it is a trade or business within the meaning of the statutes with which we are here concerned.[42]

Put another way, *Higgins* is still and has always been good law. Someone managing investments for their personal account or their family will not be engaged in a trade or business unless that taxpayer's activity rises to the level of a trader.

But some lawyers seem to think that this analysis changes for C corporations because there is a *presumption* that a C corporation has a trade or business. More precisely, lawyers and accountants point to Revenue Ruling 78-195, in which the IRS said that a corporation "that was formed for the express purpose of investing in real property purchased a tract of unimproved, non-income-producing real property, which it held for two years and sold without having made any substantial improve-

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40 Whipple v. Comm'r, 373 U.S. 193 (1963).

41 *Id.* at 202 (emphasis added).

42 Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987).

ment" was eligible to take a section 162 deduction for its expenses.[43] The ruling stated that the "the corporation did not make any significant efforts to sell the property and did not engage in any other transactions in real or personal property or in other commercial activities."[44] In other words, the corporation likely was not a dealer or trader, but the IRS still said that the entity was in a trade or business; ergo, tax practitioners rationalize that the trade or business analysis must differ for C corporations.

But the problem with this logic is that it does not come from any statute or case. Instead, the main support for this argument comes from a Revenue Ruling that was scant on analysis and rationale. It is likely that a court will not defer to this ruling as it lacks any "power to persuade" given its inconsistency with the general case law regarding trade or business.[45] Additionally, whatever presumption existed in pre-TCJA (when the corporate tax rate was 35%) likely does not exist today (when the corporate tax rate is 21%). If a corporation reinvests its profits, it is possible that a taxpayer will pay less in overall tax in a corporate structure after accounting for the time value of money than the taxpayer would pay holding an investment in his or her own name. It would simply be too easy of a work around if taxpayers could incorporate a family office and turn otherwise section 212 expenses into section 162 expenses. Instead, it is far more likely that the dealer-trader-investor analysis does not differ depending on the entity which the taxpayer uses.

B. Private Equity Funds

Private equity funds offer an interesting analogy to family office structure described in *Lender*. Because the *Lender* court spent much of the opinion comparing the family office to a typical investment fund,[46] a brief detour will enlighten the discussion of the *Lender* case.

Private equity funds "make investments in portfolio companies, usually in connection with increasing the leverage of those compa-

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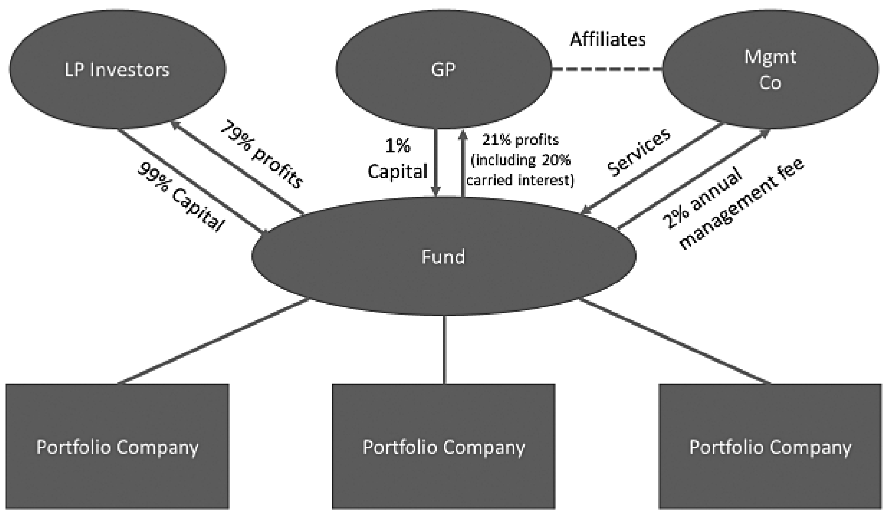
[43] Rev. Rul. 78-195, 1978-1 C.B. 39. *But see* Treas. Reg. § 1.864-3(b), ex. 2 (concluding that a U.S. subsidiary of a foreign holding company is not in a trade or business in the United States "by reason of the activities carried on in the United States by its chief executive officer in the supervision of its investment in its operating subsidiary corporations").

[44] Rev. Rul. 78-195.

[45] *See* Skidmore v. Swift & Co., 323 U.S. 134, 140 (1944).

[46] *See* Lender Mgmt., LLC v. Comm'r, T.C. Memo. 2017-246, 114 T.C.M. (CCH) 638 at *2-7 (2017). Although the *Lender* court mentioned that the family office was providing services similar to that of a hedge fund, it does not seem like the family office was trading enough to be considered a hedge fund. Because Lender Management seems to have been buying and holding its interests not for short-term speculation but for long-term potential growth, the analogy to private equity seems more apt.

nies."[47] These funds usually buy the entire company (i.e., "all or nearly all of the portfolio company's outstanding stock") and usually hold their investments for over a year.[48] Funds are typically structured as Limited Liability Partnerships where wealthy and tax-exempt investors provide nearly all of the capital and are the limited partners, private equity fund managers provide little capital and invest as general partners, and an affiliated management company provides management services to the fund in exchange for carried interest.[49] Professor Polsky has created a chart that shows a common private equity legal structure.[50]



1. *Trade or Business*

Some commentators have argued that private equity funds are engaged in a trade or business. Steven Rosenthal has argued these funds are "corporate developers" because they seek to "pursue[ ] and acquire[ ] multiple underperforming companies to turn them around and sell them for a profit."[51] These funds are not traders because their activity is not "continuous, regular and substantial" (the lifecycle of the private equity fund will likely be over several years, not days).[52] Instead,

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47 Gregg D. Polsky, *A Compendium of Private Equity Tax Games*, 146 Tax Notes 615, 615 (Feb. 2, 2015).

48 *Id*.

49 Gregg D. Polsky, *Tax Aspects of Private Equity Compensation*, S. Fed. Tax Inst. 5 (Power Point Oct. 24, 2018) (on file with author).

50 *Id.*

51 Steven M. Rosenthal, *Private Equity Is a Business:* Sun Capital *and Beyond*, 140 Tax Notes 1459, 1466 (Sept. 23, 2013).

52 *See supra* Part II.A.

Rosenthal argues that private equity funds are like "securities dealers" who "profit from selling securities from their inventory, intermediating between buyers and sellers."[53] Like dealers, the private equity fund buys securities and seeks to sell them for a far greater price years later "at a profit, which, under the circumstances, differs from a normal investor's return."[54]

Of course, this label is not perfect. First, private equity funds do not have "customers" or "inventory" in the traditional section 1221 sense. Although Rosenthal argues that private equity funds should be part of this definition under the original intent of section 1221,[55] such a distinction seems textually difficult.[56] On the other hand, for the trade or business test, the "to customers" distinction is not relevant after *Groetzinger*.[57] Second, unlike most brokers, private equity funds invest alongside its limited partners. The private equity fund not only receives compensation for the services it provides, but also receives a return as an investor. Third, many private equity funds argue that they are not engaged in a trade or business. Such a categorization is necessary to prevent adverse effects to foreign and tax-exempt investors.[58] Although this categorization does not affect the trade or business analysis, it is likely that parties structure their affairs in such a way to weaken the case that the fund has a trade or business.

But even with this incentive, two courts have concluded that a private equity fund is engaged in a trade or business. First, the Tax Court, in *Dagres v. Commissioner*, held that a general partner of a venture capital fund,[59] and by connection the member who managed it, was engaged in a trade or business.[60] The court explained that the general partner "did not vend companies or corporate stock to customers as in-

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[53] Rosenthal, *supra* note 51, at 1466.

[54] *Id.* at 1467.

[55] *Id.* at 1469.

[56] Valerie M. Hughes, *Flip This Company, but Don't Leave Its Pensioners Out in the Cold:* Sun Capital *as a Call to Action to Change Taxation of Private Equity Funds*, 92 N.C. L. REV. 1322, 1366 (2014) ("However, even if private equity funds engage in a 'trade or business,' they must still hold property 'primarily for sale to customers' in order to be subject to ordinary income rates.").

[57] Comm'r v. Groetzinger, 480 U.S. 23, 33 (1987).

[58] Gregg D. Polsky, *The Untold Story of* Sun Capital*: Disguised Dividends*, 142 TAX NOTES 556, 556 (Feb. 3, 2014) ("If private equity funds were determined to be in a trade or business for tax purposes as a result of the monitoring fee/offset structure, foreign investors might have to recognize effectively connected income, and tax-exempt investors might have to recognize unrelated business taxable income.").

