

US Tax Court: Limited Partners May Be Subject to Self-Employment Tax

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On November 28, 2023, in *Soroban Capital Partners LP v. Commissioner*, the US Tax Court denied the taxpayer's motion for summary judgment, holding that whether a limited partner in a state law limited partnership qualifies for the "limited partner" exception from self-employment tax under Internal Revenue Code (IRC) Section 1402(a)(13) depends on the functions and roles of the limited partner. Concluding that Congress clearly intended the limited partner exception to apply "only to a limited partner who is functioning as a limited partner," the Tax Court held that the limited partner exception in IRC Section 1402(a)(13) does not apply to a limited partner "who is limited in name only."

The IRC imposes a tax on the self-employment income of individuals. This includes gross income derived from any trade or business, less allowable deductions attributable to such trade or business, plus the distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which such individual is a member. However, IRC Section 1402(a)(13) provides an exception for "the distributive share of any item of income or loss of a limited partner, as such" (emphasis added here and below), other than guaranteed payments for services provided to or on behalf of the partnership. Although proposed US Treasury Department regulations exclude partners who significantly participate in a partnership's trade or business as "limited partners" for this purpose¹, the proposed Treasury regulations were never issued in final or temporary form – and neither Congress nor the Treasury Department has defined "limited partner, as such" as used in the statute.

Before *Soroban*, the IRS successfully challenged the application of the limited partner exception to active owners of various types of pass-through entities, including partners in a limited liability partnership, in cases before the Tax Court; however, these cases did not involve limited partners in state law limited partnerships, leaving open the question of whether limited partners in such entities are eligible for the exception by virtue of the label "limited partner" accorded to them under state law. The Tax Court in *Soroban* addressed this question, finding that a limited partner's role and activities, and not its status as a limited partner in a state law limited partnership, determines whether the limited partner exception to the self-employment tax applies. The Tax Court held that a functional analysis must be applied, and it concluded that Congress drafted the limited partner exclusion to refer to "limited partners, as such" to distinguish limited partners in practice from limited partners in name only.

Given the ambiguity in the statute and the prior absence of direct case law, many limited partners of management companies formed as state law limited partnerships historically relied on a literal reading of the limited partner exception to exclude their distributive shares of management company income from the self-employment tax. Following the Tax Court's decision in *Soroban* – and in light of the recent heightened focus on partnerships in the IRS's tax enforcement efforts – investment managers with limited partners claiming the limited partner exception from self-employment tax should apply a functional analysis to the limited partners' roles and activities to determine whether the exception applies. Further developments are expected in this area of law, which we will continue to monitor. Please contact a member of Cooley's tax team with any questions about the Tax Court's decision in *Soroban* and the implications that it may have for your management company.

Note

1. Proposed Treasury regulation Section 1.1402(a)-2. The proposed Treasury regulations exclude a partner who participated in the partnership's trade or business for more than 500 hours during the partnership's taxable year from the definition of "limited partner" for this purpose, along with partners who have personal liability for partnership debts, and partners who have the authority to contractually bind the partnership.

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