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Untaxingly Yours

Soboran and the SECA Calculus on Flow-Thru Entities

By Brian T. Whitlock

The soroban is a Japanese counting tray, an abacus, which traces its origins to the ancient Chinese suanpan. The suanpan and the soroban are both still in use today despite the availability of low-cost electronic calculators.

On November 28, 2023, the U.S. Tax Court published its ruling in *Soroban Capital Partners LP*,[1] which subjected the earnings of limited partners in a hedge fund to self-employment tax under the Self-Employed Contributions Act (SECA).[2] The Tax Court's ruling opens the door for the Internal Revenue Service (IRS) to increase scrutiny on the limited partners and members of limited liability companies, most notably in the arena of hedge funds, private equity funds, and investment funds. Specifically, the managers of those funds may no longer be able to hide behind their designation, in part, as limited partners in order to avoid self-employment tax on the bulk of their allocable share of the flow-thru earnings.

Self-Employment Contributions Act

Code Sec. 1402(a) defines the term "net earnings from self-employment" as "the gross income derived by an individual from any trade or business carried on by such individual, less the deductions … which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss … from any trade or business carried on by a partnership of which he is a member…." The self-employment tax is the counterpart to the social security tax on employee wages.

The managers of hedge funds, private equity funds, and investment funds have long found comfort in a specific exception contained in the statute. Code Sec. 1402(a)(13) specifically excludes "the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments … 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 order to minimize their SECA exposure, fund managers frequently create two tiers of ownership. In addition to creating a limited partnership or limited liability company to serve as the core flow-thru entity, the manager typically creates a second entity (either another limited liability company or an S corporation) to serve as the general partner of the limited partnership or the manager of the limited liability company. The key players hold equity positions in both entities, but only draw compensation from the managing entity. If the managing entity is an S corporation, then the key players will be paid wages which are reported on IRS Form W-2 and subject to FICA tax. If the managing entity is limited liability company taxed as a partnership, then the key players would receive a portion of the earnings as guaranteed payments, subject to SECA. key players would also receive a second, usually larger portion of the earnings as limited partners. Relying on the statutory exception, they would exclude their distributive share of ordinary income on their limited partnership interest from SECA.

Soboran's Ownership Structure

Soboran's legal structure consisted of multiple entities. At its core was a limited partnership with a limited liability company, serving as the general partner. Individuals and other single-member LLCs held the limited partnership interests. Although Soboran had six nominal equity owners of the two related entities, all of Soboran's equity was in fact owned directly and indirectly by three individuals. Soboran reported a total of nearly $2 million dollars of guaranteed payments to the three individuals in each of the years at issue. The guaranteed payments were reported on Schedule K-1 of Form 1065, as net earnings from self-employment. The balance of the income earned was reported to the three limited partners as their distributive share of ordinary income.

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Upon review, the IRS increased the amount reported by the partnership as net earnings from self-employment to include both the guaranteed payments and the distributive share of ordinary income. The taxpayers argued that it was inappropriate for the IRS to ignore the statutory exception for the earnings that were allocated to them as limited partners.

Functional Analysis Test

In its ruling in favor of the IRS, the Tax Court determined that the label of a person as a "limited partner" did not control the classification of an item as net earnings from self-employment. Rather, the court stated that "a functional analysis test" must be applied to each person in order to determine the roles and responsibilities of such person and whether they were acting as a limited partner within the meaning of the statute. In addition, the Tax Court considered the question of its jurisdiction in deciding the matter at hand. Applying the Tax Equity and Fiscal Responsibility Act (TEFRA) rules of Code Sec. 6221, the court ruled that it was appropriate to make the determination of whether the net earnings were from self-employment at the partnership level, which was the nature of the proceeding before the court.[3]

In reaching its determination, the Tax Court reviewed the legislative and regulatory history of the limited partner exception under Code Sec. 1402(a)(13). The court acknowledged that not only did Congress fail to specifically define the term "limited partner," but as it reviewed the history, in search of the intended meaning of the term, it specifically referred to a Congressional moratorium that temporarily prohibited the Treasury from publishing regulations on the issue.[4] To date, no temporary or final regulations have been promulgated by Treasury that specifically defines the term "limited partner."

