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Podcasts | August 6, 2026

Carried Away Series — Management Fees and Self-Employment Taxes – Structuring for Tax Efficiency After Sirius Solutions and Soroban

SPEAKERS

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The debate over self-employment taxes on management fees just got more complicated.

In the latest installment of our "Carried Away" miniseries, a multiepisode series under our *PE Pathways* podcast exploring the economics of private funds, Troutman Pepper Locke Partners Thao Le, Stephanie Pindyck Costantino, Saba Ashraf, and Tom Gray break down the evolving legal landscape surrounding the taxation of management fee income and what it means for how private equity firms structure their management companies today.

The Fifth Circuit's decision in *Sirius Solutions* handed a victory to fund managers, holding that state-law limited partners may be able to avoid self-employment taxes on management fee income — even when actively involved in managing investments. But with the First and Second Circuits weighing related cases involving Denham Capital and Soroban Capital Partners, a circuit split may be on the horizon, and the possibility of Supreme Court review may follow.

In this episode, our team covers:

- **Management company structures**
- **The self-employment tax framework**
- **The *Sirius Solutions* decision**
- **Pending decisions in the First and Second Circuits**
- **Practical planning strategies**

Whether you are launching a new fund or revisiting an existing management company structure, this episode is essential listening for GPs, CFOs, and fund counsel navigating one of private equity's most unsettled tax questions.

Transcript

Podcast: *PE Pathways*
Episode: Carried Away Series — Management Fees and Self-Employment Taxes – Structuring for Tax Efficiency

After Sirius Solutions and Soroban

Speakers: Thao Le, Stephanie Pindyck Costantino, Saba Ashraf, and Tom Gray

Recorded: July 16, 2026

Aired: August 6, 2026

Thao Le (00:05):

Welcome to *PE Pathways*, our podcast series where experienced dealmakers share their thoughts on current private equity and M&A trends and developments. My name is Thao Le, a partner in Troutman Pepper Locke's Private Equity and Investment Funds Practice, and I'm excited to continue our multi-episode miniseries entitled Carried Away. This is a focused podcast series on the economics of private funds from management fees to carry, GP co-investment, and the tax rules that sit behind them.

In each episode, we bring together Troutman lawyers to explore what's really happening in the market. Listeners will hear candid discussions of current GP fee and carry norms, the ways GPs are sharing economics with anchor LPs and strategic partners, how firms are using carry to recruit and retain talent across their organizations, and how recent and pending court decisions are reshaping tax planning for management fees.

Today, we'll be discussing everyone's favorite topics: fees and taxes. The Fifth Circuit's recent decision in the Sirius Solutions case handed a victory to private fund managers. Fund managers or state law limited partners in the Fifth Circuit may be able to avoid self-employment taxes on ordinary income attributable to management fees, even if they are actively involved in managing investments and making decisions on behalf of their management companies. As of the date of this recording, taxpayers outside the Fifth Circuit, however, are currently left facing uncertainty.

Decisions relating to the issues are expected in both the First Circuit, involving a case of Denham Capital Management, and the Second Circuit, in a case involving Soroban Capital Partners, by the end of 2026. In this episode, we will unpack the rules applicable to the taxation of management fees, strategies to minimizing self-employment taxes, and what a split among the courts could mean for how management fees should be structured going forward.

Joining me today for this episode are my fellow partners, Stephanie Pindyck Costantino, the head of our Investment Funds Practice, and Saba Ashraf and Tom Gray, two very experienced tax partners, both in flow-through taxation and fund management issues. Welcome, everyone. I introduced a lot of information about taxation and management fees, but I think it would be a good way to start the substantive discussion with level-setting some of the foundational aspects of management companies. So, Steph, why don't we start with you? Can you tell us a little bit of what you're seeing as far as PE firm management company structures and what type of legal entities they're usually using for management companies?

Stephanie Costantino (02:40):

When you look at management companies and what might be typical, there's a lot of considerations with respect to what makes sense. Oftentimes, though, management companies are a type of pass-through entity, whether that be a limited liability company or a limited partnership. Some houses do actually use a corporation, but that really depends on the house and the driver for that choice. But ultimately, when you look at a management company that is rendering services to one or more investment funds, oftentimes the management company will house payroll. It may house the benefits. It may house a number of different types of larger platforms with respect to the actual individuals that are providing services.

