THE *LENDER* LOOPHOLE & THE DEDUCTIBILITY OF INVESTMENT EXPENSES IN FAMILY OFFICES

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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.[i] Second, Congress passed the 2017 Tax Act (commonly known as "TCJA"[ii]) which disallowed operating expenses for taxpayers engaged in a profit-seeking activity like investing.[iii] Before the TCJA was enacted, 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.[iv] But the combination of *Lender* and the 2017 Tax Act made that incentive even greater for family offices.[v]

In response to this incentive, law firms and accounting firms have encouraged clients to create similar structures to the taxpayer in *Lender*.[vi] The cost savings associated with a *Lender* structure were and continue to be substantial.[vii] Because family offices are implementing this structure at a rapid pace, a thorough understanding of the core issues in *Lender* is timely and necessary. While others have focused on the practical aspects of the decision, no commentator has stepped back to consider the theoretical implications of the decision. Was the taxpayer in *Lender* engaged in a trade or business? Is the *Lender* decision bad from a tax policy perspective?

This paper will argue both questions in the negative. The decision creates what this paper will term the *Lender* loophole[viii]: family members investing through a family office structure now can take immediate ordinary income tax deductions yet pay tax at preferential long-term capital gains rate.[ix] But the immediate ordinary deduction likely contravenes current law. 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 a trade or business of investing.[x] In the subsequent years, courts have only drawn two exceptions: when the taxpayer acts as a conduit for investors (dealer) or derives profits from active trading (trader).[xi] Based on this precedent, this paper will make two arguments.

First, most family offices are investors not engaged in a trade or business. Family offices do not trade enough to be considered traders nor do they act as a conduit for other investors like a dealer. It is possible that some family offices act like private equity funds and may be considered corporate dealers, but this possibility does not apply to the vast majority of family offices. Second,

the Tax Court decision is bad from a tax policy perspective. The *Lender* loophole is not available to investors who invest outside of a family office structure nor is it available to family offices that do not have multi-generational members who are contentious with each other. This paper will argue that the near-perfect tax nirvana that some family offices enjoy is unjustified because it violates horizontal tax equity.

This paper proceeds as follows. Part II describes the sometimes-amorphous distinction between dealers, investors, and traders. It also will provide a brief case study of private equity funds. Part III discusses the Lender family office structure and the *Lender* decision. Part IV provides a critique of the case, focusing on the trade or business inquiry and the tax policy implications of the case. Part V concludes.

II. Background information

a. Trader, Investor, Dealer

Lots of people buy, sell, and hold investments for a variety of purposes and in a variety of 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.[xii] These categories are not referenced in Code, but provide a useful shorthand for the tax consequences of the activities of the taxpayer.[xiii] This distinction is not pedagogical. As the Part III will explore, the distinction of whether a taxpayer is a dealer, trader, or investor may have significant consequences as to whether the person can deduct investment expenses incurred in generating the income.

1. Dealer—a merchant of securities

A dealer is defined as "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."[xiv] Essentially, the dealer is a "merchant" who "seek[s] to profit on the resale of those securities at marked up prices."[xv] For example, a dealer is a business that, in its "ordinary course of business," may offer interest rate or currency swaps to customers.[xvi] As the next sub-section will show, some argue that some private equity and venture capital funds are also "dealers" because they act as a party who buys securities on behalf of investors in hopes of profiting from the investment.[xvii]

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 § 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."[xviii] Third, dealers are in the trade or business of dealing securities and can deduct business expenses under § 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."[xix] Similar to a dealer, the trader is engaged in a "trade or business" regarding his activities in buying and selling securities.

Traders, like dealers, can deduct business expenses under § 162 and often hold capital assets. However, 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-term capital

gains and pay tax at the higher, ordinary income tax rates. Additionally, traders can "mark to market" their securities under § 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.[xx] 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."[xxi] 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."[xxii] 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."[xxiii]

Second, Professor Oei said that traders must intend to make a short-term profit from the holding, buying, or selling the securities involved.[xxiv] 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."[xxv]

The seminal case of *Commissioner v. Groetzinger*, which held that a professional gambler—whose sole wages were derived from gambling—was engaged in a trade or business, illustrates the short-term aspect of the trader distinction.[xxvi] Rejecting the Tax Court and Seventh

Circuit's opinions that held that the gambler could not be engaged in the trade or business of gambling, the Supreme Court acknowledged that the taxpayer in *Groetzinger* was more like a stock trader than an investor.[xxvii] The taxpayer was engaged in "frequent, regular, and continuous" conduct and intended to derive profits "directed in the short-term," i.e., through regular trips to the casino.[xxviii] Although the Court did not directly state this distinction was part of the facts-and-circumstances test that the Court eventually adopted, it implied that the distinction was relevant.[xxix]

The Court also cleared one misconception that taxpayers seemed to struggle with after Justice Frankfurter's concurring opinion in *DuPont*[xxx]: a trader does not necessarily need to trade "to customers."[xxxi] 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."[xxxii] In other words, traders do not necessarily need to 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 such regularity to make himself a trader.[xxxiii] 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 investor when he manages his portfolio.[xxxiv] 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 § 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.[xxxv] Third, investors are typically not in the trade or business of investing securities and thus cannot deduct business expenses under § 162. Investors can deduct expenses under § 212, but the TCJA limited the ability of investors to deduct these expenses until 2025.[xxxvi]

The prototypical investor can be found in *Higgins v. Commissioner*,[xxxvii] which held that a taxpayer managing investments for his own family cannot establish a trade or business.[xxxviii] 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." The taxpayer argued that his actions were more akin to a trader—that "elements of continuity, constant repetition, regularity and extent' differentiate his activities from the occasional like actions of the small investor."[xxxix] The Court rejected his argument, noting that "[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."[xl]

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.[xli] 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.[xlii]

Even though *Higgins* was decided over eighty years ago and before the enactment of § 212, the Supreme Court highlighted its significance in *Groestzinger*. There, the court noted it 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.[xliii]

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. As this paper will argue later, the Tax Court's opinion in *Lender* should have come to the same conclusion: the family office in that case was an investor, not a dealer or a trader, because the office was merely managing the investments of the Lender family.

