Limited Partner Exception to SECA Taxes: Decades of Battles, Recent Taxpayer Losses, and Open Questions

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Education. Hale holds five college degrees. At the University of Kansas, he earned a B.S., with distinction, M.A., with honors, and J.D. He later received an LL.M. degree in international law, with highest distinction, from the Universidad de Chile in South America. Finally, he obtained an LL.M. degree in tax from the University of Florida, where he was a graduate tax scholar.

Awards and Recognitions. During his studies, Hale received several awards for academic excellence, including the prestigious Harry S. Truman Foundation Scholarship, Janice Dawson Quinn Tax Scholarship, Tinker Foundation Scholarship, and Senator James B. Pearson International Fellowship. Hale also served as a graduate editor of the Florida Tax Review and member of the Kansas Journal of Law & Public Policy. Chambers USA, Legal 500, Best Lawyers in America, Law 360, and other organizations have recognized Hale as a leader in tax litigation. He has also been inducted into the American College of Tax Counsel.

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SOURCES FOR THIS OUTLINE – AVAILABLE UPON REQUEST

This outline derives from the following articles, all written by Hale. If you would like a copy of any of the articles, please send Hale an e-mail at *halesheppard@eversheds-sutherland.com* or call him at 404-853-8360. He would be glad to send you the articles.

- Analyzing the Long Journey to Chaos: SECA Taxes, Limited Partner Exception, and Effects of Government Inaction, 48(6) *JOURNAL OF CORPORATE TAXATION* 3 (2021).

- 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).

- Heads the IRS Wins, Tails the Taxpayers Lose: Analyzing Inconsistent Positions on the Meaning of "Limited Partners" 49(2) *JOURNAL OF CORPORATE TAXATION* 3 (2022).

- 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)*; republished in* 109(6) *PRACTICAL TAX STRATEGIES* 14 (2022); *republished in* 34(3) *TAXATION OF EXEMPTS* 3 (2022).

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- Same Standard, Different Taxes: The IRS and New York Attack Limited Partner Exception, 138(4) *JOURNAL OF TAXATION* 22 (2023)*;*; republished in 34(5) *TAXATION OF EXEMPTS* 25 (2023).

- Tax Court Says "As Such" Means Much: Early IRS Victory in Battle over SECA Taxes and Limited Partners," 140(2) *JOURNAL OF TAXATION* 22 (2024); republished in 35 *ESTATE PLANNING* 22 (2024).

- Partnership Wins First Appeal over Limited Partner Exception to SECA Taxes: Rulings Made and Questions Triggered, ___ *JOURNAL OF TAXATION* __ (2026); republished in 115(4) *PRACTICAL TAX STRATEGIES* 11 (2026); republished in 53(2) *CORPORATE TAXATION* 15 (2026).

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I. Introduction

A. Initial Remarks

1. Many entities treated as partnerships for tax purposes are now under attack by the Internal Revenue Service ("IRS"). What have they done wrong?

2. According to the IRS, they have incorrectly treated their owners as "limited partners," thereby allowing them to escape self-employment taxes, also known as Self Employment Contributions Act ("SECA") taxes, on their distributive shares from the partnership.

3. The broad scope of the "limited partner" exception from the outset, coupled with governmental inaction during the next five decades, has led to chaos.

II. Overview of SECA Taxes

A. SECA – Components and Magnitude

1. Amounts earned by taxpayers for working generally are subject to so-called "employment taxes."

2. When dealing with employees, they are comprised of several items, including Federal Insurance Contributions Act ("FICA") taxes, which fund Social Security and Medicare.

3. However, in situations involving sole proprietors, independent contractors, and partners, SECA taxes substitute FICA taxes.[1]

4. The SECA tax rate is 15.3 percent of "net earnings from self-employment," which can represent a big payment for some taxpayers.[2]

B. Exclusion for Limited Partners

1. The term "net earnings from self-employment" normally means gross income derived by an individual from any trade or business carried on by such individual, minus certain business-related deductions, plus his distributive share from any partnership in which he is a partner.[3]

2. Section 1402(a)(13) *excludes* from "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share to a "limited partner," as a limited partner, other than certain guaranteed payments.[4]

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[1] Section 1401(a) and (b); Revenue Ruling 69-184.
[2] Section 1401(a) and (b).
[3] Section 1402(a).
[4] Section 1402(a)(13).

III. The Long Road to Uncertainty

A. Introductory Remarks

1. The Compliance Campaign that the IRS is currently conducting, along with other events described in this outline, mean that many entities treated as partnerships are already under siege, or soon will be.

2. Partnerships and their partners will be unable to defend their positions, unless they understand where we are and how things became this warped.

3. This outline describes, largely in chronological order, the major events through 2021 that have led to the current anarchy.

B. SECA Taxes Start in 1950

1. Congress established the Social Security system in 1937. Originally, self-employed workers did not contribute to, and were not eligible to receive benefits from, the system.

2. This changed in 1950, when Congress introduced SECA taxes.[5] Distributive shares to *all* partners, both general and limited, were subject to SECA taxes initially.[6]

C. Limited Partner Exception Appears in 1977

1. Statutory Language

   a. Things changed when Congress developed a carve-out for limited partners.

   b. In 1977, Congress enacted Section 1402(a)(13), which was an exception from SECA taxes for certain "limited partners."[7] This critical provision states the following:

      i. "[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."

2. Legislative Rationale

[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).

a. Understanding why Congress created Section 1402(a)(13) is pivotal. The IRS and several courts have focused primarily, if not solely, on the following portion of the legislative history: [8]

   i. "Under present law, *each partner's share of partnership income* is includable in his net earnings from self-employment for Social Security purposes, *irrespective of the nature of his membership in the partnership*. The bill [introducing Section 1402(a)(13)] would exclude from Social Security coverage the distributive share of income or loss received by a *limited partner* from the trade or business of a limited partnership. *This is to exclude for [Social Security] coverage purposes certain earnings which are basically of an investment nature . . . .*"

b. In making determinations, the IRS and courts have often ignored other portions of the same legislative history that raise the possibility of allocating income between SECA and non-SECA amounts:

   i. "Distributive shares received as a general partner would continue to be covered [by SECA taxes]. Also, if a person is both a limited partner and a general partner in the same partnership, [only] the distributive share received as a general partner would continue to be covered [by SECA taxes]."

c. Perhaps the most critical insight from Congress comes later in the same report. It clarifies the exact problem, the perceived abuse, which Congress endeavored to solve with Section 1402(a)(13):

   i. "Your committee has become increasingly concerned about situations in which certain business organizations solicit investments in limited partnerships as a means for an investor to become insured for Social Security benefits. In these situations, the investor in the limited partnership performs no services for the partnership and the Social Security coverage which results is, in fact, based on income from an investment. This situation is, of course, inconsistent with the basic principle of the Social Security program that [Social Security] benefits are designed to partially replace lost earnings from work."

   ii. "These advertisements and solicitations are directed mainly toward public [*i.e.*, government] employees whose

[8] 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.

employment is covered by public retirement systems and not by Social Security. Also, these advertisements frequently emphasize the point that those who invest an amount sufficient to realize an annual net income of $400 or more (the minimum amount needed to receive Social Security credit in a year) will eventually gain a high return on the Social Security contributions. Many of those who invest in limited partnerships will qualify for minimum [Social Security] benefits, which are heavily weighted for the purpose of giving added protection for people who have worked under Social Security for many years with low earnings. The costs of paying these heavily weighted benefits to limited partners must, of course, be bourne by all persons covered by the Social Security program. The advertising [for the sale of limited partnership interests] injures the Social Security program in the public view and causes resentment on the part of the vast majority of workers whose employment is compulsorily covered under Social Security, as well as those people without work income, who would like to be able to become insured under the Social Security program but cannot afford to invest in limited partnerships."

d. A careful reading reveals that Congress was concerned that:

i. persons were selling limited partner interests solely for purposes of allowing individuals who were otherwise ineligible for the Social Security program to gain access,

ii. based on the minimum contribution they made to the partnerships and the minimum distributive shares they received, 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 any significant SECA taxes given the minimum distributive shares they received,

iv. the purchasers of the limited partner interests would obtain 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 abuse of the Social Security system would trigger public resentment and claims of unfairness.

3. Broad Solution to Fix Narrow Problem

a. Readers might ask why anyone in their right mind would voluntarily pay SECA taxes?

i. It made sense back then, because the SECA tax rate was low, the individuals only planned to expose a small amount of income (around $400 annually) to SECA taxes, and the value of the Social Security benefits, particularly on a weighted scale, was higher than the cost of the SECA taxes.[12]

b. To address the *very narrow problem* related to the exploitation of the Social Security program, Congress implemented a *very broad solution* in 1977. Namely, it introduced Section 1402(a)(13), which generally excludes from the definition of "net earnings from self-employment," and thus from payment of SECA taxes, the distributive share to a "limited partner."

c. Congress effectively turned the tables because of its actions. From that point forward, as the SECA tax rate increased, the types of business entities available proliferated, and the longevity and financial stability of the Social Security system came into question, many taxpayers arranged their affairs to fit within the "limited partner" exception in Section 1402(a)(13).

D. IRS Introduces First Proposed Regulations in 1994

1. The IRS issued its first set of proposed regulations about Section 1402(a)(13) in 1994 ("First Proposed Regulations").[13]

2. They contained rules for treatment of limited partners in partnerships, as well as members of limited liability companies ("LLCs").

3. Under the First Proposed Regulations, the amount subject to SECA taxes generally included an individual's distributive share from any trade or business carried on by an LLC of which the individual was a member.

4. They explained that a member of an LLC would be treated as a "limited partner" for purposes of Section 1402(a)(13) if the member met two criteria.

a. First, the member could not be a "manager" of the LLC; and

[12] 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).
[13] 59 Fed. Reg. 67253, EE-45-94 (Dec. 29, 1994).

b. Second, the pertinent entity could have been formed as a limited partnership instead of an LLC, and the member could have qualified as a limited partner instead of a member.

5. What was the IRS trying to accomplish with the second criteria?

a. The Preamble explained that state laws prohibited taxpayers from conducting certain activities through partnerships, and the IRS did not want to allow a business operating as an LLC to obtain a result for SECA tax purposes that it could not otherwise achieve functioning as a limited partnership.

b. The Preamble noted that a limited partner could potentially become liable for the debts and other obligations of a limited partnership, if he were to participate in the management or control of the business. Therefore, the IRS aimed to ensure that a member of an LLC, and a limited partner in a limited partnership, who got involved in management or control of an entity to the same degree would be treated similarly for purposes of SECA taxes.

