What Limited Partners Should Know About *Soroban*

by Peter James Cline


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In this article, Cline explains how *Soroban Capital Partners* may have unintended consequences for the asset management industry by discouraging limited partners from taking oversight positions in private funds, particularly on limited partner advisory committees.

This article represents the views of the author only and does not necessarily represent the views or professional advice of Smith Anderson.

Introduction

The Tax Court's use of a functional analysis test to determine limited partner status in *Soroban Capital Partners LP*[1] has had a ripple effect in the world of asset management. The decision's impact will be felt in the tax and asset management community for years. But one of its unintended consequences may be that it discourages limited partners from taking oversight positions in private funds — particularly on limited partner advisory committees (LPACs).

Soroban is a reminder that a functional analysis test is subjective, with far fewer obvious and predictable outcomes than the objective 500-hour test in the proposed regulations governing limited partner status.[2] Limited partners should thus consider the potential application of a functional analysis test before joining an LPAC because the outcome of that test is so uncertain. Moreover, an unfavorable ruling under a functional analysis could subject a limited partner participating in an LPAC to unanticipated taxes under the Self-Employed Contributions Act (SECA).

Background

Some background is required before turning to the case. SECA works in tandem with the federal payroll tax, FICA, to ensure that American workers, both employees and the self-employed, contribute part of their earnings to Medicare and Social Security. SECA taxes the net earnings of self-employed individuals, while FICA is imposed on all employed individuals. Both SECA and FICA have total rates of 15.3 percent (12.4 percent dedicated to Social Security and 2.9 percent dedicated to Medicare), but the method of arriving at those tax rates makes a world of difference.[3] As a general rule, FICA's 15.3 percent rate is split equally between an employer and employee.[4] SECA, meanwhile, is borne entirely by the self-employed individual subject to section 162 deductions.[5] Although FICA and SECA

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

[2] Prop. reg. section 1.1402(a)-2.

[3] This is particularly true given the following variables: (1) There is no limit on taxable income subject to the 2.9 percent Medicare rate, (2) a $168,600 limit exists for taxable income subject to the 12.4 percent Social Security rate, and (3) an additional 0.9 percent Medicare tax is imposed on income above a certain threshold. IRS, "Topic No. 751, Social Security and Medicare Withholding Rates" (last updated Feb. 13, 2024).

[4] For FICA's 12.4 percent Social Security rate on employee income, 6.2 percent is paid by the employer and 6.2 percent is paid by the employee. FICA's 2.9 percent Medicare rate on employee income is also divided, with 1.45 percent paid by the employer and 1.45 percent paid by the employee. *Id.* Employers can generally deduct their 7.65 percent (6.2 + 1.45 percent) portion under section 162.

[5] IRS, "Self-Employment Tax (Social Security and Medicare Taxes)" (last updated Aug. 3, 2023).

operate independently from one another, both laws were drafted with the same end in mind: For the same percentage of employee and self-employed earnings to be paid toward Medicare and Social Security.

Despite this goal of equal tax treatment, a plethora of time and brainpower has gone into structuring corporate entities to minimize SECA taxes. This comes from the inherent truth that the calculation of a self-employed individual's net earnings is more flexible than the calculation of an employee's wages. The various structures to avoid SECA taxes are beyond the scope of this article, but one common example includes the owner of a corporation electing S corp status and receiving earnings as both an owner and employee. This division of income helps minimize the overall SECA obligation of the S corporation owner.

Soroban Application

An even more dramatic SECA tax avoidance strategy exists in the world of asset management. Guaranteed payments for services and distributions to partners are generally included in calculations of net earnings and are subject to SECA.[6] Section 1402(a)(13), however, exempts distributions to limited partners (in a limited partnership) from SECA categorization. Specifically, the statute excludes from SECA "the distributive share of any item of income or loss of a limited partner, as such other than guaranteed payments."[7] This exemption was created in 1977 to close a loophole for parties seeking additional Social Security benefits[8] but it inadvertently created a new loophole for the knowledgeable investor. For example, an executive of a private fund could structure the fund to pay a portion of their return through a limited partner interest and, consequently, avoid SECA subjugation for that portion.

That structure is often used in asset management, particularly in the relationship between a private fund and a management company. Management companies, which are usually set up as a partnership-taxed entity, are tasked with running the day-to-day operations of a private fund and often earn an annual fee of 2 percent of the assets under management. The more alluring 20 percent carried interest figure is earned by the general partner and limited partners of the private fund. A 2 percent rate may seem small compared with the 20 percent carried interest rate, but it quickly becomes consequential as assets under management rise to billions of dollars.[9] The 2 percent management fee can be distributed to the partners of the management company through guaranteed payments and distributions.

