Fifth Circuit Hands the Taxpayer a Win in the First Appeals Court Case Interpreting "Limited Partner" for Purposes of Self-Employment Tax

by Robert S. Horwitz

Social security and Medicare tax is based on wages paid employees under Internal Revenue Code (IRC) § 3101 and "net earnings from self-employment" under IRC § 1401. "Net earnings from self-employment" is defined in IRC § 1402 and includes an individual partner's "distributive share … of income or loss" of the partnership. Section 1402 contains enumerated exclusions. In 1976, Congress added subsection (a)(13) to § 1402, which reads:

> (13) there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

The provision was added to ensure that individuals did not acquire limited partner interests to qualify for social security benefits.

In the past several years there has been a proliferation of service businesses that have organized as limited partnerships, limited liability limited partnerships or limited liability companies. The members of the business, who perform the services that generate income for the partnership, are limited partners and a limited liability entity owned by one or more of the limited partners is the general partner. All or almost all the profits and losses of the limited partnership were allocated to the limited partners, who do not pay self-employment tax on the income they receive.

The IRS's position is that since the limited partners in these situations effectively manage and control the partnership and perform the services that generate the partnership's income, they were not "limited partners" for purposes of the limited partner exclusion of §1402(a)(13). The Tax Court agreed with the IRS in *Soroban Capital Partners, L.P. v. Commissioner,* 161 T.C. 310 (2023), appeal pending (2d Cir.) and *Denham Capital Mgmt., L.P. v. Commissioner*, T.C. Memo. 2014-114, appeal pending (1st Cir.).

In *Sirius Solutions, LLLP v. Commissioner*, 2026 WL 125600 (5th Cir. 2026), the partnership agreed to be bound by the *Soroban* case, subject to the right to appeal.

The Fifth Circuit reversed the Tax Court and held that a "'limited partner' is a partner in a limited partnership that has limited liability."

Facts

Sirius Solutions, LLLP (Sirius LLLP), is a Delaware limited liability limited partnership that was a business consulting firm. In 2014, it was owned by nine limited partners and one general partner, Sirius GP, which was also its tax matters partner. In 2015, four of the limited partners left the partnership. In 2015 and 2016, Sirius LLLP was owned by five limited partners and one general partner. All income and loss were allocated to the limited partners; none was allocated to Sirius GP. In 2014 and 2015, Sirius LLLP had ordinary business income and in 2016, it had a loss. Sirius LLLP excluded its limited partner's shares of income or loss in computing earnings from self-employment, which was zero.

The IRS audited Sirius LLP's partnership returns for 2014, 2015, and 2016, and determined that the limited partners were not limited partners for purposes of § 1402(a)(13). The IRS issued two Notices of Final Partnership Administrative Adjustment and Sirius petitioned the Tax Court.

A Divided Fifth Circuit Looks to the Statutory Text

The Fifth Circuit issued a split decision. The majority opinion began with the language of § 1402(a)(13), which "is to be given its ordinary meaning at the time of enactment." According to the majority, when the exclusion was enacted, a limited partner was defined as a partner in a limited partnership that has limited liability. Webster's Third International Dictionary, Black's Legal Dictionary, and other dictionaries "confirm that the key feature of a limited partner is limited liability."

The ordinary meaning of "limited partner," however, did not end the majority's analysis. The majority pointed to the IRS and Social Security Administration issuing "contemporaneous and consistent interpretations of 'limited partner.'' This consisted of the IRS instructions to Form 1065, the partnership income tax return.[1] The instructions consistently defined a limited partner as one whose liability is

[1] Under Treas. Reg. § 601.602(a), tax return instructions explain requirements of the IRS to the public.

limited to money and property contributed to the partnership." This definition was not changed until 2022 to "suggest" a possible different interpretation.

The majority noted that if Congress wanted to limit the exclusion to passive investors it could have said so or provided a carve out from the exclusion for limited partners who provide services for the limited partnership. It did not.

As a final buttress for its interpretation, the majority stated if it adopted the IRS's passive investor interpretation and its functional analysis test it would be difficult for limited partners to determine their tax liability. Thus, the majority concluded, the "passive investor interpretation is wrong."

Note: I was in law school when § 1402(a)(13) was enacted. At that time the general rule was that limited partner who participated in or exercised control over partnership management or operations lost limited liability. This rule was incorporated in § 302 of the Uniform Limited Partnership Act until the 2001 amendments. The comment to the 2001 amendment states that it "eliminated the so-called 'control rule,' which had impaired the liability protection accorded to limited partners and had become an anachronism in a world with LLPs, LLCs, and, most importantly, LLLPs." The majority ignores the fact that in 1977 members of Congress would be presumed familiar with the control rule.

The Majority's Take on *Soroban Capital*

In *Sirius Solutions, LLLP*, the majority noted that in *Soroban Capital,* the Tax Court found that § 1402(a)(13)'s use of the phrase "limited partner, as such" made clear the exception "applies only to a limited partner who is functioning as a limited partner." According to the majority (but disputed by the dissent), the IRS did not raise this argument on appeal "for good reason. It fails." To the majority, the use of "as such" did not narrow the meaning of limited partner but merely clarifies that someone who is both a limited partner and a general partner is subject to self-employment tax only on his distributive share as a general partner.