[59] A venture capital fund is typically described as a subset of private equity, except that these funds invest in start-up companies and only take a minority stake in those companies. *See* Polsky, *supra* note 47, at 615 n.1.

[60] 136 T.C. 263, 264 (2011).

ventory but nevertheless, like dealers, did earn compensation (in their case, fees and a significant profits interest) for the services they provided in managing and directing the investment of the venture capital. . . ."[61] The court explained that "[l]ike a stockbroker or a financial planner, the General Partner L.L.C.s received compensation for services they rendered to clients."

The court also dismissed the IRS's argument that the general partner was not engaged in a trade or business because it had only a one percent interest in the venture capital fund; instead, the tax court highlighted that the general partner had a carried interest on twenty percent of the profits that the venture capital fund made.[62] The court said that

> the 99-percent investors were not looking for a 1-percent co-investor; they were looking for someone in the business of managing venture capital funds, who could locate attractive investment targets, investigate those companies, negotiate investment terms, help the companies to thrive, design exit strategies, liquidate the holdings, and achieve an attractive return for them; and the General Partner L.L.C. conducted that business.[63]

A second case is *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, in which the First Circuit held that a private equity fund was engaged in a trade or business, although in the ERISA context where courts look to tax trade or business cases.[64] The appellants were two private equity funds that received investment from limited partners and management services from a general partner that received a standard two-and-twenty fee structure (as discussed in the next sub-section) as compensation for the services it provided. The private equity funds bought a trucking company and, after the trucking company declared for bankruptcy, argued that they should not be liable for the company's pension obligations. Because only a parent company engaged in a trade or business can be liable for a subsidiary's pension obligations under 29 U.S.C. § 1301, the private equity funds argued that they were not liable because "they cannot be 'trades or businesses'" under Supreme Court tax cases like *Higgins*.[65]

The First Circuit rejected the private equity funds argument and instead adopted an "investment plus" approach advocated for by the Pension Benefit Guaranty Corporation.[66] The court noted that the stan-

[61] *Id.* at 284.
[62] *Id.* at 284–85.
[63] *Id.* at 285–86.
[64] 724 F.3d 129 (1st Cir. 2013).
[65] *Id.* at 144.
[66] *Id.* at 141.

dard was "a very fact-specific approach" in which no factor "is dispositive in and of itself."[67] The court went out of its way to say that, even though "trade or business" may be applied differently in section 162 than it is used in ERISA, the investment plus test dovetails with other tax trade or business cases like *Groetzinger*. Although the court did not precisely label what constituted a "plus" activity and what did not, it was sufficiently convinced that one of the private equity funds satisfied the plus standard.[68] Several factors were important to this factual finding:

- In its partnership agreements and private placement memorandums, the funds stated that "a 'principal purpose' of the partnership is the 'manag[ement] and supervisi[on]' of its investments."
- The General Partner had "exclusive and wide-ranging management authority" about "hiring, terminating, and compensating agents and employees of the [funds]."
- The private placement memorandums noted that the General Partners "work to reduce costs, [and] improve margins" and monitor investments of the Fund.
- The overall goal of the investment fund was to "sell[ ] the portfolio company for a profit" in less than five years.[69]

Some have argued that the First Circuit's analysis was lacking. Rosenthal argued that some of the points that the court emphasized "were slender reeds to distinguish a trade or business and, in [his] view, confused the *Whipple* inquiry."[70] Instead, he argued that the court should have adopted a new test that falls in line with his corporate developer model.[71] Others have argued that "[b]y failing to define the 'plus' in its 'investment plus' standard, the First Circuit also avoided making a precedent that other courts could easily apply."[72] Some have questioned whether labeling a private equity fund a trade or business is good from a policy perspective,[73] but the label is likely here to stay for some funds.

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67 *Id.*
68 *Id.* at 133.
69 *Id.* at 142.
70 Rosenthal, *supra* note 51, at 1466.
71 *Id.* at 1466-67.
72 Hughes, *supra* note 56, at 1358.
73 *See* Sarah Sutton Osborne, Comment, *Carried Away:* Sun Capital*, Politics, and the Potential for A New Spin on "Trade or Business" in Private Equity*, 45 CUMB. L. REV. 595, 637 (2015) ("If tax analysts are able to analogize private equity funds with real estate developers, do we allow the analogy to dictate regulatory change despite the significant effect on the economy? While political forces may successfully roust carried interests from their current capital gains treatment, private contracting and market forces will likely redistribute funds' returns at the expense of the government and economy. Accordingly, regulators must consider what policy objective would such a shift in carried interest

In the end, *Sun Capital* is more remarkable because it created a new way to look at the traditional trade or business test.[74] As Part IV explores, applying this new type of test to the family office context may offer a more doctrinally consistent way to look at the trade or business characterization than the traditional trader-dealer-investor test.

2. *Compensation*

Private equity funds are often compensated in two ways, by a management fee and carried interest.[75] Top investment funds often charge an investment fee of two percent of assets under management.[76] Funds get this fee every year to ensure that they can keep the lights running in the investment firm. But private equity funds often receive the bulk of their compensation from carried interest, through which a fund will receive some of the profits that an investment vehicle makes (often twenty percent) after the vehicle makes more than a hurdle rate (often eight percent).[77]

There may be a time-delay on when the investment funds make the profit which could artificially inflate the amount of carried interest that the investment fund earns. To protect the investor, funds often have

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taxation ultimately achieve?"); *cf.* Victor Fleischer, Sun Capital *Court Ruling Threatens Structure of Private Equity*, N.Y. TIMES DEALBOOK (Aug. 1, 2013, 12:28 PM), https://dealbook.nytimes.com/2013/08/01/sun-capital-court-ruling-threatens-private-equity-structure/ ("No one disputes that the general partner (or its affiliated management company) often gets highly involved with the fund's portfolio companies. In *Sun Capital*, for example, the management company weighed in on the portfolio company's personnel decisions, capital spending and possible acquisitions. The critical question is whether the general partner's activities can be attributed 'downward' to the fund – that is, from the partner to the partnership.").

74 *Cf.* Mark J. DeLuca, *It's Not Always Sunny in Private Equity: Analysis and Impact of the First Circuit's* Sun Capital *Decision,* 46 ARIZ. ST. L.J. 1441, 1469 (2014) (quoting a Treasury official who said that the decision gave the agency the "opportunity to reassess what 'trade or business' means" for tax purposes).

75 A third way in which private equity funds receive compensation are via fees paid from portfolio companies to the general partner. But these so-called "monitoring fees" are not relevant to the family office structure. For a discussion of monitoring fees more generally, see Gregg D. Polsky, *Private Equity Monitoring Fees as Dividends: Collateral Impact*, 143 TAX NOTES 1053 (June 2, 2014).

76 *See, e.g.*, Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3 (2008); Chris William Sanchirico, *The Tax Advantage to Paying Private Equity Fund Managers with Profit Shares: What Is It? Why Is It Bad?*, 75 U. CHI. L. REV. 1071, 1075 (2008).

77 Fleischer, *supra* note 76, at 22. "The profits interest is what gives fund managers upside potential: If the fund does well, the managers share in the treasure. If the fund does badly, however, the manager can walk away. Any proceeds remaining at liquidation would be distributed to the original investors, who hold the capital interests in the partnership." *Id.* at 3.

three protections in place.[78] First, many funds take an "investor by investor" approach when determining the amount of carried interest.[79] Because investors may enter the fund at different points, the fund may be in the carry for one investor and not the other, depending on what the value of the fund was when the investor interested. This investor specific approach ensures that the firm does not earn carry that it does not otherwise deserve.

Second, investment funds typically have a "high-water mark" provision in which a fund will aggregate the amount of total losses that an investor has received over the life of a fund.[80] The high-water mark ensures that a fund will not receive carry in a later year if the fund maintained massive losses in an earlier year. For example, if fund A sustained a loss in year 1 of $10, loss in year 2 of $20, and a gain in year 3 of $30, the fund would have the same net asset value at the end of year three it had when it started. Without a high-water mark provision, the fund could earn a carry of $6 in year 3 (20% of the $30 gain). Funds that have such a provision will not get the carry in year 3 and will only get a carry after the fund has made money.

