



**SMALL WORLD BUSINESS ADVISORS**

CROSS BORDER TAX ADVISORY

---

**TaxJourney®**

# Fifth Circuit Overturns “Passive Investor” Standard for Self-Employment Tax



On January 16, 2026, the U.S. Court of Appeals for the Fifth Circuit ruled that state-law limited partners in a business consulting partnership can qualify for the self-employment tax exception on their distributive shares without examining what they actually do in the business.

The court held that a partner's allocations in a limited partnership fall within the statutory exception from self-employment tax as long as the partner has limited liability. In a 2-1 decision, the Fifth Circuit set aside the Tax Court's earlier view, which had restricted the exception to individuals who functioned as "passive investors." The court rejected that "passive investor" framework entirely, concluding that for purposes of IRC §1402(a)(13), a "limited partner" is defined by limited-liability status under state law.

The decision has also been noted for its implications for fund managers, as it confirms that limited partnership structures can be used to prevent the application of self-employment taxes.

## **The statutory backdrop (what §1402(a)(13) does)**

Self-employed individuals, including partners in businesses organized as partnerships, are generally required to pay self-employment tax (covering Social Security and Medicare) on their earnings.

For purposes of calculating what counts as earnings subject to that tax, IRC §1402(a)(13) excludes a limited partner's distributive share of partnership income and loss, except for certain guaranteed payments tied to services. The statute itself specifies that the exclusion applies to "the distributive share of any item of income or loss of a limited partner, as such," but brings guaranteed payments for "services actually rendered" back into the tax base.

The provision was originally enacted to prevent individuals from boosting their net earnings from self-employment through partnership allocations that were not tied to actual services, an approach that could have increased Social Security benefits.

## The case background (Sirius Solutions)

Sirius Solutions was a business consulting firm structured as a Delaware limited liability limited partnership. During the years under review, the firm allocated all of its ordinary business income to its limited partners and reported zero net earnings from self-employment for them, taking the position that the §1402(a)(13) limited partner exception applied. The IRS challenged that treatment, arguing that the individuals labelled as limited partners did not qualify as “limited partners” for purposes of the self-employment tax exception.

## How the Tax Court arrived at the “passive investor” standard (Soroban and later cases)

While the Sirius case was still before the Tax Court, the court issued its opinion in Soroban Capital Partners, which involved an IRS challenge to a similar position taken by an investment management firm structured as a limited partnership.

In Soroban and the cases that followed, the Tax Court applied a functional analysis, examining what the limited partners actually did in the business to determine whether their roles resembled those of passive investors. After Soroban was decided, Sirius and the government agreed that the reasoning in Soroban dictated the outcome, leading the Tax Court to rule for the government. Sirius, however, maintained that Soroban was wrongly decided and took the case to the Fifth Circuit.

The Soroban decision was seen as disrupting planning strategies used by private fund managers who relied on limited partnership structures. A later case, Denham (2024), reinforced the IRS’s challenges to these structures, with both Soroban and Denham concluding that certain mixed roles described in the litigation could not qualify for the limited partner exception.

## What the Fifth Circuit said (the new standard)

The Fifth Circuit concluded that a partner in a limited partnership qualifies as a “limited partner” for purposes of the §1402(a)(13) exception so long as the partner has limited liability. Under this approach, there is no need to examine a partner’s day-to-day responsibilities or level of involvement in the business, an explicit break from the functional analysis used by the Tax Court in Soroban.

The court’s reasoning rests on the premise that a person is a limited partner if they hold limited-liability status under state law, a view the court supported by looking to how the term “limited partner” was defined in dictionaries when §1402(a)(13) was enacted.

The Fifth Circuit also rejected the idea that a limited partner must be purely passive. It noted that if limited partners were never permitted to provide services, the statutes carve-back for guaranteed payments for “services actually rendered” would serve no purpose.

The court further criticized the Tax Court’s functional test as creating substantial compliance burdens, characterizing it as a process that would require extensive professional analysis and a fair amount of luck.

Finally, the Fifth Circuit applied its reading of the phrase “as such” in §1402(a)(13) to clarify how the exception applies when an individual holds both limited partner and general partner interests, distinguishing between amounts allocated or paid in each capacity.

## Why this matters (implications and who could care)

Although Sirius involved a consulting partnership, the Fifth Circuit’s reasoning does not hinge on the type of business involved. As a result, the decision appears relevant to other industries, such as investment management, so long as they operate through state law limited partnerships. This is also the first Court of Appeals decision addressing whether a state law limited partner can qualify for the §1402(a)(13) exception even when the individual is not a passive investor.

## Why this matters (implications and who could care) - Continued

Many private fund managers had restructured their limited partnership arrangements after Soroban, Denham, and the original Tax Court outcome in Sirius. The Fifth Circuit's ruling effectively revives the planning approach that relies on the limited partner exception.

While the decision is not binding on the IRS in cases appealed to other circuits, it may give taxpayers who previously accepted the IRS position a basis to consider refund claims or restructuring to once again claim Social Security tax exemptions for limited partners. Entities taxed as partnerships that have not previously used the limited partner exception may also want to consider protective filings to preserve the option of a future refund claim.

## Scope limits and what's next (other entity forms + pending cases)

The Fifth Circuit noted in a footnote that its opinion does not address whether owners of other entity types, such as LLPs or LLCs, might also qualify for the §1402(a)(13) exception. The Tax Court has previously refused to apply the limited partner exception to partners in LLPs and members of LLCs, relying on reasoning similar to what it used in Soroban.

Although the Fifth Circuit focused on limited liability status and emphasized that the "limited partner" label itself is not determinative, its analysis suggests that similar arguments could potentially extend to other entity forms, while making clear that the court was not deciding those issues.

The ruling also conflicts with several Tax Court decisions, including cases now on appeal in the First Circuit (Denham Capital Management) and the Second Circuit (Soroban). The outcomes of those appeals will be especially important for taxpayers located outside the Fifth Circuit.



## **SMALL WORLD BUSINESS ADVISORS**

### CROSS BORDER TAX ADVISORY

---

Small World Business Advisors ("SWBA"), is a distinguished professional services firm at the forefront of the industry. Our specialization lies in U.S. tax services focusing on complex tax planning, mergers and acquisitions ("M&A") transactions, cross-border tax structuring, and tax compliance for our clients in business, financial services, private equity, hedge funds, family offices and high net-worth individuals.

SWBA is led by former leaders at big-4 accounting firms, bringing unparalleled experience and insights to every client engagement. Our team's profound technical expertise and strategic acumen ensure that we deliver the highest quality of service.

SWBA is built on the pillars of integrity, transparency, and excellence. Our core values guide everything we do, ensuring that we operate with the highest ethical standards and provide honest, clear, and straightforward advice.

---

[info@swbadvisors.com](mailto:info@swbadvisors.com) | [www.swbadvisors.com](http://www.swbadvisors.com)

SWBA is not, by means of this publication, rendering accounting, business, financial, legal, tax, or other professional advice or services. This document is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may impact your business.

Before making any decision or taking an action that may impact your business, you should consult a qualified professional advisor. SWBA, its affiliates, and related entities shall not be responsible for any loss sustained by any person who relies on this document.

© Small World Business Advisors LLC and affiliated entities.