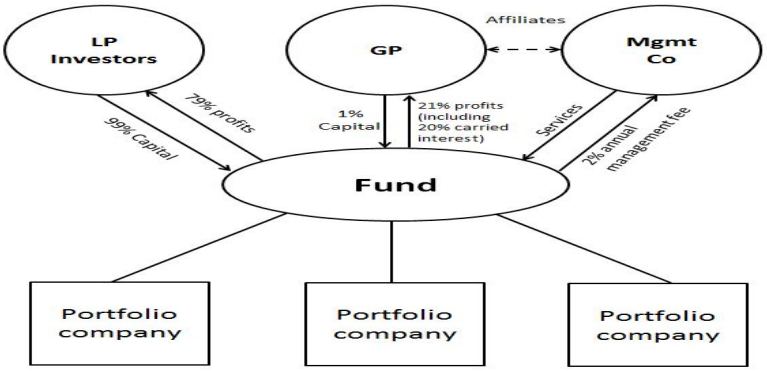
b. Private Equity Funds

Private equity funds offer an interesting analogy to family office structure described in *Lender*. Because the *Lender* court spent a significant portion of the opinion comparing the family office to a typical investment fund,[xliv] a brief detour will enlighten the critique of the *Lender* case. Specifically, this section will explain when an investment fund may be considered a trade or business and describe the typical compensation arrangement in private equity funds.

1. Trade or business?

Private equity funds "make investments in portfolio companies, usually in connection with increasing the leverage of those companies."[xlv] 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.[xlvi] Funds are typically structured as LLPs where wealthy and tax-exempt investors provide the vast majority of the capital and are the limited partners, private equity fund managers provide a small amount of capital and invest as general partners, and an affiliated management company provides management services to the fund in exchange for carried interest.[xlvii] Professor Polsky has created a chart that exemplifies a common private equity legal structure.[xlviii]



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."[xlix] These funds are not traders because their activity is not "continuous, regular and substantial," the lifecycle of the private equity fund will likely over a period of years, not days.[l] Instead, Rosenthal argues that private equity funds are like "securities dealers" who "profit from selling securities from their inventory, intermediating between buyers and sellers."[li] Like dealers, the private equity fund buys securities and attempts to sell them for a far greater price years later "at a profit, which, under the circumstances, differs from a normal investor's return."[lii]

Of course, this label is not perfect. First, private equity funds do not have "customers" or "inventory" in the traditional § 1221 sense. Although Rosenthal argues that private equity funds should be included in this definition under the original intent of § 1221,[liii] such a distinction seems textually difficult.[liv] On the other hand, for the *Groestzinger* trade or business test, the "to

customers" distinction is not relevant in the trader context and possibly is not relevant for purposes of determining whether the entity is dealer.[lv] Second, unlike most brokers, private equity funds invest alongside its limited partners. The private equity fund does not only receive compensation for the services it provides, but also receives a return as an investor. Third, many private equity funds take the position that they are not engaged in a trade or business. Such a categorization is necessary in order to prevent adverse effects to foreign and tax-exempt investors.[lvi] 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 for 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,[lvii] and by connection the member who managed it, was engaged in a trade or business.[lviii] The court explained that the general partner "did not vend companies or corporate stock to customers as inventory 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. . . ."[lix] 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.[lx] 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.[lxi]

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 not for tax but for ERISA purposes.[lxii] The two private equity funds in the case —who bought a trucking company that subsequently declared bankruptcy—argued that "under *Higgins*" and other Supreme Court tax cases, "they cannot be 'trades or businesses.'"[lxiii] The First Circuit rejected the private equity funds argument and instead adopted an "investment plus" approach.[lxiv] Although the court did not spell out what constituted a "plus" activity and what did not, it was sufficiently convinced that the private equity fund meet the plus standard, in part, because "the 'principal purpose' of the partnership [was] the 'manag[ement] and supervisi[on]' of its investments."[lxv] The court also noted that the "[f]unds [were] actively involved in the management and operation of the companies in which they [invested]."[lxvi]

Some have argued that the First Circuit's analysis was lacking. Rosenthall 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."[lxvii] Instead, he argues that the court should have adopted a new test that falls in line with his corporate developer model.[lxviii] 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."[lxix] Some have questioned whether labeling a private equity fund a trade or business is good from a policy perspective,[lxx] but the label is likely here to stay for some funds. At the end of the day, *Sun Capital* is more remarkable for its holding (that private equity can be a trade or business in some circumstances) than its rationale.[lxxi]

2. Compensation

Private equity funds are often compensated in two ways, via a management fee and carried interest.[lxxii] Top investment funds often charge an investment fee of two percent of assets under management.[lxxiii] 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, whereby a fund will receive a certain amount of the profits that an investment vehicle makes, often twenty percent, after the vehicle makes more than a hurdle rate, often eight percent.[lxxiv]

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 actually earns. To protect the investor, funds often have three protections in place.[lxxv] First, many funds take an "investor by investor" approach when determining the amount of carried interest.[lxxvi] 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.[lxxvii] 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 actually made money.

Third, some funds have a "clawback" provision, whereby 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.[lxxviii] A common provision is that a fund that earns a carry in one year but loses money within a period of time (e.g., three years after the grant of profits interest) will repay the previously earned carry. In this case, the general partner would disgorge their profits interest at liquidation if the investor did not obtain the liquidation value of their account.[lxxix]

The take-away for this subsection is that private equity compensation is not something set in stone, but rather is a function of the economic deal that limited partners strike with the funds' general partner.[lxxx] The rate that the fund charges and the protections that limited partners demand are a function of bargaining power and the risk appetite of funds and investors.[lxxxi] The compensation is dependent on the investor and fund negotiating over each term. Without this negotiation, and as Part IV explores, it is likely that a carried interest fee may not resemble a typical fee of a private equity fund.

Put differently, just because the fund uses the term "profits interest" does not necessarily mean that the profits interest is indicative of a business purpose. As the *Lender* case shows, family offices can implement profits interests in an unusual way. But 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.

