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Tax Court Determines That Limited Partners Are Not Necessarily Exempt from Self-Employment Tax – The Limits of the Limited Partner Exception, as Such

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The case is particularly significant for limited partners in private equity and hedge fund managers organized as limited partnerships. On November 28, 2023, the U.S. Tax Court (the "Tax Court" or the "Court") issued its opinion in *Soroban Capital Partners LP v. Commissioner,*[1] holding that a "functional analysis test" must be applied in determining whether the "limited partner exception" to the imposition of Self-Employed Contributions Act ("SECA") tax under section 1402(a)(13)[2] applies to limited partners in a limited partnership.[3] The case is particularly significant for limited partners in private equity and hedge fund managers organized as limited partnerships. Since the launch of its SECA tax compliance campaign in 2018,[4] the Internal Revenue Service (the "IRS") has been pursuing self-employment tax audits of limited partnerships, limited liability companies, and limited liability limited partnerships. The campaign seeks to address the IRS's contention that certain taxpayers have been improperly claiming to be "limited partners" for purposes of the "limited partner exception" from SECA tax. The decision in *Soroban Capital Partners LP* ("*Soroban*"), amidst the IRS's SECA tax compliance campaign, represents a meaningful victory for the IRS that, if sustained on appeal, could significantly limit the ability of many limited partners to assert that they are not subject to self-employment tax. **I. Background** SECA, enacted into law in 1954,[5] requires self-employed individuals to contribute to Social Security and Medicare by imposing a tax on their net earnings from self-employment. The SECA tax applies to "self-employment income," defined – somewhat tautologically – in section 1402(b) as "net earnings from self-employment" ("NESE"). The SECA tax currently comprises two component parts: a 12.4 percent Social Security tax on the first $160,200 (for 2023) of NESE and 3.8 percent Medicare tax on all NESE.[6] The SECA tax applies to a partner's distributive share of the partnership's business income, unless an exception applies, and also applies to a partner's guaranteed payments for services. Section 1402(a)(13), enacted as part of the Social Security Amendments of 1977,[7] carves out an exception from NESE (the "Limited Partner Exception") for "limited partners" that excludes "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." (Emphasis added). In enacting this exception, Congress was concerned that individuals were investing as limited partners in investment-related business ventures, paying a small amount of SECA tax, and thereby qualifying for future Social Security benefits. The Limited Partner Exception was intended to curb this perceived abuse.[8] The scope of the Limited Partner Exception has been subject to some debate because the term "limited partner" is not defined in section 1402 or in the Treasury regulations and, in general, is not a term elsewhere defined in the U.S. federal tax law or commonly understood to have a particular meaning for U.S. federal tax purposes.[9] The emergence – in the 1990s and the first decade of this century – of so-called "hybrid entities," such as limited liability companies ("LLCs"), limited liability partnerships ("LLPs"), and limited liability limited partnerships ("LLLPs"), which often are classified as partnerships for U.S. federal income tax law purposes, has given rise to questions as to

