# Limiting the "Limited Partner" Exception to SECA Tax, As Such – Can the Tax Court Find the Line?

This column provides an informal exchange of ideas, questions, and comments arising in everyday tax practice. The authors of this column are Jason A. Graham, Partner, Baker & McKenzie LLP, Dallas, Texas, and Sukbae David Gong, Associate, Baker & McKenzie LLP, Chicago, Illinois, Readers are invited to write to the editors: Richard M. Lipton, Senior Counsel, Baker McKenzie LLP, Dallas, Texas, richard.lipton@bakermckenzie.com; Samuel P. Grilli, Partner, Baker & McKenzie LLP, Chicago, Illinois, samuel.grilli@bakermckenzie.com; and Leah Gruen, Counsel, Baker & McKenzie LLP, Chicago, Illinois, leah.gruen@bakermckenzie.com. The authors write this column on the recent case of *Soroban Capital Partners LP v. Commissioner.*[1]

In *Soroban*, the Tax Court held that the limited partner exception under Section 1402(a)(13) does not apply to limited partners who were not limited partners "as such." Thus, certain "limited partners" of a partnership may be subject to Self-Employed Contributions Act ("SECA") tax under Section 1401. Given that many investment fund managers and general partners are organized as partnerships in which the principals are the "limited partners," the *Soroban* case is expected to have a broad impact on how investment fund managers and general partners are structured along with how their management fee income is treated for SECA tax purposes.

## BACKGROUND – SELF-EMPLOYED CONTRIBUTIONS ACT TAX

Social Security tax, as we commonly know it, is divided into two systems. First are the Federal Insurance Contributions Act ("FICA") taxes imposed on employers and employees under Sections 3101-3128. FICA taxes comprise a limited 12.4% tax on wages and an unlimited 2.9% tax on wages.[2] The employer and the employee each pay half of FICA taxes. Second is the SECA tax imposed on self-employed individuals under Sections 1401-1403. The SECA tax rate is the same as the aggregate employer and employee FICA tax rate, but a self-employed person is both employer and employee, and thus pays the entire tax himself or herself. Most Americans pay, and are familiar with, FICA tax because they work as an employee rather than being self-employed.

Specifically, SECA tax is imposed on an individual who earns "self-employment income," which is defined in Section 1402(b) as "net earnings from self-employment derived by an individual ... during any taxable year." The term "net earnings from self-employment" ("NESE") is defined in Section 1402(a) as the gross income derived from an individual's trade or business, less allowable deductions attributable to such trade or business, "plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member ...." However, a very meaningful exception under Section 1402(a)(13) provides that NESE does not include "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)" (emphasis added) (the "Limited Partner Exception"). This exception, enacted in 1977, was originally intended as an anti-abuse rule. Social Security was meant to replace lost earnings from work and Congress wanted to prohibit Social Security funds and benefits attributable to passive investment earnings from limited partnerships.[3]

Neither Congress nor the IRS has defined "limited partner" for purposes of Section 1402(a)(13). The IRS attempted to do so twice: first in regulations issued in 1994 (which were withdrawn), then with proposed regulations in 1997. Under the 1997 proposed regulations, the IRS provided that a partner of any entity taxed as a partnership that afforded limited liability to its owners would qualify as a limited partner under Section 1402(a)(13), provided that the member did not participate in the business of the entity for more than 500 hours per year.[4] However, Congress enacted a law specifically preventing the finalization of regulations defining "limited partner" under Section 1402(a)(13).[5] Although the injunction expired in July 1, 1998, Congress nor the IRS has defined the term "limited partner" since.

## FACTS – SOROBAN CAPITAL PARTNERS

Soroban Capital Partners LP ("SCP") is an investment firm organized as a Delaware limited partnership, classified as a partnership for US federal income tax purposes. SCP had one general partner and three limited partners analyzed by the Tax Court. Per SCP's limited partnership agreement, the general partner had authority over the business affairs of the partnership. Many of the limited partners, however, appeared to have active roles and rights over SCP's business. For example, one of its limited partners served as the managing partner and chief investment officer of SCP. Others hold or held titles as "co-founder" and/or "co-managing partner" of SCP.