The Principles of Federal Taxation

The IRS argued that a Sirius LLP's suggested interpretation ran afoul of three fundamental principles of federal taxation: (a) that federal law, not state law, controls the interpretation of federal tax statutes; (b) that federal tax law is concerned with economic realities and not labels; and (c) that federal tax law should be uniform

nationwide. The majority disagreed. First, the majority noted that state law creates legal interests, one of which is a limited partnership interest, and federal law dictates when and how those interests are taxed. Federal law provides the definition of limited partner and only looks to state law to determine if the preconditions of the statutory definition are met.

Second, the fact that a state labels someone a limited partner does not make them such if there is no limited liability. Conversely, if a member of a limited partnership has limited liability but is given another label he would still be treated as a limited partner for federal tax purposes. Thus, the majority reasoned that its interpretation looked to economic realities and not just labels.

Third, the majority claimed that its interpretation did not present a serious risk of disuniformity in the interpretation of federal tax laws. Instead, the IRS interpretation runs a greater risk of disuniformity and would engender litigation over the extent of a member's participation in a limited partnership.

The Majority's Other Arguments

The majority also disagreed with the IRS that the history of limited partnership law establishes that the exception only applies to passive investors. According to the majority, the only clear rule that emerges from history is that limited partners have limited liability.

It also disagreed with the Tax Court and the dissent's analysis of the legislative history of § 1402(a)(13). The majority found the legislative history of "dubious value in statutory interpretation" and in any event the text of the statute gave a clear answer. Further, the legislative history was ambiguous and can't be allowed to "muddy clear statutory language." Contrary to the dissent, neither legislative history nor statutory text support the claim that "limited partner" equates to "passive investor."

The majority also dismissed the dissent's arguments that (i) the instructions to Form 1065 are not supportive; (ii) the "unusual employment relationship" of Sirius' partners was relevant (which according to the majority did not change the fact that the limited partners had limited liability under state law); (iii) the majority's interpretation was not a "fair reading" of the statute; (iv) dictionaries do not support the majority; and (v) "as such" limits the meaning of limited partner.

The majority concluded its opinion by stating the "best course is to follow the plain text-which we do."

The Dissent Takes Exception to the Majority's Opinion

The dissent in *Sirius Solutions, LLLP* began with a discussion of cases before *Soroban* that discussed the exclusion of § 1402(a)(13) and which the majority ignored. In *Renkemeyer, Campbell & Weaver v. Commissioner*, 136 T.C. 137, the issue was whether a law firm formed as an LLP was subject to self-employment tax. The Tax Court held it was subject to self-employment tax since the partners were not, in fact, "limited partners" because their share of partnership income was not due to any investment in the partnership but solely to the legal services they performed. In *Hardy v Commissioner*, 113 T.C.M. 1070, a doctor owned a minority interest in a surgical center where he performed surgery. Applying *Renkemeyer*'s functional analysis, the court held that the doctor was a limited partner. Finally, in *Castigliola v. Commissioner*, 112 TCM 1296, the Tax Court used a functional analysis in determining that member-managers of a PLLC were not limited partners for self-employment tax purposes, noting that under local law a limited partners who takes part in control of the business lost limited liability.

The dissent stated that *Soroban* correctly applied a functional analysis because Congress intended the limited partner exclusion to apply to earnings of "an investment nature" and the use of the phrase "limited partner, as such" confirms that Congress meant to exclude earnings from a mere investment."

Turning to the dictionary meaning of "limited partner," the dissent chided the majority for ignoring that the term "limited partner" is qualified by Webster's and Black's to exclude partners who exercised control of the partnership. The dissent pointed out that traditionally limited partners were passive investors who did not take an active role in the management or operations of the partnership.

The dissent then argued that if Congress meant to distinguish the distributive share of limited and general partners it would not have used "as such."

The majority discussed Delaware corporate law, which the dissent found irrelevant since federal law controls federal income tax. Delaware's version of the Uniform Limited Partnership Act contains a "control of the business: provision "making a

functional analysis appropriate even if the majority were correct" about state law labels.

According to the dissent, the legislative history of § 1402(a)(13) supported the Tax Court's conclusion. As to the instructions for Form 1065, its definition of "limited partner" begins with the qualifier "generally," which makes clear that a limited partner's distributive share is not always excepted from self-employment tax. The dissent also noted that instructions for filing out a tax form is not an agency interpretation of "limited partner" and the instructions, in any event, are not inconsistent with the IRS's position.

The dissent argued that the purpose of § 1402(a)(13) was to avoid the situation where a person could get covered by social security and Medicare by passively investing in a limited partnership and paying a small amount of self-employment tax and not a case where persons provide services through a limited partnership and rely on a state law label to avoid paying the tax.

Finally, Sirius GP was owned by the limited partners but had no distributive share of income or loss and received no compensation and the parties stipulated that the limited partners performed services indicative of management or control of Sirius LLLP's business. The dissent would therefore affirm the Tax Court.

The issue of whether limited partners in a structure like that of Sirius LLLP are liable for self-employment tax on their distributive share of income is a close question. When the exception was enacted, a limited partner who was involved in the management or control of the partnership's business lost limited liability. When Congress enacted § 1402(a)(13) did it intend to focus solely on whether a limited partner had limited liability, or did it mean by the "limited partner" a partner who has limited liability and was not involved in the management or control of the business?

While the majority thought the language of the statute was clear, what is clear is that the *Sirius Solutions LLLP* opinion is not the last word. The issue is pending before the First Circuit in *Denham Capital* and the Second Circuit in *Soroban Capital*. If the Tax Court is affirmed in one of those cases, the losing party will probably petition the Supreme Court. If the Tax Court is reversed in both cases, the IRS will have to decide whether to give up the fight.

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