Practical Implications of the Limited Partner Exception After *Sirius*

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In this article, the authors examine the Fifth Circuit's holding in *Sirius Solutions* that the limited partner exception from self-employment tax applies to partners who have limited liability in a limited partnership under state law, and they explore its implications for limited partnerships.

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Introduction

On January 16 the Fifth Circuit in *Sirius Solutions*[1] held that the limited partner exception applies to partners in limited partnerships that have limited liability under state law. While this was a significant blow to the IRS's attempts to limit the application of the limited partner exception from the Self-Employment Contributions Act tax under section 1402(a)(13) to passive investors, it should comfort taxpayers who continued to rely on their state law status as limited partners in the face of mounting pressure from the IRS and the Tax Court.

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With additional cases pending before the First and Second circuits, *Sirius* does not represent the final word in the ongoing controversy over the scope of the limited partner exception. But it at least provides some stability for state law limited partnerships and their partners while they wait for further resolution of those cases. Thus, taxpayers who had been considering restructuring the manner in which they hold a partnership interest, for instance by contributing that interest to an S corporation, may wish to defer restructuring until after the pending cases are resolved. Similarly, partnerships considering abandoning a prior limited partner position in the face of the IRS's success in *Soroban* may likewise consider holding off on that decision.

Background

An individual's self-employment income generally includes their distributive share of partnership income, with certain listed exceptions (for example, dividends received from a corporation) not relevant to this discussion.[2] Section 1402(a)(13) (the limited partner exception) was introduced to the code in 1977 and provides that a limited partner's distributive share of a partnership's income or loss is excluded from the partner's self-employment income; however, it does not exclude the partner's guaranteed payments received for services rendered.[3] As the courts and the IRS later acknowledged, at the time the limited partner exception came into the code, the only state law entity types available to taxpayers seeking to conduct a business or investment through a partnership were state law general partnerships and limited partnerships.[4]

The IRS did not attempt to provide additional guidance on the definition of a limited partner until the 1990s when it issued proposed regulations during the proliferation of new types of entities (such as limited liability companies and limited liability partnerships) eligible to be classified as partnerships for tax purposes. First, the IRS and Treasury issued proposed regulations that would treat owners of an LLC interest the same as similarly situated partners in a state law partnership.[5] After receiving mixed reactions, in 1997 the IRS and Treasury issued new proposed regulations. These new regs would apply to all entities classified as partnerships (including state law limited partnerships) and would make the limited partner exception applicable based on both the treatment of the partners under state law (for example, whether they enjoyed limited liability for partnership debts) and their degree of involvement in the partnership's operations.[6] For example, partners who held management authority over the partnership, or who committed significant time to performing services in the partnership's business, would not be treated as limited partners (even if designated that way under state law). Further, partners in certain designated service businesses (for example, accounting and law firms) could never be treated as limited partners.

Congress initially reacted to the 1997 proposed regulations with a moratorium to delay their finalization until July 1, 1998.[7] A Senate resolution passed in connection with the moratorium expressed concern that the 1997 proposed regs might contradict the statutory language of section 1402(a)(13) by denying the limited partner exception to individuals who were limited partners under state law.[8] The 1997 regulations were never finalized and remain outstanding in proposed form.

Renkemeyer

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A 2011 Tax Court decision kicked off the chain of judicial decisions that ultimately led to *Sirius* and similar (pending) cases. In *Renkemeyer*,[9] the court considered applying the limited partner exception to the partners of a law firm operating through a state law LLP and held that the limited partner exception was intended to apply to partnership interests essentially of an investment nature.

Although organized as an LLP, the taxpayers in *Renkemeyer* argued that the limited partner exception applied to their distributive shares because they were designated as limited partners under their organizational documents and enjoyed limited liability under state law. The court said, "in essence, an L.L.P. is a general partnership that affords a form of limited liability protection for all its partners by filing a statement of qualification with the appropriate state authorities."[10] Further, all members of an LLP might be permitted to participate in the partnership's management while also enjoying limited liability. On the other hand, with a limited partnership, only limited partners enjoy limited liability, while the ability to manage the partnership lies with the general partners who have unlimited liability for partnership debts.

Even so, the Tax Court in *Renkemeyer* expressed a willingness to extend the limited exception beyond state law limited partnerships, provided the partnership interest in question resembled that of a state law limited partner. The court examined the legislative history to the enactment of section 1402(a)(13), which indicated that Congress's primary concern was to exclude from Social Security benefit computations "certain earnings which are basically of an investment nature" so that individuals who merely invested in a partnership and were not actively participating in the partnership's business operations (typical of limited partners at the time) would not receive credits toward Social Security coverage.[11] The *Renkemeyer* partners' distributive shares arose from their performance of legal services in the partnership's business — not from a passive investment — and so the limited partner exception did not apply.

