Tax Court Says "As Much" Means Much: Early IRS Victory in Battle over SECA Taxes and Limited Partners

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The collection of arguments raised in Sirius Solutions, LLP v. Commissioner and Soroban Capital Partners, LP v. Commissioner demonstrates that many legal issues remain unresolved, and taxpayers still might prevail on some or all of them.

INTRODUCTION

Fighting between taxpayers and the Internal Revenue Service ("IRS") over when owners of various pass-through entities, like limited partnerships, must pay self-employment taxes has lasted nearly five decades. This recurring struggle is attributable to several things, including the absence of applicable regulations, existence of merely one precedential case, rapid evolution of business entities, and more. Reasons aside, the reality is that uncertainty has reigned for a long time. This has caused taxpayers to claim disparate tax positions, relying on available guidance and common sense, while awaiting additional instruction from Congress and/or the IRS. It has also led the IRS to challenge many partnerships in recent years, triggering several big-dollar cases.

This article, the latest of many by the same author on the issue, describes the relevant rules, explores a long list of arguments advanced by taxpayers and the IRS in two pending cases, and analyzes the recent Tax Court ruling that it must apply a "functional test" to determine whether a partner in a state law limited partnership meets the relevant tax exemption.[1]

ARRESTED DEVELOPMENT OF APPLICABLE GUIDANCE

Readers need to understand the guidance, or lack thereof, about the limited partner exception in order to appreciate the significance of two recent court decisions.

Congressional Rules and Reasons

Compensation earned by taxpayers ordinarily is subject to employment taxes. In situations involving sole proprietors, independent contractors, and partners, they are comprised of federal income taxes and Self-Employment Contributions Act ("SECA") taxes.[2] The SECA tax rate has been 15.3 percent of "net earnings from self-employment" in recent years.[3] This term generally means gross income derived by an individual from any trade or business, minus certain business-related deductions, plus his distributive share of income from any partnership.[4]

Congress introduced SECA taxes in 1950.[5] Distributive shares by partnerships to *all* partners, both general and limited, were initially subject to such taxes.[6] Things changed when Congress later developed a carve-out for limited partners. In 1977, Congress enacted the predecessor to Section 1402(a)(13), which is an exemption from SECA taxes for certain limited partners.[7] This critical provision states the following:

> [T]here *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.[8]

Unpacking this a little bit, the exception provides that the distributive share from a partnership to a limited partner, as a limited partner, shall not be hit with SECA taxes. It clarifies, though, that the exception does not apply to situations in which limited partners are receiving "guaranteed payments" for rendering services to or for the partnership.

Understanding why Congress created the preceding exception is pivotal. It is surprising, too. One part of the legislative history states that the objective of the provision was to exclude for Social Security coverage purposes "certain earnings which are basically of an investment nature."[9] A careful reading of the entire record reveals that Congress was concerned in 1977 that (i) unscrupulous persons were selling limited partner interests solely for purposes of allowing individuals who were otherwise ineligible for Social Security benefits to gain access to them, (ii) the limited partners were not investing in the normal sense of the word, not risking money with hopes of getting passive income in return, (iii) the limited partners were not paying significant SECA taxes because of the minimum distributive shares they received, (iv) the limited partners were obtaining unfairly large Social Security benefits to the detriment of all workers financing the system, (v) many government workers were participating in this improper scheme, and (vi) allowing such abuse would trigger widespread ill will.[10]

Regulations Never Reaching Fruition

The IRS issued its first set of proposed regulations in 1994 ("First Proposed Regulations").[11] They contained rules for treatment of limited partners in partnerships, as well as members of limited liability companies ("LLCs") treated as partnerships.[12]

The IRS decided to revamp its approach after reviewing public comments to the First Proposed Regulations and holding a hearing. In 1997, it withdrew the First Proposed Regulations and replaced them with a new set ("Second Proposed Regulations").[13] This time, the IRS provided guidance covering *all* entities classified as partnerships for federal tax purposes. The updated rules arguably

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encompassed limited partnerships, LLCs, limited liability partnerships ("LLPs"), and other entities that had emerged since Congress introduced the limited partner exception to SECA taxes 20 years earlier.[14]

The Second Proposed Regulations maintained the exception in Section 1402(a)(13), but they changed the definition of "limited partner."[15] They stated that an individual was *presumed* to be a limited partner, *unless* (i) he was personally liable for the debts or other claims against the partnership based on his status as a partner, *or* (ii) he had authority under state law to engage in contracts for the partnership, *or* (iii) he participated in the partnership's business more than 500 hours during a year.[16]

