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Second Circuit Affirms That Active Fund Managers Cannot Escape Self-Employment Tax as 'Limited Partners' in Soroban Capital Partners

WRITTEN BY

Saba Ashraf | Thomas Gray

KEY POINTS

- In ***Soroban Capital Partners LP v. Commissioner***, the Second Circuit affirmed a functional test for the "limited partner" exception to self-employment tax under I.R.C. §1402(a)(13): a partner must not only enjoy limited liability but must also **refrain from managing, controlling, or running the partnership's business**.
- The court held that three founding principals of a hedge fund investment manager who worked full time and exercised pervasive managerial control were not "limited partners" for purposes of the exception, leaving approximately $141.5 million in distributive shares subject to self-employment tax.
- Together with the Fifth Circuit's decision in ***K Alain L.L.L.P. v. Commissioner***, the ruling signals a trend across circuits that formal limited partner status alone will not shield active managers from self-employment tax.

On September 17, 2026, the Second Circuit affirmed the Tax Court's decision that three founding principals of a hedge fund investment manager were not "limited partners" under Code Section 1402(a)(13). Their distributive shares — approximately $141.5 million across 2016 and 2017 — were therefore subject to self-employment tax. The decision adopts a functional test that looks beyond formal status to a partner's role in managing the business.

BACKGROUND

Under Code Section 1402(a), a partner's distributive share generally constitutes net earnings from self-employment and is subject to self-employment tax. Section 1402(a)(13) excludes the distributive share of a "limited partner, as such," except guaranteed payments under Section 707(c) for services actually rendered. Because the statute does not define "limited partner," the meaning of that term was central to the case.

For a detailed discussion of Soroban's partnership structure and the factual background, see our 2023 client alert, "Tax Court Rules That Limited Partners May Be Subject to Self-Employment Tax." In brief, Soroban Capital Partners LP (the partnership or Soroban) is a Delaware limited partnership that serves as an investment manager to hedge funds. Its three founding principals — who simultaneously served as limited partners of Soroban and members of its general partner — worked full time (2,300–2,500 hours per year), managed portfolio investments, sat on virtually all governing committees, and played an essential role in generating the firm's income. Despite this pervasive involvement, the principals received approximately $141.5 million in distributive shares across the 2016 and 2017 tax years while receiving only $2.5 million in guaranteed payments. Soroban excluded the distributive shares from net earnings from self-employment (NESE) under Section 1402(a)(13) on its tax returns and the principals' Schedule K-1.

THE COURT'S HOLDING AND ANALYSIS

The Second Circuit held that the Tax Court had jurisdiction under the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) (rejecting Soroban's threshold argument that the case should have been decided partner-by-partner rather than at the partnership level) because net earnings from self-employment are a partnership item: the partnership must account for them, and their components (*e.g.,* partnership income, distributive shares, and guaranteed payments) are appropriately determined at the partnership level.

On the merits, the court held that a "limited partner" under Section 1402(a)(13) must have limited liability and must not run, manage, or control the partnership's business. Applying that functional test, the court held that the principals did not qualify for the exception.

Looking to the ordinary meaning of "limited partner" when Congress enacted Section 1402(a)(13) in 1977, the court found a consistent understanding across dictionaries, leading treatises, and the Uniform Limited Partnership Act and Revised Uniform Limited Partnership Act: a limited partner does not participate in running, managing, or controlling the business.

The court read "as such" in Section 1402(a)(3) to limit the exception to income earned in the capacity of a limited partner. In other words, the exception is limited to investment income rather than compensation for active management. The court acknowledged that the guaranteed-payment carveout shows a limited partner may render some services to the partnership, but rejected Soroban's argument that this permits pervasive managerial control, holding that "merely providing services does not necessarily equate to running the business." The court also placed the exception within Section 1402(a)'s broader distinction between passive investment income and income earned through a trade or business, and found that the 1977 legislative history, which described the excluded income as "basically of an investment nature," reinforced that reading.

The court rejected Soroban's reliance on congressional silence, other Code provisions, and the Section 707(c) cross-reference, explaining that the 1977 meaning of "limited partner" already excluded active managers, making it unnecessary for Congress to add passive-investor language elsewhere in the Code and that later provisions address different contexts. It also found that Social Security Administration's 1978 regulations, and internal operational guidance supported its reading and that the 1997 moratorium on IRS regulations did not change the statute's original meaning; the proposed 500-hour test was not the court's functional standard.

RELATIONSHIP TO K ALAIN (F/K/A SIRIUS SOLUTIONS)

The Second Circuit followed the Fifth Circuit's decision in *K Alain L.L.L.P. v. Commissioner*, 184 F.4th 766 (5th Cir. 2026) (formerly captioned *Sirius Solutions, L.L.L.P. v. Commissioner*, 165 F.4th 374 (5th Cir. 2026), before the Fifth Circuit's rehearing), holding that a limited partner is one who plays no significant role in managing or running the business. Both decisions reject formal state-law labels in favor of a functional inquiry into the partner's role in managing or controlling the business, and recognize that limited partners may perform some services without controlling the business.

The courts differ mainly in emphasis: the Fifth Circuit refers to a "significant role," while the Second Circuit asks whether the partner runs, manages, or controls the business. Despite that nuance — and a dissent in *K Alain* — the decisions point in the same direction: formal limited partner status alone is not enough.

For a detailed analysis of the Fifth Circuit's ruling, see our client alert, "Fifth Circuit Narrows, but Preserves, Taxpayer-Favorable Ruling on Limited Partner Exception to Self-Employment Tax on Rehearing."

PRACTICAL TAKEAWAYS: WHAT THIS MEANS FOR CLIENTS

The decision has immediate implications for partnerships, fund managers, and tax practitioners:

- **Review Partnership Structures and Partner Roles.** Partnerships should evaluate individuals they treat as limited partners under Section 1402(a)(13) using a totality-of-the-circumstances analysis. Relevant factors include hours worked; committee and governance authority; role in generating income; hiring, firing, and promotion authority; capital contributions relative to distributive shares; and overall management involvement. No single factor is dispositive, but pervasive involvement in core business functions is difficult to reconcile with limited partner status.
- **Scrutinize Compensation Structures.** The disparity in Soroban between guaranteed payments ($2.5 million) and distributive shares ($141.5 million), a factor the court cited as consistent with the principals' active management role, underscores the need to assess whether allocations reflect economic substance. Disproportionate distributive shares paid to active managers may invite IRS scrutiny.
- **Growing Circuit Consensus and Pending Litigation.** The Second and Fifth Circuits' functional approach increases risk for actively involved partners even outside the jurisdiction of the Second and Fifth Circuits claiming the exception. Taxpayers, particularly those in the First Circuit, should monitor *Denham Capital Management LP v. Commissioner*, No. 25-1349, pending before the First Circuit after February 8, 2026, oral argument; its decision may further clarify the framework.
- **Consider Amended Returns and Protective Claims.** Taxpayers and partnerships with open years should evaluate amended returns or protective refund claims for positions that may be difficult to defend under the functional test.

Soroban and *K Alain* confirm that the self-employment tax analysis turns on economic reality, not labels. Partnerships should evaluate existing structures promptly as the circuit consensus develops.

For more information about how this decision may affect your partnership's self-employment tax positions, please contact Saba Ashraf or Thomas Gray, or visit Troutman Pepper Locke's Tax Practice Group.

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