Post-*Renkemeyer* Activity

Additional tax court cases considered whether the limited partner exception should apply to entities other than state law limited partnerships with an eye toward whether the interests in that entity were sufficiently similar to those of a limited partner.[12] The key features of that type of interest were limited liability for the partnership's debts (relatively easily satisfied) and a lack of participation in the partnership's management (more difficult to satisfy for an active partner).

The IRS also conducted a partnership compliance campaign focused on partnerships applying the limited partner exception to their active partners.[13] Several investment fund managers were caught up in the IRS's enforcement efforts post-*Renkemeyer*, including some who conducted investment management services through state law limited partnerships. These investment fund managers petitioned the Tax Court in response to the IRS's determination that their partners, although treated as limited partners under state law, did not qualify for the limited partner exception because their interests in the partnership were not akin to passive investments.[14]

Soroban and a Functional Analysis in the Tax Court

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In *Soroban Capital Partners*,[15] the Tax Court addressed whether the limited partner exception automatically applies to all limited partners in state law limited partnerships. The limited partnership structure at play in this case was typical of that used by many fund managers.[16] Soroban Capital Partners LP (Soroban LP) was a state law limited partnership. Soroban LP's sole general partner, Soroban Capital Partners GP LLC (Soroban GP), was a Delaware limited liability company that held approximately a 1 percent interest in Soroban LP. Soroban LP's limited partners were three individuals who also collectively owned 100 percent of Soroban GP in approximately the same percentages that they held in Soroban LP.

Soroban LP earned fee income (that is, compensation for services) for providing investment management services to affiliated funds but argued that its limited partners' distributive shares of its income were exempt from Self-Employment Contributions Act under the limited partner exception.

The Tax Court disagreed and held that a functional analysis test should be applied when determining whether the limited partner exception under section 1402(a)(13) applies to limited partners in state law limited partnerships.[17] It focused on section 1402(a)(13)'s use of the phrase "distributive share of any item of income or loss of a limited partner, as such." In the Tax Court's view, automatically applying the limited partner exception based on a partner's designation under state law would render the phrase "as such" to be surplusage. The Tax Court found that the phrase "limited partner, as such" meant that the limited partner exception should only apply to individuals who, in the eyes of the court, were functioning as limited partners. As with *Renkemeyer*, the Tax Court discerned from the legislative history that Congress intended the phrase "limited partner, as such" to refer to passive investors. While the Tax Court's initial 2023 opinion in *Soroban* held that a functional analysis was required, it did not describe the precise nature of that analysis.[18]

Sirius Solutions LLLP

Sirius Solutions LLLP (Sirius) is a Delaware limited liability limited partnership operating a consulting business. During the years at issue, the partnership had between five and nine limited partners and one general partner, Sirius Solutions GP LLC (Sirius GP). On its partnership returns for the 2014-2016 tax years, Sirius applied the limited partner exception to its partners' distributive shares (other than Sirius GP), even though those partners performed services in Sirius's consulting business and were not passive investors. The IRS audited Sirius's partnership tax returns for those years, and following *Renkemeyer*, issued notices of final partnership administrative adjustments determining that Sirius's partners did not qualify for the limited partner exception.

Sirius petitioned the Tax Court for readjustment of its 2014-2016 tax years. Following *Soroban*, Sirius and the IRS stipulated that: (1) *Soroban* was "precedential and applicable to the issues in this case"; and (2) the functional analysis endorsed in that case dictated that Sirius's "state-law limited partners are not 'limited partners, as such' for purposes of the limited partner exception, and their distributive shares of Sirius's ordinary business income are part of net earnings from self-employment." On February 20, 2024, the Tax Court entered its decision in the case, and three months later, Sirius filed an appeal to the Fifth Circuit.

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The Fifth Circuit's Decision in *Sirius*

As mentioned above, on January 16 the Fifth Circuit issued an opinion in which it rejected the Tax Court's functional analysis approach and found that the limited partner exception applied to partners in state law limited partnerships that had limited liability.[19] The Fifth Circuit relied heavily on general and legal dictionaries from the time section 1402(a)(13) was enacted to give meaning to the term "limited partner." The only commonality of the dictionaries the court considered was that a limited partner had limited liability for the partnership's debts. The Fifth Circuit found that long-standing, consistent interpretations of the term "limited partner" by the IRS in its Form 1065 instructions from 1976 through 2022,[20] as well as Social Security Administration regulations, confirmed that the term means a partner with limited liability in a state law limited partnership.