Turning its analysis to case law, the court reviewed is application of statutory construction principles to a case involving a service partnership (a law firm) and the classification of the participants in a legal liability partnership (LLP). In *Renkemeyer*,[5] the Tax Court applied a functional analysis test and determined that the attorneys who performed services on behalf of the law firm shared income as compensation for their services and not as a return on capital invested in the partnership. As a result, the court determined that the attorneys were liable for self-employment tax on their allocable share of ordinary income. The attorneys were not "limited partners" *per se*, but were nevertheless working within a limited liability partnership, which was under state law similar to a limited partnership.

"Limited Partner, as Such"

Unlike *Renkemeyer*, in *Soboran*, the Tax Court was faced head on with the term "limited partner." Once again, the court in *Soboran* returned to a strict construction of Code Sec. 1402(a)(13)'s specific exclusion. The court focused on the placement of the term in the statute and the words that immediately followed in order to ascertain Congress's intent. The exact phrase read "*limited partner, as such*" (emphasis added). The court concluded that the addition of the words "as such" clearly meant that the exception did not apply to persons who were limited partners, in name only. "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."[6] Personally, I find circular definitions (*i.e.*, using a term to define itself) to be a bit confusing; nevertheless, the conclusion of the court is clear: a functional analysis is necessary in order to determine if a person is a limited partner, and thus eligible for the exclusion of income from net earnings from self-employment.

Soboran's Calculus

The initial implications of the *Soboran* decision on the future structure of flow-thru entities in this arena should be obvious. Participants in hedge funds, private equity funds, and investment funds who claim to be limited partners will be under increased scrutiny and attack. The managers and worker bees in the related entities who hold equity interests, which attempt to be classified as limited partners, will clearly be subject to a functional analysis test and they will likely lose their exclusion from SECA.

The IRS attacks will likely spread to more hybrid structures in the future. Similar to the "Material Participation Regulations" found in Temporary Reg. §1.469-5-T, which permit individuals to group and aggregate their working hours across related activities for the purposes of avoiding the passive activity rules of Code Sec. 469 and the Net Investment Income Tax (NIIT) of Code Sec. 1411, surely the IRS will attempt to attribute the services rendered by an individual to the S corporation, serving as general partner or managing member, to the same person who directly or indirectly holds an equity interest in a limited partnership or limited liability company. Remember, the sword swings both ways. In one sense, the Material Participation standards may help individuals avoid the passive activity loss rules and the NIIT, but the Material Participation standards will likely be a weapon, used by the IRS, to expand the application of SECA.

Equity investors in limited partnerships and limited liability companies, who also provide services to a related entity, may need to insist upon amendments to the limited partnership agreements and operating agreements, which clearly delineate a preferential rate of return on the capital portion of the investment in order to protect income allocations from being subjected to SECA.

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A Final Note of Caution

It is unlikely that the IRS attack on net earnings from self-employment will spread to the distributive share of ordinary income attributable to S Corporation shareholders. Currently, the IRS is forced to rely upon a determination of whether the S Corporation shareholder is receiving "reasonable compensation," as W-2 wages, for the services that are being rendered. However, we are likely close to the day when Congress will connect the dots and create a statutory bridge extending the SECA tax to the distributive share S Corporation earnings to employee-shareholders who materially participate and disregard the capital component of the shareholder's investment in their S corporation stock. It all seems to "add up."

ENDNOTES

1 *Soroban Capital Partners LP, Soroban Capital Partners GP, LLC, Tax Matters Partner*, 161 TC __, No. 12, Dec. 62,310 (2023).

2 Self Employment Contributions Act (SECA) is contained within Code Sec. 1402(a) of the Internal Revenue Code.

3 The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) included provisions that allowed the IRS to unify audit and litigation procedures and thus streamline the process for making adjustments to "partnership items," which impact not only the partnership's tax return but also the tax returns of the individual partners. Code Sec. 6231(a)(3) defines a partnership item as "any item required to be taken into account for the partnership's taxable year under any provision of subtitle A to the extent ... that such item is more appropriately determined at the partnership level than at the partner level".

4 *Soroban, ibid.*

5 *Renkemeyer, Campbell & Weaver, LLp*, 136 TC 137, Dec. 58,543 (2011).

6 *Soroban, ibid.*