III. The *Lender* Loophole

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.[lxxxii] The shop was very popular on the weekend, but was dead during the week.[lxxxiii] As a result, Harry needed to bake the bagels close to the

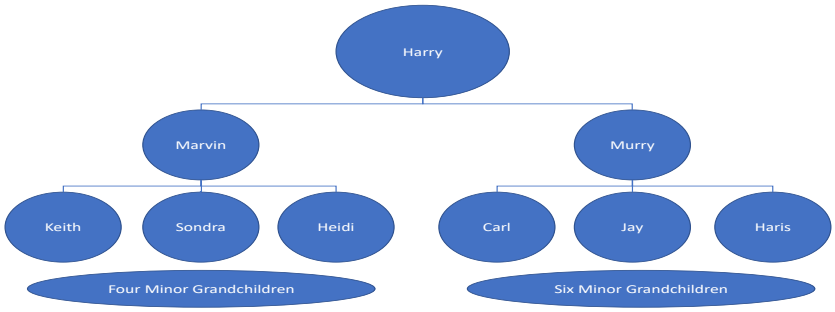
weekend because bagels staled quickly. This "uneven timed demand" create a huge amount of inefficiency and lead to poor employee morale for those people who did not want to spend their entire weekend at a bagel shop. To solve this demand, Harry froze bagels, allowing workers to make the bagels earlier in the week without getting stale before the weekend rush.[lxxxiv]

Harry's sons, Marvin and Murry, used this revolutionary idea to get bagels onto American supermarket shelves.[lxxxv] Without Marvin and Murry, bagels would not be as widely known and loved as they are today.[lxxxvi] Although bagels taste many 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."[lxxxvii] 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.[lxxxviii] Marvin and Murry sold Lender's to Kraft in 1984 for a reported $90 million dollars,[lxxxix] worth roughly $220 million in 2019 dollars.[xc] 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 dispute in the case. Lender Management facilitated investment and helped to grow the family fortune.[xci] Lender Management was a partnership for tax purposes.[xcii] Besides the other benefits of pooling investments such as lower fees and greater access to private investment vehicles,[xciii] the Lender family implemented this structure in part because there were a lot of Lenders.[xciv] 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

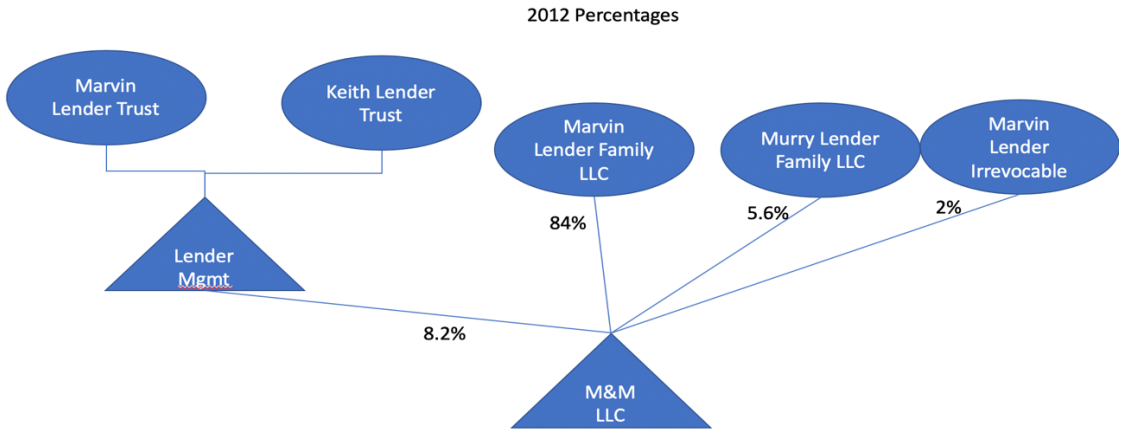
the G4 generation (ten of Harry's great-grandchildren). And the members in the G3 generation, except Keith, had careers independent of Lender Management.[xcv]



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.[xcvi] Second, one member of the G2 generation—Harry's daughter—decided not to invest within the family structure.[xcvii] Third, some of the family members "were in such conflict with others that they refused to attend the same business meetings."[xcviii] Fourth, the Lenders lived in many different states and countries.[xcix]

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."[c] After the restructuring, "Lender Management dividend 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.[ci] Each investment LLC was in turn owned by Lender Management and other entities (trusts and other family investments partnership) that Lender family members controlled.[cii] Lender Management

was owned by two trusts.[ciii] 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 the 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."[civ] 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 its clients individually, regardless of the clients' relationship to each other or to the managing member of Lender Management."[cv] 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.[cvi]

Second, Lender Management provided management services to the investment LLCs—M&M, Lenco, & Lotis. Lender Management had "the exclusive rights to direct the business and affairs of" each investment LLC.[cvii] 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.[cviii]

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.[cix] He also tried to meet once a year with each client about their investment goals in the family office structure.[cx] 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.

Including Keith, Lender Management employed five individuals and had a total payroll of over $390,000 in 2012.[cxi] The employees "main objective was to earn the highest possible return on assets under management."[cxii] 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. Lender Management outsourced many of its accounting and investment advisory responsibilities to Pathstone Family Office, LLC.[cxiii] Although Lender Management had ultimate authority, Pathstone prepared quarterly financial reports for the LLCs and provided due diligence for prospective investments.[cxiv]

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" in from the investment LLCs, similar to the carried interest described in the previous section.[cxv] 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.[cxvi]

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."[cxvii] From Lotis, it received carried interest of "2% of net asset value annually, plus 5% of net trading profits."[cxviii] These values are far over the typical "2 and 20" fee charged by investment funds. Part IV explores whether this excessive fee compensation was really an investor return because the fee did not look like similar fees charged by private equity funds.

