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Implications of *Denham Capital Management LP v. Commissioner* Tax Court opinion

January 16, 2025

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Introduction

The U.S. Tax Court in December 2024 issued a memorandum opinion on an important question for partnerships and the asset management industry: **when can partnership distributive shares to limited partners in state law limited partnerships be excluded from self-employment income?** After a full trial and briefing, the court found no special justification to reconsider the standard set out in Soroban (161 T.C. 310)—a 2023 precedential opinion—that requires a "functional analysis" to determine the partner's roles and responsibilities in every case, including cases involving state law limited partnerships. Applying this functional analysis to the evidence presented at trial, the court held that the partners were more akin to employees than passive investors and sustained the IRS determination that **all the partnership allocations at issue were subject to self-employment tax**.

The case is*: Denham Capital Management LP v. Commissioner*, T.C. Memo. 2024-114 (December 23, 2024). Read the Tax Court's opinion

Background and analysis

The taxpayer, a Delaware limited partnership subject to the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) audit and litigation procedures, made guaranteed payments and distributed ordinary business income to its limited partners and its general partner. On its partnership tax returns for the years at issue (2016 and 2017), the taxpayer reported only the guaranteed payments to its limited partners and the general partner's share of ordinary business income as net earnings from self-employment.

The IRS adjusted the taxpayer's reported net earnings from self-employment by increasing the amount to include the shares of ordinary business income allocated to the limited partners, taking the position that they were limited partners in name only.

The taxpayer proceeded to trial, asking the Tax Court to hold that **ordinary business income allocated to the taxpayer's limited partners is excluded from net earnings from self-employment, either under a functional analysis, or by virtue of such partners being limited partners in a limited partnership under applicable state limited partnership law (a "formal approach")**. Additionally, the taxpayer argued that the court did not have jurisdiction to rule on the issues presented in a TEFRA partnership proceeding.

Soroban

In a 2023 opinion deciding cross motions for summary judgment in *Soroban*, the Tax Court concluded that although section 1402(a)(13) contains a limited partner exception that excludes from net earnings from self-employment "the distributive share of any item of income or loss of a limited partner, as such," that exception does not apply to a partner who is limited in name only. In support of its conclusion, the court found that the Code did not define the term "limited partner, as such" and, therefore, the court must look to the ordinary meaning at the time of enactment. The court pointed to the inclusion of the phrase "as such" in the statute and noted that those words would be rendered superfluous if the reference to a "limited partner, as such" referred to all state law limited partners. In addition, the court rejected Soroban's appeal to legislative history, noting that at the time of enactment of section 1402(a)(13), Congress intended for the limited partner exception to apply to earnings of an investment nature, which informed the court's interpretation of the term: "limited partner, as such." Therefore, the court held that determining whether a partner is a "limited partner, as such" or merely a limited partner in name only requires an inquiry into the functions and roles of that partner.

Accordingly, in Soroban, the Tax Court determined that limited partners in state law limited partnerships are not automatically eligible for the limited partner exception under section 1402(a)(13). Rather, they must apply a similar facts and circumstances test as used in other cases to determine whether each limited partner is functioning as a "limited partner, as such."

In *Denham*, the court declined to reconsider either the substantive or procedural holdings of *Soroban*, finding that the taxpayer had offered no special justification to do so. The court elaborated on the functional analysis standard based on the complete record developed at trial, concluding that it "must analyze the [p]artners' roles and responsibilities to ascertain whether their relationships with Denham were more akin to those of passive investors or employees." Based on this standard, the court determined that the limited partners were more akin to employees than passive investors and hence did not qualify for the limited partner exception. The court also agreed with the procedural holding in Soroban that the determination of the applicability of the limited partner exception is a partnership item over which the court has jurisdiction.