Third, some funds have a "clawback" provision in which if a private equity fund earns carry in an earlier year and then loses money in a subsequent year, then the fund will refund the carry.[81] A common provision is that a fund that earns a carry in one year but loses money within a period (e.g., three years after the grant of profits interest) will repay the earned carry. Here, the general partner would disgorge their profits interest at liquidation if the investor did not obtain the liquidation value of their account.[82]

The take-away for this subsection is that private equity compensation is not something set in stone, but depends on the economic deal

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78 Still, some private equity funds engage in tricks to maximize the fund return, possibly to the detriment of investors. *See id.* at 22 (noting that private equity funds charge a fund-favorable preferable return whereby the "profits are then allocated disproportionately to the GP" after the fund crosses the hurdle rate "until the GP's compensation catches up to the point where it would have been had the GP received twenty percent of the profits from the first dollar."). On the other hand, some private equity funds arguably help investors who would have otherwise been limited by the section 67(a) limit on section 212 expenses. *See* Gregg D. Polsky*, A Compendium of Private Equity Tax Games,* 146 TAX NOTES 615 (Feb. 2, 2015) (discussing strategies of the private equity fund, including monitoring fees and monitoring fee deductions, that arguably help limited partners).

79 *See* Andrew W. Needham, *U.S. Income*, 736 TAX MGMT. PORTFOLIOS (BNA), at III.C.

80 *Id.*

81 *Id.*

82 *Id.*

that limited partners strike with the funds' general partner.[83] The rate that the fund charges and the protections that limited partners demand reflect the bargaining power and the risk appetite of funds and investors.[84] The compensation hinges on the investor and fund negotiating over each term. Without this negotiation, it is likely that a carried interest fee may not resemble a typical fee of a private equity fund. In the family office context, a future court may be more skeptical that a deal was at arm's length if the parties did not negotiate over the terms of the carry.

3. *Disguised Fee for Services*

But it is important to step back to highlight why the profits interest has become so ubiquitous in the private equity: the preferential capital gain tax rate. Much has been said about the policy arguments for and against this preferential tax rate and this paper will not reiterate that discussion.[85] This preferential capital gain rate is also essential for the family office structure. If the family office paid tax at an ordinary rate for the income on the services that it performs for the investment partnerships, it is far more likely that family offices would not be as popular as they are now. Put differently, few investors would pay tax on gains at an ordinary tax rate and deduct investment expenses if they could pay tax on gains at a preferential rate.

Private equity funds pay tax at a preferential rate when they receive compensation by a profits interest and hold that profits interest for at least three years.[86] A taxpayer receiving a profits interest would not be taxed when the taxpayer receives the interest in the partnership, but would be taxed when the taxpayer disposes of that interest. However, that is not the only way to view the transaction. The IRS may instead argue that the profits interest is in substance a fee for services that the partner provides the partnership. Section 707(a)(2)(A) allows the IRS to recharacterize a profits interest into a disguised fee for services that would be immediately taxable at ordinary rates when the partner receives that interest.

In 2015, the government released proposed regulations under section 707(a)(2)(A) which maintained that the IRS would apply a facts-and-circumstances test to evaluate whether a profits interest would be respected.[87] Although these regulations have not been finalized, they offer the most authoritative view as to when a profits interest will be

83 *See id.* at III.A.
84 *Id.*
85 *See* Fleischer, *supra* note 76, at 3-6.
86 *See* I.R.C. § 1061.
87 80 Fed. Reg. 43652, 43653 (July 23, 2015).

recharacterized as compensation for services. The regulations listed six factors for the test, with the most important factor being whether the arrangement has "significant entrepreneurial risk,"[88] which the taxpayer must show with clear and convincing evidence.[89] A profits interest that lacks significant entrepreneurial risk will likely not be respected as a profits interest and will instead be recharacterized as a payment for services. The regulations list five arrangements that lack significant entrepreneurial risk:

(i) Capped allocations of partnership income if the cap is reasonably expected to apply in most years;
(ii) An allocation for one or more years under which the service provider's share of income is reasonably certain;
(iii) An allocation of gross income;
(iv) An allocation (under a formula or otherwise) that is predominantly fixed in amount, is reasonably determinable under all the facts and circumstances, or is designed to assure that sufficient net profits are highly likely to be available to make the allocation to the service provider (e.g. if the partnership agreement provides for an allocation of net profits from specific transactions or accounting periods and this allocation does not depend on the long-term future success of the enterprise); or
(v) An arrangement in which a service provider waives its right to receive payment for the future performance of services in a manner that is non-binding or fails to timely notify the partnership and its partners of the waiver and its terms.[90]

Example five to the proposed regulations expounds on this point in the context of private equity funds. The example provides that

> A is a general partner in newly-formed partnership ABC, an investment fund. A is responsible for providing management services to ABC, but has delegated that management function to M, a company controlled by A. Funds that are comparable to ABC commonly require the general partner to contribute capital in an amount equal to one percent of the capital contributed by the limited partners, provide the general partner with an interest in 20 percent of future partnership net income and gains as measured over the life of the fund, and pay the

[88] Prop. Treas. Reg. § 1.707-2(c)(1), 80 Fed. Reg. at 43658.
[89] *Id*.
[90] *Id.* at 43658-59.

> fund manager annually an amount equal to two percent of capital committed by the partners.[91]

The example states that A's interest in the net income of the partnership has significant entrepreneurial risk because A has a clawback obligation for its profits interest, it is neither "highly likely to be available nor reasonably determinable" that A would receive an allocation of net income, and the present value of the interest equals the amount of capital that A contributed to the partnership.[92] Because there is a significant risk that A's profits interest would not be worth anything if ABC did not make any money, A's profit interest will be respected and will not be a disguised fee for services.

One hurdle to this strategy is that private equity funds try to minimize the risk that they will not be compensated. Funds can make the profits interest as a percentage of revenue, or virtually guarantee that the partner may be allocated a profits interest by way of a priority allocation, whereby a partner is allocated a percentage of the gain or revenue equal to a certain amount before any other partner receives an income allocation.[93] But there is a risk that implementing these strategies may eliminate significant entrepreneurial risk that the profits interest will not come to fruition. Private equity lawyers seek to create an allocation that minimizes risk and ensures that the gain will be taxed at preferential capital gains rates.

In summary, the disguised fees for services proposed regulations show that the term "profits interest" does not have a uniform meaning. Such an interest may not have significant entrepreneurial risk because the fund has a priority allocation or because the profits interest is based on a percentage of gross income. And because family offices need to be profitable in order to satisfy the trade or business characterization, they may have the same incentive as the private equity fund to maximize the likelihood of being allocated a portion of the gain of the partnership. As the *Lender* case shows, family offices may seek to implement profits interest as a percentage of trading costs and without clawback provisions. Before discussing how the Lender family used the profits interest, a brief detour is necessary to explain why and how the family created the family office structure.

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91 Prop. Treas. Reg. § 1.707-2(d), 80 Fed. Reg. at 43660.
92 *Id.*
93 *Id.* at 43659 (Example 3).

III. The *Lender* Case

A. Lender Family

The Lender family story begins with the patriarch of the family—Harry—who, in 1929, opened a bagel shop in New Haven, Connecticut.[94] The shop was very popular on the weekend, but was dead during the week.[95] As a result, Harry needed to bake the bagels close to the weekend because bagels staled quickly. This "uneven timed demand" create a huge amount of inefficiency and lead to poor employee morale for those people who did not want to spend their entire weekend at a bagel shop. To solve this demand, Harry froze bagels, allowing workers to make the bagels earlier in the week without getting stale before the weekend rush.[96]

Harry's sons, Marvin and Murry, used this revolutionary idea to get bagels onto American supermarket shelves.[97] Without Marvin and Murry, bagels would not be as widely known and loved as they are today.[98] Although the bagels' taste may have been lacking, some have argued that "Lender's innovated by finding a way to compromise on quality and reap huge gains in other spheres."[99] By offering an inferior product that could be frozen, Lender's marketed a new product to millions of Americans who would otherwise not have discovered the product.[100] Marvin and Murry sold Lender's to Kraft in 1984 for a reported $90 million dollars,[101] worth roughly $220 million in 2019 dollars.[102] The Lenders used their newfound wealth to diversify and make other non-bagel-related investments.

1. *Need for a Family Office Structure*

In 1987, soon after selling Lender's, the family set up Lender Management LLC (Lender Management), which was the entity under dis-

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94 *See* Matthew Yglesias, *Lender's Bagels and the Power of Mediocrity*, Slate (Mar. 27, 2012, 3:23 PM), https://slate.com/business/2012/03/murray-lender-and-frozen-bagels-the-man-who-made-america-better-by-making-bagels-worse.html.

95 *Id.*

96 *Id.*

97 *Id.*

98 *See, e.g.*, Emily S, *10 Reasons Why Bagels Are The Ultimate Breakfast Food*, TheThings (June 14, 2016), https://www.thethings.com/10-reasons-why-bagels-are-the-ultimate-breakfast-food/.

