Soroban Capital Partners LP v. Commissioner, 161 T. C. No. 12 (2023)

The U. S. Tax Court ruled that determining whether limited partners in a state law limited partnership are 'limited partners, as such,' under I. R. C. § 1402(a)(13) requires a functional analysis. This ruling impacts the application of the self-employment tax exclusion for limited partners, affecting how partnerships report net earnings from self-employment and potentially altering tax strategies for limited partnerships.

Parties

Soroban Capital Partners LP and Soroban Capital Partners GP LLC, as the tax matters partner (Petitioner), filed against the Commissioner of Internal Revenue (Respondent). The case was adjudicated in the U. S. Tax Court, with docket numbers 16217-22 and 16218-22.

Facts

Soroban Capital Partners LP (Soroban) is a Delaware limited partnership subject to the TEFRA audit and litigation procedures for the tax years 2016 and 2017. Soroban reported its net earnings from self-employment by including guaranteed payments to its limited partners and the general partner's share of ordinary business income. However, it excluded the distributive shares of ordinary business income allocated to its limited partners, Eric Mandelblatt, Gaurav Kapadia, and Scott Friedman, from its computation of net earnings from self-employment. The Commissioner challenged this exclusion, asserting that these limited partners were not limited partners 'as such' under I. R. C. § 1402(a)(13) and thus their shares of ordinary business income should be included in Soroban's net earnings from self-employment.

Procedural History

The Commissioner issued Notices of Final Partnership Administrative Adjustment on April 25, 2022, adjusting Soroban's net earnings from self-employment for the years in issue. Soroban, through its tax matters partner, timely filed a Petition challenging these adjustments. Both parties filed Motions for Summary Judgment. Soroban sought a ruling that the limited partners' distributive shares of income were excluded from net earnings from self-employment under I. R. C. § 1402(a)(13) or, alternatively, that the issue of limited partners' roles was not a partnership item subject to TEFRA proceedings. The Commissioner moved for a ruling that the inquiry into the limited partners' roles was a partnership item that could be determined in these proceedings.

Issue(s)

Whether the distributive shares of ordinary business income allocated to limited partners in a state law limited partnership are excluded from the partnership's net earnings from self-employment under the limited partner exception of I. R. C. §

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1402(a)(13)?

Whether the determination of whether a partner is a ‘limited partner, as such’ under I. R. C. § 1402(a)(13) is a partnership item that can be addressed in a TEFRA partnership-level proceeding?

Rule(s) of Law

I. R. C. § 1402(a)(13) provides an exception to net earnings from self-employment for ‘the distributive share of any item of income or loss of a limited partner, as such. ‘ The court must interpret this provision to determine the scope of the limited partner exception.

I. R. C. § 6221 and related TEFRA provisions mandate that partnership items be determined at the partnership level. Treasury Regulation § 301. 6231(a)(3)-1(b) includes legal and factual determinations underlying partnership items as partnership items themselves.

Holding

The court held that the limited partner exception under I. R. C. § 1402(a)(13) does not apply to a partner who is limited in name only. A functional analysis test must be applied to determine if a partner is a ‘limited partner, as such. ‘ Furthermore, the court determined that this inquiry into the functions and roles of limited partners is a partnership item, properly addressed in a TEFRA partnership-level proceeding.

Reasoning

The court reasoned that the phrase ‘limited partner, as such’ in I. R. C. § 1402(a)(13) indicates that Congress intended the exception to apply only to partners functioning as passive investors, not those who are limited partners in name only. This interpretation is supported by the legislative history, which aimed to exclude earnings of an investment nature from self-employment tax. The court rejected the argument that the status of limited partner under state law automatically qualifies a partner for the exception, emphasizing the need for a functional analysis to determine whether the partner’s income is derived from passive investment or active participation in the partnership’s business.

The court further reasoned that the determination of whether a partner is a ‘limited partner, as such’ is a partnership item because it involves factual determinations underlying the calculation of the partnership’s net earnings from self-employment. This aligns with Treasury Regulation § 301. 6231(a)(3)-1(b), which includes such determinations as partnership items. Therefore, the court has jurisdiction to address this issue in a TEFRA partnership-level proceeding.

The court analyzed the proposed regulations and subsequent moratorium, noting that Congress’s concern was with Treasury’s criteria potentially excluding passive

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investors from the exception. The court distinguished this from the plain text of the statute, which requires a functional analysis of the partner's role. The court also considered the TEFRA procedures, affirming that adjustments to partnership items, including the determination of net earnings from self-employment, must be made at the partnership level.

Disposition

The court denied Soroban's Motion for Summary Judgment and granted the Commissioner's Motion for Partial Summary Judgment, affirming that a functional analysis of the limited partners' roles is required and is a partnership item subject to TEFRA proceedings.

Significance/Impact

This decision clarifies the application of the limited partner exception under I. R. C. § 1402(a)(13), requiring partnerships to conduct a functional analysis to determine if their limited partners qualify for the exclusion from self-employment tax. It impacts how partnerships report net earnings from self-employment and may influence tax planning for limited partnerships. The ruling also reinforces the scope of TEFRA partnership-level proceedings, confirming that inquiries into the roles of limited partners are partnership items that can be resolved at this level. Subsequent courts may rely on this decision when addressing similar issues, and it may prompt further guidance from the IRS on the application of the limited partner exception.

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