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Tax Court Holds That Active Limited Partners of State Law Limited Partnerships May Be Subject to Self-Employment Tax

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Introduction

Section 1402(a)(13) of the Internal Revenue Code provides that the distributive share of "limited partners, as such" from a partnership is not subject to self-employment tax.[1] Managers of private equity and hedge funds are routinely structured as limited partnerships to exclude management and incentive fees from self-employment taxes. On November 28, 2023, the Tax Court in *Soroban Capital Partners LP v. Commissioner*[2] held that the phrase "limited partner, as such" means that, in order to benefit from the self-employment exclusion, a limited partner must be passive and cannot actively participate in the partnership. The Tax Court did not consider whether even *de minimis* participation would disqualify a limited partner from the exclusion. Accordingly, under *Soroban*, limited partners in private equity and hedge fund managers must pay self-employment tax if they actively participate in the manager.

The Tax Court did not set forth the specific factors that would indicate when a limited partner is actively participating in the partnership's business. Notwithstanding this continued uncertainty, under the Tax Court's reasoning, it is likely that most limited partners of investment management firms structured as limited partnerships who participate in the day-to-day activities of the firm would not be considered "limited partners, as such". And therefore, managers who take the position that their active limited partners are not subject to self-employment tax may wish to reconsider that position in light of *Soroban*.

Summary of the Law

Generally, section 1401(a) imposes self-employment tax on an individual's distributive share of income or loss from any trade or business carried on by a partnership of which the individual is a partner.[3] However, section 1402(a)(13) excludes from the computation of self-employment tax the distributive share of income or loss of a "limited partner, as such". The limited partner exception does not apply to "guaranteed payments" to a limited partner for services actually rendered to, or on behalf of, the partnership to the extent that the payments represent remuneration for those services.[4]

Neither the Code nor the Treasury regulations define "limited partner" for these purposes. The legislative history indicates that Congress enacted section 1402(a)(13) to prevent limited partners from using passive limited partnership interests to qualify for Social Security benefits.

In 1997, regulations were proposed that, if finalized, would have defined a "limited partner" as a person that provides less than 500 hours per year in services to the partnership. Congress questioned the authority of Treasury to issue regulations defining a "limited partner" for these purposes and imposed a moratorium on the issuance of any temporary or final regulations on this matter until July 1, 1998.

No regulations on this point have subsequently been issued. In 2007, the Joint Committee on Taxation interpreted the statute to mean that all state limited partners are exempt from self-employment tax.[5] However, two Tax Court cases defined the meaning of a "limited partner" for entities other than state law limited partnerships.[6]

In 2011, the Tax Court held in *Renkemeyer v. Commissioner* that a limited partner of a limited liability partnership is liable for self-employment taxes if the limited partner actively participates in the partnership's business.[7] In doing so, the Tax Court looked to the legislative history of section 1402(a)(13) and concluded that the limited partner exception applies to income from a return on a partner's investment and not income for services.

In 2017, the Tax Court held in *Castigliola v. Commissioner* that active members of a professional limited liability company were not limited partners for purposes of section 1402(a)(13).[8] There, the Tax Court concluded that, based on *Renkemeyer*, the determination of whether the owner of an entity that is not a state law limited partnership (but is otherwise a partnership for U.S. federal income tax purposes) should be based on whether the owner is the functional equivalent of a limited partner.

Summary of the Case

Soroban Capital Partners LP ("Soroban") is a hedge fund manager that is a Delaware limited partnership and a partnership for U.S. federal income tax purposes.[9]

The limited partners of Soroban each provided over 2,000 hours of services to Soroban and affiliates, for which they received guaranteed payments. On its 2016 and 2017 partnership tax returns, Soroban reported the guaranteed payments to each limited partner (but not the remaining ordinary business income) as net earnings from self-employment, but not the limited partners' share of Soroban's ordinary business income. On audit, the IRS challenged the exclusion of the limited partners' share of Soroban's ordinary business income from self-employment earnings.

Soroban moved for summary judgment, asking the Tax Court to find that, as a matter of law, tax items allocated by a state law limited partnership to its limited partners are not subject to self-employment taxes. The Tax Court rejected that argument and ruled that a "functional analysis" test is applicable in determining "limited partner" status for these purposes. The Tax Court's reasoning is based on its interpretation of Congressional intent that a "limited partner, *as such*" was only intended to refer to passive investors and, therefore, section 1402(a)(13) only excludes from self-employment earnings from investments.

The Tax Court did not provide guidance on the requisite level of participation to constitute "active participation." Similarly, the Tax Court did not provide guidance on the scope of the limited partner exception in other fact patterns, such as a limited partner that is an affiliate of a person providing services.

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[1] All references to section numbers are to the Internal Revenue Code of 1986 or the proposed Treasury regulations promulgated thereunder.

[2] 161 T.C. No. 12.

[3] Sec. 1401(a); Sec. 1402(a). The self-employment tax of 15.3% consists of the Old-Age, Survivors, and Disability Insurance tax and Hospital Insurance tax (Medicare) on each individual's self-employment income. Sec. 1401(a)-(b).

[4] Sec. 1402(a)(13).

[5] In 2007, the Joint Committee on Taxation briefly discussed the definition of "limited partner" and read the statute to mean that all state law limited partners are exempt from self-employment tax. *See, e.g.*, Staff of J. Comm. On Tax'n, 110th Cong., Present Law and Analysis Relating to Tax Treatment of Partnership Carried Interests and Related Issues, Part I, JCX-62-07, at 35 n.64 (J. Comm. Print 2007).

[6] The IRS Office of Chief Counsel addressed the scope of the exception in two Chief Counsel Advice ("CCA") Memoranda. CCA 201436049 concludes that the limited partner exception should only apply to income of an investment nature. CCA 201640014 appears to conclude that partners who actively participate in the business are required to include in self-employment earnings all income of the business from its operations, even if some portion of the earnings are attributable to a return on investment.

[7] 136 T.C. 137.

[8] *See Castigliola v. Comm'r*, T.C. Memo. 2017-62.

[9] Soroban, a TEFRA partnership, also argued in its motion for summary judgment that, even if state law limited partners could theoretically be subject to self-employment tax, the Tax Court did not have jurisdiction to consider their role in a TEFRA partnership-level hearing. Ultimately, however, the Tax Court held that it had jurisdiction to consider the level of their involvement in a TEFRA partnership-level hearing.

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