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Fifth Circuit Overturns Tax Court, Ruling in Favor of the Taxpayer in Case Evaluating Standard for Limited Partner Exception to Self-Employment Tax

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The U.S. Court of Appeals for the Fifth Circuit issued a split (2-1) decision in favor of the taxpayer in *Sirius Solutions, L.L.L.P. v. Commissioner* on January 16, 2026, holding that the “limited partner exception” to self-employment taxes applies to a “limited partner in a state-law limited partnership that is afforded limited liability,” without the need for further inquiry into the activities of the limited partner. The Fifth Circuit rejected the government’s argument that the limited partner exception applies only to limited partners that are “passive investors” based on a functional analysis of the roles and responsibilities of the limited partners.

Sirius Solutions is one of several cases in which the 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 required to pay self-employment tax (i.e., Social Security and Medicare tax — generally 3.8% for high-income earners) on their net earnings from self-employment. However, Section 1402(a)(13) of the Internal Revenue Code of 1986, as amended (the Code) excludes from such net earnings a limited partner’s distributive share of income and loss from a partnership (other than certain guaranteed payments for services).

Sirius Solutions, L.L.L.P. (*Sirius*) allocated 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 limited partner exception under Section 1402(a)(13) of the Code. The IRS challenged this position and asserted that the partners were not “limited partners” for the purposes of the limited partner exception.

While the *Sirius Solutions* case was pending before the Tax Court, the Tax Court issued an opinion in another case, *Soroban Capital Partners LP v. Commissioner*, 161 T.C. No. 12 (November 28, 2023), involving a challenge by the IRS to a similar position taken by an investment management firm organized as a limited partnership. In *Soroban*, the Tax Court issued a summary judgment holding that the limited partner exception in [Section 1402\(a\)\(13\)](#) does not apply to a partner who is limited in name only and that determining limited partner status requires a functional inquiry. It further concluded that the Tax Court has jurisdiction to conduct such an inquiry in a partnership level proceeding. See [Tax Court Rules That Limited Partners May Be Subject to Self-Employment Tax](#)

– Troutman Pepper Locke.

In a subsequent case, *Soroban Capital Partners LP v. Commissioner*, T.C. Memo. 2025-52 (2025), the Tax Court applied the functional analysis and held that the limited partners were not “limited partners, as such” for purposes of Section 1402(a)(13). The Tax Court took the same approach in *Sirius Solutions*, and Sirius appealed to the Fifth Circuit.

Fifth Circuit Decision

The Fifth Circuit rejected the Tax Court’s conclusion that the limited partner exception only applies to limited partners that are “passive investors” based on a functional analysis of the roles and responsibilities of the limited partners. Instead, the Fifth Circuit noted that “the best course is to follow the statute’s plain text”^[1] and held that when Section 1402(a)(13) of the Code refers to “limited partner” it is referring to a limited partner in a state-law limited partnership that has limited liability. It should be noted that the decision applies specifically to state-law limited partnerships and does not address other entities such as limited liability partnerships.

Immediate Impact and Future Developments

The government may, until March 2, 2026, petition for rehearing *en banc* (by the full Fifth Circuit) or file for a writ of certiorari with the U.S. Supreme Court.

Once the decision is final, the Fifth Circuit decision will be binding on taxpayers whose cases would be appealable to the Fifth Circuit, which includes Louisiana, Mississippi, and Texas. The IRS and the Tax Court may continue applying the “passive investor” test to taxpayers whose cases would be appealable to other Circuit Court of Appeals. The same issue is pending appeal in two other cases in different circuit courts of appeals: *Denham Capital Management LP v. Commissioner* (First Circuit) and *Soroban Capital Partners LP v. Commissioner* (Second Circuit). If another appellate court endorses the “passive investor” test, it would create a circuit split, leaving taxpayers in somewhat of a state of uncertainty.

Key Implications for Fund Managers

Sirius Solutions offers clarity for structuring partnership agreements and ownership of management companies for taxpayers in the Fifth Circuit. Specifically, subject to a contrary decision on a rehearing *en banc* or by the Supreme Court, fund managers that are state-law limited partners in the Fifth Circuit will be able to avoid self-employment taxes on ordinary income allocated to them attributable to management fees, even if they are actively involved in managing investments and making business decisions on behalf of the management company. Taxpayers outside the Fifth Circuit, however, are left facing uncertainty. While they may cite *Sirius Solutions* as authority, the IRS would not be bound by the decision.

Decisions in the *Denham Capital Management LP v. Commissioner* (First Circuit) and *Soroban Capital Partners LP v. Commissioner* (Second Circuit) are expected to be issued later in 2026. Please reach out to members of the tax group if you would like to discuss the implications of *Sirius Solutions*.

^[1] *Sirius Solutions, L.L.L.P. v. Comm'r*, No. 24-60240, slip op. at 23 (5th Cir. Jan. 16, 2026).

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