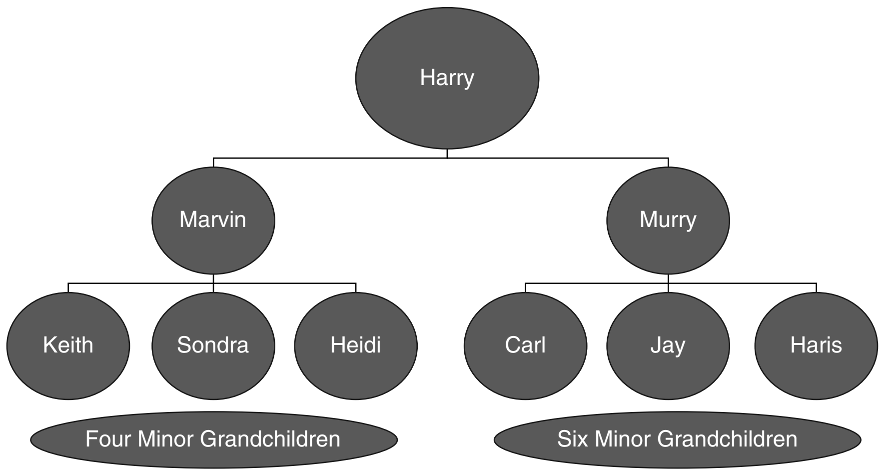
99 Yglesias, *supra* note 94.

100 *Id.*

101 Lucia Greene, *Murray Lender Cried 'long Live the Bagel!' and Now He's into the Big Dough*, People (Apr. 28, 1986, 12:00 PM), https://people.com/archive/murray-lender-cried-long-live-the-bagel-and-now-hes-into-the-big-dough-vol-25-no-17/.

102 US Inflation Calculator, https://www.usinflationcalculator.com/ (last visited Mar. 22, 2020).

pute in the case. Lender Management facilitated investment and helped to grow the family fortune.[103] Lender Management was a partnership for tax purposes.[104] Besides the other benefits of pooling investments such as lower fees and greater access to private investment vehicles,[105] the Lender family implemented this structure in part because there were a lot of Lenders.[106] At the tax year in issue, four generations of Lenders participated in the investment structure: the G1 generation (Harry's wife); G2 generation (including Marvin, Murry, and their spouses); the G3 generation (including Keith and Carl); and the G4 generation (ten of Harry's great-grandchildren). And the members in the G3 generation, except Keith, had careers independent of Lender Management.[107]

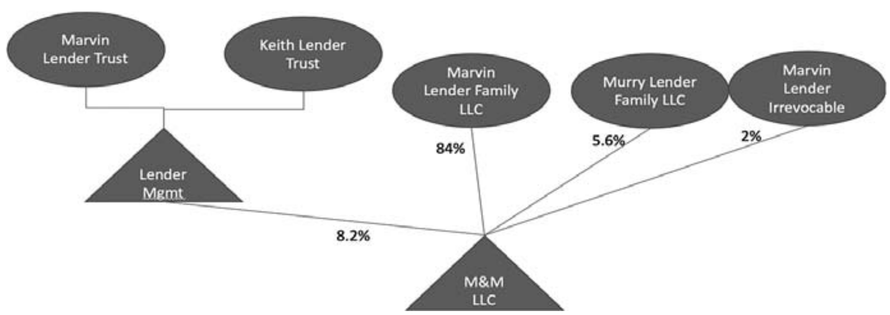


Although the family pooled their money together, a lot of things inhibited the Lender Management team from acting as one cohesive voice. First, the Tax Court recognized there were "numerous divorces among Lender family members," including a divorce from Murry and his ex-wife which depleted the Murry side of the Family Office.[108] Second, one member of the G2 generation—Harry's daughter—decided not to invest within the family structure.[109] Third, some of the family

[103] Lender Mgmt., LLC v. Comm'r, T.C. Memo. 2017-246, 114 T.C.M. (CCH) 638 at *3 (2017).
[104] *Id.* at *1.
[105] *See* Aghdami & Harris, *supra* note 5 ("A family office can create economies of scale for a family, reduce the cost of services, open investment opportunities, help guarantee privacy, and allow for greater family control over service providers.").
[106] *Lender*, 114 T.C.M. (CCH) at *2-4.
[107] *Id.* at *1.
[108] *Id.* at *2.
[109] *Id.* at *1.

members "were in such conflict with others that they refused to attend the same business meetings."[110] Fourth, the Lenders lived in many different states and countries.[111]

In 2005, Lender Management tried to assuage the concerns of some family members and "engaged a hedge fund specialist to help it restructure its affairs and its management portfolio using a hedge fund, or 'fund of funds,' manager model."[112] After the restructuring, "Lender Management divided its managed portfolio into the three investment LLCs," which were split between asset classes: Murry & Marvin Lender Investments LLC (M&M), which invested in private equity and other alternative asset classes; Lenco Investments LLC (Lenco), which invested in hedge funds; and Lotis Equity LLC (Lotis), which invested in public-company stocks.[113] Each investment LLC was in turn owned by Lender Management and other entities (trusts and other family investment partnerships) that Lender family members controlled.[114] Lender Management was owned by two trusts.[115] To illustrate the ownership diagram, below is a chart that shows the direct ownership of M&M in 2012:



2. *Activities of the Family Office*

Lender Management had two functions. First, it provided investment advice to members of the Lender family. The Lender family members had no obligation to keep money within the family office structure. Instead, the office said that its "investment choices and related activities were driven by the needs of clients."[116] And because the Lender family "did not act collectively or with a single mindset," the family office "provided investment advisory services and managed investments for each of

[110] *Id.* at *12.
[111] *Id.* at *1.
[112] *Id.* at *3.
[113] *Id.*
[114] *Id.*
[115] *Id.* at *2.
[116] *Id.* at *12.

its clients individually, regardless of the clients' relationship to each other or to the managing member of Lender Management."[117] If any investor grew dissatisfied with the family office or otherwise needed capital for other uses, that investor could withdraw their money from the investment LLCs at any point, subject to liquidity and approval from the family office.[118]

Second, Lender Management provided management services to the investment LLCs—M&M, Lenco, and Lotis. Lender Management had "the exclusive rights to direct the business and affairs of" each investment LLC.[119] The entity also "managed the downstream entities in which M&M held a controlling interest," which constituted about 12-15% of M&M's portfolio.[120]

Keith Lender, part of the G3 generation, was the Chief Investment Officer for Lender Management. He worked about fifty hours a week, communicated with his family members (whom he called "clients") about their investments, reviewed over "150 private equity and hedge fund proposals per year on behalf of the investment LLCs," and met with various investors who sought capital from the Investment LLCs.[121] He also tried to meet once a year with each client about their investment goals in the family office structure.[122] Notably, however, Lender Management was not a trader because Keith did make individual investment decisions about what asset to buy or sell, nor was it a dealer that made profit by reselling investments above-cost to clients.[123]

Including Keith, Lender Management employed five individuals and had a total payroll of over $390,000 in 2012.[124] The employees' "main objective was to earn the highest possible return on assets under management."[125] The employees managed the cash flow of the operation—including for capital calls from private equity firms—and provided financial information to the family members.[126] Lender Management outsourced many of its accounting and investment advisory responsibilities to Pathstone Family Office, LLC.[127] Although Lender Management had ultimate authority, Pathstone prepared quar-

117 *Id.*
118 *Id.* at *4, *12.
119 *Id.* at *3.
120 *Id.*
121 *Id.* at *5.
122 *Id.*
123 *See id*. at *4-5.
124 *Id.* at *4.
125 *Id.*
126 *Id.* at *6.
127 *Id.* *6-7.

terly financial reports for the LLCs and provided due diligence for prospective investments.[128]

3. *Carried Interest*

Part of the 2005 shift to the "funds-of-fund" model was a shift in how Lender Management was compensated. In exchange for the value it gave its members, Lender Management received "Class A interests" from the investment LLCs, similar to the carried interest described in the previous section.[129] But Lender received no payments from the family members whose money it advised; instead, its sole method of compensation, and the only way it received money to pay its operating expenses, was through the carried interest and management fees that it received. Lender Management argued this compensation meant that the office shifted from a cost-based to a "profit-based" office model.[130]

But the compensation of Lender Management was not like the investment funds it modeled its business after. From M&M and Lenco, Lender Management received carried interest "of 2.5% of net asset value, plus 25% of the increase in net asset value, annually."[131] From Lotis, it received carried interest of "2% of net asset value annually, plus 5% of net trading profits."[132] These values vastly exceed the typical "2 and 20" fee charged by investment funds. Part IV explores whether this excessive fee compensation was really an investor return and whether the fee was in substance a disguised fee for services because the arrangement lacked significant entrepreneurial risk.