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the scope of interpreting and applying the Limited Partner Exception. In 1994, the Treasury Department and the IRS issued proposed regulations defining "limited partner" for purposes of the Limited Partner Exception.[10] Those regulations were re-proposed in 1997.[11] The proposed regulations also applied to owners of entities other than limited partnerships, such as LLCs. These proposed regulations would have disqualified individuals from being considered limited partners if they bore personal liability for partnership debts, had authority to contract for the partnership, or participated in the partnership's trade or business for over 500 hours during the partnership's taxable year.[12] In response to negative reaction from parts of the U.S. media, Congress subsequently enacted a one-year moratorium preventing the finalization of the proposed regulations, due to a concern that the proposed change in the treatment of individuals who are limited partners under applicable state law would have exceeded Treasury's regulatory authority.[13] In the twenty-five years that have passed since the expiration of the moratorium, neither the IRS nor Congress has clarified the definition of a "limited partner."[14] Although several cases have interpreted the Limited Partner Exception in the context of LLPs and LLCs,[15] until *Soroban* no case had interpreted the Limited Partner Exception in the context of a limited partner who owns a limited partner interest in a limited partnership. Somewhat ironically, Judge Buch wrote the only opinion in this area of the law holding that a member of an LLC classified as a partnership for tax purposes should be treated as a limited partner for purposes of the Limited Partnership Exception.[16] **II. Background to Soroban Capital Partners LP** Soroban, a Delaware limited partnership, is a hedge fund manager located in New York City. During 2016 and 2017, Soroban had four partners: three individual limited partners, each of whom was a limited partner, and Soroban Capital Partners GP LLC, a Delaware limited liability company, as the general partner. The general partner was owned indirectly by the three individual limited partners. According to the limited partnership agreement, the general partner was to carry on the business and affairs of the limited partnership and had the ultimate authority to make decisions on behalf of the limited partnership. One of the limited partners served as the Managing Partner and Chief Investment Officer, another limited partner served as the Co-Managing Partner, and the third limited partner served as the Head of Trading and Risk Management of Soroban. Two of the limited partners had negative consent rights over certain enumerated actions of a fundamental nature. Each of the three individual limited partners devoted his full-time efforts to the activities of Soroban and its affiliates. During the years at issue, Soroban made guaranteed payments for services to each of the three individual limited partners and allocated the remaining ordinary business income among all of its partners. Soroban reported the guaranteed payments, as well as the general partner's share of ordinary business income, but not the limited partners' shares of ordinary business income, as subject to SECA tax. The IRS challenged Soroban's position that the limited partners' shares of ordinary business income were not subject to SECA tax and issued Notices of Final Partnership Administrative Adjustment ("FPAAs") making adjustments to Soroban's NESE for the years in issue. Soroban's tax matters partner filed a petition in Tax Court challenging the FPAAs and then filed a motion for summary judgment requesting that the Court find as a matter of law that the Limited Partner Exception precludes the limited partners' shares of ordinary business income from being subject to SECA tax. **III. The Court's Analysis** Addressing the merits of the case,[17] the Court held that the "limited partner exception does not apply to a partner who, is limited in name only,"[18] even when that person is a limited partner in a limited partnership. The Court turned to principles of statutory construction to ascertain Congress's intent, as neither section 1402(a)(13) nor applicable regulations define the term "limited partner." The Court focused on the phrase "limited partner, *as such*." In the Court's view, if Congress had intended for limited partners to be *per se* excluded from the SECA tax, Congress could have simply used the term "limited partner" without "as such." In support of its interpretation, the Court reviewed legislative history, stating that "Congress enacted section 1402(a)(13) to exclude earnings from a mere investment. It [Congress] intended for the phrase 'limited partners, as such' used in section 1402(a)(13) to refer to passive investors."[19] The Court held that it must apply a "functional analysis test" to determine whether a limited partner in a limited partnership is a "limited partner, as such." In other words, the Court effectively concluded that there is no legally relevant distinction between limited partners in a limited partnership and the partners or members