E. IRS Introduces Second Proposed Regulations in 1997

1. After reviewing written comments from the public about the First Proposed Regulations and holding a hearing, the IRS decided to revamp its approach.

2. In 1997, it withdrew the First Proposed Regulations and released a new set ("Second Proposed Regulations").[23]

3. This time, the IRS provided guidance covering *all* entities classified as partnerships for federal tax purposes, not just LLCs.

a. The updated rules arguably encompassed limited partnerships, LLCs, limited liability partnerships ("LLPs"), limited liability limited partnerships ("LLLPs") and other entities that had emerged since Congress introduced the "limited partnership" exception to SECA taxes 20 years earlier, back in 1977.

4. New Definition of "Limited Partner"

a. The Second Proposed Regulations maintained the exception in Section 1402(a)(13) that "limited partners" ordinarily are not exposed to SECA taxes on their distributive shares.

[23] 62(8) Fed. Reg. 1701 (Jan. 13, 1997); 62(8) Fed. Reg. 1702 (Jan. 13, 1997); REG-209824-96.

b. However, they changed the definition of "limited partner." The Second Proposed Regulations 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 for more than 500 hours during a year.

5. Service Partners in Service Partnerships

a. The Second Proposed Regulations indicated that an individual who is a "service partner" in a "service partnership" would *not* be a limited partner.

b. The term "service partner" meant a partner who provided services to a partnership or on behalf of a partnership's trade or business.

c. 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.

6. Example

a. The Second Proposed Regulations offered one detailed example.

i. *Facts*. A, B, and C form LLC, a limited liability company, under the laws of a state to engage in a business that is not a "service partnership." LLC, classified as a partnership for federal tax purposes, allocates all items of income, deduction, and credit of LLC to A, B, and C in proportion to their ownership of LLC. A and C each contribute $1x for one LLC unit. B contributes $2x for two LLC units. Each LLC unit entitles its holder to receive 25 percent of LLC's tax items, including profits. A does not perform services for LLC; however, each year B receives a guaranteed payment of $6x for 600 hours of services rendered to LLC, and C receives a guaranteed payment of $10x for 1000 hours of services rendered to LLC. C also is elected LLC's manager. Under applicable state law, C has the authority to contract on behalf of LLC.

ii. *Application of new definition of limited partner*. A is treated as a limited partner because A is not liable personally for debts of or claims against LLC, A does not have authority to contract for LLC under State's law, and A does not participate in LLC's trade or business for more than 500 hours during the taxable year. Therefore, A's distributive share attributable to A's LLC unit is excluded from A's net earnings from self-employment under Section 1402(a)(13).

iii. *Application of the special rule for individuals who hold one class of interest and significantly participate in the partnership*. B's guaranteed payment of $6x is included in B's net earnings from self-employment. B is not treated as a limited partner because, although B is not liable for debts of or claims against LLC and B does not have authority to contract for LLC under applicable state law, B participates in LLC's trade or business for more than 500 hours during the taxable year. Further, B is not treated as a limited partner under the special rule for certain individuals holding more than one class of interest because B does not hold more than one class in LLC. However, B is treated as a limited partner because B is not treated as a limited partner under the new definition solely because B participated in LLC's business for more than 500 hours, and because A is a limited partner under the new definition who owns a substantial interest with rights and obligations that are identical to B's rights and obligations. In this example, B's distributive share is deemed to be a return on B's investment in LLC and not remuneration for B's service to LLC. Thus, B's distributive share attributable to B's two LLC units is not net earnings from self-employment.

7. IRS Rationales

a. The Preamble to the Second Proposed Regulations explained that the IRS wanted the same standards to apply to owners of an interest in a limited partnership and owners of any other entity treated as a partnership, such as an LLC.

b. To achieve the desired "conformity," the IRS adopted a method that looked to the relationship between the individual, the partnership, and the partnership's business.

c. The IRS further explained that it decided to use "functional tests" to ensure that different individuals, owning interests in similar entities formed under different state laws, would be treated the same.

d. It then noted that "functional tests" were necessary because of the proliferation of new types of business entities after Section 1402(a)(13) was enacted in 1977 and because of the evolution of limited partnership statutes in various states.

e. The Preamble underscored that whether state law characterized an individual as a "limited partner" was "not determinative" for purposes of the Second Proposed Regulations.[40]

F. Congress Imposes a Moratorium in 1997

a. In a demonstration of governmental gridlock and political pandering, Congress stopped the IRS in its proverbial tracks.

b. Specifically, Congress enacted a law in 1997 expressly 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."[41]

c. This created a moratorium on regulations for about 18 months.

d. Congress explained in the legislative history, in a segment labeled "Sense of the Senate," that the IRS should withdraw the Second Proposed Regulations and "Congress [not the IRS] should determine the tax law governing self-employment income."[42]

e. In summary, Congress flexed its muscle to halt the IRS in 1997, declaring that only the legislative branch (*i.e.*, Congress), and not an agency of the executive branch (*i.e.*, the IRS), had authority to create law. Lamentably for the entire tax system, Congress has not issued any legislation to resolve the "limited partner" matter in two and one-half decades and the IRS, likewise, has not advanced any regulatory actions.

G. Various Groups Offer Proposals from 1998 to 2005

1. Several groups offered proposals in hopes of influencing Congress to take action during or soon after the moratorium.[43] Such action never occurred.

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[40] 62(8) Fed. Reg. 1703 (Jan. 13, 1997); REG-209824-96; Preamble – Explanation of Provisions.
[41] Taxpayer Relief Act of 1997, Public Law 105-34, Section 935 (Aug. 5, 1997).
[42] U.S. House of Representatives. Taxpayer Relief Act of 1997, Conference Report, 105th Congress, 1st Session, Report 105-220, July 30, 1997, pg. 765.
[43] *See, e.g.,* New York State Bar Association Tax Section, Legislative Proposal Regarding Employment Taxes and Professional Services Businesses (Sept. 21, 2010).

2. The proposals are nuanced. None is exactly the same, but they can be divided into three options for defining the SECA tax base.[44]

   a. The first is employing a "material participation" standard, which would apply rules similar to those currently utilized in passive activity loss-limitation cases under Section 469. With this option, individuals who materially participate in the business of the entity would be treated like *general* partners, while non-material participants would enjoy preferential treatment like *limited* partners.

   b. The second main option is the "reasonable compensation" standard. Currently, corporations must report "reasonable compensation" earned by their shareholders, and employment taxes, called FICA taxes in that context, are imposed on such compensation. Some proposed applying the same standard to entities classified as partnerships, thereby exposing to SECA taxes *only* the amount deemed to be reasonable compensation paid by the partnership for services rendered by the partner.

   c. The third option employs a "safe harbor" calculation of capital income to partners. Here, partnerships would apply a standard formula to determine the amount of income that would be considered a return on the capital investment by the partners, and thus free from SECA taxes. Partners would identify their capital base by adding the values of their capital assets, just as partnerships do when providing a balance sheet to the IRS. The partners would then multiply the total value of their capital base by 150 percent of the maximum Applicable Federal Rate for the relevant year. This, in theory, would show a reasonable rate of return on capital investment in partnerships by the partners. To put things in perspective, the rate of return in 2004 would have been 5.37 percent using the safe harbor formula.

H. IRS Gives Taxpayers Hope in 2003

1. An IRS official gave taxpayers some hope in 2003. She stated during a public event that "[if] the taxpayer conforms to the latest set of proposed rules [*i.e.*, the Second Proposed Regulations], we generally will not challenge what they do or don't do with regard to self-employment taxes."[48]

I. IRS and Courts Publish Rulings – Focus on 2011

[44] Congressional Budget Office. The Taxation of Capital and Labor Through the Self-Employment Tax. Publication 4168 (Sept. 2012), pgs. 18-23.

[48] Allison Bennett. Taxpayers Can Rely on Proposed Regulations for LLC Self-Employment Taxes, Clark Says, 114 Daily Tax Report G-3 (June 13, 2003).

1. The IRS has issued various administrative rulings, and the courts have published several decisions, involving "limited partners" and SECA taxes over the years.

2. Importantly, most of those items are of questionable value to the IRS in future tax disputes with partnerships.

    a. This is because several came in the form of Chief Counsel Advisories. The Internal Revenue Code expressly states that "written determinations" of this sort ordinarily cannot be used or cited as precedent.[52]

    b. Other authorities consist of "Memorandum Opinions" by the Tax Court, which also fall short of the precedential bar.

3. Most Famous Case – First Precedential Case

    a. The seminal case in this area is *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*.[54]

    b. Three individual partners and one corporate partner formed an LLP under Kansas law to operate their law practice ("Law Firm").

    c. The Law Firm filed a timely Form 1065 (U.S. Return of Partnership Income) for 2004, showing revenues primarily generated by the performance of legal services.

    d. The Law Firm made distributions to the individual partners that year, did not report them as "net earnings from self-employment" by the Law Firm, and thus did not subject them to SECA taxes.

    e. The Law Firm made distributions to the individual partners in 2005, which were devoid of SECA taxes again.

    f. The IRS audited the Law Firm and made some adjustments, the most important of which was recharacterizing the distributive shares in 2004 and 2005 as "net earnings from self-employment," not protected by the "limited partner" exception in Section 1402(a)(13).

    g. The Law Firm challenged the IRS in Tax Court. The Law Firm argued that its three partners, who were partners in an LLP formed under Kansas law, should be treated as "limited partners" under Section 1402(a)(13) because (i) their interests are specifically called limited partner interests in the Law Firm's organizational documents, and (ii) the partners each had limited liability under

[52] Section 6110(k)(3) and Section 6110(b)(1)(A).
[54] *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011).