B. The Tax Court Decision

Judge Kerrigan concisely summed up the issue in *Lender*: "The sole issue for consideration is whether Lender Management carried on a trade or business within the meaning of section 162. . . ."[133] After discussing the factual, procedural, and preliminary evidentiary issues, the Tax Court began its opinion by discussing the differences in deducting investment expenses under section 162, whereby a taxpayer engaged in a trade or business can take above-the-line deductions, and section 212, where a taxpayer is only engaged in making income and can only take below-the-line deductions that may be limited.[134] For the tax years at

128 *Id.*
129 *Id.* at *4.
130 *Id.* at *3.
131 *Id.* at *4.
132 *Id.*
133 *Id.* at *1.
134 *Id.* at *8.

issue, Lender Management claimed section 162 expenses of over $1 million related to the family office's management expenses.[135]

The Tax Court noted "[t]he Code does not define the term 'trade or business.' "[136] Instead, it used the facts-and-circumstances *Groetzinger* test: the taxpayer is engaged in a trade or business when it acted "with continuity and regularity" and when "the taxpayer's primary purpose for engaging in the activity" was a desire "for income or profit."[137] The Tax Court also cited *Whipple* and *Higgins* for the proposition that managing your own investments is not enough to establish a trade or business.[138]

But the court did not use the typical dealer-trader-investor label to distinguish whether a taxpayer has a trade or business. Instead, it said that a trade or business may been established if the taxpayer receives "compensation other than the normal investor's return," including "services provided to others."[139] The court explained that "[t]he trade-or-business designation may apply even though the taxpayer invests his or her own funds alongside those that are managed for others, provided the facts otherwise support the conclusion that the taxpayer is actively engaged in providing services to others and is not just a passive investor."[140]

In the court's view, "Lender Management provided investment advisory and financial planning services" to family members that "were comparable to the services that hedge fund managers provide."[141] The court mentioned that the taxpayer managed cash flow for the family's investments, provided bookkeeping functions, and selected investment managers to manage the family wealth.[142] And by providing these services, the family office "was entitled to profits interests as compensation for its services to its clients to the extent that it successfully managed its clients' investments."[143]

Based on the services the taxpayer provided and the profits interest it received, the court concluded that "Lender Management's activities were providing investment management services, which it primarily provided to and for the benefit of clients other than itself," similar to the Venture Capitalist in *Dagres* who invested money on behalf of his cli-

135 *Id.* at *7.
136 *Id.* at *8.
137 *Id.* (citing Comm'r v. Groetzinger, 480 U.S. 23, 35 (1987)).
138 *Id.*
139 *Id.* at *9.
140 *Id.*
141 *Id.* at *9-10.
142 *Id.* at *10.
143 *Id.*

ents.[144] Still, the Tax Court explained that the transactions between the Lender family members were "subject to heightened scrutiny" because of the interwoven family nature of the business.[145] But even under this more stringent test, the court found that the taxpayer had established a "bona fide business relationship" with the family members for three reasons.[146]

First, the family members were not required, nor was there any obligation or expectation, to keep their money in the investment LLCs. Lender Management needed to approve any "complete withdrawal"[147] from the investment funds, but the Tax Court was satisfied that the taxpayer would have acted reasonably.[148] Second, the family members "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."[149] Lender Management needed to tailor its investment expertise to each family member and could not provide blanket advice to everyone. Third, the court explained that many family members generated employment income besides whatever investment income they received from the investment LLCs.[150] The Tax Court's reasoning on this point was rather circular, as it explained that Keith generated employment income from Lender Management, which only received its income because it invested the family fortune.[151]

IV. Implications of *Lender*

The *Lender* decision was undoubtably a positive decision for family offices looking to deduct investment expenses. Still, the decision was not as positive as one may expect. This section expands on two points why taxpayers may not benefit from the *Lender* decision as much as they would have hoped: the court's rationale was not persuasive on some points and the holding is narrow relative to the universe of family offices.

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144 *Id.* at *11.

145 *Id.*

146 *Id.*

147 *Id.* at *12.

148 *Id.*

149 *Id.*

150 *Id.*

151 *Id.* The Tax Court also stressed there were "no applicable attribution rules that would require" Lender Management to be "owning all of the interests in the investment LLCs." *Id.* at *13. Lender Management was owned by trusts operated to benefit Keith and Murry, both of whom did not own most of the interests in the investment LLCs.

A. Critique of *Lender*

1. *Profits Interest*

One of the key facts in *Lender* was that the family office "was entitled to profits interests as compensation for its services to its clients to the extent that it successfully managed its clients' investments."[152] In other words, the court took the profits interest as a sign that the family office had a bona fide business relationship with the investment partnerships. But as Part II discussed, there are many ways in which a fund may structure a profits interest, including in ways that lack significant entrepreneurial risk. If a partner receives a profits interest that is virtually certain to create a positive profits allocation from the partnership, that partner in substance received a disguised fee for services that, if recharacterized, would be taxable at an ordinary tax rate instead of at a preferential capital gains tax rate. In contrast, if a partner receives a profits interest subject to a clawback provision (i.e., the partner only gets a profits allocation if the partnership makes money), the profits interest will be respected as such.

Although not discussed in *Lender*, it is likely that the management fee that Lender Management charged the investment partnerships did not have significant entrepreneurial risk. To recap, here is a chart of the fees that the family office charged relative to the fee that private equity funds normally charge:

Compensation Type	**Typical PE Fund**	**M&M**	**Lenco**	**Lotis**
Management Fee	2% of net asset value ("NAV")	2.5% of NAV	2.5% of NAV	2% of NAV
Carried Interest	20% profits	25% of increase in NAV	25% of increase in NAV	5% of net trading profits
Limitations on Carry	Only get carry after 8% hurdle	N/A	N/A	N/A
Clawback	If subsequent loss within 3 years	N/A	N/A	N/A

We do not know enough about the operations of Lender Management to know for sure, but one can speculate that a fee based on changes in "net asset value" or as a percentage of trading profits likely does not

152 *Id.* at *10.

have significant entrepreneurial risk under the test described in disguised fee proposed regulations.[153] These allocations seem to be ones that are "reasonably determinable" or "designed to assure that sufficient net profits are highly likely to be available" to make the allocation.[154] Although not raised by the IRS, this paper speculates that these profits interests should have been considered disguised fees for services. If the Tax Court did make that determination, Lender Management would have needed to pay ordinary income tax on the profits interest that it received for providing services to the investment partnerships.

The harder question is how a profits interest that lacks significant entrepreneurial risk changes the trade or business analysis. The *Lender* court did not address this point and it is hard to speculate how a future court will view this argument. Because the significant entrepreneurial risk test operates for a different purpose, a court may find that the analysis does not change the trade or business test because a profits interest may still show that the family office acted like a normal investment adviser or private equity fund. And because some private equity funds draft carried interest provisions that have priority allocations and do not impose a clawback obligation on the general partner, there is an argument that a profits interest that lacks significant entrepreneurial risk may show that the arrangement had a business relationship.

But a more straight-forward approach is that a profits interest that lacks significant entrepreneurial risk should not be a positive factor in determining whether the family office is a trade or business. For example, the Lender Management profits interest depends on "net asset value," which seems to be virtually certain to create some profit allocation. Because the family office could receive an allocation even if the investment partnership lost money over the life of the fund or did not achieve a sufficient return over a hurdle rate, the family office could theoretically receive a profits interest that approximated an investor's normal rate of return. The *Whipple* Court acknowledged that an investor likely does not have a trade or business when its "only return is that of an investor."[155] Because a family office receives a return similar to that of an investor when it receives a profits interest that lacks significant entrepreneurial risk, this type of profits interest should not be a positive factor that a family office has a trade or business.

Future courts should carefully consider whether the profits interest has significant entrepreneurial risk. Courts must analyze whether the profits interest seems like one in which an investor may receive a return that approximates the return that an investor should get. Because there

153 Prop. Treas. Reg. § 1.707-2(c), 80 Fed. Reg. 43652, 43658 (July 23, 2015).
154 *Id.* § 1.707-2(c)(1)(iv), 80 Fed. Reg. at 43658.
155 Whipple v. Comm'r, 373 U.S. 193, 202 (1963).

are many ways to structure profits interests, courts need to be more stringent and cannot conclude that there is such thing as a typical profits interest. And lawyers setting up future *Lender* type structures need to demonstrate why any given profits interest works and why there is significant entrepreneurial risk that the profits interest may not come to fruition.

2. *Trade or Business Test*

A second critique of *Lender* is that the case used an unconventional way to look at the trade or business question. This doctrinal analysis of *Lender* is important because the case is a memorandum opinion and therefore has no precedential value. Another Tax Court Judge may consider *Lender* persuasive, but there is no guarantee that another judge will adopt the rationale of the case.

