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United States

January 11, 2025

"Limited Partner" exception to Self-Employment Tax under IRC Section 1402(a)(13)

On December 23, 2024, the Tax Court reaffirmed its interpretation of the "**limited partner exception**" to **self-employment tax under section 1402(a)(13)** of the Internal Revenue Code in ***Denham Capital Management LP v. Commissioner*** (T.C. Memo. 2024-114).

This decision echoes its earlier ruling in ***Soroban Capital Partners LP v. Commissioner*** (161 T.C. No. 12) and has broader implications for active limited partners in state law limited partnerships.

This article examines the legal background, the Soroban case, and the facts and findings of the Denham Capital case, along with related pending cases that challenge these interpretations.

Background

Under IRC Section 1402(a), net earnings from self-employment are generally subject to self-employment tax. However, Section 1402(a)(13) provides an exception for the distributive share of income received by a limited partner—excluding guaranteed payments for services rendered.

Congress intended this exception to shield passive investors in partnerships from self-employment tax. However, over time, disputes have arisen over whether individuals who actively participate in the management or operations of partnerships qualify for the "limited partner exception."

Soroban Capital Partners LP v. Commissioner (161 T.C. No. 12)

Facts of Soroban Capital

Soroban Capital Partners LP, a state law limited partnership was engaged in investment management. Several of its partners were designated as limited partners under state law but were actively involved in the partnership's day-to-day operations, including management and decision-making.

Court's Findings

The Tax Court ruled that these partners did **not qualify** for the "limited partner exception" to self-employment tax because:

Their roles were **active and managerial**, rather than **passive**.

The "limited partner" designation under **state law** does **not control** for purposes of applying federal tax law.

Instead, the Court applied a **functional analysis**, emphasizing the **nature of the work performed** rather than formal titles.

Key Takeaway

The Soroban decision established a precedent that active involvement in a partnership's business activities disqualifies partners from claiming the limited partner exception to self-employment tax, even if they are designated as **limited partners** under state law.

Denham Capital Management LP v. Commissioner (T.C. Memo. 2024-114)

Facts of Denham Capital

Denham Capital Management LP, similar to Soroban, was organized as a state law limited partnership involved in **investment management**. Its limited partners actively participated in:

- Strategic decision-making
- Managing investments
- Supervising day-to-day operations

The IRS assessed **self-employment tax** on the distributive shares allocated to these limited partners, which the taxpayers disputed, relying on their **limited partner designation** under state law.

Court's Findings

The Tax Court reaffirmed the Soroban ruling, emphasizing that:

1. **State law designations do not override federal tax law.**
2. Partners who **actively participate** in a partnership's operations are **not passive investors**.
3. A **functional test** applies, focusing on the **substance of the partner's role** rather than formal titles.

Implications

The Denham decision strengthens the IRS's position that **active limited partners** cannot use the **limited partner exception** to avoid self-employment tax, increasing compliance requirements for partnerships with active participants.

Related Cases: Sirius Solutions and Point72 Asset Management

Sirius Solutions LLLP v. Commissioner (Docket No. 30118-21)

Sirius Solutions challenged the Soroban interpretation and is **appealing** the Tax Court's similar ruling to the **Fifth Circuit Court of Appeals**. This case could potentially lead to a circuit split, adding uncertainty to the application of Section 1402(a)(13).

Point72 Asset Management, L.P. v. Commissioner (Docket No. 12752-23)

Point72 remains in **Tax Court** and raises similar arguments about the definition of "limited partner." Its outcome could either reinforce or challenge the Soroban precedent.

Broader Impact and Future Considerations

The Denham and Soroban decisions highlight a growing judicial trend to look beyond state **law labels** and focus instead on **functional roles** in determining tax obligations. Key considerations include:

- **Active Participation** – Any partner performing managerial or operational roles faces greater scrutiny.
 - **Entity Structuring** – Partnerships may need to revisit their operating agreements and consider alternative structures.
 - **Compliance Risks** – Taxpayers should prepare for **IRS audits** and **litigation risks** if relying on the limited partner exception.
 - **Legislative Clarification** – Congress may eventually issue guidelines under Section 1402(a)(13) to provide clearer guidance on what constitutes a "limited partner."
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The reaffirmation of Soroban in Denham Capital Management LP v. Commissioner represents a significant step in resolving disputes over the limited partner exception to self-employment tax. With Sirius Solutions and Point72 still pending, the issue remains contentious, and practitioners should closely monitor these developments.

For partnerships with active participants, these rulings emphasize the need for careful tax planning and documentation to mitigate risks of adverse IRS determinations. Consulting tax professionals and legal advisors is highly recommended to navigate this complex and evolving area of tax law.

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