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VIA EMAIL

To Our Investment Adviser Clients and Other Friends:

Re: Tax Court Decision Impacts Self-Employment Tax Exception

Investment fund managers who structure their share of management fee income, as well as their share of performance fees, to qualify for a statutory limited partner exception from self-employment tax (commonly referred to as the "Medicare tax workaround," which typically uses an investment adviser entity or vehicle formed as a limited partnership to receive management fees and performance fees) are advised to take a closer look at their limited partnership agreement and the roles of their limited partners.

On November 28, 2023, the U.S. Tax Court ruled in *Soroban Capital Partners v. Commissioner*, 161 T.C. No. 12 (2023) that this statutory limited partner exception does not apply to active limited partners of a partnership. These active limited partners' distributive share of the partnership's business income would then be included in the net earnings from self-employment that is subject to the self-employment tax under the Self-Employment Contributions Act ("SECA").

Background. Self-employment tax (or "SECA tax") is imposed on net earnings from self-employment derived by an individual. This self-employment tax is comprised of several components: (a) 12.4% tax levied on a contribution and benefits base capped at $160,200 for tax year 2023, (b) 2.9% tax on all net earnings, and (c) an additional 0.9% Medicare tax on all earnings from the partnership over a certain base amount (currently $125,000 for taxpayers married filing separately and $250,000 for taxpayers married filing jointly).

However, under a statutory limited partner exception in IRC Sec. 1402(a)(13), net earnings from self-employment does not include "a distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments to that partner for services rendered to or on behalf of the partnership."

Many investment fund managers have relied on this statutory limited partner exception to take the position that management fees, as well as performance fees, that are paid to a management company that is a limited partnership may not be subject to the SECA tax when allocated to limited partners of the management company. In addition, a distributive share of management or performance fees may not be subject to net investment income tax if the limited partner materially participates in the business of the management company.

Details of the case. Soroban Capital Partners ("Soroban") is a New York hedge fund management company organized as a Delaware limited partnership. It was originally formed as a Delaware LLC but converted to a limited partnership in 2015.

For 2016 and 2017, the tax years at issue in the case, Soroban reported guaranteed payments to its partners as net earnings from self-employment subject to SECA tax. However, it did not report each partner's distributive share of the partnership's ordinary business income as earnings, taking the position that the statutory limited partner exception applied to such earnings. The IRS disagreed with this position and issued a notice of final partnership administrative adjustment that increased Soroban's net earnings from self-employment for each limited partner's distributive share of ordinary business income. Soroban challenged these adjustments by filing a petition to the Tax Court.

The Tax Court decided in favor of the IRS, ruling that state law classification does not control who qualifies as a limited partner for purposes of the limited partner exception. Because the statutory language provides that the exception is for a distributive share of an item of income or loss of a "limited partner, as such," the limited partner determination requires a functional inquiry into the role and activity of the partners. For example, the Tax Court cited legislative history of the statute in 1977 to find that the exception was intended to exclude from self-employment tax only net earnings of "an investment nature." The reasoning is similar to prior rulings by the Tax Court that denied the statutory limited partner exception to active owners of LLPs and LLCs.

In addition, the Tax Court considered whether it had jurisdiction under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA") rules to make a partner-level functional inquiry at the ongoing partnership-level proceeding.[1] Under TEFRA rules, partner-level adjustments could be made only after partnership-level proceedings. However, the Tax Court found that a functional inquiry into the roles of individual partners involved partnership level determinations and thus could be made at the partnership-level proceeding, with implications for the rules that may apply upon future audits of self-employment taxes (discussed below).

Implications. The Tax Court provided limited guidance on what would qualify as a limited partner under a functional analysis and did not rule on whether the partners in the case were limited partners under their functional analysis test. In addition, Soroban may appeal this decision to the U.S. Court of Appeals for the Second Circuit. Thus, few implications should be drawn at this time.

However, management companies organized as state law limited partnerships should consider whether the activities and roles of limited partners are those of "an investment nature" before taking the position that fee income qualifies for the limited partner exception from SECA tax. For example, it may be worthwhile to consider structuring more items of income and loss of the limited partnership as a return of capital rather than in exchange for services, or to reconsider the choice of business entity. But many restructuring options have downsides that should be carefully considered, especially in light of the fact that Congress has proposed legislation that would limit the ability to use S-corporations to reduce SECA tax exposure. In addition to proposed legislation, the IRS's Priority Guidance Plan for 2023-2024 includes issuing regulations that could further complicate questions of the applicability of SECA taxes. Management companies may want to wait until there is further clarity before embarking on complex structuring exercises.

How SECA issues will play out in an audit is also an important consideration. Current partnership audit rules under the Bipartisan Budget Act ("BBA") expressly apply only to income

[1] Because the relevant tax years were 2016 and 2017, TEFRA rules applied and the BBA partnership audit rules were not yet in effect.

taxes, rather than SECA taxes. The Biden administration has proposed expanding the scope of the partnership audit rules to include SECA taxes, but the expansion has been criticized because the partnership audit rules apply only to partnership-related items, which arguably do not include partner-level items. The Tax Court finding in Soroban that partner-level functional inquiries also involve partnership-level determinations may ease the expansion of the BBA partnership audit rules to include self-employment taxes. Investment fund sponsors are cautioned to be aware that self-employment taxes may become within scope of a revised BBA partnership tax audit regime.

Please contact your Shartsis Friese LLP tax attorney for any questions.

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