Kansas law. In other words, the Law Firm endeavored to focus the issue solely on state law titles and exposure.

h. The Tax Court disagreed with the Law Firm.

   i. It began by explaining the major differences between general partners and limited partners, in terms of management power and personal liability, concluding that a limited partner interest "is generally akin to that of a passive investor."

   ii. The Tax Court indicated that an LLP is a different beast; it is essentially a general partnership that affords limited liability protection to all partners.

   iii. The Tax Court went on to explain that the predecessor to Section 1402(a)(13), which uses the phrase "limited partner," was enacted *before* LLPs and other modern entity forms came into existence.

   iv. 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.

i. Without any additional guidance since then, from Congress or the IRS, the Tax Court indicated that it must engage in an exercise of statutory interpretation to determine what, exactly, Congress meant when it used the term "limited partner" in the context of SECA taxes and Section 1402(a)(13). It looked to just one portion of the legislative history, which stated the following:

   i. "The bill would exclude from [SECA tax] coverage the distributive share of income or loss received by a limited partner from the trade or business of a limited partnership. *This is to exclude for [SECA tax] coverage purposes certain earnings which are basically of an investment nature*."

j. The Tax Court believed that this "insight" showed that Congress intended to ensure that individuals who merely invested in a partnership and did not actively participate in its business operations would not receive credits toward Social Security coverage.

k. The Tax Court went on to explain that the legislative history does not support the notion that Congress contemplated excluding partners who performed services for a partnership, in their capacity as partners, from SECA taxes.

l. 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 in exchange for their partnership interests, and the distributive shares that they received were not, to cite the legislative history, "earnings which are basically of an investment nature." Accordingly, the Tax Court concluded that the partners must pay SECA taxes on their distributive shares and the exception under Section 1402(a)(13) does not apply.

J. IRS Authorities Gives Taxpayers More Hope in 2011

1. An attorney in the IRS's National Office announced during a conference organized by the American Bar Association in 2011 that, despite the holding in *Renkemeyer*, the Second Proposed Regulations had not been withdrawn and taxpayers "could rely" on them.[59]

2. Others have explained that "IRS officials have said many times that the [IRS] will not challenge positions taken by taxpayers who rely on the proposed regulations to determine that a partner's earnings are not subject to self-employment tax."[60]

K. IRS Initiates Compliance Campaign in 2018

1. The IRS claims that certain taxpayers are inappropriately taking advantage of Section 1402(a)(13).

   a. According to the IRS, some entities treated as partnerships are classifying *all* members as "limited partners," thereby avoiding SECA taxes on partnership distributions altogether.

   b. Other partnerships are taking a more moderate approach, arguing that only a portion of the distributions should be subject to SECA taxes. They accomplish this by labeling some amounts as wages or guaranteed payments to partners, while the rest is classified as a distributive share to "limited partners" and thus exempt from SECA.

2. The IRS, therefore, initiated a Compliance Campaign in 2018 to halt these practices, summarizing the problem as follows:

   a. "Partners report income passed through from their partnerships. Unless an individual partner qualifies as a "limited partner" for [SECA] tax purposes, the partner's distributive share is subject to

[59] Monte A. Jackel. "Has Politics Trumped Policy?" 131 Tax Notes 745 (May 16, 2011); Shamik Trivedi. "After Renkemeyer, Passthroughs Can Still Rely Safely on Proposed Regs, Officials Say," 131 Tax Notes 675 (May 16, 2011).

[60] Amy S. Elliott. "Tax Court Decision Could Reignite Debate Over Partnerships and Employment Taxes," Tax Analysts Doc. 2011-5140 (March 11, 2011).

[SECA taxes]. Some individual partners, including service partners in service partnerships organized as state-law limited liability partnerships, limited partnerships, and limited liability companies, have inappropriately claimed to qualify as "limited partners" not subject to SECA tax."[61]

L. IRS Issues Concept Unit in 2019

1. The IRS introduced a Concept Unit to its personnel to assist them in implementing the Compliance Campaign. The Concept Unit contained a few noteworthy items.[62]

   a. First, it acknowledged that Section 1402(a)(13) does not define the term "limited partner" and final regulations are non-existent, such that IRS personnel must rely solely on legislative history and case law in making determinations.

   b. Second, the Concept Unit states that it is not restricted to just limited partnerships and LLCs; it applies to *all* entities treated as partnerships for federal tax purposes, including joint ventures, LLCs, LLPs, LLLPs, limited partnerships, and other entities.

   c. Third, the Concept Unit instructs IRS personnel to ignore the long list of the taxpayer-favorable decisions regarding limited partners and the passive activity loss-limitation rules under Section 469. The Concept Unit states that "the material participation rules under [Section] 469 have no bearing on whether an individual partner may be subject to self-employment taxes under [Section] 1402."

   d. Fourth, the Concept Unit devotes three pages to a discussion of the Second Proposed Regulations, which were never finalized.[66] Interestingly, the IRS appears to have decided to overlook the incomplete status of the Second Proposed Regulations. The Concept Unit makes the following declaration in this regard:

      i. "The 1997 Proposed Regulations are not final. They may not be enforced on taxpayers. Instead, the applicable analysis is the statutory language [in Section 1402(a)(13)], legislative history, and case law. *Taxpayers, however, may rely on the 1997 Proposed Regulations. In other words, the IRS will respect a partner's status as a limited partner if the*

[61] *www.irs.gov/businesses/corporations/lbi-active-campaigns*
[62] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, February 13, 2019, pg. 10.
[66] Internal Revenue Service. LB&I Concept Unit – Partnerships, Self-Employment Tax and Partners, February 13, 2019, pgs. 19-21.

partner qualifies as a limited partner under the 1997 Proposed Regulations."

2. This announcement in the Concept Unit that the IRS will respect the taxpayer's choice of applying the Second Proposed Regulations is consistent with at least two earlier statements, by high-ranking IRS officials, back in 2003 and 2011.

M. IRS Removes Issue from Its List of Priorities in 2019

1. For many years, the annual "Priority Guidance Plan" published by the IRS contained the following entry: "Guidance on the application of [Section] 1402(a)(13) to limited liability companies."[68]

2. This disappeared after 2018, without the IRS issuing guidance.[69]

N. Presidential Administration Urges Congressional Action in 2021

1. The Administration issued its revenue proposals for 2022 ("Green Book").[70]

2. One goal was to "rationalize" conflicting rules relating to SECA taxes. The Green Book explains that, because Section 1402(a)(13) only refers to "limited partners," questions have arisen regarding whether it encompasses members of LLCs and owners of other pass-through entities.[71]

3. The Green Book contained various proposals aimed at solving the perceived problem. One was passing legislation that would cause limited partners and members in LLCs who "materially participate" in a business to pay SECA taxes on their distributive shares until reaching a certain threshold.[72]

O. IRS Representatives Threaten More Litigation in 2021

1. Attorneys from the IRS's National Office announced in 2021 that the IRS intends to continue auditing and litigating "limited partner" and SECA tax cases because it has been "fairly successful" in this area.[73]

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[68] *See*, *e.g.*, U.S. Treasury Department, Office of Tax Policy and Internal Revenue Service. 2015-2016 Priority Guidance Plan (July 31, 2015), pg. 11.
[69] U.S. Treasury Department, Office of Tax Policy and Internal Revenue Service. 2019-2020 Priority Guidance Plan – Fourth Quarter Update (Sept. 2, 2020).
[70] U.S. Treasury Department. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021).
[71] U.S. Treasury Department. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), pg. 65.
[72] U.S. Treasury Department. General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals (May 2021), pgs. 66-67.
[73] Kelley R. Taylor, "Clarity regarding 'Limited Partner' under SECA Remains Elusive," 2021 Tax Notes Today Federal 112-2 (June 11, 2021).

IV. Key Administrative Rulings and Court Cases

A. Introduction

1. Section 1402(a)(13) was enacted more than four decades ago, yet the number of IRS rulings and court cases addressing this critical provision are few. Some key ones are examined below.

B. Two Cases involving Working Interests

1. The Tax Court wrestled with two cases involving taxpayers who purchased working interests in oil and gas wells, considered it an investment, did not participate in the activity, reported the resulting income on their Forms 1040, but did not pay SECA taxes on such amounts.

2. Johnson v. Commissioner

   a. In the first case, *Johnson v. Commissioner*, the taxpayer owned working interests in several oil and gas properties in 1987.[74] The taxpayer had limited knowledge about mineral extraction, did not participate in the operations, and was "an inactive investor." She reported the income from the working interests on her Form 1040, but she did not pay SECA taxes.

   b. The IRS audited the taxpayer and ultimately issued a Notice of Deficiency claiming that (i) her working interests constituted carrying on a trade or business, either as a partner or through an agent, and (ii) she should have paid SECA taxes on the income distributed to her from such business.

   c. The taxpayer disputed the IRS's allegations by filing a Petition with the Tax Court. She argued that the working interests were "merely investments" and her lack of activity indicated that she was not engaged in any business.

   d. The Tax Court held in favor of the IRS. It explained that the definition of "partnership" in the Internal Revenue Code is quite broad, encompassing syndicates, groups, pools, joint ventures and other non-corporation organizations through which any business, operation or venture is carried out. After reviewing the standard Operating Agreement that the taxpayer signed, the Tax Court determined that the various owners of working interests, including the taxpayer, created a pool or joint venture. Because a pool or joint venture is considered a partnership for federal tax purposes, the income that the taxpayer received is a distributive share from a

[74] *Johnson v. Commissioner*, T.C. Memo 1990-461.

partnership. Therefore, the Tax Court concluded, the general rule dictates that the taxpayer should pay SECA taxes.

e. The taxpayer countered that, even if she were deemed to be a partner in a partnership, she should still be free from SECA taxes because she was a "limited partner" under Section 1402(a)(13).

f. The Tax Court did not challenge the taxpayer's minimal role, nor did it question the existence of the "limited partner" exception. However, the Tax Court emphasized that the taxpayer had failed to follow the requisite formalities. It summarized the conundrum as follows: "The short answer to this contention is that [the taxpayer] is bound by the form in which she cast her transaction" and her "argument is not persuasive because she and the other working interest owners did not take the necessary steps to comply with Texas law." In other words, the Tax Court announced that while taxpayers can form a general partnership informally, they must jump through all the proverbial hoops to create a limited partnership under state law.

3. Perry v. Commissioner

a. The second case, *Perry v. Commissioner*, featured nearly identical facts, legal issues, and conclusions.[75] The Tax Court held that the taxpayer was not a "limited partner" because "state law requires that certain formalities be observed to create a limited partnership [and] there is no evidence of such formalities having been observed by the owners of the interests in the wells."

C. Three Private Letter Rulings about Entity Conversions

1. The IRS issued three private letter rulings ("PLRs") close in time addressing various tax issues triggered by converting a general partnership into an LLC, PLR 9432018, PLR 9452024, and 9525058.

2. The first vaguely stated that the entity performed professional services, the second involved a group of doctors running a medical practice, and the third addressed several attorneys practicing law together.

