LEGAL UPDATES

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U.S. Tax Court Rules That Limited Partners of an Investment Manager Are Subject to Self-Employment Tax

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On May 28, 2025, the United States Tax Court held that the limited partners of a limited partnership providing investment management services to various investment funds were not limited partners within the meaning of Internal Revenue Code (IRC) Section 1402(a)(13). Accordingly, the limited partners' earnings were subject to self-employment taxes for the tax years at issue.

In November 2023, the Tax Court ruled that a limited partner's status under state law was not controlling when determining whether such limited partner's distributive share of partnership income (excluding guaranteed payments for services) was subject to self-employment taxes. The Tax Court held that the self-employment tax exception did not apply to a partner who is limited in name only and a "functional analysis" was required to determine whether the self-employment tax exception applies.

In the 2025 opinion noted above, the Tax Court applied a functional inquiry into each limited partner's roles and responsibilities. The Tax Court evaluated the following:

The limited partners' role in generating income (i.e., whether their time, skills, and judgement were essential to the services that generated income);

The limited partners' role in management (i.e., serving on committees, ability to bind the partnership, authority over personnel decisions);

The time devoted by the limited partners to the business;

Advertising and client communications (i.e., the extent to which marketing materials emphasized the unique skills and experience of the limited partners

and how critical their contributions were to the overall success of the business); and

The limited partners' capital contributions relative to their return on investment.

The Tax Court concluded that the limited partners were limited partners in name only because they were critical to generating income, they had a significant role in management, they worked full time, they represented to the public that they were essential to the business, and their earnings from the business were not investment in nature.

Historically, active partners in different types of partnerships have taken the position that their distributive share of partnership trade or business income (other than guaranteed payments) is excepted from self-employment tax under IRC Section 1402(a)(13). Prior to the *Soroban* decision, the IRS had successfully asserted that the exception does not apply to limited partners that actively participated in a partnership's trade or business. However, none of these IRS challenges involved a state law limited partnership, thus leaving intact the view of many that a limited partner of a state law limited partnership is entitled to the self-employment tax exception regardless of the activities conducted by such partner. *Soroban* and other recent Tax Court cases have pushed back on this view by analyzing the activities of a limited partner in a state law limited partnership. Investment managers and consultants are currently appealing the Tax Court's interpretation of the self-employment tax exception in different circuit courts.

What this means to you

While these cases proceed through the court system, a limited partner that is actively involved in a partnership's trade or business (whether investment management, consulting, or other business) and currently excludes partnership income from self-employment taxes should assess the impact of the recent decisions on his or her particular situation.

Contact us

If you have questions regarding this latest development and its potential impact on your partnership structure, please contact Kal Dargan or your Husch Blackwell attorney.