SCP listed its guaranteed payments and the general partner's share of ordinary business income as subject to SECA tax. But it did not report the limited partners' shares of ordinary business income as subject to SECA tax. The IRS contended that such distributive shares of ordinary business income should also be subject to SECA tax because the Limited Partner Exception did not apply.

## THE TAX COURT'S DECISION

SCP filed a motion for summary judgement, arguing that it should satisfy the Limited Partner Exception because its partners were limited partners in a state law limited partnership. The IRS disagreed, noting that limited partners in state law limited partnerships are not automatically exempt

from SECA tax. The IRS argued that the Tax Court must apply a functional analysis test to determine a "limited partner," similar to the test outlined for LLCs and LLPs as they had in *Castigliola v. Commissioner*[6] and *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*,[7] to determine whether individuals are limited partners pursuant to Section 1402(a)(13). The Tax Court reasoned that the scope of the Limited Partner Exception should be defined by assigning meaning to the term "limited partner, as such" rather than the term "limited partner." Accordingly, the Tax Court reviewed whether SCP's limited partners were "limited partners, as such" as set forth in Section 1402(a)(13) which, in turn, determines whether SCP's limited partners properly excluded their shares of ordinary business income from their NESE.[8]

In *Renkemeyer,* partners of a law firm organized as a limited liability partnership ("LLP") claimed to be exempt from SECA tax under the Limited Partner Exception because the organizational documents of the law firm classified their interests as "limited partnership interests" and the governing LLP statute under state law insulated them from liabilities of the law firm. The Tax Court in *Renkemeyer* disagreed. It first 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."[9] Then, the Tax Court held that the LLP partners 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."[10] Instead of relying on case law that denied the Limited Partner Exception to taxpayers because they were not "limited partners" under state law,[11] the Tax Court undertook a functional analysis of the roles of the partners to determine whether they were acting as: (a) a "limited partner" akin to passive investors, or (b) participating in the management or operations of the partnership or providing services to the partnership.

Following *Renkemeyer*, the Tax Court in *Soroban* denied SCP's motion for summary judgment and held that the Limited Partner Exception does not apply to a partner who is more than a "limited partner," even if that partner is a limited partner in a state law limited partnership. In its view, if Congress had intended that limited partners be automatically excluded from SECA tax, Congress would have simply drafted Section 1402(a)(13) to apply to a "limited partner." Instead, by adding "limited partner*, as such,*" the Tax Court concluded that Congress clearly intended that the Limited Partner Exception apply only to a limited partner who is functioning as a limited partner. The Tax Court held that a functional analysis test, as applied in *Renkemeyer*, was required to determine whether the Limited Partner Exception applied to SCP's limited partners. In doing so, the Tax Court rejected the argument that a limited partner in a state law limited partnership automatically qualifies under the Limited Partner Exception.[12] The Tax Court, however, did not undertake the application of this test because this was a ruling on SCP's motion for summary judgment. This case will involve further review of the facts and circumstances by the Tax Court and will be resolved through further proceedings, including a potential trial.

## ANALYSIS

The structure depicted in *Soroban* is a common structure among investment funds whereby the general partner or the fund manager is a limited partnership (or an LLC treated as a partnership for U.S. federal income tax purposes[13]) and the principals of the investment fund own interests in the general partner or the fund manager (directly, through a trust, or through an LLC that is disregarded for U.S. federal income tax purposes). Because of the lack of guidance on what a "limited partner" is for purposes of Section 1402(a)(13), investment funds have diverged in their interpretation of applying SECA tax to management fee income earned by the general partner or the fund manager. Some take a position similar to SCP, relying on its state law limited partnership classification to claim that its limited partners are exempt from SECA tax under the Limited Partner Exception. Others follow the 1997 proposed regulations as if they were effective.[14] Investment fund managers or general partners should take *Soroban* as a cautionary reminder to review their tax positions and risk exposure under Section 1402(a)(13). For example, managers and general partners may consider further documenting the support for their tax positions in light of recent developments, including the hours each limited partner participated in the business entity if they intend to rely on the 1997 proposed regulations.