3. All the partners, who were to become members in LLCs, actively engaged in their respective businesses.

4. The IRS concluded in all three instances that the new entities would be treated as partnerships for federal tax purposes.

[75] *Perry v. United States*, T.C. Memo 1994-215.

5. It also determined that the distributive shares received by the members would not be exempt from SECA taxes under the "limited partner" exception found in Section 1402(a)(13). The IRS's reasoning for this second conclusion was sparse, with only PLR 9432018 providing any specifics. It stated that the new LLC is not a limited partnership, the members of the LLC are not limited partners (although they might be treated as such in certain contexts), and the members will engage in the daily activities of and perform substantial services for the LLC. Accordingly, the income allocated to each member of the LLC constitutes "net earnings from self-employment" and should be subject to SECA taxes.

D. Norwood v. Commissioner

1. The sole issue in *Norwood v. Commissioner* was whether the taxpayer was liable for SECA taxes on a distribution from a partnership.[76]

2. The taxpayer was a general partner in a medical supply company, owning nearly 51 percent of the interests. He worked diligently, on a full-time basis, at the company during the first few years. His participation waned after that. Indeed, once the staff was capable of operating the business without him, he essentially stopped working there. His activities were reduced to making periodic appearances and being consulted on major decisions. In 1995, the taxpayer received a distributive share, reported it on his Form 1040, and paid the corresponding income taxes. He did not pay SECA taxes, though, which the IRS disliked. The fight ended up in Tax Court.

3. The taxpayer argued that his role in the company was minimal and passive during 1995, such that he should be shielded from SECA taxes by the "limited partner" exception in Section 1402(a)(13).

4. The IRS suggested that whether the taxpayer were active or passive with respect to the company is irrelevant because he was a general partner, not a limited one.

5. The Tax Court sided with the IRS, explaining that "[t]he passive activity rules under Section 469 have no application in this case," the taxpayer's "lack of participation in or control over the operations of [the company] does not turn his general partnership interest into a limited partnership interest," and "a limited partnership must be created in the form prescribed by state law."

E. Renkemeyer, Campbell & Weaver, LLP v. Commissioner

1. See summary earlier in this outline.

[76] *Norwood v. Commissioner*, T.C. Memo 2000-84.

F. Riether v. United States

1. The key issue in *Riether v. United States* was whether taxpayers must treat the distributive shares that they received from an LLC formed in New Mexico as income subject to SECA taxes under Section 1402.

2. The taxpayers, husband and wife, owned the LLC.[77] The husband worked as a radiologist, providing medical services through the LLC. It appears that the taxpayers tried to apportion their income from the LLC. They reported a part as wages on Forms W-2 (Wage & Income Statement), and thus were subject to income taxes, FICA, etc. They reported the remainder as passive income not subject to SECA taxes.

3. The IRS audited the taxpayers, disagreed with the income bifurcation, and determined that the remainder from the LLC was subject to SECA taxes.

4. The District Court discussed the entity-classification rules and the fact that the LLC did not elect to be treated as a corporation, such that it was a partnership by default for federal tax purposes. The District Court pointed out that the only argument raised by the taxpayers was that they received a Form W-2 from the LLC, such that they were employees, and since they were employees, they were not self-employed. The District Court found this position "interesting but unpersuasive."

5. Citing to Revenue Ruling 69-184, the District Court said that the taxpayers should have treated *all* their income from the LLC as self-employment income because "members of a partnership are not employees of the partnership" for purposes of self-employment taxes. The District Court said that the taxpayers were members in an LLC, not partners in a partnership. Moreover, even if the relevant entity were a partnership, the taxpayers do not resemble limited partners, who lack management powers and are not liable for debts of the partnership. The District Court thus concluded that "whether the [taxpayers] were active or passive in the production of the LLC's earnings, those earnings were self-employment income."

G. Howell v. Commissioner

1. The sole issue in *Howell v. Commissioner* was whether the taxpayer was liable for SECA taxes on payments that she received from an LLC formed in California.[79]

2. The husband of the taxpayer invented the concept that led to the formation of LLC. Nevertheless, the husband decided to make his wife, the taxpayer, the primary member in the LLC because she had a better credit history. This

[77] *Riether v. United States*, 919 F. Supp. 2d 1140 (2012).
[79] *Howell v. Commissioner*, T.C. Memo 2012-281.

would help the LLC in obtaining loans, credit cards, approvals, favorable interest rates, etc.

3. The taxpayer held a 60 percent interest in the LLC. The LLC entered into a Management Agreement with the husband, which delegated to him total and exclusive control of all management and operations of the LLC.

4. The LLC was treated as a partnership for federal tax purposes and filed a Form 1065 each year. It characterized certain amounts to the taxpayer as "guaranteed payments" on its Forms 1065, claiming the related deduction. The taxpayer, by contrast, eventually filed her Forms 1040 characterizing the same income as a distributive share, passive in nature, and not subject to SECA taxes.

5. The IRS started an audit of LLC, which soon broadened to cover the taxpayer, too. The IRS eventually issued a Notice of Deficiency.

6. The taxpayer contended that none of the amounts received from the LLC should be subject to SECA taxes because (i) the LLC mistakenly characterized some amounts as guaranteed payments on its Forms 1065 and (ii) she was a limited partner and thus exempt from SECA taxes under Section 1402(a)(13).

7. The IRS countered that the taxpayer previously admitted that certain amounts were guaranteed payments by labeling them as such on Forms 1065 filed by the LLC and she cannot disavow her reporting position only after being caught by the IRS. The IRS further argued that the taxpayer was an active participant in the LLC, and such participation precluded her from enjoying the exclusion from SECA taxes for "limited partners."

8. The Tax Court explained the general rule in Section 1402, the exception for limited partners, and the fact that the key term is not defined by statute. Next, the Tax Court summarized the earlier holding in *Renkemeyer*, emphasizing that the taxpayers in that case were not limited partners because their distributive shares arose from the legal services that they performed for the Law Firm and not from a passive return on investment.

9. The Tax Court then went through the two main arguments raised by the IRS. First, the Tax Court held that the taxpayer could not disavow, after the fact, the previous classification of certain amounts as "guaranteed payments." It pointed out that the taxpayer officially controlled the LLC, provided the tax-related data to the accountant, served as the Tax Matters Partner of the LLC, signed the Forms 1065, and only attempted to change the character of the income after the IRS had started the audit and raised the SECA tax issues. Even if the taxpayer had met the criteria to disavow the earlier classification, the Tax Court said that she still failed because she could not offer "strong proof" that the original reporting by the LLC on its Forms 1065 was

incorrect. The only evidence offered was a conclusory statement by the accountant, which the Tax Court found "self-serving and unreliable."

10. With respect to the "limited partner" argument, the Tax Court underscored that, according to the Operating Agreement for the LLC, the taxpayer contributed intellectual property, a business plan, and organizational design. She also executed the Management Agreement between her husband and the LLC. In addition, she testified that she provided marketing advice, implemented sales strategies, served as Tax Matters Partner, and used her personal credit card to purchase equipment for the LLC. Based on this, the Tax Court held that the taxpayer performed services for the LLC and was not merely a passive investor. Accordingly, the amounts she received were a distributive share subject to SECA taxes because the taxpayer was not a "limited partner."

H. Chief Counsel Advice 201436409

1. The main facts in Chief Counsel Advice 201436409 were as follows.[80]

2. The Management Company was an LLC treated as a partnership for federal tax purposes. It was formed to be the successor to an S corporation that previously served as investment manager to various funds. The Management Company had full authority to manage and control the business of each fund, conducted market research, and effectuated trading activity. The Management Company's primary source of income derived from management fees paid by each of the funds.

3. Several individuals were partners in the Management Company. They worked on a full-time basis, providing a wide range of investment-related services. The partners each held so-called "units" in the Management Company, pursuant to which they received a "distributive share."

4. The Management Company bifurcated the payments to the individual partners, classifying certain amounts as guaranteed payments and subjecting them to SECA tax, and classifying the majority as payments to "limited partners" exempt from SECA tax under Section 1402(a)(13). The Management Company reasoned that it had the same role as the S corporation that it succeeded, such that it was entitled to continue following the same "reasonable compensation" principles applicable to S corporations.

5. The IRS offered some introductory analysis, (i) explaining that Section 1402(a)(13) was enacted in 1977 before modern business forms, like LLCs, were common, (ii) suggesting that Revised Uniform Limited Partnership Act indicates that a "limited partner" loses his status if he participates in

[80] Chief Counsel Advice 201436409.

control of the business, and (iii) summarizing the Tax Court's holdings in *Renkemeyer* and *Riether*.

6. The IRS then turned to the facts at hand.

   a. It indicated that the partners of the Management Company performed extensive services in their capacity as partners and generated essentially all the income for the entity. Accordingly, reasoned the IRS, such income "is not income which is basically of an investment nature of the sort that Congress sought to exclude from self-employment tax when it enacted the predecessor to Section 1402(a)(13)."

   b. The IRS also opined that, even though the partners paid more than a nominal amount for their units in the Management Company, the income they received was not passive.

   c. The IRS further warned, based on the holding in *Riether*, that taxpayers, like the Management Company, cannot unilaterally change the character of distributive shares by simply labeling a portion as guaranteed payments.

   d. Finally, the IRS concluded that the Management Company was an LLC, not an S corporation, such that it cannot rely on the "reasonable compensation" rules when distributing payments to its members.

I. Chief Counsel Advice 201640014

1. The Franchisee in Chief Counsel Advice 201640014 was the majority owner of an LLC, which was treated as a partnership for federal tax purposes.[81] The LLC owned and operated various chain restaurants, deriving most of its income from food sales.

2. The agreements between the Franchisee and Franchisor mandated that the Franchisee personally devote full-time and best efforts to operating the restaurants. Similarly, the Operating Agreement for the LLC (i) named the Franchisee as President, Chief Executive Officer, and Manager, (ii) indicated that he would conduct all business affairs, and (iii) granted him authority to make all major decisions, participate in legal proceedings, enter into real property contracts, loan money, invest, oversee employees, handle correspondence, establish pension plans, appoint others to act as supervisors, hire outside accounting, legal and other professionals, etc.