And so ultimately, when you look at the management company and what role it plays and what makes the most sense for the various participants, you really have to understand and appreciate where the participants are located. You have to call people like Tom and Saba and ask them about what makes the most sense, both from a federal and state standpoint. And then you have to take into consideration what types of contracts and what types of income are going to be coming in and what kind of services they're going to be rendering. But oftentimes, we typically start with some sort of pass-through entity and then we go from there.

Thao Le (04:00):
So, Steph, would you say that it's fair that in a typical fund structure you would have one management company that is providing services to several different funds, especially if you have a serial fund formation type of manager that is in, from funds one to eight, for example, it's typically the same management company?

Stephanie Costantino (04:19):
We often will find that you have one of, I'd say, two or three types of structures in place. You either have one management company that is offering the same types of services to multiple strategies and it's agnostic to the type of strategy. In some houses, you do have management companies that are actually particular to strategies. And then I would say there are others that also then take it one step further, and in the background is actually like an ultimate holding company, which is where actually the ultimate payroll, benefits, and other things like that are housed. And then that actual holding company actually has a number of contracts in place with multiple, maybe smaller management companies for one or more reasons.

Thao Le (05:03):
It's safe to say, though, that the management companies, whether it's one or two or even a holding company structure, you do have a lot of management fees from different sources, different funds, I should say, flowing into the "management company." And so, Saba, I would turn it to you then to say, what are you seeing as the current taxation of these type of management fees and in light of the general big picture management company structure that Steph outlined?

Saba Ashraf (05:27):
Typically, as Steph was saying, the management company is usually organized as a pass-through entity. For purposes of this discussion and for purposes of the cases that Tom's going to be talking about, let's assume it's a limited partnership, which is quite common. That entity will provide management, advisory, and other professional services to the fund, and the fund will receive the services and pay a management fee to the management company. The principals of the management company often wear dual hats.

So if you have a management company that's a limited partnership, the principals will hold interest in that management company as limited partners. So that's their economic interest in the management company, pursuant to which they'll receive distributive shares of the management fee income. And there's often also a general partner entity that handles the day-to-day management. And that general partner entity might be an LLC or other type of entity, and that will have a pretty small interest, and the principals will also hold an interest in that.

So in the structure that I've just described, as I said, the management company typically receives the management fees and it distributes them to the partners, with the principals getting nearly all of the income by way of distributions with respect to their limited partnership interest. And so then the question is, how is that income taxed to the limited partners? Well, that is ordinary income. That part is fine and good. But then the question is, is that ordinary income subject to employment taxes? Specifically, is it considered net earnings from self-employment on which self-employment taxes are owed?

Thao Le (07:17):
Just to clarify this, you're talking a lot about the limited partner context, but the management companies, like you said, could be structured as a limited partnership or an LLC. It is basically a flow-through entity, right? So when you're talking about limited partners in an LP versus members of an LLC that are receiving distributions, it's a similar tax treatment and similar concerns as to the self-employment tax. Is that right?

Saba Ashraf (07:44):
It is a similar concern, yes.

Thao Le (07:46):
Okay.

Saba Ashraf (07:46):
But specifically, I'm talking about limited partnerships because I think that'll be more relevant to the cases, but we will touch on LLCs later on also.

Thao Le (07:53):
Great. Thank you.

Saba Ashraf (07:54):
Sure. With respect to self-employment taxes, the tax rate is 16.2%, which mirrors the taxes imposed on employees, which is the Social Security tax, which applies up to a cap of 12.4%. And I think in 2026 it was 184,500. In addition to that, there's the 3.8% Medicare, which there's no cap on. So in cases where the management fees are very high, that 3.8% is really what is at stake. Because that 3.8%, if you're earning millions in management fees, can be pretty substantial. And if that 3.8% sounds familiar, it's because that's also the tax rate that applies to net investment income tax to investment income for high earners, which is not coincidental.