The Fifth Circuit disagreed with the Tax Court's holding (that the limited partner exception should apply only to passive investors) on grounds that the statute's reference to guaranteed payments described in section 707(c) demonstrated that the drafters contemplated that an individual classified as a limited partner might perform services in the partnership's business. The Tax Court had found that reference to section 707(c) guaranteed payments for services indicated that a limited partner might perform some small amount of services; however, the Fifth Circuit found that the plain language of section 1402(a)(13) did not impose any express limit on the level of services a limited partner could perform. While the Fifth Circuit acknowledged that certain definitions of limited partner from the dictionaries it consulted indicated that limited partners were limited to the amount of partnership business they could conduct, it found that those definitions were in the minority and did not upset its view of the common understanding of the term "limited partner" at the time of section 1402(a)(13)'s enactment. Many states over time and the Revised Uniform Limited Partnership Act of 1976 imposed various limits on the ability of limited partners to participate in the control of their partnerships, but these limits did not change the core of what it means to be a limited partner. That is, a limited partner is one who enjoys limited liability for partnership debts.

Further, the Fifth Circuit declined to place the same degree of weight the Tax Court did on the phrase "limited partner, as such." The Tax Court indicated that this language required a functional analysis of whether a taxpayer was a bona fide limited partner and disqualified a taxpayer who was a limited partner in name only, effectively entailing a comprehensive analysis into whether the partners were generally akin to passive investors, along the lines of *Renkemeyer*.[21] However, the Fifth Circuit said that a taxpayer could hold both a general partner and a limited partner interest in the same partnership. In that situation, the phrase "as such" simply meant that the limited partner exception only applied to the portion of the taxpayer's distributive share attributable to its limited partner interest.

While the Tax Court derived its passive investor standard, in part, from language in the legislative history of section 1402(a)(13), the Fifth Circuit found that language to be of dubious value. To the Fifth Circuit, the language cited in *Soroban* and *Renkemeyer* might indicate that Congress perceived a problem in limited partnership interests being marketed for the purpose of obtaining Social Security benefits, but it provided no insight into how Congress chose to address that problem. Accordingly, the references in the legislative history to partnership interests of an investment nature did not

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influence the Fifth Circuit's view of the plain meaning of the text of section 1402(a)(13). Ultimately, the Fifth Circuit vacated the Tax Court's judgment and remanded the case.

What's Next?

What are taxpayers to make of the Fifth Circuit's holding that the limited partner exception applies to partners in state law limited partnerships that have limited liability? Although further developments in cases pending before other courts of appeals might make muddy waters even muddier, for now, the *Sirius* decision lends a significant level of comfort to applying the limited partner exception to partners in limited partnerships who have limited liability under state law.

At the outset, it is worth considering that while *Sirius* dealt with a consulting business, the Fifth Circuit's holding appears equally applicable regardless of the type of business conducted by a state law limited partnership, including the investment management services present in *Soroban*, *Denham*, and others.

Further, while *Sirius* was decided in the Fifth Circuit, for purposes of determining whether substantial authority exists for a tax position outside of the Fifth Circuit, the regulations under section 6662 indicate that residency may not be relevant to the applicability of a court decision to a taxpayer. Reg. section 1.6662-4(d)(3)(iv)(B) says that:

> The applicability of court cases to the taxpayer by reason of the taxpayer's residence in a particular jurisdiction is not taken into account in determining whether there is substantial authority for the tax treatment of an item.

The regs also say that:

> Notwithstanding the preceding sentence, there is substantial authority for the tax treatment of an item if the treatment is supported by controlling precedent of a United States Court of Appeals to which the taxpayer has a right of appeal with respect to the item.

Accordingly, taxpayers in all circuits should take *Sirius* into account when evaluating their tax reporting position regarding the limited partner exception, including for 2025 partnership tax years.

Taxpayers, particularly those in the Fifth Circuit, who have paid self-employment tax on their distributive share as limited partners (excluding guaranteed payments) should consider filing refund claims for any open tax years. If the partnership is subject to the Bipartisan Budget Act[22] centralized partnership audit regime, taxpayers should coordinate with the partnership representative to understand whether it will adjust any previously filed returns through an administrative adjustment request to remove the limited partners' distributive shares from the amount of self-employment earnings reported in box 14 of Schedule K-1. Fund management companies will typically be subject to that regime and would likely file an administrative adjustment request, make a push-out election under section 6226, and provide the corresponding adjustments on Form 8986, "Partner's Share of Adjustment(s) to Partnership-Related Item(s) (Required Under Sections 6226 and 6227)," to its

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partners. Further, because self-employment taxes are not chapter 1 taxes and, thus, are not directly adjusted through the BBA centralized audit regime, affected partners would still need to file individual amended returns to claim a refund of self-employment taxes.

