5th Circ. Ruling Clarifies Tax Rules For Limited Partners

By **Adam Tejeda and Randy Clark** (February 2, 2026)

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Under the so-called limited partner exception to self-employment taxes, an individual who is treated as a limited partner for self-employment tax purposes generally is not required to pay self-employment tax on their distributive share of partnership earnings.

On Jan. 16, in Sirius Solutions LLLP v. Commissioner, the U.S. Court of Appeals for the Fifth Circuit ruled that individuals who are partners in a limited partnership and who have limited liability under state law generally are not subject to self-employment tax on their share of the partnership's income, even if they are actively involved in the business or provide services to the partnership.[1]

The court rejected a 2024 U.S. Tax Court decision requiring a "functional analysis" test that looked at how active a partner was in day-to-day operations. The Fifth Circuit instead adopted a clearer rule based on the partner's legal status.

As a result, the decision provides greater certainty for limited partners by focusing on whether they have limited liability, rather than on the nature of their involvement in the business. Because the decision was issued by the Fifth Circuit, it directly applies to taxpayers in Texas, Louisiana and Mississippi, though it may still influence how similar issues are addressed elsewhere in the country.

Review of the Functional Analysis Test

The IRS' position in Sirius, supported by prior wins against the taxpayers in the Tax Court, relied on a functional analysis test, under which limited partners were exempt from self-employment tax based on whether those partners acted as passive investors.

The functional analysis test required a detailed factual inquiry to determine whether a partner qualifies for the limited partner exception to self-employment tax. Rather than considering only state-law labels, the test examines the actual roles and responsibilities of partners to ascertain their status for tax purposes.

Ultimately, the primary objective of the functional analysis test is to determine if a partner is functioning as a passive investor, which the IRS and the Tax Court have argued is the intended scope of the limited partner exception. The Tax Court's justification for the test relies on the phrase in Internal Revenue Code, Section 1402(a)(13), excluding from self-employment income "the distributive share of any item of income or loss of a limited partner, as such," interpreting that to mean the exception only applies when a partner is actually functioning in a limited, passive capacity.[2]

Factors Considered

Under this approach, the IRS and the Tax Court evaluate an extensive list of factors, including:

- Management and authority: whether the partner exercises managerial authority, serves on committees or has the authority to bind the partnership;

- Participation and effort: the amount of time the partner devotes to the partnership business and whether their time, skill and judgment are essential to operations;

- Marketing and expertise: how the partnership markets the partner's expertise to its clients; and

- Economic relationship: whether the partner's distributive share of income bears a meaningful relationship to their capital contributions.

A common critique of the functional analysis test is that, like any facts and circumstances-based analysis, it creates uncertainty. The IRS nevertheless has successfully asserted its application in the Tax Court to partners in state-law limited partnerships.[3]

Rejection of the Passive Investor Standard

The Fifth Circuit explicitly rejected the functional analysis test, concluding that the statute does not require an inquiry into the roles, responsibilities or daily participation of the partner to determine their limited partner status for tax purposes. The court established a bright-line rule that a limited partner is simply a partner in a limited partnership who possesses limited liability.

Drawing on dictionary definitions, the court defined this liability as being limited to the amount of capital or financial investment the partner has contributed to the partnership, which contrasts with a general partner, whose liability for partnership debts is unlimited.

While the court relied on state law, it noted that federal meaning does not depend on state labels alone and that a partner must actually be afforded the substantive attribute of limited liability to qualify as a limited partner under its test. For example, if a partner's participation in management was extensive enough that they lost their limited liability protection under state law, they would no longer be considered a limited partner for the purposes of Section 1402(a)(13).

Dual-Status Partners and Guaranteed Payments

The court interpreted the statutory phrase "limited partner, as such" to distinguish the capacity in which a partner receives income. In the court's view, this clarifies that if an individual is both a general partner and a limited partner in the same partnership, only the distributive share of income received in their capacity as a limited partner was exempt from self-employment tax.

The court noted that Section 1402(a)(13) already excludes guaranteed payments from the exemption, reasoning that Congress must have contemplated that limited partners could be active in the business without losing their status for the exclusion on their distributive shares of income because the statute explicitly subjects guaranteed payments made to limited partners for services rendered to self-employment tax.

