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FIFTH CIRCUIT REJECTS "PASSIVE INVESTOR" TEST FOR LIMITED PARTNER SELF-EMPLOYMENT TAX EXCLUSION

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As a rule, an individual partner's distributive share of ordinary business income is included in net earnings from self-employment under Internal Revenue Code § 1402(a) and is subject to federal self-employment tax. As an exception, IRC § 1402(a)(13) excludes the distributive share of ordinary business income of "a limited partner, as such" (other than guaranteed payments), from net earnings subject to self-employment tax. The IRC does not define "limited partner, as such" for these purposes.

In a January 16, 2026, decision rejecting the Tax Court's reliance on the "functional analysis test/passive investor rule" established in *Soroban Capital Partner LP v. Commissioner*, the Fifth Circuit Court of Appeals in *Sirius Solutions, L.L.L.P. v. Commissioner* concluded that individuals who were designated as limited partners, and had limited liability, under state law were "limited partners" under IRC § 1402(a)(13) without the need for further inquiry into the activities of the limited partner. Therefore the limited partners could exclude their allocable shares of the partnership's ordinary business income from self-employment tax for the tax years 2014, 2015 and 2016. The result was the elimination of self-employment tax on net earnings ranging from approximately $5.9MM to $7.4MM.

Sirius Solutions L.L.L.P. ("Sirius") is a business consulting firm formed as a Delaware limited liability limited partnership and classified as a partnership for federal income tax purposes. For the years at issue, the Sirius limited partners received allocations of all of the ordinary income earned by Sirius. Sirius took the position that all of the limited partners' distributive share of partnership income was excluded from net earnings from self-employment tax. This meant that Sirius reported zero net earnings from self-employment each year. The IRS proposed to increase Sirius's net earnings from self-employment because the limited partners were not mere passive investors and therefore not "limited partners" within the meaning of IRC § 1402(a)(13). Citing *Soroban* as precedent, the Tax Court upheld the IRS adjustments.

On appeal, the Fifth Circuit Court of Appeals expressly rejected the Tax Court's functional analysis test/passive investor rule stating that a "limited partner" is a partner in a state-law limited partnership that has limited liability - period. The Court found support for its conclusion in dictionary definitions and interpretations by both the IRS and Social Security Administration, including over 40 years of IRS instructions to Form 1065 (*U.S. Return of Partnership Income)* defining "limited partner" solely by reference to limited liability and SSA regulations ("You are a 'limited partner' if your financial liability for the obligations of the partnership is limited to the amount of your financial investment in the partnership"). The Court also noted that the law already imposes self-employment tax on "guaranteed payments" for services performed by a limited partner and that if Congress had intended for active limited partners to be excluded from the exception entirely, the "guaranteed payments" clause would be unnecessary. Lastly, the court noted that the IRS and Tax Court interpretation of "limited partner" would lead to disuniformity and likely a great deal of litigation about how much participation by a limited partner terminates their status as such for purposes of IRC § 1402(a)(13).

The holding in *Sirius* represents a significant victory for taxpayers in the investment funds industry but its precedential value is limited to taxpayers in that jurisdiction (Louisiana, Mississippi and Texas). Taxpayers

located in other jurisdictions, including New York, Connecticut and Massachusetts, for example, may continue to be subject to the functional analysis test/passive investor rule adopted by the IRS and Tax Court. Also, the Fifth Circuit expressly limited its holding to partners in state law limited partnerships and stated that it does not specifically apply to members of other entities - such as LLPs and LLCs classified as partnerships for federal income tax purposes - that may qualify for the self-employment tax exception if they are afforded limited liability under applicable state law. The government has until March 2, 2026 to pursue a further appeal.

It is important to note that the First and Second Circuits also have Tax Court appeals pending (*Denham Capital Management LP* and *Soroban Capital Management LP,* respectively) on the meaning of "limited partner" for purposes of the self-employment tax exception. If one or both of those circuits adopt the IRS's and Tax Court's analysis, the U.S. Supreme Court may be the final arbiter of the issue.

If you have any questions regarding this alert, please contact your Cummings & Lockwood private clients attorney.