3. The LLC bifurcated the amounts it paid to the Franchisee each year.

[81] Chief Counsel Advice 201640014.

a. Certain amounts were treated as guaranteed payments, similar to reasonable compensation for services provided by the Franchisee, and subject to SECA taxes.

b. Other amounts were characterized as passive income, attributable to return on capital invested or the efforts of others, and not subject to SECA taxes. Regarding the second category, the LLC believed that the Franchisee was entitled to certain passive income thanks to the significant cash capital contributions he made, which were deployed to buy buildings and equipment, make improvements, hire employees, and more.

4. In addressing the limited partner exception issue, the IRS pointed out the following: (i) The Franchisee had sole authority over the LLC; (ii) He was the President, Chief Executive Officer and Manager; (iii) Even though the LLC had several executive-level employees, he was the only active member of the LLC; and (iv) He participated in the LLC's operations and management, in his capacity as a member, and was not a mere investor. Consequently, the IRS determined that the Franchisee could not benefit from the "limited partner" exception in Section 1402(a)(13).

5. The LLC conceded that, pursuant to the legislative history, as quoted in *Renkemeyer*, service partners, like the Franchisee, are not "limited partners." However, the LLC argued that it was distinct because it derived income from the sale of products instead of services, the Franchisee made significant capital contributions to the LLC, and the Franchisee delegated significant management responsibilities to executive-level employees. The LLC urged the IRS to apply substance-over-form principles to allow a portion of the distributive share to the Franchisee to be treated as passive return on investment.

6. The IRS rejected this suggestion, indicating that the LLC was confusing the SECA tax rules for partners and the employment tax rules for corporate shareholder employees.

7. In short, the IRS stated that the LLC "is not a corporation and the 'wage' and 'reasonable compensation' rules which are applicable to corporations . . . do not apply."

8. The IRS went on to explain that, although the Tax Court in *Renkemeyer* identified the small capital contributions by the partners as one of the factors in its decision that the partners were not "limited partners," that case does not stand for the idea that a capital-intensive partnership should be treated like a corporation for employment tax purposes.

J. Hardy v. Commissioner

1. *Hardy v. Commissioner* is a rarity in that the taxpayer prevailed on the "limited partner" issue.[82]

2. The taxpayer was a plastic surgeon who operated a medical practice through one LLC that he wholly owned. Surgical procedures generally have three fee components: a fee for the doctor, a fee for the anesthesiologist, and a fee for the surgical facility. The taxpayer performed medical procedures in various facilities, including Missoula Bone & Joint Surgery Center, LLC ("MBJ"). The taxpayer held a minority interest in MBJ, but he never managed it, had day-to-day responsibilities, provided input for operational decisions, or got involved with personnel matters. The taxpayer only performed surgeries at the MBJ facility about once a week, and he received a distribution from MBJ regardless of how many surgeries he did there.

3. The taxpayer reported passive income on his Form 1040 from MBJ during the relevant years, thus acknowledging that he was not "materially participating" for purposes of Section 469. The taxpayer did not, however, claim that he was entitled to the "limited partner" exception to SECA taxes under Section 1402(a)(13). Instead, he reported ordinary income from MBJ and paid the related SECA taxes.

4. The IRS audited. Among other things, it took the position that the income from MBJ was not passive, such that it could not be offset by a passive loss carryover from an earlier year.

5. The taxpayer ultimately took his dispute to the Tax Court. One point of contention was whether the taxpayer should have paid SECA taxes on the distributions he received from MBJ. The taxpayer suggested to the Tax Court that he never should have paid those in the first place, and the IRS owed him a refund.

6. The Tax Court determined that the taxpayer did not materially participate in the activities of MBJ, such that the income flowing to him from such entity was passive for purposes of Section 469.

7. The Tax Court then turned to the related issue; that is, whether the income from MBJ was exempt from SECA taxes under Section 1402(a)(13) because the taxpayer was a "limited partner."

8. The IRS argued that the taxpayer was not a "limited partner" in MBJ because he performed certain procedures at the surgical center operated by MBJ.

9. The Tax Court rejected that contention. It acknowledged the holding in *Renkemeyer,* as well as the discussion in that case about the pertinent legislative history. However, the Tax Court pointed out that (i) the taxpayer

[82] *Hardy v. Commissioner*, T.C. Memo 2017-16.

was "an investor" in MBJ, (ii) he used the surgical facility only 10 percent of the time, (iii) he was not involved in the business operations of MBJ, and (iv) the patients paid MBJ for use of the medical facility, but they separately paid the taxpayer for his surgical services. Therefore, the Tax Court held that the taxpayer was a "limited partner" not subject to SECA taxes with respect to MBJ.

K. Castigliola v. Commissioner

1. The taxpayers in *Castigliola v. Commissioner* were a group of attorneys who practiced law through a firm organized as a professional limited liability company ("PLLC") in Mississippi.[83] The PLLC was treated as a partnership for federal tax purposes, filing an annual Form 1065. During the relevant years, the firm had a Compensation Agreement, which called for certain guaranteed payments to the members. Any amounts remaining thereafter were distributed to the members.

2. Based on the advice of their longstanding accountant, the taxpayers reported the guaranteed payments as self-employment income and paid SECA taxes, but they did not pay SECA taxes on their distributive shares in excess of the guaranteed payments.

3. The IRS audited the taxpayers and claimed that *all* amounts received from the PLLC should have been subject to SECA taxes. The dispute eventually found its way to Tax Court.

4. The Tax Court began by acknowledging and summarizing *Renkemeyer*. Based on that case, the Tax Court held that its first job was to determine whether the party claiming the benefit of the "limited partner" exception under Section 1402(a)(13) held a position that is functionally equivalent to that of a limited partner in a limited partnership. In other words, "the issue is whether a member of such a [member-managed] PLLC is functionally equivalent to a limited partner in a limited partnership."

5. The Tax Court examined several sources describing the characteristics of a limited partnership. It observed that the most common were limited liability and lack of control over the business. In this case, the PLLC was member-managed, such that each attorney had power over the business. The Tax Court pointed out that the PLLC lacked a written Operating Agreement or any other evidence of limitations on control. Moreover, all members actually participated in control by supervising associate attorneys and making decisions about distributive shares, borrowing money, personnel, etc. The Tax Court also underscored that the PLLC did not have at least one general partner, which is a requirement for a limited partnership. The members confirmed this, testifying that they each participated equally in

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

decisions and had substantially identical relationships with the PLLC. For these reasons, the Tax Court determined that the taxpayers were not "limited partners" for purposes of Section 1402(a)(13).

L. Joseph v. Commissioner

1. The taxpayer in *Joseph v. Commissioner* was a doctor, who had ownership interests in many entities.[84]

2. At some point, the IRS audited the taxpayer and then issued a Notice of Deficiency, alleging, among other things, that he owed SECA taxes with respect to certain entities. Tax Court litigation ensued.

3. The parties focused their attention on Greenville Avenue Surgical Partners, LP, a limited partnership. The taxpayer raised several defenses over the course of the litigation, first arguing that income from a partnership is never subject to SECA taxes, then suggesting that he was not taxable because he held a "limited partner interest," and finally clarifying that he should benefit from the "limited partner" exception under Section 1402(a)(13).

4. The Tax Court disagreed. It recited its earlier holding in *Renkemeyer*, suggesting that just having limited liability will not suffice, and a taxpayer can only benefit from the exception if he "is merely a passive investor in the entity who does not actively participate in the entity's business operations." In this case, the taxpayer testified that he used GASP to receive income for various surgeries he performed for another entity. Thus, the Tax Court concluded that the taxpayer "actively participated" in the business and thus was not a "limited partner" for purposes of Section 1402(a)(13).

V. Heads the IRS Wins, Tails the Taxpayer Loses

A. Setting the Scene

1. Business has evolved more quickly than tax law in many ways, and this has led the IRS to take conflicting positions about the meaning of "limited partner." The IRS uses this term broadly or narrowly, in different contexts, in furtherance of its goal of always maximizing tax revenue.

2. When it comes to the passive activity loss-limitation rules in Section 469, the IRS argues that "limited partner" must be loosely defined. This is because the rules generally provide that a "limited partner" does *not* "materially participate" in the relevant activity. Therefore, *including* as many taxpayers as possible in the "limited partner" category benefits the IRS for purposes of Section 469.

[84] *Joseph v. Commissioner*, T.C. Memo 2020-65.

3. By contrast, when a case involves whether certain amounts from partnerships should be subject to SECA taxes, the IRS argues that a tight definition of "limited partner" is appropriate. This is because Section 1402 indicates that the distributive share of income items to a "limited partner" is *not* hit with SECA taxes. In other words, *excluding* the greatest number of taxpayers from the "limited partner" group helps the IRS when dealing with Section 1402.

B. IRS's Position in Passive Activity Loss Cases – Broad Interpretation

1. It is in the IRS's financial best interest to interpret the concept of "limited partner" broadly, to encompass the maximum number of taxpayers when addressing Section 469 issues. Why? Because there is a legal presumption that "limited partners" are not "materially participating" in the relevant activities, so they receive passive losses from the partnerships, and their ability to utilize such losses from a tax perspective is restricted.

2. Overview of Section 469

a. Standards and Tests for Material Participation

i. A taxpayer generally may only deduct losses from "passive" trade or business activities in a year to the extent that such losses do not exceed income from "passive" activities.[85]

ii. Consequently, a taxpayer cannot use passive losses to offset income from unrelated, non-passive activities, and cannot claim passive losses if they surpass passive income.

iii. The taxpayer cannot claim the disallowed losses, also known as "suspended losses," until he disposes of his entire interest in the passive activity in question.[86]

iv. Taxpayers often arrange their business affairs to avoid the negative impact of the passive activity loss-limitation rules of Section 469. This includes ensuring that they are "materially participating" in the relevant activity.

v. The term "passive activity" is defined in the negative. It is any activity involving the conduct of a trade or business in which the taxpayer does not "materially participate."[87]

[85] Section 469(a)(1)(A); Section 469(d)(1).
[86] Section 469(g).
[87] Section 469(c)(1).

vi. To meet the "material participation" standard, the taxpayer must demonstrate that he meets any one of seven tests.[88]

(a) Test 1. The taxpayer participates in the activity more than 500 hours during the year.

(b) Test 2. The taxpayer's participation in the activity constitutes substantially all the participation in such activity by all individuals during the year.

(c) Test 3. The taxpayer participates in the activity more than 100 hours during the year, and his participation is not less than that of any other individual.

(d) Test 4. The activity is a "significant participation activity," and the taxpayer's aggregate participation in all significant participation activities during the year exceeds 500 hours.