As Part II explained, the traditional way to look at whether someone buying and selling securities is engaged in a trade or business is through the trader-investor-dealer lens. Using a strict doctrinal test is probably bad for a family office taxpayer. These taxpayers do not trade enough to be considered a "trader" nor do they vend securities to other customers like a brokerage house and therefore likely are not considered a "dealer." The default under this standard would be that a family office would be an investor unable to take a section 162 deduction for investment expenses. Under this traditional analysis, it is hard to see how any family office or private equity fund would ever be engaged in a trade or business. Such analysis follows from the cases described in Part II but may produce an unduly harsh result for family offices or funds that seem to have a legitimate trade or business.

Many courts have not followed this traditional approach, and the result in *Lender* is unsurprising given the progression of the trade or business doctrine. As one commentator has noted: "Pity the poor Treasury Department and the long-suffering IRS. They won a big victory in the United States Supreme Court in the *Higgins* case back in 1941 and have spent the better part of the last 70 years defending their victory from Congress and the courts."[156] Investors have been successfully chipping away at the trade or business distinction and the core holding in *Higgins* ever since. But *Higgins* is still good law and the courts that chip away too much are likely contravening this precedent.

That said, Part II showed how the trade or business test can apply to private equity and other investment funds in a way that might be consistent with *Higgins* and other Supreme Court cases. The Tax Court

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[156] Stafford Smiley & Michael Lloyd, Sun Capital Partners *and the Private Equity Industry*, 41 J. Corp. Tax'n 35, 35 (Jan./Feb. 2014).

in *Dagres* and the First Circuit in *Sun Capital* used innovative approaches to argue that a private equity fund is engaged in a trade or business. Given that the Supreme Court decided *Groetzinger*, its last trade or business case, long before the meteoric rise in private equity, such a malleable approach is necessary. Many private equity and investment funds have an important effect on the economy and should be a trade or business for deducting investment expenses. While a fund-of-funds may not have enough activity to constitute a trade or business,[157] it is very likely that private equity funds like the ones in *Dagres* and *Sun Capital* have enough activity to be considered a trade or business.

But even if private equity funds are engaged in a trade or business, should family offices also have a trade or business label? It is likely that many family offices—including the $25 billion family office run by George Soros and the multi-billion office run by the Pritzker Group[158]—are engaged in a trade or business. These funds manage billions of dollars and compete directly with the top private equity and hedge funds for talent and acquisitions. Drawing the line between what is a trade or businesses is difficult, especially considering infamous words that the trade or business inquiry does not depend on "how large the estate or how continuous or extended the work required may be."[159]

Smaller family offices like Lender Management fall somewhere in between a funds-of-funds and a private equity fund. On one hand, a family office typically does more than a fund-of-funds because they give personalized advice to the group of individuals that invest in the funds. On the other hand, a family office typically takes a minority ownership in companies and does not have the same business model as a typical private equity fund.

The Tax Court noted that Lender Management provided "services similar to those of a hedge fund manager,"[160] and "did substantially more than keeping records and collecting interest and dividends."[161] Yet the family office only selected the fund that would deploy the family's capital. Nor did the family office conduct due diligence about the funds in which it invested; instead, it outsourced that function to outside accountants.[162] Unlike the general partner in *Dagres*, the Lender family office did not "investigate" companies, "negotiate investment terms, help the companies to thrive, design exit strategies, [or] liquidate the

157 Rev. Rul. 2008-39, 2008-31 I.R.B. 252.

158 *See How the 0.001% invest*, The Economist, Dec. 15, 2018.

159 Higgins v. Comm'r, 312 U.S. 212, 218 (1941).

160 Lender Mgmt., LLC v. Comm'r, T.C. Memo. 2017-246, 114 T.C.M. (CCH) 638 at *13 (2017).

161 *Id.* at *12.

162 *Id.* at *6.

holdings."[163] Nor was the family office like the private equity fund in *Sun Capital* that adopted an active and substantial role in the "management and supervision" of the portfolio companies that it acquired.[164] Put differently, it is unclear given the court's reasoning why Lender Management was in a trade or business.

This paper advocates for courts to take the approach of Judge Lauber in *Hellmann*, which is discussed in the next section, by asking narrow questions that get to the essence of the family office's activities. This test aligns with the "investment plus" standard in *Sun Capital* because it seeks to ask whether the family office has done enough to satisfy some sort of "plus" standard that sets it apart from an investor like the taxpayer in *Higgins*. Asking questions about how the family office operates is more helpful than asking how that family office relates to a traditional investment fund because, as Part II showed, there is so much variety in the private equity and hedge fund world.

B. The Narrow *Lender* Holding

The take-away from the *Lender* case is that a family office *can* be a trade or business, not that *every* family office is a trade or business. And even with the beneficial income tax deduction, some family offices may choose not to create a *Lender* structure because creating that type of structure would lead to other adverse tax consequences. This paper lists four reasons why the costs to implementing this structure may exceed the benefits.

1. *Many Family Offices Do Not Satisfy the* Lender *Standard*

First, many family office structures cannot strictly fall into the *Lender* guidelines and may be unable to claim the section 162 deduction. An order by Tax Court Judge Lauber in *Hellmann v. Commissioner* illustrates this point.[165] Both parties in the case moved for summary judgment on the issue of whether the family office was engaged in a trade or business.[166] The family office was a limited liability company owned equally by four individuals of the same family.[167] The family created six investment partnerships where the family office

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163 Dagres v. Comm'r, 136 T.C. 263, 285–86 (2011).

164 Sun Capital Partners III, LP v. New England Teamsters & Trucking Indus. Pension Fund, 724 F.3d 129, 142 (2013).

165 Order at 4, Hellmann v. Comm'r (T.C. Oct. 1, 2018) (No. 8486-17), https://www.ustaxcourt.gov/InternetOrders/DocumentViewer.aspx?IndexSearchableOrdersID=271882&Todays=Y (rejecting cross-motions for summary judgment).

166 *Id.* at 1.

167 *Id.*

owned 1% of the partnership and trusts created for the benefit of the four individuals owned the rest of the 99%.[168]

Judge Lauber noted that although the cases consolidated before him "appear to resemble *Lender Management* in some respects," there were key distinctions: all four individuals were from the same family and were on good terms.[169] Judge Lauber declined to state that the family office was engaged in a trade or business by virtue of the profits interest that the family office received.[170] Unlike the family office in *Lender* that was controlled by one family member who had a 99% profit interest, the family office in *Hellmann* was controlled by all four members who, if they also proportionally owned the investment partnerships, "would simply replace investment income that each person would otherwise have derived from the investment portfolios."[171] Or, put in *Whipple* terminology, the return of the family office would simply be that of a typical investor.

In that Order, Judge Lauber said that he planned to consider at least five non-exclusive factors for determining this question:

1. the manner in which the family office was compensated for its services;
2. the nature and extent of the services provided by the family office employees;
3. the relative amounts of expertise possessed and time devoted by family office employees versus outside investment managers and consultants;
4. the individualization of investment strategies for different family members with differing investment preferences and needs; and
5. the proportionality (or lack thereof) between the share of profits inuring to each family member in his or her capacity as an owner of the family office and the share of profits inuring to that same individual in his or her capacity as an investor in the managed funds.[172]

Although Judge Lauber ordered the parties to brief why the family office was or was not engaged in a trade or business, he eventually denied the both sets of motions and the parties settled outside court. We do not know whether a judge would find that the family office in *Hellmann* is a trade or business, but this paper speculates that the taxpayer

[168] *Id.*
[169] *Id.* at 3.
[170] *Id.*
[171] *Id.* at 4.
[172] *Id.* at 3-4.

agreed to the settlement because it did not think that its chances were good.

The corollary of *Hellmann* and *Lender* is that family offices can satisfy the trade or business test only if the family office advises a multigenerational, contentious, and geographically dispersed family and receives compensation in a way that differs from a normal investor's return. Perhaps some family offices that do not follow this structure may still qualify as a trade or business, but given the extremely factual nature of this inquiry, there is no guarantee as to how a court will view a new fact pattern. And given this paper has argued that the *Lender* rationale is not persuasive, it is unclear how a future court will interpret this type of fact pattern.

The broader point is that this *Hellmann* order should give lawyers and family office advisers pause. Although clients may have a strong urge to conclude that their family office is a trade or business based on the *Lender* decision, advisers must temper their client's expectations. This is an unsettled area of the law that the IRS will be eager to litigate.

