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Limited Partner Exception to SE Tax Does Not Apply to a Partner Who Is Limited in Name Only

Cross References

- *Soroban,* 161 T.C. No. 12, November 28, 2023

In addition to income tax, a partner in a partnership is also subject to self-employment tax (SE tax) on his or her distributive share of partnership income. There are exceptions to this rule. One exception, IRC section 1402(a)(13), excludes from SE tax a limited partner's distributive share of income. This exclusion does not apply to guaranteed payments for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature or remuneration for those services.

IRC section 1402(a)(13) does not define the phrase "limited partner, as such." However, legislative history and case law provides an insight on Congress's intended meaning.

The limited partner exception under IRC section 1402(a)(13) was enacted in 1977 to 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. In 1997, the IRS issued a proposed regulation seeking to define the scope of the limited partner exception. The proposed regulation provided that an individual would not be treated as a limited partner if the individual had personal liability for partnership debts, had authority to contract on behalf of the partnership, or participated in the partnership's trade or business for more than 500 hours during the partnership's tax year.

This proposal received much criticism. That criticism led Congress to issue a moratorium prohibiting the IRS from issuing any temporary or final regulation with respect to the definition of a limited partner under IRC section 1402(a)(13) until July 1, 1998. Congress's reasoning behind the moratorium was that "the Senate [was] concerned that the proposed change in the treatment of individuals who are limited partners under applicable state law exceeds the regulatory authority of the U.S. Treasury Department and would effectively change the law administratively without congressional action.

Since the moratorium, Congress has not defined the term limited partner, and the Treasury Department has yet to issue any final or temporary regulation defining limited partner under IRC section 1402(a)(13).

In 2011, the Tax Court was called upon to determine the scope of the limited partner exception. The Tax Court applied statutory construction principles to determine whether partners in a limited liability partnership (LLP) should be considered limited partners under IRC section 1402(a)(13). (*Renkemeyer,* 136 T.C. No. 7)

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In that case, the court analyzed the legislative history of IRC section 1402(a)(13) and concluded that its intent "was to ensure that individuals who merely invested in a partnership and who were not actively participating in the partnership's business operations… would not receive credits towards Social Security coverage."

The court further found that "the legislative history…does not support a holding that Congress contemplated excluding partners who performed services for a partnership in their capacity as partners (i.e., acting in the manner of self-employed persons), from liability for self-employment taxes."

The court held that the partners in that case were not limited partners for purposes of IRC section 1402(a)(13) because their "distributive shares arose from legal services…performed on behalf of the law firm" and not "as a return on the partners' investments."

The *Renkemeyer* case specifically applied a functional analysis test to determine whether the limited partner exception applied. But that case specifically dealt with an LLP and not a limited partnership.

The taxpayer in this case is an investment firm that is organized as a Delaware limited partnership. It was originally formed as a limited liability company (LLC), but converted to a limited partnership pursuant to Delaware law. The taxpayer is classified as a partnership for federal income tax purposes.

The partnership has six partners in total, which includes one general partner and five limited partners. However, because two of the limited partners are single-member LLCs wholly owned by two individual partners, they are disregarded for federal income tax purposes. Therefore, for federal income tax purposes, the partnership has only three limited partners.

The Limited Partnership Agreement provides the roles and responsibilities of the partners. It lists the general partner and his role and authority over the business affairs of the partnership. It also lists the limited partners and their roles and interests in the partnership, how the profits and losses are to be allocated, the terms surrounding capital contributions, the voting classes, and the compensation provided to the limited partners in exchange for their services. All three limited partners received guaranteed payments in exchange for providing services to the partnership.

The partnership filed its tax return and included the limited partner's guaranteed payments in its SE tax computation. However, it excluded their ordinary business income from SE tax. The IRS issued Notices of Final Partnership Administrative Adjustment for the tax years in issue, increasing the partnership's net earnings from self-employment and gross nonfarm income. The partnership's tax matters partner filed a timely petition in Tax Court challenging the IRS's determinations.

The taxpayer argued that the three limited partners are state law limited partners and therefore, the distributive shares of income are excluded from net earnings from self-employment under IRC section 1402(a)(13). The taxpayer argued that because the partnership is a state law limited partnership and its Limited Partnership Agreement identifies the three individuals who are limited partners, IRC section 1402(a)(13) is satisfied.

The IRS disagreed, arguing that the distributive shares of income of limited partners in state law limited partnerships are not automatically exempt from self-employment income. The IRS said the court must apply a functional analysis test, similar to the test outlined in *Renkemeyer* and subsequent cases, to determine whether individuals are limited partners pursuant to IRC section 1402(a)(13).

The court agreed with the IRS.

The court stated it is a well-established rule of construction that if a statute does not define a term, the term is to be given its ordinary meaning at the time of enactment. Under the canon against surplusage, the court gives effect to every clause and word of a statute. When construing a statute, the court must interpret it so as to avoid rendering any part of the statute meaningless surplusage.

Turning to the statute in question, the court noted that the limited partner exception does not apply to a partner who is limited in name only. IRC section 1402(a)(13) reads: "there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments…" If Congress had intended that limited partners be automatically excluded, it could have simply said "limited partner." By adding "as such," Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner.

A 1977 House of Representatives report supports this conclusion, stating IRC section 1402(a)(13) was intended "to exclude for coverage purposes certain earnings which are basically of an investment nature." The text in this report makes clear that Congress was looking to the nature of the earnings and that it intended IRC section 1402(a)(13) to apply to partners that are passive investors.

The court ruled that the limited partner exception of IRC section 1402(a)(13) does not apply to a partner who is limited in name only.

Author's Comment

The 2011 *Renkemeyer* case answered the question of whether or not the distributive share of partnership earnings from LLPs and LLCs may be subject to SE tax. That case ruled that the SE tax exclusion did not apply simply because the partner enjoyed some type of limited liability protection. LLPs and LLCs are relatively new types of entities that generally did not exist back in 1977 when Congress enacted IRC section 1402(a)(13). At that time, state law limited partnerships were the only type of limited partnership, and they always have at least one general partner who is subject to SE tax. This case is new in that it is the first time the Tax Court has applied the functional analysis test to the limited partners of a state law limited partnership.

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