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of the other entities (e.g., LLCs and LLPs) addressed under the Court's prior precedent. This is a surprising expansion of the prior precedent given the very clear language of the Code and the much more obvious meaning of the words "as such," reflecting a distinction between the distributive share of income received by an individual who is both a limited partner and a general partner in the limited partnership. As stated in the legislative history, "if a person is both a limited partner and a general partner in the same partnership, the distributive share received as a general partner would continue to be covered …."[20] Thus, "as such" was a necessary clarification that only the distributive share of income attributable to the limited partnership interest is excepted from NESE. **IV. Implications** Because the *Soroban* opinion addressed only the legal question on summary judgment of whether a partner in a limited partnership is *per se* excluded from SECA tax, the Tax Court has not yet addressed whether the limited partners in Soroban satisfy the "functional analysis test," which will depend on the specific facts and circumstances. Resolution of that issue will require further proceedings, including potentially a trial, for the Tax Court to hear evidence on and apply the functional analysis test. We expect that, if, in applying that test, the Soroban limited partners are found not to be "limited partner[s], as such," Soroban will appeal the Tax Court's decision to the U.S. Court of Appeals for the Second Circuit. It is also possible that, to avoid a potentially unnecessary trial, Soroban could pursue an interlocutory appeal of the Tax Court's summary judgment order, which would require approval of both the Tax Court and the Second Circuit to proceed. There has yet to be a circuit court review of section 1402(a)(13), and now appears to be an opportune time for such a review given both the legal history of this provision and the broad effects on taxpayers. A decision by the Second Circuit in the *Soroban* case, however, would only control Tax Court cases appealable to the Second Circuit. As a result, in cases appealable to other circuits, taxpayers or the IRS could be expected to continue to litigate the issue. Currently, there are two other pending Tax Court cases relating to fund managers which raise the same arguments as Soroban, and the IRS is still actively auditing numerous partnerships as part of its SECA tax compliance campaign. Please reach out to your Gibson Dunn lawyers for assistance with any IRS examinations on this topic or to determine how this case may influence your compliance with SECA tax obligations going forward. _____ [1] 161 T.C. No. 12 (2023). [2] Unless indicated otherwise, all "section" references are to the Internal Revenue Code of 1986, as amended (the "Code"), and all "Treas. Reg. §" references are to the Treasury regulations promulgated under the Code. [3] Judge Buch authored the *Soroban* opinion, which is the second opinion he has written for the Tax Court applying section 1402(a)(13). *See Hardy v. Commissioner*, 113 T.C.M (CCH) 1070 (2017) (holding that a plastic surgeon's distributive share of income from a surgical center organized as an LLC (classified as a partnership) was exempt from SECA tax under section 1402(a)(13) because he was a mere investor in the LLC). [4] *IRS Announces Rollout of Five Large Business and International Compliance Campaigns* (March 13, 2018), *available at* https://www.irs.gov/businesses/irs-lbi-compliance-campaigns-mar-13-2018. [5] Self Employment Contributions Act of 1954, c. 736, 68A Stat. 353. [6] Section 1401(a), (b). The base Medicare tax is 2.9 percent, but it increases to 3.8 percent on NESE in excess of certain thresholds. [7] Pub. L. No. 95-216, Title III, § 313(b), 91 Stat. 1536. [8] H.R. Rep. No. 95-702, pt. 1, at 40-41 (1977). [9] In 2011, the IRS issued proposed regulations under section 892 defining a "limited partner interest" as an interest held by a partner who does not have rights to participate in the management and conduct of the partnership's business at any time during the partnership's taxable year under the law of the jurisdiction in which the partnership is organized or under the governing agreement. REG-146537–06, 76 Fed. Reg. 68119 (Nov. 3, 2011). In addition, in 2011, the IRS proposed regulations under section 469(h)(2) that was intended to clarify the definition and tax treatment of "limited partners" for purposes of defining material participation in partnership activities. REG-109369-10, 76 Fed. Reg. 72367 (Nov. 23, 2011). Neither of these proposed regulations addressed the definition of a limited partner for purposes of section 1402. [10] 59 Fed. Reg. 67253 (Dec. 29, 1994). [11] REG-209824096, 62 Fed. Reg. 1701 (Jan. 13, 1997). [12] *Id.*, Prop. Treas. Reg. § 1.1402(a)-2(h)(2)(i)-(iii). [13] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, Title IX, § 935, 111 Stat. 882. [14] Just weeks before issuance of the Tax Court's decision in *Soroban*, the IRS and Treasury Department released the 2023-2024 Priority Guidance Plan, adding "[g]uidance under

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section 1402(a)(13)" and indicating a renewed interest in addressing the Limited Partner Exception through regulations or other published guidance. *2023-2024 Priority Guidance Plan*, *available at* https://www.irs.gov/pub/irs-utl/2023-2024-priority-guidance-plan-initial-version.pdf. [15] *See*, e.g., *Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. No. 137 (2011). In *Renkemeyer*, the Court analyzed the legislative history of section 1402(a)(13) and concluded that its intent "was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations … would not receive credits towards Social Security coverage." *Id.* at 150. The Court held that partners in a law firm organized as a limited liability partnership were not limited partners for purposes of section 1402(a)(13) because their "distributive shares arose from legal services … performed on behalf of the law firm" and not "as a return on the partners' investments." *Id.* [16] *See Hardy v. Commissioner*, 113 T.C.M (CCH) 1070 (2017). [17] The Court also held that, under the now-repealed TEFRA partnership audit rules, SECA tax adjustments constituted "partnership items" within the meaning of former section 6231(a)(3), giving it jurisdiction to decide the case. *Soroban*, 161 T.C. No. 12, slip. op. at 13-15. Under partnership audit rules enacted by the Bipartisan Budget Act (the "BBA"), which generally are effective beginning with the 2018 tax year, the treatment would be different as the BBA is limited to Subtitle A, Chapter I Income Tax and does not include the SECA tax under Subtitle A, Chapter 2. [18] *Soroban*, 161 T.C. No. 12, slip. op at 11. [19] *Id*. [20] H.R. Rep. No. 95-702, pt. 1, at 40 (1977).

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