By focusing on the term "limited partner, as such," the *Soroban* Tax Court created a narrower meaning of the term "limited partner" under Section 1402(a)(13). Under *Soroban*, the Limited Partner Exception only applies to a limited partner who is functioning as a limited partner under a functional analysis test, not automatically to a limited partner in a state law limited partnership. The Tax Court, however, appears to have overlooked an alternative reading of the words "as such" in connection with the subsequent language of Section 1402(a)(13), which provides that the Limited Partner Exception does not apply to guaranteed payments under Section 707(c).[15] Congress already considered a situation of a limited partner serving a dual role and determined that certain guaranteed payment income for services will remain subject to SECA tax.[16] Moreover, the legislative history shows that Congress considered the situation of an individual as both a general partner and a limited partner, concluding that only such partner's distributive shares as a general partner (but not such partner's distributive shares as a limited partner) are subject to SECA tax.[17] But this seems to contradict the *Soroban* Tax Court's reading of Section 1402(a)(13) where, under a functional analysis test, a limited partner providing services to the partnership is no longer treated as a "limited partner" under Section 1402(a)(13). So is the guaranteed payment exception of Section 1402(a)(13) redundant, *as such*, in the eyes of the *Soroban* Tax Court?

Despite its precedential status, however, readers should note that *Soroban* is likely not the final word on the matter. *Soroban* could be overruled in appeal and there could be a circuit split on the matter given that the IRS is litigating the same issue in multiple circuit courts.[18]

SECA tax was already an agenda item for the IRS's 2018 compliance campaign, so given its preliminary success under *Soroban*, we may expect more IRS scrutiny in this area during audits. Readers should

also stay tuned for guidance to be issued under Section 1402(a)(13) in the near future as it is a topic included in the IRS's 2023-2024 Priority Guidance Plan, which is the list of tax issues that the IRS identified to prioritize issuance of administrative guidance. Finally, given the history in 1997 and the growing uncertainty in the application of SECA tax, this issue may garner renewed Congressional attention.

*As such,* we welcome our readers' views and thoughts on this issue.

## End Notes

[1] 161 T.C. No. 12 (2023).

[2] Beginning in 2013, the employee portion of the Medicare tax on wages in excess of a certain amount increased from 2.9% to 3.8%.

[3] H.R. Rep. No. 95-702, pt. 1, at 41 (1977).

[4] Prop. Reg. §1.1402(a)-2(h)(2) (1997).

[5] Taxpayer Relief Act of 1997, Pub. L. No. 105-34, §935 (providing that "No temporary or final regulation with respect to the definition of a limited partner under section 1402(a)(13) of the Internal Revenue Code of 1986 may be issued or made effective before July 1, 1998.").

[6] T.C. Memo 2017-62. *See also* PLR 9630012; PLR 9432018; PLR 9452024.

[7] 136 T.C. 137 (2011).

[8] The Tax Court ruled on several other issues, including Section 6221, but the focus of this column is on Section 1402(a)(13) only.

[9] *Renkemeyer*, 136 T.C. at 150.

[10] *Id.*

[11] *Perry v. Commissioner*, TC Memo 1994-215; *Moorhead v. Commissioner*, TC Memo 1993-314; *Johnson v. Commissioner*, TC Memo 1990-461.

[12] *Soroban*, 161 T.C. at 181.

[13] *See* CCA 201436049 (holding that LLC members are subject to SECA tax where the LLC was the management company for an investment fund structure).

[14] *Taxpayers Can Rely on Proposed Regulations for LLC Self-Employment Taxes, Clark Says*, 22 Tax Mgmt. Wkly. Rep. 926 (June 16, 2003) ("'If the taxpayer conforms to the latest set of proposed rules, we generally will not challenge what they do or don't do with regard to self-employment taxes,' Lucy Clark, a national issue specialist in the IRS's Examination Specialization Program, said ...").

[15] Section 1402(a)(13) ("there shall be excluded 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).

[16] H.R. Rep. No. 95-702, pt. 1, at 40 (1977) ("exclusion from coverage would not extend to guaranteed payments ... such as salary and professional fees, received for services actually performed by the limited partner for the partnership").

[17] *Id.* ("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 [for social security coverage, thus subject to SECA tax]").

[18] *Denham Capital Management LP v. Commissioner,* Dkt. No. 9973-23; *Point72 Asset Management LP v. Commissioner*, Dkt. No. 12752-23; *Sirius Solutions LLLP v. Commissioner*, Dkt. Nos. 11587-20, 30118-21.