The Tax Law Center NYU LAW

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We offer here a brief overview of the reasons why we believe that the best reading of section 1402(a)(13) is that it provides authority for Treasury and the IRS to promulgate regulations or other guidance that lays out a functional test for "limited partner." These include: (1) the longstanding reasons discussed in prior analyses of guidance (and potential guidance); (2) rationales discussed in *Soroban*, placed appropriately in this broader context; and (3) the best understanding of the structure and role of the guaranteed payment carve-out.

1. Reasons given in prior analysis of potential regulations.

In the years since the 1997 proposed regulations that sought to define "limited partner" under section 1402(a)(13) there has been significant discussion about whether authority for such a regulatory project exists. The Tax Section of the New York State Bar Association ("NYSBA") has issued a number of helpful reports touching on the issue, including a comprehensive report in 2011 ("NYSBA 2011 Report") that explains in detail why "Treasury clearly has the necessary authority." Similarly, prominent partnership commentators (see here) have also stated that Treasury should issue regulations and "there is almost certainly authority" to do so." (See also David W. Mayo and Rebecca C. Freeland, *Delimiting Limited Partners: Self-Employment Tax of Limited Partners*, 66 Tax Law. 391 (2013), which provides a reasoned analysis as to why "Treasury would be on solid ground" in issuing regulations defining limited partner.) Other articles have cited contrary practitioner viewpoints that section 1402(a)(13) applies simple state law terminology.

We continue to believe that authority exists for regulations or other guidance that lays out a functional test for "limited partner" under section 1402(a)(13). The well-documented congressional intent and purpose behind section 1402(a)(13), together with the significant legal and business developments since section 1402(a)(13) was enacted, illustrate how and why the best, and most logical, reading of section 1402(a)(13) is one that applies a functional test to determine the meaning of "limited partner." (Such key legal and business developments are (1) changes in state laws that allow limited partners to participate in the underlying business in expansive ways they previously could not and (2) the proliferation, under state law and business practices, of other types of tax partnerships such as limited liability companies.) The Tax Court has also reached this conclusion in multiple cases when applying the statute to real world situations. See *Renkemeyer LLP v. Commissioner*, 136 T.C. 137 (2011) (addressing "limited partner" in the context of a state law limited liability partnership) and *Soroban Capital Partners, LP v. Commissioner*, 161 T.C. No. 12 (2023) (addressing "limited partner" in the context of a state law limited partnership). See also Mayo & Freeland, *supra* (cataloguing the limited other cases in which the Internal Revenue Code and its regulations use the term "limited partner" and highlighting that there is no recognized general U.S. federal income tax definition of the term).

Some of these sources were written prior to the Supreme Court's decision in *Loper Bright*, but

they are most relevant for their sound reasoning from the statutory text and framework which points to a functional test as the best interpretation.

2. Rationales in *Soroban*, appropriately read in this broader statutory context.

Soroban cemented the Tax Court's view (from *Renkemeyer*) that "limited partner" under section 1402(a)(13) means passive investor. Accordingly, the *Soroban* holding reiterates that the Tax Court still believes, consistent with *Renkemeyer*, that this is the best reading of the statute. Accordingly, in providing additional evidence that "limited partner" does not depend solely on state law terminology, the *Soroban* conclusion provides yet further support for authority to issue regulatory guidance.

Even beyond the reasoning in *Soroban*, authority to issue regulations adopting a functional test for "limited partner" status is found in other aspects of the existing legislative framework. In particular, the purpose behind section 1402(a)(13) is well documented—it was enacted to reverse the result of a 1973 Tax Court case (*Estate of Ellsasser*, 61 T.C. 241 (1973)) that allowed a limited and inactive partner to come within the Social Security net by investing in a partnership. In this respect, Congress made clear that the statute's concern was situations in which an "investor in the limited partnership performs no services for the partnership" and obtains Social Security coverage "based on income from an investment" rather than earnings from work (emphasis added). H.R. Rep. No. 702, Part I, 95th Cong., 1st Sess. 40-41 (1977). Legal developments since the enactment of section 1402(a)(13) provide additional support—e.g., the existence and enactment of the net investment income tax (see NYSBA 2011 Report at page 38), the broad changes in state law that depart from a state law understanding of "limited partner" in 1977, and the *Renkemeyer* holding and reasoning. And broader support for authority exists in the Supreme Court's general approach to the use of state law terms in federal statutes—see *United States v. Craft*, 535 U.S. 274, 278-79 (2002) (holding that while state laws can provide rights that affect the applicability of a term of a uniform federal statute, state law labels are irrelevant to whether state-law-provided bundles of rights meet the definition of a term in a uniform federal statute).