Notably, the IRS explained that it decided to use these "functional tests" to ensure that different individuals, owning interests in similar entities formed under different state laws, would be treated the same.[17] It then suggested that "functional tests" were necessary because of the proliferation of new types of business entities since the limited partner exception was enacted in 1977 and because of the evolution of limited partnership statutes in various states. In particular, the IRS observed that state laws back in 1977 ordinarily prohibited limited partners from participating in the operations of the partnership, but that had changed. Thus, even in situations involving a limited partnership formed under state law, the IRS supposedly needed to rely on "functional tests" to ensure that SECA tax consequences were similar for all individuals, regardless of the state in which the relevant partnership was organized.[18]

The Second Proposed Regulations also indicated that an individual who was a "service partner" in a "service partnership" would *not* be a limited partner.[19] For these purposes, the term "service partner" meant a partner who provided services either to a partnership or on behalf of its trade or business.[20] A "service partnership," meanwhile, was a partnership substantially all of whose activities involved the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, or consulting.[21]

Putting on the Brakes

Congress stopped the IRS in its tracks by enacting a law expressly prohibiting it from finalizing the Second Proposed Regulations, at least temporarily.[22] It essentially imposed a moratorium on regulations for about 18 months. In summary, Congress halted the IRS in 1997, declaring that the legislative branch (*i.e.*, Congress), and not an agency of the executive branch (*i.e.*, the IRS), had authority to create law regarding the definition of limited partner.[23]

Only Precedential Case

Several cases and IRS rulings have wrestled with the limited partner exception.[24] The most famous dispute, and arguably the only one with precedential value, was *Renkemeyer, Campbell & Weaver, LLP v. Commissioner.*[25]

The taxpayers formed an LLP under Kansas law to operate their law practice ("Law Firm"). The Law Firm had three individual partners, each of whom held a General Manager Partner Interest and an Investment Partner Interest, had equal authority, and was entitled to an equal distributive share. The Law Firm filed timely Forms 1065 (U.S. Return of Partnership Income) showing revenues primarily generated from performance of legal services. Such revenues were distributed to the individual partners, not reported as net earnings from self-employment, and thus not subjected to SECA taxes.

The IRS audited the Law Firm and made some adjustments, the most important of which was recharacterizing the distributive shares as net earnings from self-employment, not protected by the limited partner exception. The Law Firm challenged the IRS in Tax Court. It argued that its three partners should be treated as limited partners because they were partners in an LLP formed under Kansas law, their interests were called limited partner interests in the Law Firm's organizational documents, and each of the partners had limited liability under Kansas law.

The Tax Court disagreed. It began by explaining the major differences between general partners and limited partners, in terms of management power and personal liability. The Tax Court concluded that a limited partner interest "is generally akin to that of a passive investor."[26]

The Tax Court went on to explain that the predecessor to Section 1402(a)(13), which used the phrase "limited partner," was enacted *before* LLPs and other modern entities came into existence. It then recognized that the IRS attempted to address this issue many years ago, in 1997, by issuing the Second Proposed Regulations, but Congress prevented the IRS from finalizing them. Without any additional guidance since then, from Congress or the IRS, the Tax Court indicated that it had to engage in statutory interpretation to determine what, exactly, Congress meant when it used the term "limited partner." The Tax Court looked to just one small portion of the legislative history, which stated that Congress introduced Section 1402(a)(13) to exclude from SECA taxes "certain earnings which are basically of an investment nature.[27]

The Tax Court held that the Law Firm derived nearly all its revenue by providing legal services, the partners contributed only a nominal amount of capital for their partnership interests, and the distributive shares that they received were not "earnings which are basically of an investment nature." Accordingly, the Tax Court concluded that the partners had to pay SECA taxes on the amounts received, and the limited partner exception did not apply.[28]

Them's Fighting Words

The IRS believed, after years of observation, that taxpayers persisted in improperly taking advantage of Section 1402(a)(13). According to the IRS, some partnerships were classifying *all* members as limited partners, thereby avoiding SECA taxes altogether. Other partnerships were taking a more moderate approach, claiming that only a portion of the distributions were hit by SECA taxes. They accomplished this by labeling small amounts as wages or guaranteed payments to partners, while classifying the majority as distributive shares to limited partners. The IRS initiated a Compliance Campaign in 2018 to scrutinize these practices.[29] This attention has triggered several high-profile SECA disputes recently.

