



TAX COURT DECISION EXPOSES LIMITED PARTNERS TO SELF-EMPLOYMENT TAX

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Under U.S. federal income tax law, self-employment tax is imposed at a rate of 15.3%, with 12.4% for Social Security and 2.9% for Medicare. This self-employment tax generally applies to a partner's total distributive share of partnership income. However, IRC Section 1402(a)(13) provides an exception from self-employment tax for "the distributive share of any item of income or loss of a limited partner, as such, other than [certain] guaranteed payments. . . ." The reason for this exception is that a limited partner is typically viewed to be a passive investor and investment income (e.g., dividends, capital gains, rental income and loan interest) earned by a passive investor outside the partnership context is not subject to self-employment tax.

In a recent Tax Court case, *Soroban Capital Partners L.P. v. Commissioner*, decided on November 28, 2023, a New York hedge fund management business organized as a Delaware limited partnership reported guaranteed payments to its limited partners as net earnings from self-employment on its partnership tax returns, but excluded the limited partners' distributive share allocations of ordinary income. The IRS adjusted the reported net earnings from self-employment to include the income allocated to the limited partners based on its finding that the limited partners were "limited partners" in name only and therefore, not entitled to the exception under IRC Section 1402(a)(13). Soroban filed a motion for summary judgement asserting that the limited partners qualified for the limited partner exception because they were "limited partners" under applicable state laws in a state law limited partnership. The Tax Court focused on the inclusion of the phrase "as such" in the statutory language and concluded that these words demonstrate that the limited partner exception applies only to a limited partner who is functioning as a limited partner (i.e., passive investor) and that the court must "examine the functions and roles of the limited partners in the partnership to determine whether their share of earnings are excluded from net earnings from self-employment." Therefore, the Tax Court denied Soroban's motion for summary judgment and held that the determination of eligibility for the limited partner exception requires a "functional analysis test to determine whether a partner in a state law limited partnership is a 'limited partner, as such' for purposes of section 1402(a)(13)."

Hedge funds, investment funds, private equity funds, venture capital funds and other investments vehicles structured as limited partnerships which have customarily applied the limited partner exception to all state law limited partners may need to reconsider their tax reporting for any limited partner who is active in management or otherwise provides services to the partnership. For these limited partnerships, it may not be appropriate to automatically exclude the limited partners' distributive share of partnership income from self-employment tax. Rather, they might need to engage in a functional analysis of their limited partners' roles and responsibilities and whether a distinction can be made between income attributable to a limited partner's services for the partnership as opposed to the limited partner's equity ownership in the partnership. Partnerships may also wish to consider reorganizing their operations into multiple entities to enable a limited partner to be paid any managerial income through an entity that is separate from the entity through which the limited partner receives his distributive share of partnership income that would not be considered net earnings from self-employment.

If you have any questions regarding this alert, please contact your Cummings & Lockwood private clients attorney.