Accordingly, the legislative emphasis on passive investment income, along with these various other legal developments, illustrate that *Soroban*'s technical reliance on the statute's phrase "as such," while helpful, does not need to be the cornerstone of any authority analysis.

Moreover, the Tax Court's conclusion in *Soroban* is only the first step in the analysis—the Court did not lay out the functional test for determining "limited partner" status. The substantive goal of any new guidance will likely be to take that second step and provide a functional test for "limited partner." This, coupled with the pre-existing legislative purpose described above, should provide a sufficient basis for new regulations.

3. The guaranteed payment carve-out.

In addressing the best reading of section 1402(a)(13), we think it may be worthwhile to address pre-emptively the statute's express carve-out for guaranteed payments—i.e., to explain why the carve-out does not foreclose a functional test that also effectively "carves out" other distributive share items as active service-related earnings.

Section 1402(a)(13) carves out from its general exception any "guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services." The statute thus makes clear that guaranteed payments for services are always subject to self-employment taxes (i.e., whether or not paid to a "limited partner"). It could be argued that this express carve-out for guaranteed payments means that the statute forecloses a functional test based on the activity of the partner (and such arguments have been made). This line of argument says that by including the guaranteed payment carve-out, the statute itself contemplates that a "limited partner" may perform services (and receive some guaranteed payments) and therefore, a partner active in the business can still be a "limited partner" under the statute.

We do not believe the guaranteed payment carve-out is so limiting. At most, it suggests that an activity-based functional test must give effect to the statutory language by leaving open the possibility that a "limited partner" could, in some cases, receive guaranteed payments for services. Any functional test that assesses non-"limited partner" status only above a threshold level of activity (such as a test based on material, rather than any, participation) should succeed in doing so. The 1997 proposed regulations, for example, would have done this—a partner active in the partnership's business for fewer than 500 hours in a given year could have qualified as a "limited partner" while still performing some services (e.g., for 450 hours during the year) and could therefore have received salary for those services in the form of guaranteed payments. Those guaranteed payments would remain subject to self-employment taxes but the limited partner's entire distributive share would have been exempt. Such a functional test gives effect to the statutory language. (Similarly, such a test would be entirely consistent with the statement in the House report to the 1977 legislation stating that guaranteed payments "such as salary and professional fees" for "services actually performed by the limited partner"—a statement also contemplating that "limited partner" is permitted to perform some level of services. H.R. Rep. No. 702, Part I, 95th Cong., 1st Sess. at 40 (1977).)

Furthermore, guaranteed payments for services are treated in a manner similar to a partner's distributive share for certain purposes under the Code (e.g., section 706(a), which treats section 707(c) payments as amounts included in income in the same manner as other section 702 distributive share items). The carve-out can thus be read as a simple clarification that eliminates a (clearly incorrect) technical argument that guaranteed payments should also be exempt from self-employment taxes as distributive share (or as similar to distributive share). We have not found (in legislative history or various commentaries over the years) any detailed discussion of the specific rationale behind the guaranteed payment carve-out, but one report clarifies that these guaranteed payments are simply "analogous to wages earned by an employee"—reason enough for a simple clarification that section 1402(a)(13) does not cover them given the other nuances of

partner vs. employee compensation structures.

Finally, regardless of the guaranteed payment carve-out, it is clear under general principles of partnership tax law that a partner active in the partnership's operations may receive, as partner, payments in respect of services (i.e., earnings from work) that are determined by reference to partnership income. For example, a partner providing services to or for the benefit of a partnership may receive an interest in partnership net income in respect of those services, with such interest subject to forfeiture in the event the partner ceases to provide services. The receipt of such interest may be taxable as compensation under section 83 but any partnership income subsequently allocable in respect of such interest would be taxed as distributive share to the partner regardless of whether (and to what extent) it was received in consideration for services. Such amounts would not generally be taxed under section 707(c) (or section 707(a)(1)) since they are based on partnership income and so would qualify entirely as items of distributive share taxed under section 704. But to the extent those payments are earnings from work, the legislative framework described above suggests they were intended to be subject to the self-employment tax regime. Accordingly, the existence of a clarifying carve-out addressing guaranteed payments should not be read to override a result that, when combined with this general aspect of partnership tax law, effectuates the statute's purpose.

We hope this brief outline of statutory authority is helpful in progressing this guidance project.