TWO IMPORTANT CASES

A handful of SECA cases are currently moving through the court system. Two engender particular interest at the moment. One because it highlights many of the positions that partnerships and the IRS might be adopting as the battles persist. The other because it resulted in two significant holdings favorable to the IRS, which might alter how partnerships defend themselves going forward.

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First Case – Show Me What You Got

The first case is *Sirius Solutions, LLLP v. Commissioner.*[30]

Main Facts and Relevant Filings

Sirius Solutions, LLLP ("Sirius") is a limited liability limited partnership formed in Delaware and governed by a Limited Partnership Agreement. Sirius is a consulting firm with over 200 employees located in various offices. It is managed by Sirius Solutions GP, LLC ("General Partner"), which must act through a Board of Directors.

The Limited Partnership Agreement generally prohibits limited partners from participating in management or control of the business. It also forbids limited partners from transacting business for, acting on behalf of, or binding Sirius. Finally, it does not permit any "guaranteed payments" to partners, and Sirius made no such payments.

At the end of 2014, the only year in dispute, Sirius had five individual limited partners and a General Partner. All limited partners made capital contributions to Sirius, many of which were significant. Some partners, in addition to providing cash, contributed services to Sirius.

Sirius made distributions of "net cash flow" to the limited partners in 2014 in accordance with their ownership interests. Such distributions were not linked to, or dependent on, hours worked, revenues generated, or any other formula related to services provided by the limited partners. Indeed, the limited partners who provided few or no services received the same pro-rata distributions. Sirius took the position on its Form 1065 that the distributions to the limited partners were not subject to SECA thanks to the exception in Section 1402(a)(13).

The IRS later audited Sirius and issued a notice of Final Partnership Administrative Adjustment ("FPAA") alleging that (i) the ordinary income generated by the business-consulting services should be included in net earnings from self-employment, (ii) the individual partners do not fall within the exception for limited partners, and (iii) the amount of net earnings from self-employment should increase from $0 to approximately $6 million.

Sirius disagreed with the IRS' positions, of course, and challenged them by tendering a Petition to the Tax Court. The parties completed their initial pleadings, the trial was postponed, and Sirius submitted a Motion for Summary Judgment during the reprieve. Sirius asked the Tax Court to determine, without a trial, that distributions to limited partners according to relevant state law are excluded from SECA taxes, period. The IRS opposed the Motion for Summary Judgment.

Positions of the Parties

The legal briefing by the parties was extensive and detailed; capturing it all in this article would be unfeasible. The following is merely a summary of the main points.

Sirius raised the following points with the Tax Court:

- Section 1402(a)(13) generally states that "the distributive share of any item of income or loss of a limited partner" is excused from SECA taxes.
- The Internal Revenue Code does not define the term "limited partner," and the IRS has never issued any final regulations containing such definition. Therefore, the Tax Court should look to the "ordinary meaning" of the term at the time Section 1402(a)(13) was enacted, in 1977.
- The ordinary meaning of limited partner is a person who satisfies the definition of limited partner under state law. A limited partner under the laws of Delaware, the state in which Sirius was formed, is a person admitted to a limited partnership as a limited partner.
- In 1997, Congress "confirmed" that the term limited partner for these purposes means a limited partner under applicable state law. It did so by imposing a moratorium against the IRS finalizing the Second Proposed Regulations. The moratorium is "important evidence" that Congress "made a considered judgment to retain the relevant statutory text."
- Congress has amended Section 1402 a total of 32 times since adding Section 1402(a)(13) in 1977, and 14 of these times occurred *after* Congress imposed the moratorium in 1997. Despite all those opportunities, Congress never defined the term limited partner.
- When it comes to statutory interpretation, it is unnecessary to consider outside sources when a statute is clear on its face. Section 1402(a)(13) is clear in that the exception to SECA taxes applies to limited partners, unless they receive guaranteed payments. Given the clarity of the provision, the analysis should begin and end there.
- Even if it were necessary to turn to outside sources, like legislative history, it "corroborates" that the limited partners in Sirius satisfy the definition.
- The legislative history also recognizes the appropriateness of bifurcating distributions (with some being subject to SECA taxes and some not) when a partner is acting as both a general partner and limited partner. Thus, any participation by the limited partners of Sirius in management or operations would not trigger blanket exposure to SECA taxes.
- The IRS has issued various administrative rulings and other materials indicating that the term limited partner for purposes of Section 1042(a)(13) means a person defined as such under applicable state law. For instance, the Instructions to Form 1065 for 2014 informed taxpayers that a limited partner was "a partner in a partnership formed under a state law limited partnership law, whose personal liability for debts is limited to the amount of money or other property contributed or is required to contribute to the partnership."
- The "functional test," which the Tax Court used in *Renkemeyer*, only applies to entities that are *not* limited partnerships under state law. It is improper to utilize the functional test in other scenarios, and Sirius is a Delaware limited liability limited partnership.
- Decisions in various federal cases support the notion that the term limited partner for purposes of Section 1402(a)(13) means a limited partner as defined by state law.
- Courts frequently look to state law, such as Delaware partnership law, in applying federal tax law.
- Delaware law contains a non-exclusive list of activities (*i.e.*, safe harbors), the performance of which by limited partners does not constitute participation in the management or control of the partnership, and does not cause them to lose their status as limited partners.

