

Recent Circuit Court Decisions Coalesce on Scope of LP Self-Employment Tax Exception

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The long saga of who is a limited partner for purposes of the limited partner exception may finally be inching towards a resolution, with two circuit courts recently converging on similar definitions, both of which make it difficult for taxpayers engaged in management activities to claim the exception.

On August 12, 2026, the US Court of Appeals for the Fifth Circuit ruled that a partner who plays “no significant role in managing or running a business” is a “limited partner” for purposes of the limited partner exception to self-employment taxes described in Internal Revenue Code (IRC) Section 1402(a)(13).¹ In doing so, the Fifth Circuit withdrew its January 2026 opinion in *Sirius Solutions, L.L.P. v. Comm’r*,² which previously defined a “limited partner” for this purpose as a partner with limited liability.

Ruling on the same issue, on September 17, 2026, the US Court of Appeals for the Second Circuit similarly defined a limited partner for purposes of the exception as a partner that has limited liability and “who does not run, manage, or otherwise exert control or managerial authority over the partnership.”³

Limited partner exception

As discussed [this December 2023 client alert](#), the IRC imposes a tax on the self-employment income of individuals, including gross income derived from any trade or business, less allowable deductions attributable to such trade or business, plus the distributive share (whether or not distributed) of income or loss from any trade or business carried on by a partnership of which such individual is a member. However, IRC Section 1402(a)(13) provides an exception for “the distributive share of any item of income or loss of a limited partner, as such,” other than guaranteed payments for services provided to or on behalf of the partnership.

Judicial interpretation of ‘limited partner’

The first decision in a series of cases at the Tax Court involving the limited partner exception was the Tax Court’s November 2023 decision in *Soroban Capital Partners LP v. Comm’r*.⁴ In *Soroban*, the Tax Court held that state law limited partners are not per se entitled to the limited partner exception under IRC Section 1402(a)(13). The Tax Court concluded that a functional analysis must instead be applied to determine whether a partner is a “passive investor” entitled to the limited partner exception. In decisions after *Soroban*, the Tax Court has consistently opined that a functional analysis should be applied – including in *Denham Capital Management v. Comm’r*⁵ and *Sirius Solutions L.L.P. v. Comm’r*.⁶ *Denham* has an appeal pending in the First Circuit.

On January 16, 2026, in the appeal for *Sirius Solutions*, the Fifth Circuit held that the term “limited partner” means a partner who, under state limited partnership law, has limited liability status in a limited partnership (the prior opinion). The government petitioned the Fifth Circuit for rehearing en banc. The Fifth Circuit denied the petition, but on August 12, 2026, the Fifth Circuit withdrew its prior opinion, defined a “limited partner” consistent with its “ordinary public meaning,” at the time of the statutory enactment, and rejected both the Fifth Circuit’s own “limited liability” test and the Tax Court’s “functional analysis” test. The opinion does not clearly describe when participation becomes “significant,” which, similar to the “functional analysis” test, leaves the application of the standard dependent on the partner’s functions and authority. The Fifth Circuit vacated the Tax Court’s decision and remanded the case using the revised reading of the term “limited partner” for purposes of IRC Section 1402(a)(13).

In the appeal for *Soroban*, the Second Circuit adopted a comparable standard to the Fifth Circuit in *Sirius Solutions*, concluding that a limited partner is a partner with limited liability who does not run, manage, or

otherwise exert control or managerial authority over the partnership. The Second Circuit noted the Fifth Circuit's holding in *Sirius Solutions* and said that to the extent that the Fifth Circuit held that "a limited partner may provide some services to the partnership, we do not disagree ... [s]o long as the activities in question do not constitute controlling, managing or running the business, a partner may play a role in the partnership and still qualify as 'limited.'"

While both the Second Circuit and the Fifth Circuit permit limited partners to provide services to the partnership, the "significant participation" standard adopted by the Fifth Circuit in *Sirius Solutions* is potentially more taxpayer-friendly than the standard adopted by the Second Circuit in *Soroban*. Both standards are less taxpayer-friendly than the Fifth Circuit's withdrawn January 2026 opinion and indicate a narrowing limited partner exception. In response to the revised Fifth Circuit standard, the Department of Justice argued in a letter to the First Circuit (in Denham) that under the definition applied by the Fifth Circuit, the First Circuit should uphold the decision of the Tax Court.

Partners of investment managers claiming the limited partner exception should continue to monitor developments in the various circuit courts and continue to assess the application of the exception to their particular situations.

Notes

1. *K Alain, L.L.L.P. v. Commissioner*, No. 24-60240, slip op. (5th Cir. Aug. 12, 2026) (per curiam).
2. 165 F.4th 374 (5th Cir. 2026).
3. *Soroban Capital Partners LP v. Commissioner*, No. 25-2079, slip op. (2d Cir. Sept. 17, 2026).
4. *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023).
5. T.C. Memo. 2024-114.
6. Docket Nos. 11587-20 and 30118-21 (T.C. Feb. 20, 2024).

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