

# Tax Court limits meaning of “limited partner” for self-employment tax purposes

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## In brief

On November 28, 2023, in *Soroban Capital Partners v. Commissioner* (161 T.C. No. 12), the Tax Court held that determining whether a limited partner in a state law limited partnership is a limited partner for purposes of the Section 1402(a)(13) exclusion from self-employment tax for limited partners requires an inquiry into the function and roles of the limited partner. Under the decision, a limited partner who actively participates in the business of the partnership would not be able to exclude his distributive share of income or loss from net earnings from self-employment.

Under Section 1401(a), individuals are subject to tax on self-employment income. This generally includes a partner's distributive share of partnership income. Section 1402(a)(13), however, provides an exception for limited partners that excludes from net earnings from self-employment

[t]he 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.

The term “limited partner, as such” is not defined by the statute or the legislative history. The Tax Court held that the inclusion of “as such” made clear that Congress did not intend the limited partner exception to apply beyond those partners functioning as passive investors.

**Takeaway:** The Tax Court's interpretation of the statute, if upheld, would extend the decision in *Renkemeyer v. Commissioner*, and require analysis of limited partners' functions and roles to determine whether a state law limited partner is entitled to apply the limited partner exception to exclude his distributive shares of partnership earnings from net earnings from self-employment.

## In detail

Soroban Capital Partners LP (Soroban) is an investment firm organized as a Delaware limited partnership and treated as a partnership for US federal income tax purposes. Soroban's limited partners received guaranteed payments in exchange for providing services to Soroban and also received allocations of Soroban's ordinary business income. Soroban excluded its limited partners' shares of ordinary business income from its computation of net earnings from self-employment. The IRS disallowed this treatment in a Notice of Final Partnership Administrative Adjustment, increasing Soroban's net earnings from self-employment.

Soroban's general partner petitioned the Tax Court for review. In a motion for summary judgment, Soroban's GP argued that ordinary business income allocated to Soroban's limited partners should be excluded from Soroban's net earnings from self-employment because the partners are limited partners under state law. The parties also filed cross motions for summary judgment on whether a limited partner's role in partnership activities is a partnership item that can be resolved in a TEFRA partnership proceeding.

There is no definition of limited partner in the statute or in final regulations. At the time the limited partner exception was enacted, state law limited partnership statutes generally limited the activities a limited partner could perform; thus, whether a partner was a limited partner was a question of state law.

Proposed regulations issued in 1997 provided that an individual would not be treated as a limited partner if the individual had personal liability for partnership debts, had authority to contract on behalf of the partnership, or participated in the partnership's trade or business for more than 500 hours during the taxable year. After many commenters raised concerns about the proposed regulations, a temporary moratorium preventing Treasury and the IRS from issuing regulations defining a limited partner under Section 1402(a) was issued over concerns that Treasury had exceeded its regulatory authority. As described in an Engrossed Amendment Senate to the Revenue Reconciliation Act of 1997, the Senate was concerned that the proposed regulations "would effectively change the law administratively without congressional action." The Senate's concern was that a limited partner's income could be subject to self-employment tax even if they were a passive investor; for example, a true passive partner who was personally liable for his share of partnership debts would not be treated as a limited partner under the proposed regulations.

Soroban's GP relied on the legislative history to argue that the plain language of the statute required that the limited partner exception apply to state law limited partners. The Tax Court was unconvinced, finding that "as such" would not have been included in the statute had it been intended to apply to limited partners functioning as limited partners in name only.

In 2011, the Tax Court considered a similar question with respect to a limited liability partnership in *Renkemeyer v. Commissioner* (136 T.C. 137). In *Renkemeyer*, the Tax Court applied a functional analysis that considered the functions and roles performed by the limited partners to determine whether the limited partners were passive investors or were actively participating in the operations of the partnership. In the Soroban case, the Tax Court held that a similar test must be applied in the case of limited partners in a state law limited partnership, denying Soroban's GP's motion for summary judgment.

The Tax Court also determined that an inquiry into the activities of Soroban's limited partners was a partnership item appropriately determined in a TEFRA proceeding.

Tax Court rules allow the taxpayer to seek an interlocutory appeal of the opinion. Absent the success of an interlocutory appeal, the Tax Court will turn to applying the functional analysis test. An order will be issued reflecting the opinion and next steps.

**Observation:** In light of the court's decision, taxpayers with facts similar to those in *Soroban* should consider whether they are functionally limited partners under the tests articulated in *Renkemeyer* and discuss tax reporting with their advisors.

**Observation:** Since 2018, the IRS has maintained a compliance campaign focused on the application of self-employment tax to partner income where examinations are opened specifically focused on this issue. The issue also is raised by the IRS in the scope of broader partnership examinations, which are actively increasing. With the decision, we expect IRS activity to continue with ongoing facts and circumstances determinations and disputes as to the status of limited partners for self-employment tax purposes.

## Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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