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None of the allegations by the IRS about supposed activities of the limited partners in Sirius rises to the level of management or control under Delaware law.

The IRS saw things differently, of course. It asked the Tax Court to accept the following logic:

- The Internal Revenue Code does not define limited partner for purposes of Section 1402(a)(13).
- The term is nuanced, complex, and based on the functions performed by particular individuals; state law does not determine it.
- The term limited partner should be given its "ordinary meaning." To determine this, the Tax Court should ignore the large number of dictionary definitions introduced by Sirius and, instead, focus on its earlier decision in *Renkemeyer*. That case looked to the legislative history, concluded that limited partners are equivalent to passive investors, and held that it is necessary to utilize a functional test that evaluates the actions and abilities of the partners, not merely their state law titles.
- The Tax Court has "continued to follow and build upon" the holding in *Renkemeyer* in subsequent cases.
- Reports by the Joint Committee on Taxation, Private Letter Rulings, and Instructions to returns do not constitute federal tax authorities, and the Tax Court should ignore them.
- The moratorium in 1997 does not mean that Congress "confirmed" or "made clear" the proper definition of limited partner. Rather, the moratorium merely shows that Congress was concerned that the Second Proposed Regulations might contain rules that exceeded the IRS' regulatory authority.
- The only legislative history that might be relevant to this case is that from the time the limited partner exception was enacted, in 1977, not from 20 years later when the moratorium occurred, in 1997.
- Federal courts do not commonly look to state law in applying federal tax law. In fact, federal law supersedes state law thanks to the Supremacy Clause of the U.S. Constitution. State law controls only when the relevant federal law, by express language or necessary implication, makes interpretation of federal law dependent on state law. Section 1402(a)(13) never mentions state law, and entity-classification at the federal level is done in accordance with specific federal tax regulations.
- If the Tax Court were to accept the contention by Sirius that state law dictates the outcome for purposes of Section 1402(a)(13), this would spark a bad overall result. Specifically, the Tax Court would be forced to ponder 50 different states, with 50 different partnership laws, rendering 50 different results.
- The Revenue Proposals by the Biden Administration, as found in the so-called Green Book, do not constitute precedent and do not warrant inclusion in the analysis.
- The functional test described in *Renkemeyer* mandates a review of all facts and circumstances, including the actions and abilities of the partners. Therefore, a trial is necessary to develop more evidence, and the case should not be decided by Motion for Summary Judgment.

Narrow Decision by the Tax Court

The Tax Court released an Order in August 2022 denying the Motion for Summary Judgment filed by Sirius. The Order indicated that a comprehensive ruling was premature because material facts remain unresolved with respect to the meaning of the term limited partner as used in Section 1402(a)(13), as well as the involvement of the partners in business operations.[31] Because of the grounds for such Order, the Tax Court did *not* analyze the multitude of arguments raised by Sirius and the IRS, as described above.

Second Case – Two Early Blows to Partnerships

The Tax Court did not miss its opportunity to delve into substance the second time around, when it made its initial decisions in *Soroban Capital Partners, LP v. Commissioner.*[32]

Main Facts and Relevant Filings

The entity at issue, Soroban, was a Delaware limited partnership during the relevant years. It was a hedge fund, which provided various services related to the management of private investment funds, including buying and selling securities and other instruments.

The IRS audited its Forms 1065 for 2016 and 2017, concluding that Soroban had understated net earnings from self-employment by approximately $142 million. Soroban disputed this allegation by filing Petitions with the Tax Court. They indicate that Soroban had one general partner, three individual limited partners, and 27 individual employees whose work contributed to the profits.[33]

The Limited Partnership Agreement dictated that (i) only the general partner could manage, operate, and control Soroban, (ii) although the limited partners had to approve certain events related to Soroban before they could occur, the general partner had the "ultimate authority" to take actions or make decisions, (iii) the partners had limited liability, and (iv) the partners would receive allocations of profit and loss pursuant to their ownership percentages. The Petition pointed out that the limited partners had limited liability for any problems under Delaware law, too.