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. . . ."[cxix] After discussing the factual, procedural, and preliminary evidentiary issues, the Tax Court began its opinion by discussing the differences in deducting investment expenses under § 162, whereby a taxpayer engaged in a trade or business can take above-the-line deductions, and § 212, where a taxpayer is only engaged in making income and can only take below-the-line deductions that may be limited.[cxx] For the tax years at issue, Lender Management claimed § 162 expenses of over $ 1 million related to the family office's management expenses.[cxxi]

The Tax Court began its analysis by noting "[t]he Code does not define the term 'trade or business.'"[cxxii] Instead, it started with the facts-and-circumstances *Groetzinger* test to determine when a taxpayer engaged in a trade or business: whether the taxpayer acted "with continuity and regularity" and whether "the taxpayer's primary purpose for engaging in the activity" was a desire

"for income or profit."[cxxiii] The Tax Court also cited *Whipple* and *Higgins* to note that managing your own investments is not enough to establish a trade or business.[cxxiv]

But the court did not use the typical dealer/trader/investor label to distinguish whether a taxpayer has a trade or business. Instead, it took the unusual step of saying 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."[cxxv] 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."[cxxvi]

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."[cxxvii] 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.[cxxviii] 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."[cxxix]

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 clients.[cxxx] But as the next section will show, this part of the court's analysis was lacking. Lender Management it was not run like a typical investment fund nor did not compensate itself like a traditional investment fund would.[cxxxi]

The court explained that the transactions between the Lender family members were "subject to heightened scrutiny" because of the interwoven family nature of the business.[cxxxii] 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.[cxxxiii]

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" from the investment funds, but the tax court was satisfied that the taxpayer would have acted reasonably. 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."[cxxxiv] 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. 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.[cxxxv]

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."[cxxxvi] Lender Management was owned by trusts operated to benefit Keith and Murry, both of whom did not own the majority of the interests in the investment LLCs.

Although there are undoubtedly facts that support the trade or business categorization, many of the same facts were present in investor cases explored in Part II like *Higgins* and *Whipple*. The Tax Court's decision boils down to two points: that Lender Management tried to mimic an

investment fund structure and that the taxpayer was compensated via carried interest. As the next section explains, both of these points are lacking.

IV. Critique of *Lender*

a. The Tax Court's decision contravenes precedent

Lender Management acted like an investor, not a trader or dealer. This paper argues there are three reasons for why this label is correct and why the Tax Court got to the incorrect answer. First, Lender Management doesn't have "clients" like a traditional investment fund. The Tax Court stressed that Lender Management "was in the business of providing investment services to its clients"[cxxxvii] But in reality, Keith, a member of the third generation and the Chief Investment Officer, managed investments for himself and his family. By making a few assumptions[cxxxviii] about the ultimate beneficiaries of the trusts owned by Marvin and Murry, a graphical representation expresses the beneficial interests of M&M and Lenco:

These graphs show the close familial connection between all of the investors in the Lender family office structure. An important consideration to this structure, not mentioned in Tax Court's

opinion, is that the family office did not need to register as an investment advisor with the Securities and Exchange Commission (SEC). SEC rule 202(a)(11)(G)-1 defines a family office as an entity that "has no other clients other than family clients. . .is wholly owned by family clients and exclusively controlled. . .by one or more family members. . .[and] does not hold itself out to the public as an investment adviser."[cxxxix] If the family office meets this definition, the office need not register as an adviser with the SEC.[cxl] The exemption from the Advisers Act is 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.[cxli]

The SEC adopted this rule in part because family offices do not act like traditional investment advisers.[cxlii] 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.[cxliii]

There seems to be a disconnect in the rationale of the SEC's proposed rule and the Tax Court's rationale in *Lender*. A family office cannot both function like an investment adviser (*Lender*) and be designed primary to "regulate the interactions of family members in the management of their own wealth" (SEC). This disconnect creates an unjustified regulatory arbitrage opportunity in which a family office can escape registering yet benefit from deducting business expenses because it acts like a typical registered financial adviser.[cxliv] The Tax Court may be correct that family offices can act like investment advisers, but it is likely that the SEC's policy is more persuasive here. The agency made a policy distinction that most family offices are different enough from traditional investment advisers so as to not justify greater regulation. The agency thought this

distinction was necessary because of the experience and prior knowledge it has about family offices. It is far more plausible that the family office structure is generally implemented to facilitate and grow wealth within a group of people who consider themselves family.

And it is likely that the Lender family acted with a collective purpose. Even if each individual Lender family member had separate financial goals, they acted as one family by entering into this structure. Each family member knew there was an advantage to pooling investments in order to invest in alternative investments like private equity and hedge funds. It would be unlikely that any individual Lender would be able to invest in hedge funds on their own. But by collecting all of the Lender family money together, the Lenders were able to entertain offers from at least 150 private equity and hedge funds that sought their capital.[cxlv]

Second, the activities of Lender Management were not like the activities of a typical investment fund. The Tax Court noted that Lender Management provided "services similar to those of a hedge fund manager,"[cxlvi] and "did substantially more than keeping records and collecting interest and dividends."[cxlvii] Yet the family office did not make actual investment decisions outside of selecting 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.[cxlviii] 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 holdings."[cxlix] 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.[cl] In other words, Lender Management acted like an investor, not a dealer or a trader.

Another significant "business" purpose of Lender Management appeared to be that Keith meet one on one with each family member throughout the year and tailored investment advice to meet the needs of each member. But framed in this light, Lender Management looks similar to the taxpayer in *Higgins* who rented office space and employed individuals to help him invest his fortune. And at least the investor in *Higgins* made actual investment decisions—Lender Management only decided which fund was the best fit for that family member.

Third, the carried interest that Lender Management charged the family members was unusually high and did not signal a bona fide business purpose. To put it more poignantly, no rational unrelated investor would have agreed to the fee compensation that Lender Management required of the family members. Compare the fees Lender Management charged to that of a typical private equity fund:

Compensation Type	**Typical PE Fund**	**M&M**	**Lenco**	**Lotis**
Management Fee	2% net asset value	2.5% of net asset value ("NAV")	2.5% of NAV	2% of net asset value
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

A few things are apparent with this comparison. For one thing, the fee that Lender Management charged is high—25% more than the fee charged by a typical investment fund. A nascent investment fund like Lender Management could not demand that fee if it sought outside funding. And the metric by which the fee is charged is similarly quite manager-friendly. It is curious that Lender Management earns a return from an increase in *net asset value* or *trading profits* and not actual profits.[cli] Lender Management could earn a carry even if the fund did actually earn a profit after subtracting operating expenses and the carried interest. The Lender Management

definition is a sharp contrast to the typical definition that outside investors would demand and negotiate over.

