

# Navigating the Self-Employment Tax Rules for Limited Partners



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Every year, countless real estate investors channel their investments through limited liability companies (LLCs), partnerships, private equity and hedge funds. These taxpayers need to stay informed about the intricacies of self-employment tax obligations and keep on top of the latest regulatory shifts, such as the changes to the limited partner exception and the implications of the IRS's audit campaign.

Self-employment taxes require self-employed individuals to contribute to Social Security and Medicare taxes by taxing their net earnings. Unless an exception is met, the tax applies to a partner's distributive share of the partnership's business income.

As of the current tax year, self-employment tax rates are 12.4% for Social Security on the first \$168,600 of net earnings and 2.9% for Medicare on all net earnings. Unlike employees, who split these taxes with their employers, self-employed individuals pay the full amount, making the combined rate 15.3%.

The limited partner exception is a tax code provision that exempts limited partners from paying self-employment taxes on their share of partnership income under certain conditions. To qualify for the limited partner exception, an individual must hold an interest in a partnership without actively participating in the partnership's trade or business. Generally, limited partners contribute capital but do not engage in the partnership's day-to-day management or operational decisions.

Earnings of a limited partner

subject to self-employment taxes have been an unsettled area of the tax code. In 1997, the U.S. Treasury Department and the Internal Revenue Service proposed regulations to resolve the issue. These regulations were highly criticized by Congress and never finalized. The proposed regulations set forth criteria to disqualify someone from being considered a limited partner for self-employment tax purposes.

These include:

- Bearing personal liability for partnership debts.
- Having authority to contract on behalf of the partnership.
- Participating in the partnership's trade or business for more than 500 hours during the partnership's taxable year.

For years, the IRS has been concerned taxpayers were underreporting self-employment taxes. In 2018, the IRS launched a compliance campaign to increase compliance with the law. The IRS has increased audits in the area, and taxpayers need to evaluate their reporting of self-employment taxes.

On November 28, 2023, the U.S. Tax Court issued its opinion in *Soroban Capital Partners LP v. Commissioner*. Soroban Capital Partners, a New York hedge fund manager organized as a Delaware limited partnership, reported guaranteed payments to its limited partners as net earnings from self-employment on its partnership tax returns but excluded the limited partners' distributive share allocations of ordinary income.

The IRS challenged Soroban's position and adjusted the reported net earnings from

self-employment to include the income that was allocated to the limited partners.

Soroban challenged the decision and was denied. The courts held that a functional analysis was required to determine whether a partner was acting as a limited partner, and the limited partner exception does not apply to a partner who is limited in name only.

The case is particularly significant for limited partners and a big win for the IRS. The decision, if upheld, could significantly limit the ability to claim the limited partner exception. In addition to *Soroban*, there are other pending cases regarding taxpayers' self-employment taxes.

Last year, the IRS announced it will target high-net-worth individuals and partnership taxpayers. The IRS has recruited new auditors from outside the agency for this campaign to address areas with high noncompliance risks. Partnerships and high-income taxpayers are often subjects of these campaigns due to the complexity of their tax situations and the potential for tax avoidance or evasion.

As a limited partner in LLCs, partnerships and funds, navigating the self-employment tax rules can be complex. The limited partner exception is not a universal shield against self-employment taxes, and one must evaluate their role in the partnership's activities.

It's crucial to consult with tax professionals and keep up-to-date with recent developments to avoid legal implications and to manage tax liabilities effectively.