Initial impressions

Although the Tax Court declined to reconsider the holdings of *Soroban*, it is worth noting that the court did specifically address a technical argument related to guaranteed payments that was raised by the taxpayers in *Denham* and that had not been considered in *Soroban*. Specifically, in *Denham*, the taxpayers argued that because the limited partner exception carves out guaranteed payments for services, and completely passive partners could never receive such payments, using the passive partner standard would violate the canon against surplusage since the carve out for guaranteed payments for services could never apply. In dismissing this argument, the court took the opportunity to further expand upon its view of the proper functional analysis. More specifically, the court stated it must determine whether the taxpayers "were 'generally akin' to passive investors." According to the court, this standard does not preclude a partner who provides services and receives guaranteed payments for services from qualifying for the limited partner exception with respect to the partner's distributive share "as long as other circumstances of the partner's economic relationship with the partnership sufficiently indicate that it is one of passive investment."

In fleshing out its view of the proper functional analysis to determine if the limited partner meets a "passive investor standard," the Tax Court specifically considered the sources of the partnership's income, the limited partners' role in generating such income, and the relationship between the limited partners' distributive shares and any capital contributions they made to the partnership.

In summary, the following facts were relevant to the court's determination and may be useful to evaluate how a taxpayer would fare under a functional analysis:

- Denham's income consisted solely of fees for services (which were $130 million over the two years at issue), and the limited partners' time, skills, and judgment were essential to the provision of these services,
- The limited partners devoted substantially all of their time to Denham, and each participated in the management of Denham in some way, either through their participation on various committees or by exercising authority delegated to them to negotiate and execute any agreement or document to conduct Denham's business,
- The limited partners' expertise and judgement were a significant draw for fund investors and the marketing materials made clear that the limited partners had a significant role in Denham's operations, and
- The limited partners exercised significant control over personnel decisions.

Furthermore, the court noted that although one of the limited partners (the founder) had invested capital of $8 million into the partnership, "when the size of a partner's investment is relatively small in comparison to the income the partnership earned for the services the partner provided, the small investment is not sufficient to classify the partner's distributive share as a return on investment."

Lastly, the court considered the fact that Denham had made guaranteed payments to the limited partners for services of approximately $325,000 each per year. However, the distributions made to each limited partner were "multiple times larger" than the guaranteed payments. The court also noted that Denham planned to spend over $23 million in employee compensation for 2017 and that a sizable number of Denham employees were scheduled to receive total compensation exceeding the limited partners' guaranteed payments. Denham provided no evidence to show how the guaranteed payments were calculated. All of this suggested to the court that the guaranteed payments were not designed to adequately compensate the limited partners for the value of their services.

KPMG observation

Although there is no explicit authority providing for a reasonable compensation standard in the context of partnerships, with the court's analysis partly focusing on the adequacy of guaranteed payments for services, one wonders if the guaranteed payments had represented fair value for the services of the limited partners, whether the court would have been sympathetic to the treatment of only the guaranteed payments as net earnings from self-employment rather than the limited partners' full distributive share.

Based on the above, the court concluded that when individuals serve roles as integral to their partnerships as those of the limited partners, they cannot be said to be merely passive investors.

Looking ahead

KPMG will continue to follow the development of *Denham* and other similar cases related to the limited partner exception under section 1402(a)(13). It is too soon to tell whether the taxpayer will take an appeal to the First Circuit Court of Appeals. Briefs have been filed in the *Soroban* case with the Tax Court, and the merits decision is pending. Venue for any appeal in *Soroban* would lie in the Second Circuit Court of Appeals. In another case already on appeal from the Tax Court, *Sirius Solutions LLLP*, argument before the Fifth Circuit Court of Appeals has been set for February 6, 2025. The key issues on appeal from any of these cases, questions of statutory interpretation, are subject to de novo review—that is, the appellate courts need not defer to the Tax Court's reasoning or conclusions.

Several other limited partnership cases with this issue are in earlier stages of controversy because of the recent IRS enforcement campaign.

KPMG resource

- The Soroban Case: SECA and the Limited Partner Exception

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