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Cases to Watch – Investment Partnerships and Self Employment Taxes

WRITTEN BY

Joan C. Arnold

Taxpayers have long attempted to limit the application of the Self-Employment Contributions Act (SECA) taxes to income that is akin to employment income and not investment, or passive income, by relying on Code §1402(a)(13).[1] That section provides that the SECA base excludes the distributive share of income or loss of a limited partner other than guaranteed payments to that partner for services actually rendered to or on behalf of the partnership.

In 2022 followed by June 2023, Tax Court cases were docketed that evidence the Internal Revenue Service's (IRS) position that the bifurcation of a persons' interest in an investment partnership into two tranches — one that produces compensation income and the other that produces a distributive share that is not compensation, is not feasible.[2]

In both cases the partnership had gone to some pains to compensate partners at what they apparently believed were fair market values for the work they performed on behalf of the partnership and those amounts were subjected to SECA. The IRS' argument is that not only is the guaranteed payment subject to SECA, but the distributive share of net profit is also subject to SECA. Reading the taxpayers petitions, the IRS' argument is based on the position that the individuals are not "limited partners" as that term is used in Section 1402(a)(13).

That argument was met with success in a number of cases in which the entity taxed as a partnership was not a state limited partnership in form. For example, 100% of the income of a limited liability partnership (LLP) that operated a law practice was held liable to SECA.[3] Similar results were obtained in two cases in which the entity was a limited liability company (LLC).[4] But, in addition to noting the differences in form, all three cases involved entities that generated solely services income.

The IRS did not prevail, however, in a case involving a surgeon who was a member of an LLC that operated a surgical center. The surgeon occasionally performed procedures at the center, and only his compensation income was subject to SECA.[5]

In 2018, the IRS announced a campaign to audit SECA compliance in investment partnerships, and it appears that *Soroban* and *Denham* are the first two that have gone to Tax Court in which (i) the entity was a state law limited partnership and (ii) the entity generated service and passive income.

The IRS tried in the 1990s to issue regulations to address the issue, but they were rebuffed by Congress and the regulations never moved beyond proposed status. It's challenging to plan in an environment of such uncertainty,

and we will continue to monitor the landscape and provide updates.

If you have any questions, please contact Joan C. Arnold at 215.981.4362 or e-mail: joan.arnold@troutman.com.

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[1] SECA taxes include up to 12.4% Social Security tax (on income below the applicable cap) and 2.9% Medicare tax (which has no income cap).

[2] *Soroban Capital Partners LP v. Comm.*, Dkt. Nos. 16217-22 and 16218-22; *Denham Capital Management LP v. Comm.*, June 22, 2023

[3] *Renkemeyer, Campbell & Weaver LLP v. Comm.*, 136 T.C. 137 (2011).

[4] See, *Riether v. U.S.*, 919 F.Supp 2d 1140 (D.N.M. 2012); *Castigliota v. Comm.*, T.C. Memo 2017-62.

[5] *Hardy v. Comm.*, T.C. Memo 2017-16.

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