

# Tax Court Rules That Limited Partners May Be Subject to Self-Employment Tax

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### Summary

On November 28, the Tax Court, granting the Internal Revenue Service (IRS) summary judgment, held in [Soroban Capital Partners LP v. Commissioner](#) that a state law limited partner who is limited in name only, is not exempt from self-employment taxes under the limited partner exception found in [Section 1402\(a\)\(13\)](#) of the Internal Revenue Code of 1986, as amended (the Code). Rather, the court found that, for this purpose, a functional inquiry of the interest is required.<sup>[1]</sup> *Soroban* is one of a handful of Tax Court cases that have been docketed concerning the application of self-employment taxes to a limited partner's allocation of partnership income. These cases address a position some fund managers take that fund managers who are limited partners under state law are not subject to self-employment taxes on their allocable share of partnership ordinary income, even though they are active in the partnership's business.

The decision is considered to be a significant win for the IRS by many. The Tax Court's holding results in the potential for considerable additional taxes — generally 3.8% — payable by fund managers on ordinary business income. With the denial of summary judgment to the taxpayer and the Tax Court's holding that the functional analysis test applies at the partnership level, *Soroban* must now decide whether to settle with the IRS, appeal the summary judgement decision, or argue at the Tax Court on the application of the functional analysis test to its partners.

### Background

Individuals are generally subject to self-employment taxes on their income under the Self-Employment Contributions Act (SECA). The self-employment taxes are in addition to any income taxes and are analogous to employment taxes imposed under the Federal Insurance Contributions Act (FICA) on the wages of employees. The rate of taxes under SECA is the same as that under FICA. A 12.4% rate consisting of social security taxes applies to a capped portion of the wages or net earnings from self-employment, while a rate of 2.9% (or 3.8% in the case of income above a threshold) applies to all wages or net earnings from self-employment. Net earnings from self-employment generally include all business income. However, under Section 1402(a) they do not include, among other things, dividends, rental income from real property, capital gains, interest on indebtedness, and most importantly for purposes of the *Soroban* case, "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments ... to that partner for services actually rendered to or on behalf of the partnership... ."

## The Case

Soroban Capital Partners LP (Soroban) is a New York-based hedge fund, three partners of which were the subject of discussion. Soroban argued that because the three partners in question are state law limited partners they are also “limited partners” for purposes of the exclusion on self-employment taxes found in Section 1402(a)(13) of the Code. Each of the three limited partners received certain guaranteed payments in exchange for providing services to Soroban. While the three limited partners included their “guaranteed payments” as net earnings from self-employment, they excluded all other ordinary business income from net earnings from self-employment.

The IRS, on the other hand, argued that income allocated to limited partners in a state law limited partnership is not automatically exempt from self-employment income and that a functional analysis test should be applied to determine whether individuals are “limited partners” pursuant to Section 1402(a)(13) of the Code. The functional test would look at exposure to liability, management, and participation in the business of the partnership. Although the Tax Court has previously applied the functional analysis test with respect to partners of a limited liability partnership, it has not previously had the opportunity to consider its application to partners of a state law limited partnership.<sup>[2]</sup>

Section 1402(a)(13) of the Code provides that “limited partners” are not subject to self-employment taxes on their distributive share of the partnership’s income. Specifically, “there shall be excluded the distributive share of any item of income or loss of a *limited partner*, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.”<sup>[3]</sup> The Tax Court focused on the phrase “limited partner, as such” and considered the text of the statute and legislative intent. “If Congress had intended that limited partners be automatically excluded, it could have simply said ‘limited partner.’ By adding ‘as such,’ Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner.”<sup>[4]</sup>

To determine what is meant by “limited partner,” the Tax Court looked at the legislative history and concluded that Congress enacted Section 1402(a)(13) of the Code to exclude from self-employment income earnings from a mere investment.<sup>[5]</sup> In other words, the phrase “limited partners, as such” refers to passive investors. The Tax Court therefore concluded that the exception found in Section 1402(a)(13) does not apply to a partner who is limited in name only.

Once it decided that the Tax Court must examine the functions and roles of limited partners in the partnership to determine whether a limited partner’s allocable share of partnership income is excluded from self-employment taxes, the Tax Court examined whether the analysis is performed at the partnership level or the partner level. To state this differently, are the activities of the limited partners for purposes of determining the exception under Section 1402(a)(13) of the Code a partnership item? The Tax Court cited Treasury Regulation Section [301.6231\(a\)\(3\)-1\(b\)](#) as support, stating a “functional inquiry into the roles and activities of Soroban’s individual partners as required by section 1402(a)(13) involves factual determinations that are necessary to determine Soroban’s aggregate amount of net earnings from self-employment.”<sup>[6]</sup> The Tax Court therefore held that not only is a functional inquiry appropriate, but the analysis is done at the partnership level.

Following the Soroban ruling, it will be interesting to see how cases such as [Point72 Asset Management LP v.](#)

*Commissioner, Denham Capital Management LP v. Commissioner*, and *Sirius Solutions LLLP v. Commissioner* will be decided. While each of these cases is before the Tax Court, upon appeal the cases would be appealed to different circuit courts.

### **Future Planning**

We expect that the victory in *Soroban* will encourage the IRS to expand and deepen audits of the issue.

Managers may also wish to evaluate alternative structures for minimizing earnings subject to employment taxes. In addition, to avoid any uncertainty as to the streams of income that may be treated as net earnings from self-employment, managers may want to ensure that any managerial income is held by a separate company that does not also hold a right to other income, which might be considered net earnings from self-employment, and as to which the manager does not actively participate.

We will continue to monitor and provide updates on whether *Soroban* is appealed and the decisions to come for the pending cases mentioned, and will be available to help evaluate any existing or alternative structures.

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[1] *Soroban Capital Partners LP et al. v. Commissioner*, 161 T.C. No. 12 (November 28, 2023).

[2] The IRS cited *Renkemeyer LLP v. Commissioner*, 136 T.C. 137, 150 (2011). In *Renkemeyer*, the Tax Court applied a functional analysis test to determine whether the distributive share of income for partners in a law firm was covered under the limited partner exception. The functional analysis test considered the functional role of the partner to determine whether the partner's distributive share arose "as a return on the partners' investment and [was considered] 'earnings which are basically of an investment nature.'" Ultimately, the Tax Court determined the partners' distributive share arose from legal services for the firm and were not of an investment nature.

[3] Emphasis added.

[4] *Soroban Capital Partners LP et al. v. Commissioner*, 161 T.C. No. 12 (November 28, 2023).

[5] Interestingly, Section 1402(a)(13) was enacted in 1976 to prevent purely passive limited partners from attempting to come within the social security tax system and obtain social security coverage on investment income from partnerships in which the partner was purely passive. Proposed regulations from 1997 would have provided guidance on when partners in partnerships would be treated as limited partners for purposes of self-employment tax. See Prop Reg § 1.1402(a)-2. Under the proposed regulations, a partner would not be treated as a limited partner if the partner: had personal liability for the debts of or claims against the partnership by reason of being a partner, had authority to contract on behalf of the partnership, or participates in the partnership's trade or business for more than 500 hours during the taxable year. Notably, for service partnerships (in health, law, engineering, architecture, accounting, actuarial science, or consulting), under the proposed regulations any individual who provided services as part of the partnership's trade or business would not be considered a limited

partner. The proposed regulations became a political “hot potato” and were never finalized.

[6] *Soroban Capital Partners LP et al. v. Commissioner*, 161 T.C. No. 12 (November 28, 2023).

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