If the partnership representative is not willing to file an administrative adjustment request, partners can potentially act independently and file a refund claim at the individual level. A refund claim filed at the individual level may be accomplished by a partner filing an amended return (Form 1040-X) and including Form 8082, "Notice of Inconsistent Treatment," with their Form 1040-X notifying the IRS that they are taking a position inconsistent with the Schedule K-1 received from the partnership. As of the date this article was drafted, the IRS had not acquiesced to the result in *Sirius*, so taxpayers filing refund claims knowing that the IRS takes a contrary position should be prepared to litigate.[23] Partnerships and partners filing refund claims might consider a disclosure option to mitigate potential penalty exposure.

It remains to be seen how the Tax Court and the IRS will respond to *Sirius*. For now, *Soroban*'s functional analysis remains the rule in the Tax Court. However, taxpayers whose appeal would be to the Fifth Circuit could expect the Tax Court to follow the "*Golsen* rule" and apply the *Sirius* definition in their cases.[24] The Tax Court's position in *Soroban* is also now being appealed before the First Circuit (*Denham*) and the Second Circuit (*Soroban*), and an IRS-favorable outcome in either or both of these cases could affect the relative weight that taxpayers place on *Sirius*. However, until there are further developments in the Tax Court or other courts of appeal, the Fifth Circuit's ruling in *Sirius* appears to support the ability to apply the limited partner exception to members of a state law limited partnership, without regard to any functional analysis of the partners' activities.

How does *Sirius* affect partners in entities other than state law limited partnerships? The Fifth Circuit expressly declined to answer whether members of other types of entities, such as an LLC or an LLP, may also qualify for the limited partner exception. It seems extremely difficult to rely solely on *Sirius* to apply the limited partner exception to entity types other than limited partnerships simply on the ground that they also provide the type of limited liability that was held to be the defining feature of a limited partner in *Sirius*.

As mentioned above, the Tax Court has not issued further opinions regarding the definition of a limited partner since its reversal in *Sirius*. However, given that the court has already ruled that a functional analysis test must be applied to state law limited partners, it seems arduous to return to the stance that partners holding interests in entities other than state law limited partnerships may qualify for the limited partner exception based solely on a position that they enjoy limited liability under state law.

Limited Partner Exception Planning After *Sirius*

For many taxpayers, *Sirius* likely prompts a pause in any tax planning or restructuring regarding the limited partner exception. Following *Renkemeyer*, the IRS's compliance campaign put taxpayers on notice that it was prepared to challenge and potentially litigate against partnerships that applied the limited partner exception to their active partners. Still, although they could not ignore the IRS's

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contrary position and the possibility of litigation, many taxpayers, including those in the fund management space, felt relatively comfortable relying on their status as limited partners under state law to apply the limited partner exception. For those partners, *Sirius* just provides an additional degree of comfort, at least while they wait for further cases to work their way through the courts of appeals. Thus, any taxpayers who were considering moving to alternative structures, such as the use of an S corporation to hold a partnership interest, or considering abandoning their limited partner exception positions, may want to hold off until additional appellate courts issue their decisions. Even if the Tax Court's functional analysis in *Soroban* is affirmed by one or more appellate courts, this holding pattern could continue until the Supreme Court has weighed in on the issue.

Partnerships organized as LLCs or entity types other than state law limited partnerships could consider conversion to a limited partnership to potentially avail themselves of the limited partner exception. Obviously, entities considering a conversion will need to evaluate factors beyond federal employment tax issues (for example, the effect of liability allocations under section 752). As previously mentioned, both the IRS and Tax Court continue to assert that a functional analysis is required for section 1402(a)(13) limited partner status, so conversion comes with a degree of uncertainty. However, taxpayers within the Fifth Circuit may have additional incentive to convert, given the directly applicable authority in *Sirius*.

Conclusion

Sirius marks a significant development in the ongoing dispute over the scope of the limited partner exception in section 1402(a)(13). The case will likely provide a degree of comfort and stability to taxpayers holding interests in state law limited partnerships who wish to apply the limited partner exception to their distributive shares. In the meantime, taxpayers and observers will continue to monitor cases pending in the appellate courts and Tax Court. Realistically, absent congressional action, controversy as to the scope of the limited partner exception is likely to continue for months, if not years.