Soroban focuses on whether management company income is distributed to partners as a guaranteed payment to a service provider, or as a return of capital to a limited partner. It concerns an IRS determination that a management company's distributions to its limited partners were subject to SECA (despite section 1402(a)(13)) because the limited partners were not acting like true passive investors. The IRS likely found dispositive the fact that the individual limited partners spent between 2,300 and 2,500 hours annually on the management company, the general partner, and their affiliates.[10]

The structure at issue in *Soroban* is not unusual. Soroban Capital Partners LP is a management company with one general partner (Soroban Capital Partners GP LLC) and five limited partners. The limited partners included three natural persons and two limited liability companies that are disregarded for tax purposes[11] and are wholly owned by two of the natural-person investors. This is outlined in the figure.

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[6] *See* section 1402(a).

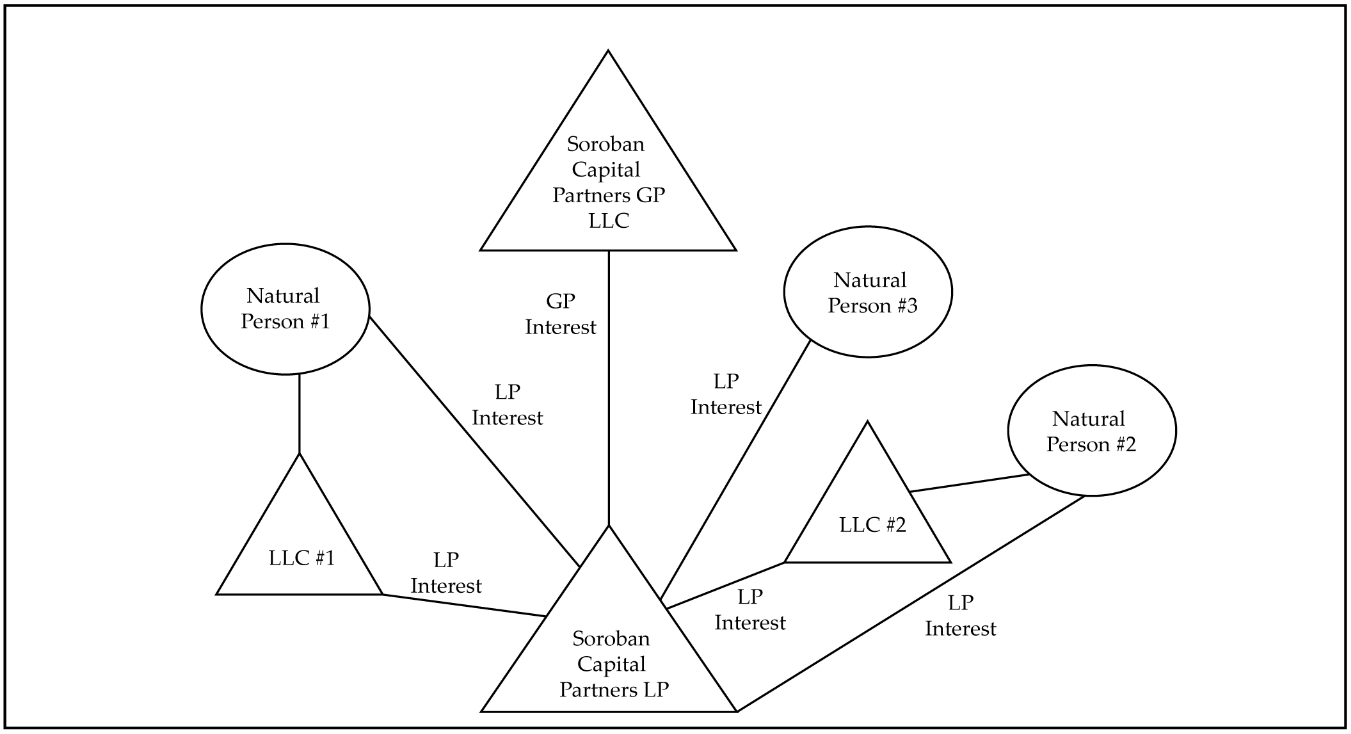
[7] Section 1402(a)(13).

[8] Before the passage of the Social Security Amendments of 1977, certain professionals and public employees were not covered by Social Security even though, at that time, "the value of Social Security benefits was still widely perceived to outweigh their tax cost." Patricia E. Dilley, "Breaking the Glass Slipper: Reflections on the Self-Employment Tax," 54 *Tax Law.* 85 (2000). This created an incentive for those taxpayers to invest in limited partnerships to accrue Social Security benefits. *Id.*

[9] It is important to note that the 2 percent management fee and 20 percent carried interest often cited in the industry does not necessarily reflect the financial arrangement of Soroban Capital Partners and its affiliates.

[10] Jeff Bilsky and Neal Weber, "Limited Partner Status for SECA Tax Exemption Requires Functional Analysis, Tax Court Holds," BDO USA (Dec. 13, 2023).

[11] *See* reg. section 301.7701-3(f)(2).