(e) Test 5. The taxpayer materially participated in the activity for any five tax years (consecutive or not) during the 10 years immediately preceding the year at issue.

(f) Test 6. The activity is a "personal service activity," and the taxpayer materially participated in it for any three years (consecutive or not) before the year at issue.

(g) Test 7. Based on all the facts and circumstances, taking into account the special rules found elsewhere in the regulations, the taxpayer participated in the activity on a regular, continuous, and substantial basis during such year.

b. Special Rules for Limited Partners

i. There are various exceptions to the general rules described above. One applies to participation in an activity through a limited partnership. The relevant statute, Section 469(h)(2), states the following:

(a) "*Except as provided in the regulations*, no interest in a limited partnership as a limited partner shall be

[88] Treas. Reg. § 1.469-5T(a).

treated as an interest with respect to which a taxpayer materially participates."

ii. At first glance, Section 469(h)(2) appears to establish a harsh legal presumption:

(a) The IRS and the courts will start with the idea that a taxpayer owning an interest in a limited partnership, as a limited partner, is not materially participating in the activities of such partnership. The loss-limitation rules of Section 469, therefore, would apply to the detriment of the taxpayer.

iii. However, the regulations supply four clarifications about the legal presumption applicable to limited partners.[89]

(a) First, the regulations allow the taxpayer some latitude to demonstrate that he materially participates in the activities of the limited partnership. In particular, a limited partner will overcome the legal presumption of passivity if he can satisfy one of the following three material participation tests: Test 1, Test 5, or Test 6.

(b) Second, the regulations state that an ownership interest is a "limited partnership interest" if it is designated as such in the Limited Partnership Agreement or the Certificate of Limited Partnership, regardless of whether the liability of the taxpayer holding such interest for obligations of the partnership is limited under applicable state law ("Formation-Documents-Label-Them-Limited-Partners Test").

(c) Third, the regulations establish that an ownership interest is a "limited partnership interest" if the liability of the taxpayer holding such interest for obligations of the partnerships is limited by applicable state law to a fixed amount, such as the taxpayer's capital contribution and his contractual obligation to make additional contributions ("State-Law-Says-Liability-Is-Limited Test").

[89] T.D. 8175, 53 Fed. Reg. 5686 (Feb. 25, 1988).

(d) Finally, the regulations establish that a *general* partner is not a *limited* partner ("General Partner Exception").

C. IRS's Position in SECA Tax Cases – Narrow Interpretation

1. In cases involving whether certain distributions from partnerships should be subject to SECA taxes, the IRS argues that the concept of "limited partner" must be tightly defined.

2. Why? Because Section 1402 says a "limited partner" does *not* need to pay SECA taxes on his distributive share of income items from a partnership. Thus, from the IRS's perspective, classifying as few persons as possible as "limited partners" is best when dealing with Section 1402.

D. Conclusion

1. This segment of the outline highlights that the IRS takes different positions, in different contexts, regarding the same term, to maximize its tax revenue.

2. For instance, the IRS avidly maintained for decades that, when it comes to applying the passive activity loss-limitation rules of Section 469, the term "limited partner" should be *broadly* defined. This resulted in more determinations that taxpayers did not "materially participate" in activities, they received passive losses, and they were restricted from using such losses. The IRS clung to that position until it suffered losses in every single court in which federal tax disputes can be heard, namely, the Tax Court, District Court, and Court of Federal Claims.

3. At the same time, the IRS has argued in the past, and continues to argue in current disputes, that the concept of "limited partner" must be *narrowly* interpreted when dealing with SECA taxes and Section 1402(a)(13). This triggers more rulings that distributive shares that individuals receive from a partnership are subject to SECA taxes. The precise meaning of the term "limited partner," when it comes to limited partnerships, LLCs, LLPs and other entities is far from clear.

4. What is beyond doubt, though, is that the IRS intends to continue auditing and litigating these issues.

VI. Major Tax Court Decisions

A. First Case - Sirius Solutions, LLLP v. Commissioner[130]

1. Overview of the Facts

[130] *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20.

a. Sirius Solutions, LLLP ("Sirius") is a limited liability limited partnership formed in Delaware in 2002 and governed by a Limited Partnership Agreement. Sirius is a consulting firm consisting of 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.

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

c. At the start of 2014, the only year in dispute with the IRS, nine individual limited partners and the General Partner owned Sirius. Two individual partners retired and liquidated their ownership interests during the year, and two others voluntarily withdrew as partners and became full-time employees. Thus, at the end of 2014, five individual partners and the General Partner remained.

d. All limited partners made capital contributions to Sirius, some of which were significant. In addition to providing cash, some partners contributed services to Sirius.

e. Sirius made distributions of "net cash flow" to the limited partners in 2014 in accordance with their ownership interests. The 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.

f. Sirius took the position on its Form 1065 for 2014 that the distributions to the limited partners were not subject to SECA thanks to the exception in Section 1402(a)(13).

g. The IRS later audited and issued a Notice of Final Partnership Administrative Adjustment ("FPAA"), alleging the following:

    i. "[Y]our individual partners are not 'limited partners' within the meaning of [Section] 1402(a)(13), and thus their distributive shares of the partnership's ordinary business income are not excluded from their net earnings from self-employment. Therefore, the net earnings from self-employment is $5,915,918 rather than $0, as shown on your

[Form 1065]. Accordingly, the net earnings from self-employment is increased by $5,915,918."

2. Summary Judgment Motion and Opposition

   a. Sirius disagreed with the IRS's position in the FPAA, of course, and challenged it by tendering a Petition with the Tax Court.

   b. 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 individuals who are limited partners under state law (in this case, Delaware) are excluded from SECA taxes under Section 1402(a)(13) as a matter of law.

   c. The IRS opposed the Motion for Summary Judgment.

3. Arguments of the Parties

   a. Main Positions by Sirius

      i. Sirius explained that 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.

      ii. 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 that Section 1402(a)(13) was enacted, in 1977.

      iii. The ordinary meaning of limited partner is a person who satisfies the definition of limited partner under the relevant 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.

      iv. In 1997, Congress "confirmed" that term limited partner for purposes of Section 1402(a)(13) means a limited partner under applicable state law. It did so by imposing a moratorium against the IRS finalizing the Second Proposed Regulations, as they constituted an impermissible change of law by the Executive Branch, the IRS, instead of by the Legislative Branch, Congress. The moratorium is "important evidence" that Congress "made a considered judgment to retain the relevant statutory text."

v. 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 or altered the term limited partner.

vi. When it comes to statutory interpretation, it is unnecessary to consider outside sources, including legislative history, when a statute is clear on its face. Section 1402(a)(13) is clear on its face in that the exception to SECA taxes applies to limited partners, unless they received guaranteed payments in exchange for services rendered to the partnership. In light of the clarity of Section 1402(a)(13), the analysis should begin and end with that provision.

vii. Even if it were necessary to turn to outside sources, like legislative history, it "corroborates" that the limited partners in Sirius satisfy the definition. Moreover, the legislative history 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 the Board of Directors would not trigger blanket exposure to SECA taxes.

viii. The IRS has issued various administrative rulings and Instructions to tax and information returns indicating that the term limited partner for purposes of Section 1042(a)(13) means a person defined as such under applicable state law.

(a) 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."

(b) Additionally, the Instructions for Schedule SE (Self-Employment Tax) for 2014 explained that, in calculating self-employment taxes, limited partners "should include only guaranteed payments for services actually rendered to or on behalf of the partnership."

(c) Sirius warned the Tax Court that accepting the IRS's position would effectively mean telling all taxpayers

they cannot rely on express guidance from the IRS in completing returns, which would make compliance virtually impossible for ordinary taxpayers.

ix. The "functional test," which the Tax Court used in *Renkemeyer*, only applies to modern entities that are *not* limited partnerships under state law. It is improper to utilize the "functional test" in other scenarios. Sirius is a Delaware limited partnership, whereas *Renkemeyer* involved a special entity treated as a Kansas general partnership.

x. 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.

xi. Courts frequently look to state law, such as Delaware partnership law, in applying federal tax law.

xii. Treating the limited partners in Sirius as such would not start a trend of imposing disparate federal tax treatment on similarly-situated taxpayers.

xiii. 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.

(a) In particular, Delaware law states that a limited partner does not "participate in the control of the business" as a result of the following: (i) Transacting business with a limited partnership or its general partner; (ii) Being a member, manager, agent, or employee of a limited liability company that serves as a general partner of a limited partnership; (iii) Consulting with or advising a general partner or any other person with respect to any matter, including the business of the limited partnership; (iv) Guarantying or assuming any obligations of the limited partnership or general partner; or (v) Convoking, requesting, attending, or participating in a meeting of the partners or limited partners. Therefore, none of the allegations by the IRS about supposed activities of the limited partners in Sirius rises to the level of "control" under Delaware law.

xiv. There are no genuine disputes of fact regarding material issues in this case; therefore, the Tax Court should be able to resolve matters by ruling on the Summary Judgment Motion. Indeed, the only fact necessary for the Tax Court to rule in favor of Sirius is that the limited partners meet the definition of limited partner under Delaware law. The IRS is trying to fabricate a factual dispute to prevent a swift Tax Court ruling on this fundamental issue.

b. Main Positions by the IRS

i. 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.

ii. The IRS agrees with Sirius in that the term limited partner should be given its "ordinary meaning," but it disagrees on how it should be determined. The IRS urges the Tax Court to ignore the large number of dictionary definitions introduced by Sirius and, instead, focus solely on its earlier decision in *Renkemeyer*. The IRS insists that such case looked to the legislative history from 1977, 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.

iii. The Tax Court has "continued to follow and build upon" the holding in *Renkemeyer* in subsequent cases.

iv. Reports by the Joint Committee on Taxation, Private Letter Rulings, and Instructions to tax and information returns do not constitute federal tax authorities, and the Tax Court should ignore them.

v. The regulatory 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 contains rules that exceed the IRS's regulatory authority.

vi. The only legislative history that might be relevant to this case is that from the time Section 1402(a)(13) was enacted, in 1977, not from 20 years later when the moratorium occurred, in 1997.

vii. Contrary to what Sirius suggests, 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 mentioned state law, and entity-classification at the federal level is done according to specific tax regulations.

viii. If the Tax Court were to accept the contention by Sirius that state law (in this case, Delaware partnership law) dictates the outcome for purposes of Section 1402(a)(13), this would spark a bad overall result. Specifically, the IRS urges the Tax Court to ponder 50 different states, with 50 different partnership laws, rendering 50 different results.

ix. The Revenue Proposals of the Biden Administration, as found in the Green Book, do not constitute precedent and do not warrant inclusion in the analysis. Even if the Tax Court were to consider the Green Book, Sirius allegedly misinterprets what it signifies. The IRS claims that the presidential suggestions are designed to ensure consistent tax treatment for all business income from pass-through entities, not solely to address the definition of limited partner for purposes of Section 1402(a)(13).

x. Material facts remain in dispute, such that resolution of this case, without a trial, through a Summary Judgment Motion, is improper. Moreover, because the "functional test" described in *Renkemeyer* mandates a review of all relevant facts and circumstances, including the actions and abilities of the partners, a trial is necessary to develop more evidence.

