Alert

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COZEN O'CONNOR

Tax Court: Limited Partner Exception to Self-Employment Taxes Is…Limited

The Tax Court recently ruled that a limited partner's share of business income may be earnings from self-employment.[1] Earnings from self-employment are subject to the self-employment tax.

Earnings from self-employment generally include an individual's distributive share of partnership trade or business income. However, the applicable statute excludes from those earnings "items of partnership income of a limited partner, *as such"* (the "limited partner exclusion").[2]

Three limited partners of Soroban Capital LP petitioned the Tax Court to rule on the meaning of the limited partner exclusion. The limited partners argued that their status as limited partners determined the matter. The Tax Court disagreed. The Tax Court held that a limited partner's status is only a threshold matter. The limited partner exclusion applies only if that limited partner's partnership income is of an investment nature.

The Tax Court's opinion did not establish whether the Soroban limited partners' earnings were of an investment nature. The opinion only addressed legal issues. The Tax Court, however, declared how it would make that determination. Referencing a 2011 Tax Court opinion (*Renkemeyer*[3]), the Tax Court stated that determining whether that income is of an investment nature depends on a functional analysis test. Under that test, a court will consider the function and role of the claiming partner in the partnership's business. In short, the functional analysis test is used to determine whether a partner is actively participating in the partnership's business. If that partner is actively participating, the limited partner exclusion will not apply.

In *Renkemeyer*, general partners in a limited liability partnership claimed that they should be entitled to the limited partner exclusion. Another case concerned a similar claim made by members of a limited liability company.[4] The Tax Court's decision in *Soroban* is the first ruling addressing whether the "functional analysis test" applies to limited partners of a limited partnership. *Soroban* thereby differs from the other decisions in that the claimants were actually limited partners, arguing that their status determined the outcome. As noted above, the Tax Court rejected that argument. In the words of the Tax Court, the limited partner exclusion will not apply to persons who are limited partners in name only.

In light of *Renkemeyer* and its progeny (including *Soroban*), unless an appeals court reverses *Soroban,* the Tax Court will likely apply the functional analysis test to any partner[5] claiming the benefits of the limited partner exclusion.

A little planning might help here. The self-employment tax only applies to individuals. However, limited partners that are entities do not need to consider the self-employment tax. In *Soroban*, two of the limited partners were single-member limited liability companies owned by individuals. What if a partner elected to cause his LLC to be classified as an S corporation? That election is permitted. Would that partner have saved on employment taxes? Perhaps.

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[1] *Soroban Capital Partners LP v. Commissioner,* 161 T.C. No. 12 (November 28, 2023).

[2] *See* Section 1402(a)(13) of the Internal Revenue Code of 1986, as amended. The exclusion, however, does not apply to guaranteed payments to a limited partner for services rendered to or on behalf of the partnership.

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[3] *Renkemeyer, Campbell, & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011).

[4] *Castigliola v. Commissioner,* T.C. Memo 2017-62.

[5] The term “partner” here refers to a partner for tax purposes. That term includes a person who holds a limited liability company interest in a limited liability company.