The Petitions underscored that everyone respected the limited partnership form. They alleged, in particular, that the general partner performed all management functions, the limited partners did not participate in the management of Soroban "to any extent" in their capacities as limited partners, the limited partners received Schedules K-1 (Partner's Share of Current Year Income, Deductions, Credits, and Other Income) identifying them as limited partners, the general partner paid SECA taxes on its distributive share, and the 27 employees paid federal employment taxes on their compensation through withholding.

The Petitions acknowledged that the three limited partners (i) devoted considerable hours to working for Soroban, the general partner, and other affiliates, (ii) held different positions for Soroban, including Managing Partner, Co-Managing Partner, Chief Investment Officer, and Head of Trading and Risk Management, and (iii) were members of the Management Committee. The Petitions emphasized, however, that Soroban made guaranteed payments to the limited partners for providing such services and subjected those payments to SECA taxes.

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The IRS, predictably, filed Answers with the Tax Court denying essentially all the allegations that Soroban made in its Petitions. Similar to the situation in *Sirius*, Soroban and the IRS each tried to convince the Tax Court to rule in its favor on key issues, before trial, by filing Motions for Summary Judgment. The specific requests differed from those previously raised in the *Sirius* case, though.

Positions of the Parties

Soroban made the following two contentions in its Motion for Summary Judgment. First, a limited partner of a limited partnership is exempt from SECA taxes under Section 1402(a)(13) on all distributions, other than guaranteed payments, pursuant to the clear language of the provision and other applicable guidance issued by the Treasury Department and the IRS. Second, even if the functional test proposed by the IRS were relevant to the role of the limited partners, this analysis is not a "partnership item" that can be conducted as part of a partnership proceeding, but rather an "affected item" that must be addressed in separate, subsequent, individual proceedings with each of the three limited partners. These two arguments, their subarguments, and opposing positions by the IRS are examined below.

Soroban relied on some of the same claims previously raised in *Sirius*, with several additions. The main ones are featured below.

- The rules of statutory construction indicate that, when the language of a provision is clear, the search for its meaning cannot go beyond the text itself. Section 1402(a)(13) "unambiguously excludes" distributive shares of partnership income from net earnings from self-employment "for limited partners in state law partnerships," except when it comes to guaranteed payments.
- Statutory construction also requires courts to apply "ordinary meanings" to undefined terms. Section 1402 does not elucidate the meaning of limited partner, but several other sources, including cases, Instructions to Form 1065, and Frequently Asked Questions posted on the IRS' website, support the notion that the ordinary meaning of limited partner is "a limited partner in a state law limited partnership."
- Even if the term limited partner were ambiguous, Congress and the Treasury Department have repeatedly "affirmed" that limited partners in state law limited partnerships only pay SECA taxes on guaranteed payments. For example, although the legislative history mentions omitting earnings that are "basically of an investment nature," Congress did not adopt such language or limitation. Moreover, at that time that Congress imposed the moratorium against finalizing the Second Proposed Regulations in 1997, it announced its concern that the IRS was attempting to administratively change the law "for individuals who are limited partners under applicable state law." In addition, the fact that Congress has never expanded or modified the text of Section 1402(a)(13) since its enactment nearly five decades ago constitutes "important evidence" that Congress "made a considered judgment" to leave it as is. Finally, the Joint Committee on Taxation issued a report back in 2005 stating that "limited partner status is determined under state law."
- After encountering problems applying rules initially designed for limited partners to modern entities, Congress took steps in the context of the passive activity loss rules under Section 469 to rectify matters. It enacted a new default rule and expressly authorized the IRS to issue regulations about the circumstances in which such rule should apply. This proves that Congress knows how to modify the tax treatment for limited partners based on their level of participation in partnership affairs. The fact that Congress chose not to do so for limited partners and SECA taxes is telling.
- The Treasury Department has expressly acknowledged the general exclusion from SECA taxes of partnership distributions to limited partners in various Green Books.
- Even if the functional test advanced by the IRS were relevant to the role of the limited partners in Soroban, this analysis would not be a "partnership item" that can be explored as part of a partnership proceeding, but rather an "affected item" that must be addressed in future proceedings centered on each of the three limited partners. Decisions that involve the liability or status of just one partner, and those that require examination of the activity of each individual partner, "are classic non-partnership determinations." Moreover, any functional analysis of the roles of the limited partner is effectively the same as the inquiry under the passive activity loss rules of Section 469, which the Tax Court has recognized as a partner-level inquiry.

