New Ruling May Reshape Self-Employment Tax Laws for Real Estate Partnerships

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In light of the Tax Court's refusal to grant summary judgment in Soroban Capital Partners et al. v Commissioner, real estate partnerships must approach the categorization of partnership income and guaranteed payments with caution. While a partner's share is often exempt from self-employment (SE) tax, the November 2023 ruling brings attention to the Self-Employed Contributions Act (SECA) tax compliance and the IRS's heightened scrutiny on this issue. This case highlights the necessity of a functional analysis to determine SE tax exceptions and may have wider implications for self-employment tax laws and compliance strategies.

Soroban Capital Limited Partnership was formed under Delaware law in 2015 and is a tax partnership for federal income tax purposes. Three of its partners received guaranteed payments for services performed for the partnership and an allocation of partnership income, which was shown on the entity's U.S. tax filing as not subject to SECA tax. Upon audit, the IRS increased the partnership's net earnings from self-employment to include the distributive share income.

Most business income allocated to a partner is subject to self-employment (SE) income tax, but under IRC sec 1402(a)(13), limited partners' distributive shares, except for guaranteed service payments, are excluded.

This is referred to as the Limited Partner exception. In Soroban, the petitioner asserted that the Limited Partner exception applies, and the distributive share is excluded from the SE tax.

The court stated that it must interpret the statutory language contained in the Limited Partner exception based on its actual wording. The statutory exception does not apply to "limited partners" but to "limited partners, as such." It focuses on the phrase "as such" as providing a limitation on the SE tax exception and concludes that it does not apply broadly and automatically to all state law limited partners of limited partnerships.

The court believes the service is correct in proposing a functional analysis to determine whether the exception should apply in a particular case.

This case is important since it is one of several docketed cases dealing with the Limited Partner exception from SECA and indicates that under the SECA tax compliance program, the IRS is scrutinizing limited partnerships and LLCs more. These cases collectively suggest that simply holding a partnership interest is insufficient to categorize earnings as passive and exclude them from self-employment tax when the partner actively provides services to or for the partnership.

This ruling may have significant ramifications for the future of the self-employment tax. If the case results in a decision that sets a legal precedent, it can influence how similar cases are decided in the future, potentially affecting many taxpayers. It may also provide new guidance on what constitutes self-employment income and who is subject to self-employment tax.

The IRS may then respond to a court decision by amending regulations or issuing new guidance to clarify how the self-employment tax applies in situations like Soroban.

Significant court decisions can lead to legislative changes if Congress decides to amend the tax law to address issues raised by the case. As a result, taxpayers, especially partnerships and their partners, may need to review and adjust their tax planning strategies based on the case's outcome.

For those in the professional community affected by this case or interested in its impact on self-employment tax, consulting with a tax professional or attorney specializing in tax law is advisable. These experts can provide detailed analysis and advice based on the specifics of the Soroban Capital Partners L.P. case and any relevant court opinions or documents associated with it.