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How 'As Such' Changes LPs' Self-Employment Tax Exposure

By **Jennifer Breen, Richard Zarin and Daniel Carmody** (December 7, 2023, 5:19 PM EST)


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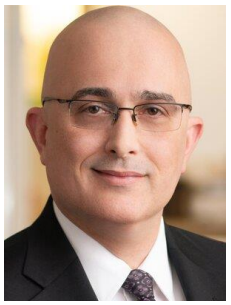
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Private equity, hedge fund and other investment fund sponsors should be aware of a recent development in the Internal Revenue Service's audit campaign with respect to potential liability for the Self-Employment Contributions Act, or SECA, tax on investment professionals through their limited partnership interests in fund management vehicles.

In 2018, the IRS launched its SECA tax compliance campaign and began opening issue-based examinations, focusing its audit attention on limited partnerships and other similar entities — e.g., state law limited partnerships, limited liability companies, limited liability partnerships and limited liability limited partnerships — operating in the asset management, financial services, private equity and hedge fund industries.[1]

Historically, many asset management businesses structured as state law limited partnerships have taken the position that their limited partners are not subject to SECA tax on allocations of partnership net earnings.

Meanwhile, the IRS has argued that limited partners in these partnerships should in fact be subject to SECA tax on such allocations. On Nov. 28, the U.S. Tax Court issued an opinion in Soroban Capital Partners LP v. Commissioner of Internal Revenue that will have an impact on how state law limited partnerships address these audits going forward.

The Decision

In Soroban, a New York hedge fund management business organized as a Delaware limited partnership reported guaranteed payments to its limited partners as net earnings from self-employment on its partnership tax returns, but excluded from the returns the limited partners' distributive share allocations of ordinary income.

The IRS adjusted the reported net earnings from self-employment to include the income allocated to the limited partners.

Soroban challenged these adjustments by filing a petition in the Tax Court and subsequently filing a motion for summary judgment.

This motion sought, among other things, a ruling that, under the plain meaning of the statute, limited partners of state law limited partnerships were not subject to SECA tax on their distributive share

allocations of income as a matter of law.

The plain language of the SECA tax statute appeared to support Soroban's position with respect to summary judgment. Specifically, the limited partner exception in Section 1402(a)(13) of the Internal Revenue Code provides:

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.

In its decision, the Tax Court denied Soroban's motion for summary judgment, holding that the determination of eligibility for the limited partner exception requires a "functional analysis test to determine whether a partner in a state law limited partnership is a 'limited partner, as such' for purposes of section 1402(a)(13)."

Pointing out that the Internal Revenue Code does not define the term "limited partner," the Tax Court noted that it was required to look at the ordinary meaning of this term at the time of enactment. The Tax Court focused on the inclusion of the phrase "as such" in the statutory language to hold that the statute did not apply to a partner who is "limited in name only."

The Tax Court further held that a functional analysis was required to determine whether a partner was acting as a limited partner for the allocation period, or instead should be considered a partner who is limited in name only. This functional analysis would require an inquiry into the functions and roles of that partner.

The decision did not address what a functional analysis would include or articulate how it might be applied in this or in any case. Discovery will continue in the case, and an inquiry into the functions and roles of these partners will be the focus of the litigation going forward.

The Tax Court's opinion was issued as a division opinion, also known as a "T.C. opinion." This type of opinion is issued in cases where the full Tax Court believes the opinion involves a sufficiently important legal issue or principle, and thus the opinion is binding and precedential.

Notable Aspects of the Opinion

The key to the Tax Court's decision was explained this way: "By adding 'as such,' Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner."

While the Tax Court based its holding on the phrase "limited partner, as such" found in the statute, neither the taxpayer nor the IRS raised the argument that the phrase "as such" demanded a functional analysis.

Arguably, the Tax Court's reliance on the phrase "as such" is inconsistent with the "party presentation rule," a common law principle discouraging courts from rendering decisions on an issue or based upon a theory or argument that the parties did not present, although the IRS argued on other grounds that a functional analysis was required.

This principle is considered a fundamental aspect of due process, as it protects a party from having its rights denied based upon a legal theory that the party never had an opportunity to address.[2] While judges are not bound by this rule, they will often ask the parties for supplemental briefing on the new issue or theory to avoid inconsistency with the party presentation rule.

In addition, the Tax Court focused on the phrase "as such" in the statute, without considering the legislative history regarding the use of that phrase. In prior cases, the Tax Court applied a functional analysis by reference to the legislative history, but this is the first time we have seen a theory of why a functional analysis is required for a state law limited partner.

Arguably, the use of the phrase "as such" was intended to reflect the fact that in many instances a partner receives distributive share allocations as both a limited partner and a general partner: The legislative history explicitly acknowledges that if a person is both a limited partner and a general partner in the same partnership, the distributive share allocation received as a general partner would continue to be subject to SECA tax.

In those cases, the allocations that would be exempt from SECA tax are those received by the limited partner, "as such" — as opposed to those allocations received by the partner in their capacity as a general partner.

Going Forward

Subject to any appeals or subsequent decisions, the Soroban decision changes how state law limited partnerships and their limited partners should approach this issue.

Moving forward, a limited partnership and its limited partners should consider engaging in a functional analysis of the partners' roles and responsibilities.

Based on this functional analysis, they should consider whether a distinction can be made with respect to income attributable to a partner's services to, or for the benefit of, the partnership, as opposed to income attributable to a partner's equity ownership in the partnership.

Many firms operating in the asset management, financial services, private equity and hedge fund industries may have facts demonstrating that these separate types of income exist for the partnership's limited partners.

The IRS had recently indicated that it would pause its audit activity in this area. However, in light of the Soroban decision and the IRS' commitment to increased audits of high-net-worth individuals and partnerships, we may start to see increases in SECA tax audits and enforcement.

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[1] See, https://www.morganlewis.com/pubs/2023/03/us-tax-court-will-weigh-in-on-self-employment-tax-for-limited-partners.

[2] See Ryan, "How the Party Presentation Rule Limits Judicial Discretion," St. Thomas Journal of Complex Litigation, Summer 2017, for further discussion of the party presentation rule.