Additionally, outside investors would have asked for more protections before investing. Lender Management did not have a hurdle rate in place so Lender Management could theoretically earn a hurdle even if M&M did not earn a risk-adjusted positive return. For example, if M&M earned a return of 5%, Lender Management would have received 1% of that return via the carry. This outsized return is unjustified considering that M&M invests in particularly risky assets; a typical investor would demand a high hurdle rate so that Lender Management was not compensated for achieving a normal return that the investor would have otherwise received by investing in an index fund.[cliii] And investors would also likely demand that Lender Management put in place a clawback to prevent Lender Management from earning a carry in one year when, considering the life of the investment LLC, the fund did not earn an overall profit.

To put this discussion in terms of the *Whipple* terminology, "the only return" that Lender Management received "is that of an investor."[cliii] This distinction is subtle but critical. Lender Management earned carry because of an "enhancement in the value of [the Lender family's] investment[s]."[cliv] It did not earn a fee that made it seem as if it was rewarded for selecting profitable investments. Without a hurdle rate or a clawback provision, Lender Management might have been compensated even if the investment did not make money which leads to the conclusion it was compensated like an investor and not like an adviser.

These three points come together to form the same conclusion: Lender Management was more similar to the taxpayer in *Higgins* than the private equity "dealers" in *Dagres* and *Sun Capital*. Because Lender Management had no outside investors, did not need to register as an adviser with the SEC, did not actually monitor or evaluate its investments like traditional private

equity funds, and was not compensated like a traditional private equity fund, Lender Management did not provide services similar to that of an outside investment fund. Therefore, under *Higgins* and its progeny, Lender Management should not be thought of as engaging in a trade or business.

This result is not surprising 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."[clv] 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. *Lender* is likely a case that violates the core principle in *Higgins* and is contrary to the trade or business framework.

An obvious solution would be for another court to decide a family office structure case differently. Because *Lender* is a memorandum opinion, the decision has no precedential value in Tax Court, any federal district court, or any appellate court. Another solution would be for the IRS to publish a revenue ruling that explains when and how a family office structure with less favorable facts of *Lender* (e.g., a family office that controls the fortune of two generations and does not employ any non-family members in the office) is not engaged in a trade or business. A better solution may be to argue that any family office that relies on the SEC's exemption is presumed not to be engaged in a trade or business absent clear and convincing evidence showing a bona fide family office. This burden shifting would be helpful to the government when litigating future cases. The presumption would fall on the family office seeking to establish that it is engaged in a trade or business.

b. Unjustified Tax Nirvana

But even if *Lender* contravenes relevant precedent, does it matter? Why does, as a matter of tax policy, this decision get to the wrong outcome? This paper argues there are two primary reasons. First, the tax treatment for family offices is better now than the tax treatment for any other type of investor or dealer. As described in Part II, traders and dealers can claim ordinary tax deductions but need to pay gains at ordinary tax rates, while investors pay gains at the preferential capital gain rate but cannot take ordinary tax deductions.[clvi] On the other hand, after *Lender*, family offices can take ordinary tax deductions *and* pay gains at the preferential capital gains rate. There is no sensible reason to think that families who create family offices need a reason to invest money, and there is little reason for this unequal treatment. Family offices invest so that they can grow the family fortune[clvii] and do not need a tax subsidy to do so.

Second, the decision violates horizontal tax equity because similar taxpayers are now treated differently.[clviii] One might imagine that a similarly situated taxpayer, relative to a typical investor in a family office, as a lawyer who seeks management or estate planning advice from a wealth planner in her community. This expense would be a non-deductible § 212 expense after TCJA. But an opportunity exists for multi-generational families who participate in a carried interest family office structure after *Lender*: these people can turn non-deductible § 212 expenses into deductible § 162 expenses.

There is nothing inherently different from the lawyer seeking advice within the community and the family office beneficiary receiving this advice through the family office structure. And there is no reason to suggest why this difference makes any sense from a tax policy perspective. To make matters even more unequal, this tax opportunity only exists for a unique number of family offices. Families need a lot of money in order to create a family office, but, without creating a family office, are unable to take advantage of the *Lender* decision.[clix] And there is no reason to

suggest that the family office trend will stop anytime soon. The Economist notes that "[w]ith upwards of [two trillion dollars] expected to pass from entrepreneurs to their heirs over the next 15 years, the family office is entering a Gilded Age."[clx]

Still, it is likely that some family offices—like the $ 25 billion family office run by George Soros and the multi-billion office run by the Pritzker Group[clxi]—are trade or businesses. 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 is not dependent on "how large the estate or how continuous or extended the work required may be."[clxii] The distinction does not depend on how many assets the family office is managing, but has something to do with the sophistication, expertise, and investment decisions of the family office.

The First Circuit's "investment plus" standard is a step in the right direction in trying to clarify when an entity is engaged in a trade or business, although, as critics have correctly point out,[clxiii] it is not a detailed-enough proposal to be adopted for purposes of § 162. Future courts looking the trade or business inquiry should focus on the underlying activity of the fund and whether the investment fund or family office satisfies something that resembles a "plus" standard. A fund-of-funds, like the taxpayer in *Lender* or the one in Revenue Ruling 2008-39,[clxiv] likely does not have enough activity—particular with respect to the underlying investment—so as to constitute a trade or business. On the other hand, it is very likely that some private equity funds, like the ones in *Dagres* and *Sun Capital*, have enough activity to be considered a trade or business.

This test has even more importance considering that Congress, in enacting the § 199A pass-through deduction, decided to tie the deduction to those entities who are engaged in a trade or business. Although the pass-through deduction has been criticized on general policy grounds,[clxv]

the pass-through deduction makes even less sense if family offices can structure their affairs in such a way to obtain it.[clxvi] And because the *Lender* decision makes it so attractive for wealthy families to create a similar type structure, it is likely that more family offices will try to take the § 199A deduction.