When that net investment income tax was put into place, it was intended to mirror sort of the employment taxes that apply to basically wages and self-employment income. So the planning that's often implemented and that was at stake in the case that Tom will describe is that the principals take the position that the distributions they receive in their capacity as limited partners are not considered net earnings from self-employment and should not be subject to that 6.2% tax. This is despite the fact that the principals are providing substantial services to the fund through the management company.

Their argument is that they are state law limited partners in a limited partnership and as such their distributive share of income from the management company is not net earnings from self-employment. Specifically, to get into the tax code supporting the position, Section 1402(a)(13) of the Internal Revenue Code provides that the distributive share of income received by a limited partner as such from a trade or business carried on by a partnership is excluded from the net earnings from self-employment. And so, based on the specific language of 1402(a)(13), fund managers often structure themselves into limited partner status in order to claim the exclusion. And a lot of these fund managers are likely pretty active and not completely passive.

Thao Le (10:24):
Thanks Saba for that detailed history. It seems quite a bit is at stake. So Tom, with the Fifth Circuit case decision, what really is at stake here and what was the impact of the Fifth Circuit decision on what the current rules are?

Tom Gray (10:38):
What's at stake here is the meaning of limited partner and whether or not the self-employment taxes that Saba described are applicable to that distributive share of net earnings that that limited partner is receiving. So, you had mentioned three cases, Sirius Solutions, Denham Capital, and Soroban. Those all come up from the Tax Court. And in the Tax Court case they first looked at Soroban. That case created this functionality test for limited partners. So this is a judicially created standard. It's not in the code, it's not in the regulations.

And what they said was based on the legislative history, based on the timing of when this section that Saba mentioned that refers to limited partner as such, we read that as really being a passive investor. So somebody who should be not involved because when you look at the history at the time, those limited partners weren't really having any type of active management role in these companies. And at the time there was somewhat of a play that was described as persons creating partnerships and bringing in limited partners who could get Social Security benefits because their net earnings would be subject to self-employment tax.

And Congress said well that's not really the intention. The intention was that this should all be with respect to active income from trade or businesses. So the Tax Court created this functionality test and in each of these cases came back and said these persons who are limited partners were actively involved and therefore the earnings attributable to them from this trade or business would be subject to self-employment tax. So for these individuals, it could be a big tax bill. In Sirius Solutions, which goes up to the Fifth Circuit, and Fifth Circuit covers Texas, Louisiana, and Mississippi, the years in audit were 2014, '15, '16, so it's been a while for this to work through the system. And the Fifth Circuit looked at the Tax Court decision and in a 2-to-1 decision vacated and remanded the decision and said, "We don't agree. We look at this and say a limited partner is someone with limited liability. There is no indication of this passive investor situation."

So they go back and they read through the text, they look at dictionary definitions at the time when the legislation was passed and say that all these definitions are looking at limited liability. IRS instructions with respect to the returns do not describe a passive investor, and it's all consistent there. They come out with this decision and vacate and remand it. Meanwhile, the dissent comes back and says, "Well, not so fast. I don't agree with you on this because when you look at these definitions, yes, it mentions limited liability, but there's also other provisions in here and you're kind of cherry-picking."

And when you look at the Uniform Limited Partnership Act and the revised at that time, which was in effect in most states, there's a very limited amount of activities that limited partners could do. So the dissent's argument supports the Tax Court saying this looks more like a passive investor scenario. So, you have that decision and now you also have in the Second Circuit, Denham Capital coming through. You have Soroban making its way up through the First Circuit. Soroban had its oral arguments a few weeks ago and the reporting from those oral arguments came out that the justices were not as convinced as the majority in the Fifth Circuit.

And Denham Capital was trying also to make an argument that these type of items, the self-employment concept, shouldn't even be a partnership issue. It's an individual issue and the whole thing is not relevant. And so there's more arguments going on. We'll see what happens because there could be a split here between the jurisdictions, or it could go either way. We don't know.

Thao Le (15:23):
So, Tom, just sticking on the topic of court cases here. What happens if there is a split decision?