The IRS saw things differently. It urged the Tax Court to accept the following reasoning:

- Because Section 1402 does not define the term limited partner, the Tax Court must look to legislative history and applicable caselaw. The only precedent, *Renkemeyer*, utilized a functional test and determined that a limited partner is akin to a passive investor. Several other cases, instructive yet not precedential, have adopted the holdings from *Renkemeyer*.
- Informed inaction by Congress is not significant; that is, the lack of changes to Section 1402 over the years carries little weight. However, if it were pertinent, it is noteworthy that the Tax Court decided *Renkemeyer* in 2011, Congress amended Section 1402 twice thereafter, it was aware both times that the Tax Court and others were applying a functional test to determine limited partner status, and it did not take any legislative action to halt the use of the functional test or remove "state law limited partners" from its scope.
- Using an approach that looks only to labels under state law, without considering the roles of the partners, would generate different results, for different types of entities, formed in different states, which are functionally similar.
- Congress could have specified in Section 1402(a)(13) that it intended for the term limited partner to be linked to state law, but it did not.
- The only authoritative sources of federal tax law are statutes, regulations and certain judicial decisions; therefore, all references by Soroban to IRS Instructions to tax returns, Frequently Asked Questions published by the IRS, reports by the Joint Committee

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on Taxation, Green Books, and other informal guidance is not relevant.

- If the term limited partner in Section 1402(a)(13) is synonymous with "state law limited partner," as Soroban suggests, logic dictates that members of LLCs and owners of pass-through entities other than limited partnerships would not qualify for the SECA tax exemption. However, the Tax Court has recognized in several cases that such members and owners are eligible for the exemption.
- The term partnership items includes those "required to be taken into account for the partnership's taxable year under any provisions of Subtitle A" of the Internal Revenue Code, and the key provision in this dispute, Section 1402, is part of Subtitle A.
- Section 1402(a), which defines the phrase "net earnings from self-employment," requires two separate determinations. First, a partnership must analyze the extent to which its income qualifies. Second, the partners must figure the amount of SECA taxes they must pay on their distributive shares from the partnership. Soroban focuses solely on the latter, the "non-partnership prong," while ignoring the former, the "partnership prong." This is inconsistent with how courts have treated affected items in prior self-employment tax cases, where they used a two-step analysis, following the stated order.

Decision by the Tax Court

The Tax Court, not being coy, stated in its initial overview of the case that "Congress intended for the limited partner exception to apply to earnings of an investment nature [and determining this] necessarily requires an inquiry into the functions and roles of the limited partners."[34]

Then, after summarizing the relevant facts, standards for granting a Motion for Summary Judgment, the SECA tax exception for limited partners, and the actions by Congress and the IRS over the past several decades, the Tax Court confirmed that Soroban is a case of first impression. It explained that the Tax Court has not addressed "whether a limited partner in a state law limited partnership must satisfy a functional analysis test to be entitled to the limited partner exception."[35]

The Tax Court then worked backward. It began by stating its conclusion that a "functional analysis test should be applied when determining whether the limited partner exception under Section 1402(a)(13) applies to limited partners in state law limited partnerships."[36] It went on to explain its reasoning, which was *not* rooted in the specific arguments raised by Soroban or the IRS in their dueling Motions for Summary Judgment. The Tax Court ordered off the menu, if you will.

The Tax Court emphasized that the key phrase in Section 1402(a)(13) is not "limited partner," but rather "limited partner, as such." Because Congress never defined this phrase, the Tax Court had to resort to the principles of statutory interpretation. These include looking to the express text of the law, using the ordinary meaning of terms where possible, and giving effect to every word and clause in a statute. Applying these ideas, the Tax Court concluded that the limited partner exception does not apply "to a partner who is limited in name only." Why? If Congress had desired that outcome, it could have just said "limited partner," instead of "limited partner, as such." The use of the longer phrase, reasoned the Tax Court, makes it clear that "the limited partner exception applies only to a limited partner who is functioning as a limited partner."[37] The Tax Court then refined its conclusion on this issue as follows: "The Court must apply 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)."[38] Finally, the Tax Court swiftly dispensed with the other arguments and theories proffered by Soroban; it required less than two pages to banish them all.