But even if a new trade or business test is not miraculously developed in the next few years, Congress can make incremental changes that ease the stress on the *Lender* decision. First, it can adopt a "cost of capital" approach to taxing carried interest that recharacterizes capital income to ordinary income under certain circumstances if the partner originally received a partnership interest for services that the partner performed for the partnership.[clxvii] Essentially, this approach would prevent gamesmanship by investment funds who earn an "extraordinary return" on profits interest that they receive for services.[clxviii] It would also make the carried interest structure less attractive in the family office context. Although Congressman Dave Camp proposed this approach in a 2012 piece of draft legislation,[clxix] Congress instead enacted a more modest carried interest tax reform in the TCJA.[clxx] Many have noted that the new carried interest proposal is relatively tame and will likely not prevent the gamesmanship of carried interest.[clxxi] A cost-of-capital approach will ensure that family offices and private equity funds earn a risk-adjusted return relative to the effort that it provides.

Second, Congress should consider reinstating § 212 expenses. Even before these expenses were deducted, one professor noted that the "[t]he root cause of the problems" of expenses like § 212 is "the erroneous characterization of expenses that are directly related to the production of income as itemized deductions."[clxxii] In other words, the problem of trying to distinguish between § 162 and § 212 expenses is a structural, not a practical, problem. Although eliminating § 212 expenses were necessary for budgetary purposes so that the TCJA could satisfy the so-called Byrd

rule,[clxxiii] eliminating these expenses did not make sense from a policy perspective.[clxxiv] And re-establishing the § 212 expenses, and perhaps making them above-the-line like § 162 expenses, will go a long way to establishing tax equity among similar taxpayers.

V. Conclusion

This article has considered two aspects of *Lender Management* that may be open to interpretation: whether a family office engages in a trade or business and whether the profits interest that a family office charges its investment LLCs is like the carried interest that other investment funds charge investors. Although families have a greater incentive to mimic the *Lender* structure since the enactment of the TCJA, this paper argues family offices like the one in the Tax Court case are not engaged in a trade or business. As a matter of law and policy, this paper has argued for an end to the *Lender* loophole.

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[i] 114 T.C.M. (CCH) 638 (2017).

[ii] However, TCJA was not the Bill's official name. *See* H.R. 1, 115th Cong. § 1 (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").

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

[iv] *Compare* I.R.C. § 162 *with* I.R.C. § 67(a).

[v] *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 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 (last accessed May 14, 2019) (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.").

[vi] *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 Contributing Partners*, SKADDEN (Jan. 2018); ANCHIN, BLOCK & ANCHIN LLP, *Tax Court Ruling That Family Office Carried on a Trade or Business May Offer Tax Planning Opportunities* (Feb. 5, 2018), https://www.anchin.com/uploads/1413/doc/Alert_02052018_Tax-FamilyOffice-FS.pdf; KIRKLAND & ELLIS LLP, *The Profits Interest Family Office Structure* (Sept. 25, 2018) https://www.kirkland.com/-/media/publications/newsletter/2018/09/private-investment-family-office-insights/privateinvestmentfamilyofficeinsights92518.pdf.

[vii] 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.").
[viii] It is rather ironic the Tax Court case dealt with members of the Lender family, a family that made their fortune in the bagel industry. *See supra* Part II.A.
[ix] A third prong of the *Lender* loophole 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. A discount of 10-20% is common in these situations. *See generally* Louis A. Mezzullo, 722 Tax Mgmt. (BNA) U.S. Income, at I.C (last visited May 13, 2019). This paper acknowledges the potential estate tax benefit of putting assets in an investment LLC, similar to what the Lender family did, but will not discuss this potential benefit.
[x] Higgins v. Comm'r, 312 U.S. 212, 218 (1941).
[xi] *See infra* Part II.A.
[xii] Shu-Yi Oei, *A Structural Critique of Trader Taxation*, 8 FLA. TAX REV. 1013, 1016–17 (2008).
[xiii] BITTKER & LOKEN, FED. TAX'N INCOME, EST.& GIFTS ¶ 47.2 (2018) (discussing how the dealer and trader distinction is a label associated with the expense because neither term appears in § 1221).
[xiv] Oei, *supra* note xii, at 1017 (citing Treas. Reg. § 1.471-5(c)).
[xv] *Id.*
[xvi] *Id.* (citing Reg. § 1.475(c)-1(a)(2)(ii) exs. 1, 2).
[xvii] *See infra* Part II.B.1.
[xviii] BITTKER & LOKEN, *supra* note xiii, at ¶ 107.8.
[xix] Oei, *supra* note xii, at 1017–18.
[xx] *Id.* at 1032.
[xxi] *Id.* (quoting Fuld v. Comm'r, 139 F.2d 465, 485–89 (2d Cir. 1943)).
[xxii] *Id.* (quoting Mayer, 67 T.C.M. (CCH) 2949, 2949-4, -5 (1994)).
[xxiii] *Id.* (citing Chen, 87 T.C.M. 1388 (2004)).
[xxiv] *Id.* at 1035.
[xxv] *Id.* at 1036 (citing Moller, 721 F.2d 810, 813 (1983)).
[xxvi] 480 U.S. 23 (1987).
[xxvii] *Id.* at 26.
[xxviii] *Id.* at 33.
[xxix] *Id.* at 28 (noting that "the Court appears to have drawn a distinction between an active trader and an investor").
[xxx] *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, (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").
[xxxi] 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.).
[xxxii] *Id.* at 29.
[xxxiii] Treas. Reg. § 1.471-5(c).
[xxxiv] Gregg Polsky, *Income Tax*, *in* STAY AHEAD OF THE PACK: YOUR COMPREHENSIVE GUIDE TO THE UPPER LEVEL CURRICULUM 443 (2018).
[xxxv] *See* I.R.C. § 1211.
[xxxvi] *See supra* note iii.
[xxxvii] 312 U.S. 212 (1941). The taxpayer in *Synder v. Commissioner* also exemplifies a typical investor. 295 U.S. 134 (1935). The taxpayer in that case was a "salaried secretary" who make a series of margin trades and tried to argue that he was in a trade or business. *Id.* 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.* at 139. In other words, the taxpayer in *Synder* was not a trader because he managed his did not engage in enough regular activity to gain the trader label.
[xxxviii] *Higgins*, 312 U.S. at 218.
[xxxix] *Id.* at 215.
[xl] *Id.* at 217.
[xli] 373 U.S. 193 (1963).