Tom Gray (15:29):
If there's a split decision, usually somebody's pushing it to the Supreme Court. The Treasury is going to want the Supreme Court to rule on this. They want uniformity throughout the nation. That is one of the key aspects of it. So then it becomes a question of will the Supreme Court take the case and then what happens there? It goes back and forth between commentators. Some commentators thought the majority in Denham relied too much on the definition of limited partner in the state law definition. Federal tax law does not rely on state law. It can look to state law, but it is not necessarily determined by state law. So because somebody is called a limited partner for state law purposes does not necessarily mean there is a limited partner for tax purposes.

And one of the things that when Saba was mentioning the code section was the references to limited partner "as such." And that was something the Tax Court really focused on, saying that phrase means you got to look beyond the specific definition. You got to look at "as such." What does that really mean? And the majority in the Denham case said, "You know what? We're looking at that, and what that really means is you got a partner that's both the general partner and a limited partner." So that is the issue they're focusing on. If you have Person A who's the general partner and limited partner, "as such" means for A, you're just looking at that interest as a limited partner, not the general partner. There's a whole bunch of different arguments going on. I wish I had a crystal ball to say how it would come out, but I don't know.

Thao Le (17:13):
As transactional lawyers, we always joke to say that tax most of the time drives decision-making on how things are structured. And it seems like with this uncertainty, there's a lot of uncertainty of how we would be advising managers one way or the other on how to structure things. And so, Steph, I would turn it to you because oftentimes the first line of defense in advising clients on structuring management companies and overall fund structures, it often first comes to the fund formation lawyers, right? So what would you be talking to clients and telling them at this time?

Stephanie Costantino (17:46):
I think really what we are looking at here is flexibility, and that's often what we've always counseled with respect to our structures, right? We often want to create the kernel or the nucleus of our structure to retain as much flexibility as possible. And we want to create a structure with elections that can be forward-thinking, not something that has to be… So it can be undone, so to speak, right? So oftentimes, for example, you'll hear, "Well, don't make an S corp election unless you really mean it," for example, right? Because undoing it takes a lot of conviction. I'm not saying that it doesn't make sense for certain people, that's not what I'm saying. But I'm just

saying that in this case where we're really trying to understand and appreciate what it might look like going forward, I would say to clients that right now we want to create a structure that retains as much flexibility as possible.

And if a certain election makes sense, if using an LP makes sense for you right now, or we're really kind of indifferent between one or the other, then that's really something that we take into consideration. I think that's really where we are right now. I think is… To highlight what Tom said, I think we don't have a crystal ball. I think we're really trying to understand and appreciate and read the tea leaves a little bit. But again, that's really difficult as it's unfolding in real-time. And so again, it's really understanding and appreciating what makes the most sense for the house now and trying to plan the best we can for the future, and really trying to plan the best you can for the house as a whole, right? I think that's the thing we always try and stress. You're not always going to be able to plan for every individual circumstance.

Tom Gray (19:33):
One of the things I wanted to add was in the cases there's commentary about, "Well, this is really something Congress should clarify." So even if the Supreme Court comes down and says, "You know what? We agree with the Fifth Circuit. It should be this," or all the circuits come out this way, it is possible, because this could be a significant hit to the fisc, that somebody could go beyond all the back and forth and say, "We think this is a tax that should be imposed," and there could be a new congressional tax act that comes through and impose the tax. So it's always possible that outside of the court cases, there could be some new legislation that comes through.

Thao Le (20:16):
Tom and Saba, I think I want to throw a question to you because Steph was mentioning a lot about flexibility, and that's certainly one of the things that we try to achieve when we're structuring, whether it's a transaction or an organizational structure for clients. But when you look at the fact that there's so much uncertainty among the First, the Second, and the Fifth Circuit, what might happen there, what might happen at the Supreme Court if they hear this case or cases, or whether there's legislative action? If you can boil it down to say there are two paths: Path A would be the best result for fund managers and it would look like this, and Path B would be the best result for the tax regulators, it would look like this. I mean, how can you simplify that into a bifurcated approach? Or can you even give me a bifurcated answer?

