

## Fifth Circuit Rejects “Passive Investor” Test for Limited Partner Exception from Self-Employment Tax

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January 23, 2026 Don Shiman, Annie Lawson, Sam Starr

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On January 16, 2026, the U.S. Court of Appeals for the Fifth Circuit rejected the “Passive Investor” test used by the Tax Court in *Soroban Capital Partners LP v. Commissioner* (“*Soroban*”) and determined that limited partners are exempt from the self-employment tax in accordance with Internal Revenue Code (“*Code*”) Section 1402(a)(13). The Fifth Circuit case, *Sirius Solutions, L.L.P. v. Commissioner* (“*Sirius*”) extends the limited partner exemption to *both* active and passive limited partners.

Under the Self-Employment Contributions Act (“SECA”), partners generally pay Social Security and Medicare tax (“SECA tax”) on their “net earnings from self-employment.” Code Section 1402(a)(13) carves out an exception for limited partner income. In *Soroban* and two subsequent opinions, the U.S. Tax Court restricted that exception to limited partners who are “passive investors.” The *Soroban* court defined “passive investor” to mean someone “who merely invested in a partnership and who [is] not actively participating in the partnership’s business operations.” To determine whether a limited partner fit that definition, the Tax Court applied a test that weighed whether the “function and roles of the limited partner” were “of an investment nature.” The Tax Court reasoned that SECA was “enacted to exclude earnings that are ‘of an investment nature.’ It intended the phrase ‘limited partner, as such’ to refer to passive investors — that is, partners whose returns are attributable to the capital they contributed rather than to services they perform for the partnership.” The Tax Court went on to conclude that permitting a SECA exemption for limited partners who were actively involved in the partnership and thus limited “in name only” would effectively allow service partners to evade employment tax.

The taxpayer in *Sirius*, Sirius Solutions, is a Texas consulting firm organized as a Delaware limited liability limited partnership. The limited partners of Sirius Solutions were heavily involved in day-to-day client service. Sirius Solutions challenged the IRS’s assessment of SECA tax on its partners. In a 2-1 ruling, the Fifth Circuit agreed with Sirius Solutions and declined to uphold the assessment of SECA tax. The court reasoned that the ordinary meaning of “limited partner” when the statute was enacted referred to limited liability, not a degree of participation. The court further reasoned that the IRS had consistently defined “limited partner” by reference to liability for forty years following the enactment of SECA. In keeping with that reasoning, the court rejected a test based on limited partner activity and adopted a test that extended the Section 1402(a)(13) exemption to any partner with limited liability. Applying that test, the court rejected the assessment of SECA tax against the limited partners of Sirius Solutions.

The *Sirius* ruling now governs state-law limited partnerships in Louisiana, Mississippi, and Texas. Limited partners in those states should confer with counsel to explore potential relief from SECA tax. This can impact many businesses, including fund managers who can structure their economics through their limited partnership interests to avoid the SECA tax. Other jurisdictions are not bound by the *Sirius* ruling and cases involving this issue are pending in the First and Second Circuits and it is uncertain whether those Courts will follow the precedent set in *Sirius* or *Soroban*. Businesses with limited partners in all jurisdictions should review their state-law partnership status and tax status to ensure compliance with the controlling rule for their jurisdiction.

*Sirius* creates a liability-based reading of limited partnership and rejects the Tax Court's passive investor test. In doing so, it creates both opportunity and uncertainty for businesses with limited partners.

Please reach out to Haynes Boone's [Tax Group](#) for fact-specific guidance.

Read the *Sirius* ruling [HERE](#).