[xlii] *Id.* at 202.
[xliii] 480 U.S. 23, 35 (1987).
[xliv] 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.
[xlv] Gregg D. Polsky, *Private Equity Monitoring Fees as Dividends: Collateral Impact*, 143 TAX NOTES 1053, 1053 (2014).
[xlvi] *Id.*
[xlvii] Gregg D. Polsky, *Tax Aspects of Private Equity Compensation*, SOUTHERN FEDERAL TAX INSTITUTE 5 (Power Point Oct. 24, 2018).
[xlviii] *Id.*
[xlix] Steven M. Rosenthall, *Private Equity Is a Business: Sun Capital and Beyond*, 140 TAX NOTES 1459, 1466 (2013).
[l] *See supra* Part II.A.
[li] Rosenthall, *supra* note xlix, at 1466.
[lii] *Id.* at 1467.
[liii] *Id.* at 1469.
[liv] Valerie M. Hughes, note, *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.").
[lv] *See supra* note xxvii.
[lvi] 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 in- come.").
[lvii] 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 xlv, at 1453 n.1.
[lviii] 136 T.C. 263 (2011).
[lix] *Id.* at 284.
[lx] *Id.* at 285.
[lxi] *Id.* at 285–86.
[lxii] 724 F.3d 129 (1st Cir. 2013).
[lxiii] *Id.* at 144.
[lxiv] *Id.* at 141.
[lxv] *Id.*
[lxvi] *Id.*
[lxvii] Rosenthall, *supra* note xlix, at 1466.
[lxviii] *Id.*
[lxix] Hughes, *supra* note liv, at 1358.
[lxx] *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 taxation ultimately achieve?"); *cf.* Victor Fleischer, *Sun Capital Court Ruling Threatens Structure of Private Equity*, N.Y. TIMES DEALBOOK (Aug. 1, 2013, 12:28pm), *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.").
[lxxi] *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, (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).

[lxxii] 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 Polsky, *supra* note xlv.
[lxxiii] *See* Victor Fleischer, *Two and Twenty: Taxing Partnership Profits in Private Equity Funds*, 83 N.Y.U. L. REV. 1, 3 (2008); Chris W, 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 (2008).
[lxxiv] Fleischer, *supra* note lxxiii, at 3 ("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.").
[lxxv] 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 arguable help investors who would have otherwise been limited by the § 67(a) limit on § 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).
[lxxvi] Andrew W. Needham, 736 Tax Mgmt. (BNA) U.S. Income, at III.C (last visited May 13, 2019).
[lxxvii] *Id.*
[lxxviii] *Id.*
[lxxix] *Id.*
[lxxx] Andrew W. Needham, 735 Tax Mgmt. (BNA) U.S. Income, at III.A (last visited May 13, 2019).
[lxxxi] *Id.*
[lxxxii] *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.
[lxxxiii] *Id.*
[lxxxiv] *Id.*
[lxxxv] *Id.*
[lxxxvi] *See, e.g.,* Emily S, *10 Reasons Why Bagels Are The Ultimate Breakfast Food*, THETHINGS.COM (Jun. 14, 2016) https://www.thethings.com/10-reasons-why-bagels-are-the-ultimate-breakfast-food/.
[lxxxvii] Yglesias, *supra* note lxxxii.
[lxxxviii] *Id.*
[lxxxix] Lucia Greene, *Murray Lender Cried 'long Live the Bagel!' and Now He's into the Big Dough*, PEOPLE (Apr. 28, 1986 12:00pm), https://people.com/archive/murray-lender-cried-long-live-the-bagel-and-now-hes-into-the-big-dough-vol-25-no-17/.
[xc] US Inflation Calculator, https://www.usinflationcalculator.com/ (last accessed May 14, 2019).
[xci] 114 T.C.M. (CCH) 638, at *3 (2017).
[xcii] *Id.*
[xciii] *See* Aghdami & Harris, *supra* note v ("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.").
[xciv] *Lender*, 114 T.C.M. (CCH) at *4.
[xcv] *Id.*
[xcvi] *Id.* at *4.
[xcvii] *Id.*
[xcviii] *Id.* at *34.
[xcix] *Id.*
[c] *Id.* at *9;
[ci] *Id.* at *6.
[cii] *Id.*
[ciii] *Id.*
[civ] *Id.* at *35.
[cv] *Id.* at *36–37.
[cvi] *Id.* at *35.

[cvii] *Id.* at *11.
[cviii] *Id.*
[cix] *Id.* at *15.
[cx] *Id.* at *16.
[cxi] *Id.* at *14.
[cxii] *Id.* at *14.
[cxiii] *Id.* at *19.
[cxiv] *Id.*
[cxv] *See supra* Part II.B.
[cxvi] *Lender*, 114 T.C.M. (CCH) at *12.
[cxvii] *Id.* at *12
[cxviii] *Id.*
[cxix] *Id.* at *2.
[cxx] *Id.* at *23–24.
[cxxi] *Id.* at *20
[cxxii] *Id.* at *24.
[cxxiii] *Id.* at *24 (citing Groetzinger v. Cmm'r, 480 U.S. 23, 35 (1987)).
[cxxiv] *Id.* at *25.
[cxxv] *Id.* at *26.
[cxxvi] *Id.*
[cxxvii] *Id.* at *29.
[cxxviii] *Id.*
[cxxix] *Id.* at *29–30.
[cxxx] *Id. at* *33
[cxxxi] *See infra* Part IV.A.
[cxxxii] *Lender*, 114 T.C.M. (CCH) at *34.
[cxxxiii] *Id.* at *34–35
[cxxxiv] *Id.* at *36.
[cxxxv] *Id.*
[cxxxvi] *Id.* at *38.
[cxxxvii] *Id.* at *29
[cxxxviii] Three plausible assumptions are key to these graphs. First, the ultimate beneficiaries of the trusts and interests owned by Marvin and Murry (the G2 level) are the next generation (Keith and the other G3 members). Second, Keith and the rest of the G3 generation split their interests in these trusts and other instruments evenly amongst each other. Third, the grandchildren at the G4 generation split their interests evenly among each grandchildren. Nevertheless, because these trust instruments are not public, there is no way to know if these assumptions are true. The essential assumption, however, is that the trusts leave the Lender family money within the Lender family. As long as this point is true, the main point of the graph remains: 100% of the beneficial ownership of the Lender family office structure will be with individuals who have a close relationship with Keith.
[cxxxix] 17 C.F.R. § 275.202(a)(11)(G)-1 (2019).
[cxl] *Id.*
[cxli] Kirkland & Ellis, *supra* note 6 (discussing the costs of complying with the relevant SEC rules).
[cxlii] 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, T*he Family Office Exclusion Under the Investment Advisers Act of 1940,* 69 SMU L. REV. 97, 133 (2016).
[cxliii] Family Offices, 75 Fed. Reg. 63753, 63755 (Oct. 18, 2010).
[cxliv] *Cf.* Emily Cauble, *Exploiting Regulatory Inconsistencies*, 74 WASH. & LEE L. REV. 1895 (2017)
[cxlv] 114 T.C.M. (CCH) 638, at *15 (2017).
[cxlvi] *Id.* at *38.
[cxlvii] Higgins, 312 U.S. 212, 218 (1941).
[cxlviii] *Lender*, 114 T.C.M. at *37.
[cxlix] 136 T.C. 263, 285–86 (2011).
[cl] 724 F.3d 129, 141.
[cli] *See supra* Part II.B.