Tom Gray (21:04):
I'll take the first shot at this. I'll say for fund managers, the best outcome is everybody agrees with the Fifth Circuit. If the First and Second Circuit comes down with this, that's IRS is striking out three times. I mean, would they go for a fourth in, like, the Ninth circuit or something? I don't know. I don't even know if there's any cases that they're looking at there. So that seems unlikely. And with that, then you have… Anybody who has a limited partnership could take advantage of this. And it raises interesting questions because let's say I'm a sole proprietor. Can I create a state law limited partnership where I create a GP, maybe I have that as a corporation, and I have 99% as a limited partnership, so all my income comes through? Can I avoid self-employment tax that way?

There's a lot of different implications that can result from this that may not be intended. For the Treasury, I have heard they are trying for the whole Fifth Circuit embankment to review this case. I don't know if that's going to happen. So I don't know what the decision was there. But for the first and second to rule the other way and follow the Tax Court, and then for them to win at the Supreme Court, because they do not want the Fifth Circuit keeping its decision out there without a Supreme Court review.

Saba Ashraf (22:34):
If I were a fund manager, here's what I would be doing right now. First, I would be reviewing my existing structure to see how close or far away you are from the Sirius facts or the reasoning. And in reviewing that existing structure, it matters greatly where you're located, whether you're located in the Fifth Circuit or outside the Fifth Circuit. So to plan for the possibility that Sirius might be, in fact, the prevailing decision, it would be helpful to be in a structure that could convert into a limited partnership structure relatively easily. So if you're already somehow involved with S corporations or you're a limited liability company, I would start thinking about ways that could translate over.

And if you're outside the Fifth Circuit, I would give some thought to how aggressive… What my risk tolerance profile is. If it's high enough, do I want to follow the position of Sirius? And if not, if I'm more conservative, then maybe I sit on the sidelines and see how this eventually all falls out. If I'm in the Fifth Circuit, I'm probably relatively confident. I still need to be mindful that this en banc might come out differently or that this could go up to the Supreme Court and a decision could come out differently, in which case you're potentially looking at penalties and interest. Most likely not penalties, but interest would still run, so you need to be mindful of that.

If I'm starting from scratch, meaning I don't have sort of prior management companies that I need to worry about whether I should be filing refund claims for those or planning for those, if you're starting from scratch, probably to leave yourself as much possibility as possible, it might be helpful to set up a structure that technically could fall squarely within section 1402(a)(13). That's not to say that you need to take the position right now that your earnings, your distributive share is going to be excluded from self-employment taxes, but that would set you up to take advantage of that should it turn out that ends up being the law that applies to everyone.

Thao Le (24:46):
Thanks, Saba. And just to close out this question, Steph, any other takeaways that you would be thinking of from a practical perspective and on the non-tax side?

Stephanie Costantino (24:56):
You took away kind of my glib answer, which was make sure you contact your tax individuals, and I don't mean just your tax counselors. I think it's also right you want to make sure that you're circling up your accountants and everyone else all at once. I think again it really underscores that it's really never too early to understand and appreciate what your upper tier is going to look like. I think often in the formation stage, there's a rush to kind of get your fund up and running sometimes. And I think this underscores really the importance of really wanting to understand how your upper tier can be impactful with respect to the people that comprise your team, with your house in general, with ultimately where your fees are going to run, the different types of fees that are going to come in and how that might be structured, and really what ultimately the net result is for the team as a whole as you begin and actually as you continue to evolve.

And when you create the management company and you create the upper tier as a whole, I think this just underscores the importance of really trying to take a moment to kind of map it out. And even if you don't put the whole thing in place in the beginning, to take the time to really at least think through what might be the various ramifications and questions you should ask.

Thao Le (26:22):
Thanks, Steph. Thanks, Saba and Tom. This has really been a great discussion, and thank you all for taking the time to talk to us, as well as thank you to our audience for listening today. We encourage our listeners to check out the other episodes in our Carried Away series to get more information on GP economics and carried interest. You can access and subscribe to these episodes and other *PE Pathways* episodes on major audio platforms. Please keep your eyes open for future episodes of *PE Pathways*, where we bring experienced dealmakers on to share their thoughts on current private equity and M&A trends and developments.

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