

Hedge Fund Alert

THE WEEKLY UPDATE ON FUND MANAGEMENT INTELLIGENCE

Tax Rulings, IRS Stance Spawn Uncertainty Over Established Practices in Hedge Fund Industry

A U.S. Tax Court decision to reexamine how **Soroban Capital** used a long-standing practice to limit self-employment taxes will bolster the **Internal Revenue Service's** new assertive approach to collecting revenues from hedge funds, industry lawyers say.

The Nov. 28 decision in *Soroban Capital Partners L.P. v. [IRS] Commissioner* sparked a flurry of alerts, phone calls and meetings between tax lawyers and hedge fund clients scrambling to understand the ruling's broader implications.

The tax court agreed with the IRS' request in the case for a so-called "functional analysis," or a reexamination, of how Soroban employed what has been a widely accepted industry practice for decades; namely claiming a limited partnership exemption to making contributions to self-employment taxes.

The court's determination provides a glimpse into how it might rule in two similar pending cases, one involving **Point72 Asset Management**, **Steve Cohen's** well-known multi-strategy operation, and the other focusing on **Denham Capital**, a private equity shop. Industry lawyers are closely monitoring both cases. The ruling also potentially foreshadows how the IRS will handle countless other firms currently under audit or that might get audited in the future.

Industry participants have been further set on edge by a separate U.S. Tax Court ruling in November in another widely watched case: *YA Global Investments v. Commissioner*. In that proceeding, the court ruled that a hedge fund managed by **Yorkville Advisors** was liable for U.S. federal withholding taxes with respect to its non-U.S. limited partners in a Cayman Islands-domiciled fund (see story on Page 6).

"The IRS is trying to create a chilling effect" in both the Soroban and YA Global cases, said **Jay Freedman**, a

tax lawyer who heads **KPMG's** hedge fund tax practice.

At issue in each of the Soroban, Point72 and Denham cases is an exemption that allows typical limited partners to avoid paying employment taxes under provision 1402 (A) (13) of the Self-Employment Contributions Act. Industry practice has been for general partners to also take the exemption. SECA requires the self-employed to contribute the equivalent to both employer and employee portions of the Federal Insurance Contributions Act tax that funds Social Security and Medicare.

The total Social Security Tax is 12.4% of employees' first \$168,600 of earnings in 2023, while Medicare is 3.8% of earnings with no upper limit. Those who work for themselves pay all of those amounts.

Most hedge fund partners who receive profit cuts from their funds' limited partnerships are paid a salary in excess of the Social Security limit by their firm's general partnership. As a result, the amount in dispute in these IRS cases is generally the Medicare tax that the firms haven't been applying to profits they receive via their limited partnerships.

Since initiating a SECA "compliance campaign" in 2018, the IRS has been aggressively pursuing self-employment tax audits for limited partnerships, and the Soroban case follows successful challenges the agency has made against similar legal structures including limited liability companies and limited liability limited partnerships. The IRS initiates such "campaigns" to educate itself on evolving tax-avoidance practices that become commonplace.

An estimated 300 asset managers, including hedge funds firms, have been subject to SECA-focused IRS examinations, leading many targets to pay taxes owed rather than endure the pain of fighting the agency, lawyers say.

Soroban, however, filed a motion for summary judgment in February 2023 aiming for the tax court to put the issue to rest by agreeing with the hedge fund manager's interpretation of the tax code. But the court denied the motion and favored the IRS' position that a "functional analysis" was necessary to determine if Soroban really should benefit from the exemption.

The court also indicated the “exception does not apply to a partner ‘who is limited in name only’ and who is not actually functioning as a passive investor,” according to a client alert issued Nov. 30 by law firm **Foley & Lardner**.

The tax court must now determine if a general partner in a hedge fund can also be a limited partner for SECA tax purposes. Hedge fund lawyers argue that the distributive shares of a partnership’s net income via their limited partnership stakes is passive income that is exempted from the SECA taxes.

“Many hedge fund managers have been trying to claim, ‘I’m an LP and a GP,’ or participate in the activities indirectly through the general GP,” Freedman said. “The government has said ‘this LP exception is for limited partners [not general partners]. If you are doing something in the partnership that is not just passive investing, the taxpayer will need to determine whether they are really functioning as an LP.’”

What happens next isn’t totally clear, including when the court will conduct that analysis or when it will issue its conclusions. It’s also possible Soroban will appeal the decision, a move that could delay any conclusive determination by the court, lawyers said.

While the court’s decision in the Soroban case is an incremental step in the IRS’ tax-collection efforts, it has nevertheless set off a flurry of concern among lawyers and their clients.

The Soroban decision “had the possibility of ending a lot of controversy,” said **Jennifer Breen**, a tax attorney with law firm **Morgan Lewis**. “However, it’s not the end of the story. We live to fight another day. All the decision tells us is that we have to do a functional analysis to determine whether a partner is actually a limited partner for SECA purposes. As someone who practices in this area, I believe many firms operating in this industry have facts that demonstrate that their partners are in fact limited partners.”

What’s more, the decision and the related pending cases coincide with a new aggressive approach the IRS is taking toward the kind of limited partnerships seen at hedge funds. In September, the IRS released a statement announcing plans to hire 3,700 new revenue agents nationwide as part of a “sweeping, historic effort to restore fairness in tax compliance by shifting more attention onto high-income earners, partnerships, large corporations and promoters abusing the nation’s tax laws.”

The IRS said in the statement it planned to open examinations on 75 of the largest limited partnerships in the U.S. That group includes hedge funds, real estate investment partnerships, publicly traded partnerships, large law firms and corporations.

Founded in 2010 by **Eric Mandelblatt**, Soroban is an equity hedge fund shop in New York. It managed \$10 billion of gross assets at yearend. ■