### **Insights** Thought Leadership



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## Generations Spring 2024 - Are Limited Partners Subject to Self-**Employment Tax?**

Limited partners of state law limited partnerships may no longer be considered "limited partners" for purposes of selfemployment tax. Family offices and asset managers are often structured as state law limited partnerships, in part to take advantage of the "Limited Partner Exception" described below. The Internal Revenue Service is investigating selfemployment tax compliance, and courts are taking a more nuanced approach to determine which taxpayers are limited partners for certain purposes of the self-employment tax under the Internal Revenue Code.

#### **Self-Employment Tax and the Limited Partner Exception**

Employees and employers are generally subject to a 15.3 percent tax that is assessed on employee wages. The employee pays half of the tax, and the employer pays the other half. The Self Employment Contributions Act imposes a similar tax on self-employed taxpayers to ensure they are contributing to Social Security and Medicare. The self-employment tax applies to "self-employment income," which is defined as "net earnings from self-employment." There are two components of the selfemployment tax: (i) a 12.4 percent Social Security tax and (ii) a Medicare tax that ranges from 2.9 percent to 3.8 percent, based on income levels. However, the Social Security tax is assessed on only the first \$168,600 of a taxpayer's net earnings from self-employment. The Medicare tax is not capped. Therefore, the Medicare tax is the primary concern for high-income taxpayers.

The Internal Revenue Code provides an exception, called the Limited Partner Exception, to self-employment tax for limited partners. This exception excludes the "distributive share of any item of income or loss of a limited partner, as such, other than quaranteed payments" from net earnings from self-employment. The Limited Partner Exception was intended to prevent individuals from investing small amounts in limited partnerships and paying a correspondingly low amount of self-employment tax to gain eligibility for Social Security benefits.

Neither the applicable provisions of the Internal Revenue Code nor the corresponding Treasury Regulations define the term "limited partner." The development of entities such as limited liability companies and limited liability partnerships in the 1990s complicated the issue of what it means to be a limited partner for purposes of the Limited Partner Exception. In 1997, the IRS issued proposed Treasury Regulations that used a functional analysis to determine if a partner should be considered a limited partner for purposes of the Limited Partner Exception, but these proposed Treasury Regulations were never finalized.

#### Case Law

In 2018, the IRS launched a self-employment tax compliance campaign and began focusing attention on state law limited partnerships, limited liability companies, limited liability partnerships and limited liability limited partnerships in the private equity/hedge fund industries. There have been more than 80 audits of self-employed individuals related to this campaign since it began.



Courts have applied the functional analysis test developed by the proposed Treasury Regulations to determine if partners of limited liability partnerships or members of limited liability companies were considered limited partners for purposes of the Limited Partnership Exception. This functional analysis had not been applied to a state law limited partnership until recently.

#### **Soroban Capital Partners**

Soroban Capital Partners L.P., a New York hedge fund organized as a Delaware limited partnership, did not report its limited partners' distributive share allocations of income as "net earnings from self-employment" on its partnership tax returns. The IRS challenged that reporting, and Soroban responded by filing a petition in Tax Court to challenge those adjustments.

On November 28, 2023, the Tax Court rejected the argument that a limited partner can never be subject to self-employment tax on his or her allocable share of partnership income. The Tax Court ruled that eligibility for the Limited Partner Exception requires a functional analysis to determine whether a limited partner in a state law limited partnership is receiving its distributive share of "income or loss of a limited partner, as such." The Tax Court emphasized that the addition of the words "as such" to the statute was intended to emphasize that the exception to self-employment income did not apply to a partner that was limited in name only.

#### **Future Implications**

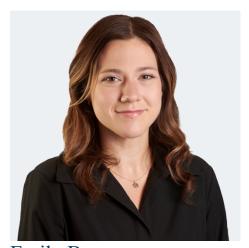
The Soroban opinion only addressed whether a limited partner in a limited partnership is per se excluded from selfemployment tax. The Tax Court has not addressed whether the limited partners in Soroban satisfied the functional analysis test. Thus, there are no cases applying the functional analysis to limited partners of a state law limited partnership. The Soroban opinion was issued as a "Tax Court Opinion," which means it is binding and precedential. There are multiple cases with similar fact patterns that are ongoing, such as Tax Court cases involving Point 72 Asset Management L.P. and Denham Capital Management L.P.

Until more rulings are issued and the functional analysis test is applied, the most robust guidance available to determine if a limited partner qualifies for the Limited Partner Exception can be found in the proposed Treasury Regulations from 1997. Those proposed regulations provide factors that disqualify a limited partner from claiming the Limited Partnership Exception, such as whether the limited partner (i) bears personal liability for partnership debts, (ii) has authority to contract for the partnership, or (iii) participates in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

In light of the Soroban opinion and until future court decisions or guidance from the IRS clarify the issue, taxpayers who claim the Limited Partnership Exception should consider the factors that the IRS has indicated it thinks are relevant to this determination to determine if they would qualify to claim the Limited Partnership Exception from self-employment tax.



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