4. Decision by Tax Court

a. The case was scheduled for trial in 2024, but it never happened because of an earlier decision by the Tax Court in late 2023 in another SECA case, *Soroban Capital Partners, LP v. Commissioner*.[131]

b. After issuing a opinion in that case and reminding everyone that the Tax Court follows "the doctrine of stare decisis and thus affords precedential weight to its prior reviewed and division opinions," the

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

Tax Court asked Sirius and the IRS about whether or how they wanted to proceed with *Sirius Solutions, LLLP v. Commissioner*.

c. That resulted in two items filed with the Tax Court.

i. The parties filed a Stipulation of Settled Issues wherein they agreed that (i) the opinion in *Soroban Capital Partners, LP v. Commissioner* was precedential and applicable, and (ii) using the functional test endorsed in that case would dictate that the limited partners in *Sirius* are not "limited partners, as such" for purposes of Section 1402(a)(13) and their distributive shares are not exempt from SECA taxes.

ii. Sirius filed a Status Report asking the Tax Court to file an Entry of Decision in favor of the IRS, such that it could challenge the holdings with the Court of Appeals.[132]

5. Notice of Appeal

a. Appealed to Fifth Circuit Court of Appeals in May 2024

B. Second Case - Soroban Capital Partners, LP v. Commissioner[133]

1. Overview of the Facts

a. The entity at issue ("Soroban") is a Delaware limited partnership during the years at issue. To be clear, it was a limited partnership, consistent with the terminology in the SECA tax exception in Section 1402(a)(13), not another type of entity merely treated as a partnership for tax purposes.

b. Soroban is a hedge fund. It provides various services related to the management of private investment funds, including buying and selling securities and other instruments.

c. The IRS apparently audited Forms 1065 for 2016 and 2017, concluding in its FPAAs that Soroban had understated its net earnings from self-employment by approximately $142 million.

d. Soroban disputed the IRS's initial determinations, of course, by filing Petitions with the Tax Court.

[132] *Sirius Solutions, LLLP v. Commissioner*, Tax Court Docket No. 11587-20, Order and Decision (Feb. 20, 2024).
[133] *Soroban Capital Partners, LP v. Commissioner*, Tax Court Docket Nos. 16217-22 and 16218-22.

e. They indicate that Soroban had one general partner, three limited partners, and 27 individual employees whose work contributed to the profits.

f. The Limited Partnership Agreement dictated:

i. only the general partner could manage, operate, and control,

ii. some of the limited partners had to approve events related to Soroban before they could occur, but the general partner had "ultimate authority" to take actions or make decisions,

iii. the partners had limited liability, and

iv. the partners receive allocations pursuant to their percentages.

g. The Petitions alleged the following:

i. the general partner performed all management functions,

ii. the limited partners did not participate in the management "to any extent" in their capacities as limited partners,

iii. the limited partners received Schedules K-1 (Partner's Share of Current Year Income, Deductions, Credits, and Other Income) identifying them as such,

iv. the general partner paid SECA taxes on its distributive share, and

v. the 27 employees paid taxes on their compensation through withholding.

h. 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, along with three employees.

i. However, the Petitions explained that Soroban made "guaranteed payments" to the limited partners for such services and subjected them to SECA taxes in accordance with Section 1402(a)(13).

j. The Petitions further indicated that the other amounts directed to each of the three limited partners (*i.e.*, their distributive shares or profit allocations) did not constitute compensation for services

rendered to or on behalf of Soroban, such that they were not exposed to SECA taxes.

k. The IRS, predictably, denied in its Answers filed with the Tax Court all substantive allegations by Soroban in its Petitions.

2. First Tax Court Decision

a. The Tax Court stated in its 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."[134]

b. The Tax Court then stated 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."

c. The Tax Court said that the key phrase in Section 1402(a)(13) is not "limited partner," but rather "limited partner, as such."

i. Because Congress never defined this phrase, the Tax Court used principles of statutory interpretation. These include looking at the express text of the law, using the ordinary meaning of terms where possible, and giving effect to every word in a statute.

ii. Applying these ideas, the Tax Court concluded that the limited partner exception does not apply "to a partner who is limited in name only."

iii. The Tax Court then defined the key issue in the following manner: "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)."

3. Second Tax Court Decision

a. The Tax Court issued another Opinion about 18 months later.[135]

b. It applied a functional analysis designed to determine whether the partners in question "were generally akin to passive investors."

[134] *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (Nov. 28, 2023).
[135] *Soroban Capital Partners, LP v. Commissioner*, T.C. Memo 2025-52.

c. It looked at factors that the Tax Court had recently used in another case addressing the limited partner exception to SECA taxes, *Denham Capital Management, LP v. Commissioner*.

d. The Tax Court said that it considered several items, including (i) the partnership's sources of income, (ii) the relationship between the capital contributions made by the partners and the distributive shares they received, (iii) the extent to which the time, skills and judgment of the partners were essential to generating the partnership's income, (iv) the roles played by the partners, including whether they participated in committees, had authority to bind the partnership, and participated in personnel decisions, (v) how much time the partners devoted to the business of the partnership, and (vi) whether the partnership highlighted specific skills or expertise of the partners when advertising itself.

e. The Tax Court, after applying its functional test and contemplating only those factors it deemed pertinent, supplied the following ruling:

i. "Soroban's limited partners were limited partners in name only. They were essential to generating the business's income, they oversaw day-to-day management, they worked for the business full time, and they were held out to the public as essential to the business. Their capital accounts make clear that their earnings were not of an investment nature. They are not limited partners within the meaning of Section 1402(a)(13), and their earnings constitute net earnings from self-employment for the years in issue."

4. Notice of Appeal

a. Appealed to Second Circuit Court of Appeals in August 2025

C. <u>Third Case – Denham Capital Management LP v. Commissioner</u>[136]

1. Overview of Main Facts

a. IRS increased net earnings from self-employment subject to SECA by about $50 million over two years, 2016 and 2017.

b. Taxpayer filed Petition with Tax Court in June 2023

c. Main positions in the Petition:

i. Taxpayer is a Limited Partnership under Delaware law

[136] *Denham Capital Management, LP v. Commissioner*, T.C. Memo 2024-12.

ii. General partner treated as such, paying SECA taxes

iii. Limited partners treated as such

iv. Limited partners paid SECA on "guaranteed payments"

v. Limited partners "wore two hats" – bifurcation position

(a) Investors

(b) Officers, committee members, service providers

2. Tax Court Decision

a. The Tax Court reviewed the main points from other cases addressing the limited partner exception. It placed particular emphasis on *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, the fact that a functional analysis was used there, and the reality that several later cases followed a similar approach.

b. The Tax Court then explained that Denham's position, in addition to ignoring "settled precedent," violates the notion that federal law, as opposed to state law, governs how individuals and entities will be classified for federal tax purposes.

c. Alluding to the legislative history, the Tax Court next explained that partners can avoid SECA taxes if they are "generally akin" to passive investors. This is called the "passive investor standard."

i. Making this determination requires an analysis of the sources of Denham's income, the role of the partners in generating it, and the relationship between the distributive shares of the partners and any capital contributions they previously made.

ii. The Tax Court began by pointing out that Denham's income consisted solely of fees for providing investment-related services, including advising and operating private funds.

iii. Only one party, Mr. Porter, contributed any capital to the endeavor, which weighs against having return on investment for limited partners.

iv. The Tax Court added that Mr. Porter cannot be considered a passive investor either because of his relatively small contribution compared to the large fees earned by Denham, the central role he played in generating fees, and the fact that Denham purchased "key man" insurance on him.

d. The Tax Court also rejected that the "guaranteed payments" made to the partners, which were less than 10 percent of their distributive shares, represented fair compensation for the services they provided.

e. The Tax Court explained that the partners, except Mr. Porter, were required to "devote substantially all their time and attention" to the affairs of Denham and its affiliates.

f. The partners participated in management in various ways, serving as members of various committees, and negotiating and executing agreements on behalf of Denham.

g. The Tax Court described the partners as "crucial and active parts" of Denham, playing a "significant role" in business operations, soliciting capital, evaluating investments, making personnel decisions, and offering "directional and strategic guidance" that drew investors to Denham.

h. The Tax Court declared that "Denham does not exist without the partners" and "individuals that serve roles as integral to their partnerships as those the partners served for Denham cannot be said to be merely passive investors."

3. Notice of Appeal

a. Appealed to Second First Court of Appeals in April 2025

VII. First Decision by Court of Appeals - Sirius

A. Victory for Partnerships, Finally

1. In January 2026, a court saw things the way partnerships have for years. That occurred when the Fifth Circuit ruled in favor of Sirius.[137]

B. Reasons for Ruling in Favor of Sirius

1. The Fifth Circuit explained that the sole and narrow issue on appeal was the meaning of "limited partner" in Section 1402(a)(13).

2. The Fifth Circuit quickly stated that this term means "a partner in a limited partnership that has limited liability."

[137] *Sirius Solutions, LLLP v. Commissioner*, U.S. Court of Appeals for the Fifth Circuit, Decision, Case No. 24-60240 (Jan. 16, 2026); *See also* Kristen A. Parillo, "Fifth Circuit Overrules Tax Court on Meaning of Limited Partner," 190 Tax Notes Federal 684 (Jan. 26, 2026); Kristen A. Parillo, "Tax Pros Dissect Court's Ruling on Limited Partner Exception," 190 Tax Notes Federal 860 (Feb. 2, 2026).

3. It arrived at this conclusion after examining just two things, namely, the text of the statute and the interpretation of the term limited partner by both the IRS and the Social Security Administration ("SSA").