2. *Some Family Offices Will Need to Register with the SEC*

Second, many family office structures will be unable to implement a *Lender* structure without registering with the Securities and Exchange Commission (SEC). An important consideration to this structure, not mentioned in the Tax Court's opinion, is that the family office did not need to register as an investment advisor with the SEC. Generally, people or entities that give investment advice are labeled as an "investment adviser," which means that they need to register with the SEC and comply with the Investment Advisers Act of 1940.[173]

SEC rule 202(a)(11)(G)-1 provides an exception to registration for certain family offices, which it defines as an entity that "has no other clients other than family clients . . . is wholly owned by family clients and is exclusively controlled . . . by one or more family members . . . [and] does not hold itself out to the public as an investment adviser."[174] Family clients generally include any family member (including entities controlled by trusts for the benefit of that family member) or a current or former "key employee," which is defined as someone who "in connection with his or her regular functions or duties, participates in the investment activities of the family office or affiliated family office . . . ."[175]

If the family office meets this definition, the office need not register as an adviser with the SEC.[176] The exemption from the Advisers Act is

173 15 U.S.C. § 80b-1 through 80b-21 (2012).
174 17 C.F.R. § 275.202(a)(11)(G)-1(b) (2019).
175 *Id.* § 275.202(a)(11)(G)-1(d)(8).
176 *Id.* § 275.202(a)(11)(G)-1(a).

essential: without it, it is likely that the costs of complying with the adviser rules would be too burdensome for a small entity like Lender Management.[177] The SEC adopted this rule in part because family offices do not act like traditional investment advisers.[178] It explained that

> [t]he core policy judgment . . . is the lack of need for application of the Advisers Act to the typical single family office. The Act was not designed to regulate the interactions of family members in the management of their own wealth. Accordingly, most of the conditions of the proposed rule . . . operate to restrict the structure and operation of a family office relying on the rule to activities unlikely to involve commercial advisory activities, while permitting traditional family office activities involving charities, tax planning, and pooled investing.[179]

This rationale creates a win-win situation for family offices like Lender Management who can escape registration from the SEC by managing family wealth and deduct investment expenses by performing actions like an investment adviser. This disconnect may not last forever but is extremely beneficial to family offices that can satisfy this exemption.[180]

But the rule is not beneficial to all family offices pursuing a *Lender* structure. As discussed above, the corollary of *Lender* and *Hellmann* is that family offices should manage the wealth of multi-generational, disjointed families. Families with multi-generational wealth like the Lender Family will no doubt be able to advise this type of client without having to register with the SEC. But families compromised of one or two generations of wealth (e.g., a husband, wife, and children) will likely be unable to satisfy the income tax standard because the office would look like the taxpayer in *Higgins*. These types of families would be unable to start a family office that is in a trade or business without advising investments of non-family members, which would require the family office to register with the SEC. For that reason, families with newer wealth will be less likely to create a *Lender* structure because in order to create such a structure, those families would need to manage outside-the-family wealth and may need to register with the SEC.

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177 KIRKLAND & ELLIS, *supra* note 6 (discussing the costs of complying with the relevant SEC rules).

178 The SEC rule was an outgrowth of a Senate Banking Committee explanation of Dodd-Frank, which said that "[t]he Advisers Act is not designed to regulate the interactions of family members, and registration would unnecessarily intrude on the privacy of the family involved." Nathan Crow & Gregory S. Crespi, *The Family Office Exclusion Under the Investment Advisers Act of 1940,* 69 SMU L. REV. 97, 133 (2016) (quoting the Senate Committee on Banking, Housing, and Urban Affairs).

179 Family Offices, 75 Fed. Reg. 63753-01, 63755 (Oct. 18, 2010).

180 *Cf.* Emily Cauble, *Exploiting Regulatory Inconsistencies*, 74 WASH. & LEE L. REV. 1895 (2017).

3. *Profits Interest May Create Unsavory Results*

Third, the profits interest may create a few adverse tax consequences that may negate any income tax benefit of the deduction.

a. *"Deemed Gift" Under Section 2701*

A profits interest may trigger a "deemed gift" under section 2701. This deemed gift applies when the taxpayer retains a preferred equity interest and transfers a subordinate equity interest to another family member. In such a scenario, section 2701 could potentially turn a bona fide profits interest into a deemed taxable gift under a complex valuation formula by valuing the transferor's retained interest at zero.[181]

A family office may trigger this gift tax obligation when it receives a profits interest and the owners of the family office differ from the owners that invest in the family limited partnership. More precisely, the profits interests must be a "subordinate interest," which would occur if other family members that invest in the family limited partnerships hold onto an "applicable retained interest" that has an "extraordinary payment right" (i.e., a right that "confers a distribution right which consists of the right to a qualified payment and there are 1 or more liquidation, put, call, or conversion rights with respect to such interest").[182] Because partners who receive a profits interest do not receive a liquidation right with the profits interest, section 2701 may apply.

A recent piece of sub-regulatory guidance suggests that the IRS would try to argue that section 2701 applies when a family office receives a simple profits interest. In Chief Counsel Advisory 201442053, the IRS responded to a scenario in which a donor recapitalized an LLC with her two children where the children managed the LLC and received an interest for "all profit and loss" of the LLC.[183] The IRS said that this type of recapitalization was subject to section 2701 because "Donor's interest, which carried a right to distributions based upon an existing capital account balance, is senior to the transferred interests, which carried only a right to distributions based on future profit and

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[181] In short, if the section 2701 rule applies to the profits interest transfer, the value of the gift is equal to (A) the total value of interest of the transferor and the transferee post-transfer minus (B) the aggregate amount of property retained by the transferor (where some of the transferor's retained interests are deemed to be zero). N. Todd Angkatavanich, et al., *Carrying the Day with Carried Interest Wealth Transfer Planning for Fund Principals*, NYS Soc'y CPAs (Dec. 1, 2019), http://www.nysscpa.org/news/publications/the-tax-stringer/stringer-article-for-authors/carrying-the-day-with-carried-interest-wealth-transfer-planning-for-fund-principals. This approach contrasts with the general gift valuation rules that value an interest by trying to approximate what someone would pay for that gift. *Id.*

[182] I.R.C. § 2701(a)(3)(B).

[183] I.R.S. CCA 201442053.

gain."[184] Although not directly on point, it seems like the IRS would similarly argue that profits interest like the one in the *Lender* case would also be subject to section 2701 because the family office would receive a profits interest that did not include an immediate distribution right. But there is much lacking in the IRS's rationale.

Prominent practitioner Richard Dees argues that the IRS's memorandum was wrongly decided and did not provide enough explanation to show how that type of profits interest would be taxable under section 2701.[185] Of relevance to this paper, he argued that the capital interest was not necessarily an applicable retained interest because it did not necessarily have an extraordinary payment right if the partnership agreement did not provide for a priority distribution of capital:

> As in many private equity partnerships, the amended LLC agreement might provide that all capital would be distributed before any profits are distributed. If so, the memorandum is correct that the distributions of profits would be subordinate to distributions of capital, although a capital distribution still would not be a distribution right. . . . The memorandum states that distributions of capital were permitted, but capital distributions may have been permitted only after all profits were distributed. If that was the case, the profits interest would be senior to the capital interest. Alternatively, capital distributions may have been prohibited until the end of the term, at which time all capital would be distributed pro rata to the members. The right to participate proportionately in that kind of liquidating distribution would not be a senior interest or a distribution right.[186]

Put differently, Dees argues that a capital interest is not necessarily an extraordinary payment right, and if it is not one, section 2701 will not apply. Instead, Dees argues that a simple profits interest (perhaps like the one in *Lender* or the CCA from 2014) should not be subject to 2701.[187] Under this logic, family offices may be able to plan around section 2701 by providing that the profits interest has priority over the capital interest. This distribution right may be unsuitable because it changes

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184 *Id*.