After deciding that it must utilize the functional test to ascertain whether distributive shares to limited partners can benefit from the SECA tax exception, the Tax Court had to clarify when. In particular, the Tax Court had to determine whether it should apply the test during the partnership proceeding or, later, during the subsequent partner-level proceedings. This, explained the Tax Court, depends on whether the limited partner exception is a partnership item or an affected item.

The Tax Court offered an overview of the special partnership proceedings under the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"). It started with the basic idea that "the tax treatment of any partnership item . . . shall be determined at the partner level."[39] It then explained that partnership items are those that (i) must be taken into account for a partnership's taxable year under Subtitle A of the Internal Revenue Code, and (ii) are more appropriately determined at the partnership level according to the regulations.[40] The Tax Court described both of these criteria as "easily resolved" in this case. To begin with, Section 1402 is found in Subtitle A, and it requires partnerships to separately state the amount of income that would be net earnings from self-employment in the hands of the ultimate recipients. Moreover, the relevant regulations indicate that partnership items encompass the accounting practices, as well as the legal and factual determinations, which underlie the amount, timing, and characterization of items of income, credit, gain, loss, deduction, etc.[41]

The Tax Court concluded as follows:

> A functional inquiry into the roles and activities of Soroban's individual partners as required by Section 1402(a)(13) involves factual determinations that are necessary to determine Soroban's aggregate amount of net earnings from self-employment Accordingly, the functional inquiry into their roles is a partnership item and appropriate from these [partner level] proceedings.[42]

If that were not clear enough, the Tax Court added that "[f]or a partnership that is subject to TEFRA, the application of the functional analysis test is a partnership item that we have jurisdiction to determine in a TEFRA proceeding.[43]

CONCLUSION

Has the IRS' position regarding how to interpret the limited partner exception changed? No, it has been advancing the idea of a functional test since it introduced the Second Proposed Regulations nearly three decades ago. The difference now, though, is that the Tax Court agrees.

The collection of arguments raised in *Sirius Solutions, LLP v. Commissioner* and *Soroban Capital Partners, LP v. Commissioner* demonstrates that many legal issues remain unresolved, and taxpayers still might prevail on some or all of them. The tax community is hoping for some victories against the IRS. However, the recent rulings by the Tax Court, combined with its laser focus on

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the statutory language and legislative history to the exclusion of all other guidance, makes things more difficult for taxpayers. Several cases involving similar issues are awaiting trial, the IRS has announced more partnership audits, and treatment of limited partners as exempt from SECA taxes, either partially or completely, is widespread. These types of battles, therefore, are far from over.

End Notes

[1] This article supplements earlier ones by the same author. *See* Hale E. Sheppard, "Analyzing the Long Journey to Chaos: SECA Taxes, Limited Partner Exception, and Effects of Government Inaction," 48(6) *Journal of Corporate Taxation* 3 (2021); Hale E. Sheppard, "Heads the IRS Wins, Tails Taxpayers Lose: Analyzing Inconsistent Positions on the Meaning of 'Limited Partners,'" 49(2) *Journal of Corporate Taxation* 3 (2022); Hale E. Sheppard, "The Resurgence of IRS Disputes about Which Limited Partners Escape SECA Taxes Thanks to the Section 1402(a)(13) Exception," 49(1) *Journal of Corporate Taxation* 18 (2022); Hale E. Sheppard, "New Tax Court Case Shows that the IRS is Getting 'Sirius' about SECA Taxes and the Limited Partner Exception," 49(6) *Journal of Corporate Taxation* 13 (2022); Hale E. Sheppard, "Tax Court Showdown over SECA Taxes and Limited Partners: Exploring the Catalyst for the Second Case of Many," 138(2) *Journal of Taxation* 3 (2022); Hale E. Sheppard, Same Standard, Different Taxes: The IRS and New York Attack Limited Partner Exception," 138(4) *Journal of Taxation* 22 (2023).

[2] Section 1401(a) and (b); Revenue Ruling 69-184.

[3] Section 1401(a) and (b). This is the SECA rate from 2020.

[4] Section 1402(a).

[5] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax (Sept. 2012), pg. 1.

[6] T.D. 7333 (Dec. 19, 1974); Treas. Reg. § 1.1402(a)-2(d).

[7] Social Security Amendments of 1977, Public Law No. 95-216, Section 313(b).

[8] Section 1402(a)(13) (emphasis added).

[9] U.S. House of Representatives, Committee on Ways and Means, Social Security Financing Amendments of 1977, 95th Congress, 1st Session, House Report 702 – Part 1 (Oct. 12, 1977), pg. 11.