Along with earning income through their limited partner interests, the three natural persons all served in executive-level positions in the management company (Soroban Capital Partners LP).[12] They maintained that although the income they earned as guaranteed payments was subject to SECA under section 1402(a)(13), the income earned through their limited partner interest was not. The IRS disagreed and applied a functional analysis test to determine that the three individual investors were not acting as limited partners and passively earning income, but were actively involved in the management company's business and should be subject to SECA. The Tax Court agreed with the IRS, finding that a limited partner is not treated as a limited partner because of "name only" but rather because of how the partner operates.[13]

Much thought has been given to the definition of a limited partner. In 1997, Treasury issued proposed regulations that often permitted individuals to be categorized as limited partners so long as they did not commit more than 500 hours to a partnership's trade or business.[14] There was significant pushback to this, and Congress even issued a moratorium on Treasury finalizing the regulations. Although that moratorium ended in 1998, Treasury decided to wait for guidance from Congress before considering any further rules on the subject. That guidance never came. In the meantime, many practitioners have taken the position that the IRS will not challenge individuals on their limited partner status so long as the proposed regulation requirements, including the 500-hour rule, are met.[15]

The functional analysis test implemented by the Tax Court in *Soroban* may have been a noble effort to abide by the original intent of section 1402(a)(13), but it could lead to unintended consequences. As the application of the functional analysis test becomes more widespread, there is a risk that other provisions in the proposed regulations will be cast aside. Care should be taken to ensure continued recognition of the 500-

[12] Lee A. Sheppard, "Functional Analysis of Limited Partner SECA Taxes," *Tax Notes Federal*, Jan. 1, 2024, p. 9.

[13] *Soroban*, 161 T.C. No. 12.

[14] The proposed regulations also require limited partners to be neither personally liable for partnership obligations nor have the ability to contract on behalf of the partnership. Prop. reg. section 1.1402(a)-2(h).

[15] Congressional Budget Office, "The Taxation of Capital and Labor Through the Self-Employment Tax" (Sept. 2012).

hour safe harbor under the proposed regulations, especially in the context of an LPAC.

LPAC Application

LPACs are a powerful oversight tool for investors in a private fund. Limited partners with leverage are often granted a seat on a fund's LPAC, usually by committing a higher percentage of capital than other investors. Once on the LPAC, these limited partners typically are given tremendous oversight power and an advisory role. For example, LPAC approval can be required for transactions with underlying conflicts of interest (such as when the general partner seeks a sale between two private funds it controls). This type of transaction encourages the general partner to have one of the controlled private funds get a better deal at the expense of the other (presumably the fund that provides higher earnings and fees for the general partner). That inherent conflict of interest is why LPAC approval is often required in a private fund's governing documents. Other important examples of LPAC power include approval to (1) extend the term of a fund, (2) alter investment techniques and concentrations, and (3) acquire third-party financing.[16]

The oversight powers of an LPAC are critical to the success and operation of a private fund. This makes it even more important for investors to be properly encouraged to serve on them. If, however, the 500-hour rule were to be cast aside — in favor of the functional analysis test from *Soroban* — then limited partners may opt against serving. Using a functional analysis test, without an accompanying 500-hour safe harbor, would heighten the risk that limited partners serving on an LPAC will be categorized as participating in the business of the fund instead of acting as passive limited partners. That label could subject those limited partners to SECA tax. From a practical perspective, investors would be required to pay a premium (through the form of SECA taxes) to join an LPAC and represent the interests of the limited partners of the private fund.

It is not an ideal outcome when investors are forced to conduct a cost-benefit analysis between greater oversight and additional taxes. Instead, Treasury should tread carefully before disavowing the 500-hour rule or, in the alternative, create a specific SECA exception for limited partners who engage in oversight roles within a private fund. This oversight SECA exception would have the same result as section 1402(a)(13) for LPAC members but without potentially penalizing them for participating in oversight activities. An additional exception would also provide a fallback for limited partners who find they are spending more than 500 hours a year fulfilling their duties on the LPAC.

Care should be taken regarding how Treasury defines "oversight." The *Soroban* court used a functional analysis test in part to stop private fund executives from categorizing their service provider earnings as a return on capital and avoid SECA tax. A similar result could occur if an employee of the fund works in a compliance role (for example, chief compliance officer) while also investing as a limited partner. Specifically, the compliance employee could argue that their limited partner interest is exempt from SECA tax (under the proposed oversight exception) because of their compliance position. That result could be avoided by requiring the exempted oversight to be conducted by a small number of limited partners, unaffiliated with the general partner, the management company, and their affiliates. This would align the oversight exception with *Soroban* by permitting LPAC roles only for limited partners who do not work for the private fund in a service provider capacity.

Conclusion

It has been more than 20 years since Congress imposed the moratorium on Treasury's 500-hour rule. With the *Soroban* decision and heightened use of the functional analysis test, the time may have come for Treasury to revisit the issue and provide definitive guidance, which would ideally include practical exceptions that comply with the spirit of SECA. In particular, an exception for limited partners on an LPAC would help stop any inadvertent incentive for limited partners to avoid oversight of their own investments — a worthy goal. ■

[16] Institutional Limited Partners Association, "ILPA Principles 3.0: Fostering Transparency, Governance and Alignment of Interests for General and Limited Partners" (2019).