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Tax Update

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Tax Court Addresses Limited Partners' Self-Employment Tax Status

Investment fund managers and founders can no longer take comfort that being classified as a state law limited partner qualifies them for the exclusion from self-employment taxes on their distributive share of the partnership's income and loss. The Tax Court's decision this week in *Soroban Capital Partners LP v. Commissioner* authorizes the IRS to apply a functional test if a limited partner is "limited in name only." That is, if the state law limited partner is active in management or otherwise provides services to the partnership, they may not automatically exclude their distributive share of partnership income from self-employment taxes.

This decision is expected to have wide-ranging and costly repercussions for limited partners of investment entities structured as tax partnerships. Even if an individual is a state law limited partner, the IRS and the Tax Court may now inquire into the level of activity and services provided by that individual to the partnership to determine whether he or she is considered a limited partner for these tax purposes. If he or she has more authority than the Tax Court associates with a "true" limited partner, he or she will owe self-employment tax on his or her distributive share of income. This is inherently a fact-intensive inquiry. Investment funds will need to give more consideration to how they structure equity awards to individuals and what additional limitations should be imposed on activities of individuals who seek limited partner status for employment tax purposes.

Limited Partner Exception

Partners are generally required to report their distributive shares of income from the partnership as self-employment income subject to tax under Section 1401 of the Internal Revenue Code of 1986, as amended, commonly referred to as Self-Employment Contributions Act (SECA) tax. SECA tax is imposed at a 12.4% rate on all earnings from self-employment up to the Social Security wage base, plus an additional 2.9% Medicare tax and an additional 0.9% Medicare tax on high earners.

Section 1402(a)(13) provides an exception from SECA tax for a limited partner's distributive share of income or loss. The exception reads as follows:

> … 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)

Hedge funds, investment funds, private equity funds, venture capital funds, and other investment vehicles structured as tax limited partnerships have customarily understood this limited partner exception to apply broadly to all state law limited partners and generally do not report state law limited partners' distributive shares of ordinary income as subject to SECA tax.

Soroban Decision

Soroban Capital Partners, LP did just that when it reported only guaranteed payments (roughly equivalent to salaries) as self-employment income to its three limited partners and excluded their distributive shares of ordinary business income from their reported self-employment income. Importantly, although Soroban had initially been formed as a state law LLC, it had converted to a state law limited partnership for the tax years at issue.

The Tax Court commented that the term "limited partner" is not defined for purposes of the Section 1402(a)(13) limited partner exception and looked to legislative history to determine Congress's intended meaning. Soroban urged the Tax Court to take a plain reading approach, arguing that the SECA tax exception should apply to any state law limited partner. However, the Tax Court was not persuaded, fixing on the language "*limited partner, as such*" and stating that "Congress's express text makes clear that it was looking to the nature of the earnings. Congress intended Section 1402(a)(13) to apply to its partners that are passive investors." Ultimately, the Tax Court held that a functional analysis test must be applied to determine whether the SECA tax exception applies to limited partners in state law limited partnerships.

Partnership Audit Procedural Argument

Soroban also asserted that classification of a limited partner's distributive share of income as non-self-employment income was not properly determined in a TEFRA proceeding. That is, that the IRS should have been required to audit each partner separately on this issue. The Tax Court also dispensed with this argument, holding that the functional inquiry into the roles and activities of Soroban's limited partners "involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment" and therefore, such inquiry is a partnership item appropriate for TEFRA proceedings. Although this case involved tax years prior to the effective date of the Bipartisan Budget Act of 2015 (BBA), which modified partnership audit procedures, application of the SECA tax exception to limited partners may continue to be treated as a partnership item that may be audited at the partnership level in certain circumstances under the BBA partnership audit procedures. Note that while the BBA procedures generally do not apply to SECA tax because the BBA authorizes adjustments to income tax items only, the IRS recognizes that the partnership level classification of a distributive share of partnership income as subject to SECA tax (or not) does affect each partner's income taxes. While no cases to date have addressed this issue, the IRS has signaled that it may treat SECA tax as a partnership item under a BBA proceeding when deemed relevant to an income tax item.

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