



TAX COURT HOLDS STATE LAW LIMITED PARTNERS ARE NOT LIMITED PARTNERS FOR FEDERAL SELF-EMPLOYMENT TAX PURPOSES

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As a rule, an individual partner's distributive share of ordinary business income is included in net earnings from self-employment under Internal Revenue Code § 1402(a) and is subject to federal self-employment tax. As an exception, IRC § 1402(a)(13) excludes the distributive share of ordinary business income of "a limited partner, as such" (other than guaranteed payments), from net earnings subject to self-employment tax. The IRC does not define "limited partner, as such" for these purposes.

On May 28, the Tax Court in *Soroban Capital Partners, LP v Commissioner* issued a memorandum opinion in which it applied a functional analysis to conclude that individuals who were designated as limited partners under state law were not "limited partners, as such" under IRC § 1402(a)(13), and therefore could not to exclude their allocable shares of the partnership's ordinary business income from federal self-employment tax for the tax years 2016 and 2017. The result was an increase in Soroban's 2016 and 2017 net earnings from self-employment by \$77,663,962 and \$63,866,302, respectively.

Soroban is a Delaware limited partnership classified as a partnership for federal income tax purposes. For the years at issue, Soroban's limited partners received allocations of ordinary income earned by Soroban for managing investments. When calculating net earnings from self-employment, Soroban included only guaranteed payments made to its limited partners, excluding their remaining share of partnership income. The IRS proposed to increase Soroban's net earnings from self-employment by including the ordinary income allocated to the limited partners. The IRS's position was that these individuals were not limited partners under IRC § 1402(a)(13) and that a functional analysis into their roles and responsibilities was necessary.

The court first reaffirmed that federal tax law, not state law labels, controls the classification of partners for federal tax purposes. The court then explained that to exclude a partner's distributive share under IRC § 1402(a)(13), the surrounding circumstances must indicate the partner's economic relationship with the partnership is one of passive investment. The court then applied a functional analysis of the roles and responsibilities of the limited partners including consideration of:

1. *their role in generating Soroban's income*: The limited partners' time, skills and judgement were essential to the generation of Soroban's income;
2. *their role in management*: The limited partners participated in the management of Soroban and were crucial and active parts of Soroban's business;
3. *the time they devoted to Soroban's business*: The limited partners devoted 100% of their time to the management and investment activities of Soroban;
4. *how Soroban marketed the role of the limited partners in the business*: The limited partners were publicly held out as essential to the operation of Soroban; and

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5. *the limited partners' capital contributions relative to their distributive shares of income:* The limited partners' capital contributions were insignificant compared to their distributive share of income indicating the income was not a return on investment.

On the basis of this analysis, the court concluded that Soroban's limited partners were limited partners in name only, they were not limited partners within the meaning of IRC § 1402(a)(13) ("limited partners, as such"), and their earnings constituted net earnings from self-employment for the years in issue.

Soroban makes it clear that the state law designation of an individual as a limited partner will not be determinative of the IRC § 1402(a)(13) self-employment tax exception. In light of *Soroban*, partnerships should perform a functional analysis of their limited partners' actual involvement in the partnership's business regardless of the limited partner's title or state law classification. Importantly, however, *Soroban* may not be the last word on this issue because appeals by two similarly situated investment firms have been filed in the Court of Appeals for the First and Fifth Circuits contesting the Tax Court's "passive investor" criteria for benefiting from the self-employment tax exception. From a state law perspective, it is certainly feasible that state courts could apply the factors used by the Tax Court in *Soroban* when analyzing whether limited partners should be subject to personal liability under state law.

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