FOOTNOTES

[1] *Sirius Solutions LLLP v. Commissioner*, 165 F.4th 374 (5th Cir. 2026). Sirius was originally formed as a limited partnership but converted to a limited liability limited partnership in 2002.

[2] Section 1402(a), (a)(2)-(3).

[3] Social Security Amendments of 1977, section 313(b), 91 Stat. 1536.

[4] *See Renkemeyer, Campbell & Weaver LLP v. Commissioner*, 136 T.C. 137, 147-149 (2011).

[5] EE-45-94 (Dec. 29, 1994).

[6] REG-209824-96 (Jan. 13, 1997).

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[7] Taxpayer Relief Act of 1997, section 935.

[8] 143 Cong. Rec. 13297 (1997).

[9] *Renkemeyer*, 136 T.C. 137.

[10] *Id.* at 149.

[11] *Id.* at 150 (citing H.R. Rep. No. 95-702 (Part 1), at 11 (1977)).

[12] *See, e.g.*, *Castigliola v. Commissioner*, T.C. Memo. 2017-62.

[13] *See* IRS, "Large Business and International Active Campaigns" (last updated Jan. 5, 2026; last accessed Mar. 12, 2026).

[14] In addition to *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023), on appeal Nos. 25-2079 and 25-2250 (2d Cir. 2025), which is examined below, petitions were filed for *Denham Capital Management LP v. Commissioner*, No. 25-1349 (1st Cir. 2024), and *Point72 Asset Management LP v. Commissioner*, No. 12752-23 (T.C. 2023). The Tax Court found that the limited partner exception did not apply to Denham's active limited partners in *Denham Capital Management v. Commissioner*, T.C. Memo. 2024-114.

[15] *Soroban Capital Partners*, 161 T.C. 310.

[16] The initial Tax Court opinion in *Soroban* was decided on a motion for summary judgment and did not go into detail regarding Soroban's legal structure. A later opinion in the case provided additional factual background (and concluded that the partners at issue did not qualify as limited partners under section 1402(a)(13)). *Soroban Capital Partners v. Commissioner*, T.C. Memo. 2025-52.

[17] The court also ruled that the application of the limited partner exception was to be determined in a partnership-level proceeding under the Tax Equity and Fiscal Responsibility Act of 1982 rules in effect for the relevant tax year.

[18] *Soroban Capital Partners*, 161 T.C. at 320 ("Congress enacted section 1402(a)(13) to exclude earnings from a mere investment. It intended for the phrase 'limited partners, as such' used in section 1402(a)(13) to refer to passive investors.").

[19] *Sirius Solutions*, 165 F.4th 374. During the pendency of Sirius's appeal before the Fifth Circuit, the Tax Court issued opinions in *Denham*, T.C. Memo. 2024-114, and *Soroban*, T.C. Memo. 2025-52, in which the court applied its functional analysis test to fact patterns involving fund managers. In both cases, the Tax Court found that the partnership's limited partners, who performed services in the partnership's fee-earning activity, did not qualify for the limited partner exception.

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[20] *See* IRS, 2014 Instructions for Form 1065 (Jan. 15, 2015; last accessed Mar. 16, 2026). The Form 1065 instructions for 2014 defined limited partner as "a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership."

[21] *See Soroban*, T.C. Memo. 2025-52, at *25 (applying a functional analysis to the *Soroban* state law limited partners).

[22] Bipartisan Budget Act of 2015, signed into law on November 2, 2015. The BBA replaced the auditing and tax collection procedures for partnerships under TEFRA and the electing large partnership rules with a centralized partnership audit regime. This article is not intended to address the full range of reporting and other technical aspects under the BBA.

[23] The government continues to strongly oppose the Fifth Circuit's holding in *Sirius*, referring to it as being "fundamentally flawed and unpersuasive." *See* Answering Brief for the Appellee, *Soroban*, Nos. 25-2079 and 25-2250 (2d Cir. Mar. 9, 2026). Additionally, on April 1, 2026, the Department of Justice filed a petition for a rehearing en banc, noting that the appeal "concerns a question of exceptional importance."

[24] Under the rule in *Golsen v. Commissioner*, 54 T.C. 742, 757 (1970), *aff'd*, 445 F.2d 985 (10th Cir. 1971), the Tax Court will follow a "squarely in point" decision of the appellate court, to which an appeal of a case would lie when the appellate court's decision contradicts the Tax Court's own precedent.

END FOOTNOTES

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