The court said the IRS' passive investor requirement would then render the guaranteed-payments clause "entirely superfluous" because, if the exclusion were only available to strictly passive investors who performed no services, there would be no reason for the

statute to detail how to tax a limited partner's services.

Scope and Limitations

The court expressly limited its holding to partners in state-law limited partnerships. It did not address whether members of other entities, such as limited liability companies or limited liability partnerships, qualify for the same interpretation of limited liability.

Most importantly, however, this ruling is binding only for taxpayers within the Fifth Circuit, which includes Texas, Louisiana and Mississippi.

A Potential Circuit Split

The Fifth Circuit is the first federal appellate court to address this specific issue, but appeals relating to the functional analysis test are currently pending in Denham Capital Management LP v. Commissioner, in the U.S. Court of Appeals for the First Circuit, and Soroban Capital Partners LP v. Commissioner, in the U.S. Court of Appeals for the Second Circuit.[4]

If different circuits apply different standards to the same federal tax issue, the U.S. Supreme Court may ultimately be called upon to resolve the definition and ensure a uniform nationwide application of the self-employment tax exception.

In the meantime, the Tax Court can continue to apply its functional analysis test to any taxpayers whose cases would be appealed to circuits other than the Fifth Circuit.

Uncertainty in Current Planning

While the ruling is limited, Sirius Solutions does provide an administrable standard, and may present opportunities for taxpayers in other circuits to restructure their organization and compensation structures to enable asserting a self-employment tax exemption under the bright-line test.

From a planning perspective, taxpayer-owners actively working in pass-through businesses have historically been able to cause their distributive shares to be exempt from self-employment tax, so long as that pass-through business was conducted through an S corporation.[5]

The critical variation in such a structure is that compensation paid to a shareholder-service provider of an S corporation was subject to the Federal Insurance Contributions Act, Federal Unemployment Tax Act and income tax withholding — i.e., the shareholder could be both an owner and a W-2 employee, and the IRS has historically asserted that shareholder-service providers of an S corporation must be paid reasonable compensation for their services.

As a backstop to this, the IRS' position is that dividends received by a shareholder-employee from an S corporation, in the absence of adequate salaries, can be treated as wages and subject to withholding.[6]

However, this is generally still a favorable result as compared to being an active service provider-partner in a limited partnership under the functional analysis test, whereby a partner's entire distributive share of income from the partnership could be subjected to self-employment tax.

One possible way for the IRS to reconcile the treatment of S corporation shareholder-

employees and active limited partners is offered by the Fifth Circuit highlighting the continuing application of self-employment tax to guaranteed payments, which include payments to a partner for services to the extent not based on partnership income.

The IRS could respond to Sirius Solutions by asserting that reasonable guaranteed payments are required for services provided by an active limited partner to a partnership, similar to the reasonable compensation required to be paid to S corporation shareholder-employees.

Sirius Solutions potentially allows active principals of service-based businesses — such as asset management, consulting and professional services firms, and other operating businesses organized as limited partnerships — to avoid self-employment tax on their share of partnership income based on their limited liability status under state law, particularly if they are taxpayers located in the Fifth Circuit.

Planning opportunities may provide the potential for refund claims on previously paid self-employment taxes, provided the statute of limitations remains open.

Taxpayers considering relying on this exception may also wish to evaluate whether to continue treating some portion of their partnership income as subject to self-employment tax — at least up to the Social Security wage base — in order to preserve eligibility for maximum Social Security benefits.

However, until further appellate rulings or legislative action occurs, taxpayers outside the Fifth Circuit should carefully consider the opportunities and risks resulting from the decision in Sirius Solutions.

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

[2] I.R.C. § 1402(a)(13).

[3] Soroban Capital Partners LP v. Comm'r, 161 T.C. No. 12 (2023); Renkemeyer v. Comm'r. 136 T.C. 137 (2011).

[4] One meaningful difference in the landscape of these three cases is that, in Sirius Solutions, the taxpayer stipulated that they would lose if a functional test applied. In contrast, Soroban and Denham involve more extensive consideration of the "functional test" itself, as well as the specific activities of the partners involved.

[5] Rev. Rul. 59-221, 1959-1 C.B. 225.

[6] Rev. Rul. 74-44, 1974-1 C.B. 287.