[cliii] *Cf.* Fleischer, *supra* note lxxiii, at 22 (noting that in the private equity context, "[m]oral hazard concerns prevent private equity funds from doing away with the preferred return entirely").
[cliii] 272 U.S. 193, 202 (1963).
[cliv] *Id.*
[clv] Stafford Smiley & Michael Lloyd, *Sun Capital Partners and The Private Equity Industry*, 41 J. CORP. TAX'N 35, 38, 2014 WL 890633, 6 (Jan./Feb. 2014).
[clvi] *See supra* Part II.A.
[clvii] *See* Leeds, *supra* note 5 ("Whether wealth is new or old, however, affluent families understand . . .that successfully managing investments is as important as the initial wealth creation. For this reason, many families create and staff family offices whose mission it is to invest and manage family capital.").
[clviii] *See* David Elkins, *Horizontal Equity as a Principle of Tax Theory*, 24 YALE L. & POL'Y REV. 43, 43 (2006) ("The principle of horizontal equity demands that similarly situated individuals face similar tax burdens.").
[clix] Anupreeta Das and Juliet Chung, *New Force on Wall Street: The 'Family Office'*, Wall Street J., (Mar. 10, 2017 5:18 pm) ("For clans with at least $250 million in assets to invest, family offices have become the preferred vehicle through which to put their money to work, because they afford complete control and near-secrecy. They don't have to register with federal regulators as long as they limit their investment advice to descendants of a common ancestor within 10 generations, plus others such as key employees, adopted children and former spouses.").
[clx] *See Family Offices become Financial Titans*, The Economist (Dec. 15, 2018).
[clxi] *See id.*
[clxii] Higgins v. Comm'r, 312 U.S. 212, 218 (1941).
[clxiii] *See supra* notes lxix–lxxi.
[clxiv] Rev. Rul. 2008-39, 2008 IRB LEXIS 516 (I.R.S. July 3, 2008).
[clxv] *See generally* Daniel Shaviro, *Evaluating the New US Pass-Through Rules*, 2018 BRITISH TAX REV. 48 (2018).
[clxvi] Heller & Taback, *supra* note 5 ("The new 20 percent deduction may generate planning opportunities for family offices and investment entities. As one example, families with holdings that are likely to qualify for the new deduction might consider compensating family office executives with a profits interest in a family investment partnership rather than W-2 wage income. The profits interest arrangement may enable executives to enjoy the lower tax rate resulting from the deduction while further aligning the interests of the family office and the executive.").
[clxvii] Fleischer, *supra* note lxxiii, at 21 ("A true preferred return would limit the GP's profit-sharing right to amounts that exceed a target rate of return that reflects the investor's cost of capital. Economically, a carried interest subject to a true preferred return would function like a cost-of-capital indexed stock option, which is thought to properly align incentives for corporate executives. A true preferred return gives the GP a financial incentive to invest only in companies that will generate a return in excess of the stated interest rate. Rather than a true preferred return, however, most funds use a hurdle rate.").
[clxviii] Dan Primack, *Dave Camp's Confusing (and Understated) Private Equity Tax Plan*, FORTUNE (Feb. 27, 2014), http://fortune.com/2014/02/27/dave-camps-confusing-and-understated-private-equity-tax-plan/.
[clxix] *Id.*
[clxx] I.R.C § 1061 (2017).
[clxxi] Marie Sapire, *Carrying On With Carried Interest*, TAX NOTES (Jun. 19, 2018), https://www.taxnotes.com/tax-reform/carrying-carried-interest ("Steven M. Rosenthal of the Urban-Brookings Tax Policy Center said the problems with section 1061 start with the flawed approach of only reclassifying profits or gains from assets that have been held for less than three years. He said that because private equity funds typically hold assets for four to five years, the provision's design fails to tax the purported target.").
[clxxii] Jeffrey H. Kahn, *Beyond the Little Dutch Boy: An Argument for Structural Change in Tax Deduction Classification*, 80 WASH. L. REV. 1, 67 (2005).
[clxxiii] *See* Ellen Aprill & Daniel Hemel, *The Tax Legislative Process: A Byrd's Eye View*, 81 LAW & CONTEMPORARY PROBLEMS 99, 100 (2018) ("The Byrd rule also is the reason that key elements of the new tax law—including the reduction in individual income tax rates, the expansion of the child tax credit, the increase in the standard deduction, the new deduction for pass-through income, and the increase in the estate and gift tax exemption—are set to expire at the end of 2025.").
[clxxiv] *See, e.g.,* Douglas A. Kahn, *Suspension of Miscellaneous Itemized Deductions is Ill-Advised*, 102 TAX NOTES 777 (Feb. 18, 2019).