4. The Fifth Circuit started with the text of Section 1402(a)(13), emphasizing its duty to define limited partner according to its "ordinary meaning."

    a. The discussion about dictionary definitions lasted about two pages, which readers are spared here. The takeaway is what counts. The Fifth Circuit observed the following:

        i. "Each contemporaneous dictionary has one and only one characteristic in common: limited liability. The touchstone of "limited parter" [when Congress introduced the relevant exception] in 1977 was limited liability."

5. Attention next turned to how the IRS and SSA have always defined the concept of limited partner.

    a. Shout Out to Supreme Court

        i. The Fifth Circuit first acknowledged the recent Supreme Court decision in *Loper Bright Enterprises v. Raimondo* and the duty of courts to exercise independent judgment in determining the meaning of statutory terms.

        ii. It pointed out, however, that interpretations by executive agencies, like the IRS and SSA, are particularly useful in deciphering terminology when they are issued at the same time as the statute and have remained consistent thereafter.

    b. The Fifth Circuit then turned to interpretations of the term limited partner by the IRS since 1977.

        i. It gave lots of attention to the "instructions" that the IRS published in connection with Forms 1065.

        ii. Initially, they told those completing tax returns that a limited partner was "one whose potential personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership."

        iii. Things were even more explicit during the years at issue in the case, 2014 through 2016. The "instructions" related to Forms 1065 for that period said that a limited partner was "a partner in a partnership formed under a state limited partnership law, whose potential personal liability for

partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership."

iv. The Fifth Circuit wrapped things up as follows: "From 1976 to 2022, the IRS issued instructions interpreting limited partner as a partner with limited liability in a limited partnership."

c. The Fifth Circuit next turned to the SSA, which interprets the term limited partner in determining whether certain amounts from partnerships will count toward the Social Security benefits a person might receive later in life.

i. It emphasized the "congruence" between the SECA taxes that an individual pays and the retirement benefits for which he is eligible in the future.

ii. The two relevant provisions, one administered by the IRS and the other by the SSA, both derive from the same law enacted in 1977.

iii. The Fifth Circuit explained that the SSA proposed a rule in 1979 about the limited partner exception, which became final in 1980. It provided that "you are a limited partner [for SSA purposes] if your financial liability for the obligations of the partnership is limited to the amount of your financial investment in the partnership."

d. The Fifth Circuit concluded its analysis about the meaning of limited partner for purposes of SECA taxes as follows:

i. "Dictionary definitions and the longstanding views of the two agencies tasked with administering the Social Security Amendments of 1977 [*i.e.*, the IRS and SSA] all point in one direction: The term's "single, best meaning" is a partner in a limited partnership that has limited liability."

C. Reason for Rejecting Contrary Positions

1. The Fifth Circuit said that all the counterarguments raised by the IRS, Tax Court, and the dissenting judge failed. It discredited them one by one.

2. Summary of Rejected Positions

a. The Tax Court and IRS suggested that, for SECA purposes, the term limited partner means a "passive investor." The Fifth Circuit held that the position makes little sense when one reads Section

1402(a)(13) in its totality, particularly the part about taxes on guaranteed payments. Moreover, the Fifth Circuit pointed out that, if lawmakers had wanted to exclude passive investors from SECA taxes, they "could have easily written the exception to do so." It identified several instances where Congress had taken similar actions in other contexts, but not in Section 1402(a)(13).

b. The Tax Court held in *Soroban* that the phrase "as such" Section 1402(a)(13) means that it only applies to a limited partner who is functioning as a limited partner, and that to function as a limited partner means to be solely a passive investor. The Fifth Circuit said that inclusion by Congress of the words "as such" operates to avoid ambiguities when it comes to dual-status partners (*i.e.*, those serving as both limited and general partners).

c. The IRS argued that three tax principles undermine the decision by the Fifth Circuit: (i) Federal law, not state law, governs the interpretation of federal tax statutes, like the limited partner exception to SECA taxes; (ii) Federal law focuses on economic reality, not labels; and (iii) Federal tax law should be uniform throughout the country. The Fifth Circuit acknowledged these principles and explained why its ruling does not violate any of them.

d. The IRS suggested that the history of limited partnership law demonstrates that the SECA tax exception applies only to passive investors. The Fifth Circuit rejected this idea, explaining that the only clear rule originating from "that ever-changing patchwork" was that a limited partner has limited liability.

e. The IRS, Tax Court, and dissent all point to the legislative history to Section 1402(a)(13), which introduces the "passive investor" concept. The Fifth Circuit explained that the limited legislative history in this case is "ambiguous," "tells us nothing," and is contrary to the plain language of the statute.

D. Ultimate Ruling by Fifth Circuit

1. "In any complex statutory dispute, the best course is to follow the statute's plain text. When [Section] 1402(a)(13) says "limited partner," it is referring to a limited partner in a state-law limited partnership that has limited liability . . . We hold that a "limited partner" in [Section] 1402(a)(13) is a limited partner in a state-law partnership that is afforded limited liability. And we reject the IRS's newly adopted passive investor rule."

VIII. Second Decision by Court of Appeals - Sirius

A. Replacement Opinion Issued by Fifth Circuit

1. Court “withdrew” its prior opinion and “substituted” one in August 2026

2. New ruling

   a. “The sole question on appeal is what ‘limited partner’ means in Section 1402(a)(13). We hold the ordinary public meaning of this phrase is a partner who plays no significant role in managing or running a business.”

   b. “At bottom, all relevant sources [including dictionaries, legislative history, tax treatises, and caselaw] suggest that, in 1977, the ordinary public meaning of ‘limited partner’ included a partner who did not play a significant role in managing or running the business.”

   c. “In adopting this reading, we reject the Tax Court’s Soroban decision . . . An informed reader of the English language in 1977 would have understood that a ‘limited partner’ could not manage the partnership, but perhaps could participate in certain non-managerial aspects of the business.”

   d. “We vacate [the Tax Court’s] judgment and remand the case for further proceedings consistent with this opinion.”

IX. Third Decision by Court of Appeals – Soroban

A. Key Rulings

1. Opinion issued in September 2026

2. “We hold that "limited partner," as used in Section 1402(a)(13), means a partner who, in addition to having limited liability, does not run, manage, or control the partnership's business.”

   a. “We arrive at this conclusion based on three sources that provide guidance as to the meaning of the term as used here: (1) the text of the statute and its ordinary meaning in 1977, when Section 1402(a)(13) was enacted; (2) the statute's surrounding text and structure; and (3) the statute's legislative history and historical context.”

3. “We do not disagree that a limited partner in 1977 could provide *some* services to the partnership. But that fact does not cast doubt on our conclusion that limited partners nevertheless could not *exercise managerial control* over the partnership, because merely providing services does not necessarily equate to running the business. Accordingly, the inclusion of guaranteed payments in the definition of "self-employment income" shows that in 1977, Congress omitted from the term "limited partner" any partner with management authority over the partnership.”

4. "In 1977, the ordinary meaning of "limited partner" had two features. First, a limited partner's liability for partnership obligations was limited to the amount of their contributions to the partnership; second, a limited partner did not take part in running the business. The text, surrounding text, statutory structure, historical context, and legislative history of Section 1402(a)(13) support this understanding. *Accordingly, we hold that, for the purposes of Section1402(a)(13), a "limited partner" is one who has limited liability and who does not run, manage, or otherwise exert control or managerial authority over the partnership*."

5. "We note that a panel of the Fifth Circuit also recently addressed the meaning of "limited partner" for purposes of Section 1402(a)(13) in [Sirius]. There, the court held that a limited partner is "a partner who plays no significant role in managing or running a business." The Fifth Circuit did not expound on what it considers to be a non-significant role, but to the extent [Sirius] holds that a limited partner may provide *some* services to the partnership, we do not disagree. Nor does the Commissioner . . . *So long as the activities in question do not constitute controlling, managing, or running the business, a partner may play a role in the partnership and still qualify as "limited" under Section 1402(a)(13)*."

6. "Finally, we hold that the Principals exercised control and managerial authority over Soroban, such that they are not "limited partners" under Section 1402(a)(13) . . . The Principals — who were Soroban's Managing Partner and Chief Investment Officer, Co-Managing Partner, and Head of Trading and Risk Management — worked full time for Soroban, managed its investments, played critical roles in generating its income, sat on all of its governing committees in 2016 and all but one in 2017, and participated in the decisions to hire, fire, promote, terminate, and evaluate Soroban's employees. In short, the Principals "exercised managerial control over Soroban" and "played an essential role in generating [Soroban's] income." Accordingly, the Principals are not limited partners within the meaning of Section1402(a)(13). Their distributive shares are thus subject to the Medicare and Social Security taxes on self-employment income."

X. Pending Cases

A. Cases Pending in Tax Court

1. Riverstone Equity Partners, LP v. Commissioner, Dkt. No. 17512-24

2. MKP Capital Management, LP v. Commissioner, Dkt. No.126-25

3. Moon Capital Management, LP v. Commissioner, Dkt. No. 1929-25

4. Atalaya Capital Management, LP v. Commissioner, Dkt. No. 3253-25

5. Stelliam Investment Management, LP v. Commissioner, Dkt. No. 7843-25

6. Valinor Management, LP v. Commissioner, Dkt. No. 9716-25

7. Summit Rock Advisors, LP v. Commissioner, Dkt. No. 9713-25

8. MDRA GP LP v. Commissioner, Dkt. No. 13466-25

B. Cases Pending in Courts of Appeal

1. Denham Capital Management, LP v. Commissioner – First Circuit

XI. Conclusion

A. Many Unresolved Issues

1. How will the recent rulings in *Sirius* and *Soroban* affect the First Circuit in deciding *Denham Capital Management*?

2. If the Courts of Appeal disagree, thereby creating a "circuit split," will the Supreme Court agree to resolve the controversy?

3. How will the Tax Court handle pending cases?

4. Will significant workforce reductions at the IRS in the past year decrease its ability to carry out the "Large Partnership Compliance Program," which, logically, entails scrutinizing SECA tax issues?

5. Will the IRS consider introducing some type of settlement initiative given how widespread reliance on the limited partner exception to SECA taxes is?

6. Will the IRS pick up where it left off in 1997, release a new version of the Proposed Regulations, gather comments, and then issue final regulations?

7. Will Congress finally enact a statutory definition of limited partner as used in Section 1402(a)(13) five decades after fact?

8. Will lots of partnerships continue to cite the limited partner exception to SECA taxes, counting on the two facts-and-circumstances standards created by *Sirius* and *Soroban*?

9. More?

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