

## Appeals court overturns Tax Court's "passive investor" standard for self-employment tax LP exception

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The Fifth Circuit held that allocations to a partner in a limited partnership qualify for a statutory exception from self-employment tax if the partner has limited liability. Overturning the Tax Court's decision, the Fifth Circuit rejected the standard adopted by the Tax Court in several other recent cases, which limits the exception to "passive investors." The Court's decision is the first decision from an appellate court on this issue.

On January 16, 2026, the U.S. Court of Appeals for the Fifth Circuit held that state law limited partners of a business consulting partnership can qualify for an exception from self-employment tax for their distributive shares of partnership income without inquiry into the roles and responsibilities of each of the limited partners. In a 2-1 decision, the Court overturned the Tax Court's prior decision, which had narrowed the availability of the self-employment tax exception to individuals who are generally "passive investors" in the partnership. The Fifth Circuit squarely rejected the Tax Court's passive investor standard, finding that a "limited partner" is, for purposes of the self-employment tax exception, a partner in a limited partnership with limited liability. The case, *Sirius Solutions*,<sup>1</sup> is one of several cases in which Tax Court had adopted the passive investor standard in favor of the government, and the Fifth Circuit's rejection of the Tax Court's approach is the first decision from a Court of Appeals on this issue.

### Background

Self-employed individuals, including individual partners in businesses organized as partnerships, are generally required to pay self-employment tax (*i.e.*, Social Security and Medicare tax) on their earnings. However, for purposes of determining an individual's earnings subject to self-employment tax, Section 1402(a)(13) of the Internal Revenue Code excludes from net earnings a limited partner's distributive share of income and loss from a partnership (other than certain guaranteed payments for services). The question before the Court was whether the individual limited partners of the taxpayer partnership qualified as "limited partners" for purposes of this statutory exception.

*Sirius Solutions* (*Sirius*) was a business consulting firm organized as a Delaware limited liability limited partnership. In the years at issue before the Court, *Sirius* allocated all of its ordinary business income to its limited partners, and reported zero net earnings from self employment to its partners on the basis that the income was allocated to limited partners and therefore qualified for the exception under Section 1402(a)(13). The Internal Revenue Service (IRS) disagreed, asserting that the partnership's limited partners were not "limited partners" for purposes of the exception from self-employment tax.

While the *Sirius Solutions* case was pending before the Tax Court (a lower court), the Tax Court issued an opinion in another case, *Soroban Capital Partners*,<sup>2</sup> involving a challenge by the IRS to a similar position taken by an investment management firm organized as a limited partnership. In *Soroban*, as well as subsequent decisions, the Tax Court undertook a functional analysis of the roles and responsibilities of the limited partners to determine whether the limited partners were generally akin to passive investors.<sup>3</sup>

Following the *Soroban* decision, Sirius and the government stipulated that *Soroban* controlled the outcome of the case, resulting in a Tax Court decision in favor of the government. However, Sirius maintained in the stipulation that the *Soroban* case was incorrectly decided and appealed to the Fifth Circuit.

## Fifth Circuit decision

In a 2-1 decision, the Fifth Circuit rejected the Tax Court's "passive investor" standard and held that a partner in a limited partnership constitutes a "limited partner" for purposes of the self-employment tax exception if the partner has limited liability. Under the Fifth Circuit's approach, it is not necessary to analyze the roles and responsibilities of a partner, as would be required under the Tax Court's opinion in *Soroban*. Rather, the fact that a partner in a limited partnership has limited liability is sufficient to qualify for the exception in Section 1402(a)(13).

## Observations

Although Sirius was a consulting partnership, the reasoning of Court's decision does not appear to depend on the type of business that the partnership is engaged in. Therefore, the Court's reasoning would appear to apply to other types of businesses, such as investment managers, that are organized as limited partnerships under state law.

The Court specifically clarified in a footnote that its opinion does not discuss whether members of legal entities other than limited partnerships, such as limited liability partnerships (LLPs) or limited liability companies (LLCs), may also qualify for the self-employment tax exception. The Tax Court has previously denied the application of the limited partner exception to partners in LLPs and members of LLCs for reasons similar to the analysis in *Soroban*. However, in holding that qualification for the limited partner exception turns on whether a partner has limited liability, the Fifth Circuit specifically noted that the label of a person as "limited partner" is not controlling, which suggests that a similar analysis may apply in the case of other types of entities.

In light of the Fifth Circuit's opinion, LLCs, limited partnerships and other entities treated as partnerships for tax purposes that have not taken advantage of the limited partner exception may wish to consider protective filings to preserve the possibility of a refund claim.

*Sirius Solutions* is the first decision from a Court of Appeals on the issue of whether a state law limited partner can qualify for the exception in Section 1402(a)(13) if the individual is not a passive investor in the partnership. However, the Fifth Circuit's decision is contrary to the holdings of several other Tax Court decisions, including one currently pending before the First Circuit (*Denham Capital Management*) and another currently pending before the Second Circuit (*Soroban*). (*Denham* is scheduled for oral argument in February, but arguments in *Soroban* have not yet been scheduled as briefing is ongoing.) The outcome of these other cases, and whether the other circuits agree with the Fifth Circuit's opinion, will be key to the ongoing judicial development of this issue, particularly as it applies to taxpayers outside of the Fifth Circuit.

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<sup>1</sup> *Sirius Solutions, L.L.L.P. et. al v. Commissioner*, No. 24-60240, slip op. (5th Cir. Jan. 16, 2026).

<sup>2</sup> 161 T.C. 310 (2023)

<sup>3</sup> *Soroban Capital Partners LP et. al v. Commissioner*, TC Memo 2025-52, *Denham Capital Management LP et. al v. Commissioner*, TC Memo 2024-114.