185 Richard L. Dees, *Is Chief Counsel Resurrecting the Chapter 14 'Monster'?*, 145 TAX NOTES 1279 (Dec. 15, 2014).

186 *Id.*

187 Richard L. Dees, *Profits Interests Gifts Under Section 2701: 'I Am Not a Monster'*, 123 TAX NOTES 707 (May 11, 2009) (arguing that a "simple partnership profits interest" should not be subject to gift tax under section 2701 because a "corporate equivalent" of that structure would not be taxed under the statute).

the economic deal that family members agree to, but it would be preferable from a transfer tax perspective.[188]

This paper does not solve the puzzle of when section 2701 applies in the family office context. How the deemed gift rule applies in this situation is inherently a factually intensive question that applies differently to one family office than it does to other family offices. The bigger point remains: some family offices may be unable to create a profits interest structure because section 2701 may trigger a gift tax obligation.

b. *Immediate Taxation if Outside Rev. Proc. 93-27*

Profits interest may also create an unexpected taxable event for family offices. Generally, service providers need to recognize taxable income equal to the fair market value of any property that they receive "in connection with the performance of services."[189] Courts have long struggled with whether a profits interest is immediately taxable upon the grant of the interest.[190] Fearing a circuit split, the IRS released a favorable Revenue Procedure in 1993 that created a safe harbor for partnerships granting profits interests.[191]

The Revenue Procedure said that "if a person receives a profits interest for the provision of services to or for the benefit of a partnership in a partner capacity," the granting of a profits interest will not be a taxable event except in the following situations:

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188 Of course, there are two easy fixes to section 2701 in the non-family office context that likely do not work here. First, the partnership agreement may lock in the interests of its members and prohibit capital withdrawals. In this case, the other family members who did not receive a profits interest would not have an "applicable retained interest" because they would not have a right to a distribution or liquidation. But prohibiting capital withdrawals would weaken the trade or business argument because the *Lender* court noted that it was a positive fact that the investors could not pull their money from the family limited partnerships at any time. *See supra* note 147 and accompanying text. Second, the partnership agreement could grant a "vertical slice" of equity in the family limited partnership that "is proportionally the same as the transferred interest." *See* Angkatavanich et al., *supra* note 181. But this would mean that the partnership would also grant a capital interest, which would weaken the trade or business argument and result in immediate taxation to the family office (at ordinary rates).

189 I.R.C. § 83.

190 For example, The Seventh Circuit said that a profits interest "with determinable market value" was taxable income, but the Eighth Circuit suggested in dicta that a profits interest was not taxable income. *Compare* Diamond v. Comm'r, 56 T.C. 530 (1971), *aff'd*, 492 F.2d 286 (7th Cir. 1974) *with* Campbell v. Comm'r, 943 F.2d 815, 823 (8th Cir. 1991).

191 The IRS helpfully defined a profits interest as any interest that is not a capital interest. Rev. Proc. 93-27, 1993-2 C.B. 343. It also said "[a] capital interest is an interest that would give the holder a share of the proceeds if the partnership's assets were sold at fair market value and then the proceeds were distributed in a complete liquidation of the partnership." *Id.*

(1) If the profits interest relates to a substantially certain and predictable stream of income from partnership assets, such as income from high-quality debt securities or a high-quality net lease;

(2) If within two years of receipt, the partner disposes of the profits interest; or

(3) If the profits interest is a limited partnership interest in a "publicly traded partnership" within the meaning of section 7704(b) of the Internal Revenue Code.[192]

This Revenue Procedure provides clarity and a taxpayer-favorable result to those looking to grant and receive profits interests. But family offices may be unable to take advantage of this taxpayer-favorable Revenue Procedure in certain situations.

For example, a person providing services to the family limited partnership through a corporation does not fall with the safe harbor and may be taxed on the grant of the profits interest. Put more directly, the corporation that receives the profits interest would satisfy the section 83(b) safe harbor, but the person who works for the corporation and performs services to the partnership would be subject to section 83(a) because he or she performed services to the family limited partnership, the property "is transferred to any person other than the person for whom such services are performed," and the safe harbor does not apply. Thus, the owner of the corporation cannot rely on the 1993 Revenue Procedure and may be subject to phantom taxable income under section 83.

Additionally, the family office may be unable to take advantage of the safe harbor if the profits interest creates a "certain and predictable stream of income." For example, the *Lender* profits interest was based on changes in "net asset value," which would seem to be a certain and predicate stream of income provided that the family office invests in assets like equities and bonds that are almost certain to increase in value. Although it is ultimately a factual finding as to whether the payment from the profits interest is "certain" or "predictable," this paper notes that this test may be comparable to the test for disguised fee for services under section 707(a)(2)(A) and whether the profits interest lacks significant economic risk. Both tests get at the same issue: did the partner receive something that is risky and may not come to fruition or did the partner receive an asset that is virtually certain to bring about some payments? Only the profits interests that are risky enough can fall within this safe harbor and avoid immediate taxation.

[192] *Id.*

c. *Capital Gains into Ordinary Income*

In addition to creating an income event upon grant, the profits interest that a family office receives may turn capital gain income into ordinary income. Without a *Lender* structure, a family would invest through a series of family limited partnerships. If the partnerships invested in equities or private equity funds, the partnerships would likely be able to pay tax on any gain at preferential capital gain rates. A family office that receives a profits interest may also be eligible to pay tax on gain at preferential capital gains rates. But a family office that structures its profits interest incorrectly may need to pay tax on this profits interest at ordinary rates in three situations.

First, as discussed above, if the profits interest lacks significant entrepreneurial risk, the IRS will recharacterize the profits interest as a disguised fee for management services under section 707(a)(2)(A). In this situation, part of the profits interest would be ordinary income to the family office. As Part II explored, lawyers will likely try to create a profits interest that would create enough significant entrepreneurial risk to satisfy the disguised fee for services regulations, but not so much that the profits interest is unlikely to come to fruition. Drafting this type of profits interest is difficult, especially if the family office cannot estimate how much money it will make.

Second, a taxpayer that receives a profits interest outside of the safe harbor discussed above (e.g., if the profits interest creates a "certain and predictable stream of income") will need to pay tax equal to the fair market value of the profits interest at the time of issuance. Although the profits interest would be a capital asset, the family office would have to pay ordinary rates because they would not qualify for the long-term preferential capital gains rate.

Third, section 1061 may turn certain types of gain into short-term capital gains. This section applies to an "applicable partnership interest" that is "transferred to . . . the taxpayer in connection with the performance of substantial services by the taxpayer . . . in any applicable trade or business."[193] Section 1061's definition of "trade or business" applies to an entity that invests, develops, or raises capital "on a regular, continuous, and substantial basis,"[194] which is potentially broader than the section 162 definition. If a family office sells a profits interest that is characterized as an applicable partnership interest and is sold within three years of grant, the family office gain will be recharacterized from long-term capital gain property into short-term capital gain property. Advisers need to be cautious to implement a profits interest structure

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193 I.R.C. § 1061(c)(1).
194 *Id.* § 1061(c)(2).

without addressing these risks. Family offices should weigh the risk of triggering a gift tax obligation, immediate taxation on grant, and ordinary taxation of profits interest against the benefit of having a profits interest in the trade or business analysis.

4. *Family Limited Partnerships Will Still Be Unable to Deduct Investment Expenses*

Fourth, families may be unable to deduct outside investment management expenses if those expenses accrue in family limited partnerships and not through the family office. In the *Lender* case, the Tax Court said that the family office was engaged in a trade or business but did not say that the family limited partnerships (M&M, Lenco, or Lotis) were engaged in a trade or business. The IRS addressed a similar point in Revenue Ruling 2008-39, which considered a situation where an investor invested in an upper-tier partnership (not in a trade or business) that in turn invested in a lower-tier partnership (that was in a trade or business).[195] The IRS said that the management fee that the lower-tier partnership charged the upper-tier partnership would be a section 212 expense because the "entity" theory would apply to whether an entity is in a trade or business.[196]

For example, M&M would be unable to deduct any management fee that it was charged even though Lender Management was able to deduct its business expenses. M&M economically incurred two types of management fees: one related management fee and one management fee from outside private equity funds. Both types of fees would be section 212 expenses and thus not deductible. Nevertheless, most of the compensation that Lender Management and outside private equity funds charged M&M was in the form of a profits interest. This compensation is preferable to M&M because the entity would receive less gross income rather than a larger amount of gross income less a nondeductible section 212 expense. Still, the about 2% management fee is not insignificant in many cases.

Families are likely unable to deduct management fees of outside private equity and hedge funds even after *Lender*. In most cases, these outside investment fees would still be non-deductible section 212 expenses, so creating a *Lender* structure would not help a family office unless the office itself has a significant amount of operating expenses.

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[195] Rev. Rul. 2008-39, 2008-31 I.R.B. 252.

[196] *Id. See also* Goodwin v. Comm'r, 75 T.C. 424 (1980), aff'd, 691 F.2d 490 (3d Cir. 1982).

V. Conclusion

This article has considered the *Lender* decision and its impact on family offices trying to deduct investment expenses. Because the Tax Court did not adequately address the profits interest of the family office and did not frame the trade or business analysis in the most persuasive way, this paper has suggested that a future court may not accept the rationale of the *Lender* court. Additionally, this paper highlights several ways in which a family office that implements a *Lender* structure may not benefit as much as they would hope. Implementing a family office structure may create adverse income tax and gift tax consequences that may negate any income tax benefit from deducting investment expenses of the family office.