[10] Laura E. Erdman, "Reinterpreting the Limited Partner Exclusion to Maximize Labor Income in the Self-Employment Tax Base," 70(4) Washington and Lee Law Review 2389 (2013) (explaining that the SECA tax rate was merely 7.9 percent in 1977 and it applied only to the first $16,500 of net earnings).

[11] 59 Fed. Reg. 67253, EE-45-94 (Dec. 29, 1994).

[12] 59 Fed. Reg. 67253, EE-45-94, Proposed Treas. Reg. § 1.1402(a)-18 (Dec. 29, 1994).

[13] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96.

[14] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96 (stating that "[t]hese proposed regulations apply to all entities classified as a partnership for federal tax purposes, regardless of the state law characterization of the entity.")

[15] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(g).

[16] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(2).

[17] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.

[18] Id.

[19] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(5).

[20] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(i).

[21] 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96; Proposed Treas. Reg. § 1.1402(a)-2(h)(6)(ii).

[22] Taxpayer Relief Act of 1997, Public Law 105-34, Section 935 (Aug. 5, 1997) (stating that "[n]o temporary or final regulation with respect to the definition of limited partner under Section 1402(a)(13) may be issued or made effective before July 1, 1998.")

[23] U.S. House of Representatives. Taxpayer Relief Act of 1997, Conference Report, 105th Congress, 1st Session, Report 105-220, July 30, 1997, pg. 765.

[24] *See, e.g.*, *Johnson v. Commissioner*, T.C. Memo 1990-461; *Perry v. United States*, T.C. Memo 1994-215; Private Letter Ruling 9432018; Private Letter Ruling 9452024; Private Letter Ruling 9525058; *Norwood v. Commissioner*, T.C. Memo 2000-84; *Riether v. United States*, 919 F. Supp. 2d 1140 (2012); *Howell v. Commissioner*, T.C. Memo 2012-281; Chief Counsel Advice 201436409; Chief Counsel Advice 201640014; *Hardy v. Commissioner*, T.C. Memo 2017-16; *Castigliola v. Commissioner*, T.C. Memo 2017-62; *Joseph v. Commissioner*, T.C. Memo 2020-65.

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

[26] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 147 (2011).

[27] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011) (citing the Social Security Amendments of 1977, Public Law 95-216, Section 313(b)).

[28] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137, 150 (2011).

[29] *www.irs.gov/businesses/corporations/lbi-active-campaigns*

[30] *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20. The facts, arguments and issues described in this article derive from the following sources: Notice of Final Partnership Administrative Adjustment dated June 12, 2020; Petition filed September 3, 2020; Answer filed November 11, 2020; Joint Motion for Continuance filed March 8, 2021; First Stipulation of Facts filed June 2, 2021; Motion for Summary Judgment filed June 4, 2021; Brief in Support of Motion for Summary Judgment filed June 4, 2021; Reply in Support of Petitioner's Motion for Summary Judgment and to Petitioner's Brief in Support of Motion for Summary Judgment filed August 13, 2021; Sur-Reply in Opposition of Petitioner's Motion for Summary Judgment and Petitioner's Brief in Support of Motion for Summary Judgment filed September 13, 2021; First Supplemental Stipulation of Facts filed December 3, 2021; and Respondent's Response and Brief in Opposition to Petitioner's Motion for Summary Judgment and to Petitioner's Brief in Support of Motion for Summary Judgment filed December 16, 2021.

[31] *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20, Order issued Aug. 8, 2022.

[32] *Soroban Capital Partners, LP v. Commissioner*, Tax Court Docket Nos. 16217-22 and 16218-22. The information regarding this case derives from Petitions dated July 22, 2022, Answers dated September 15, 2022, Petitioner's Motion for Summary Judgment and Memorandum in Support dated February 7, 2023, Respondent's Motion for Partial Summary Judgment and Memorandum in Support dated March 2, 2023, Respondent's Objection to Petitioner's Motion for Summary Judgment and Memorandum in Support dated March 2, 2023, and *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023).

[33] More precisely, two of the limited partners held their interests in Soroban through single-member LLCs treated as disregarded entities, while one held his interest personally.

[34] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 3.

[35] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 10.

[36] Id.

[37] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 11.

[38] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 15.

[39] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 14 (citing Section 6221).

[40] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 14 (citing Section 6231(a)(3) and Treas. Reg. § 301.6231(a)(3)-1).

[41] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 15 (citing Treas. Reg. § 301.6231(a)(3)-1(b)).

[42] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023), pg. 15.

[43] Id.

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