Mar 18, 2026

Categories:

Tax Law Defined™ Blog

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Fifth Circuit Hands a Big Win to Limited Partners

The U.S. Court of Appeals for the Fifth Circuit issued a significant decision affecting how limited partners are treated for self employment tax purposes on January 16, 2026. In *Sirius Solutions, L.L.L.P. v. Commissioner*, the court rejected the IRS's "passive investor" test and held that a "limited partner is a partner in a limited partnership that has limited liability."

This ruling has immediate implications for taxpayers in Texas, Louisiana, and Mississippi, and it may influence pending litigation in the First Circuit (*Denham Capital Management LP v. Commissioner*) and Second Circuit (*Soroban Capital Partners LP v. Commissioner*). However, these appeals could evolve in different directions, creating uncertainty that could linger for several years unless Congress or the U.S. Supreme Court steps in to resolve the split. Even though the *Sirius Solutions* decision does not resolve the issue nationwide, it is a big win that confirms taxpayers can rely on the plain meaning of "limited partner" under Internal Revenue Code Section 1402(a)(13).

What the Court Decided

The Fifth Circuit reached the following conclusions:

- A limited partner is defined by limited liability status, not by the level of activity or involvement in the business. The court rejected the IRS's argument that the term "limited partner" does not cover partners who actively participate in business. The opinion brought the emphasis back to reading the law as written and applying it in a manner that works for taxpayers.
- The court pointed out that, for 40 years, the IRS's own Form 1065 partnership return instructions even defined a "limited partner" by referencing a partner's limited liability protection. Thus, there was no "passive investor" definition of limited partner or any other definition hinted at in the instructions.
- However, according to the Fifth Circuit, guaranteed payments for services rendered by a limited partner to the limited

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partnership remain subject to self-employment tax.

Who It Affects

- **Limited partnerships:** The ruling directly applies to state-law limited partnerships. Limited partners in these entities may have a stronger basis for excluding their distributions from self-employment tax.
- **LLC and LLP entities:** The Fifth Circuit expressly declined to address whether members and partners of limited liability companies (LLCs) or limited liability partnerships (LLPs) may also qualify for the limited partner exception.
- **General partners:** For all taxpayers, even those residing in the Fifth Circuit, guaranteed payments for services and distributions to a general partner remain subject to self-employment tax.

Why This Matters

- **Potential tax savings:** Limited partners in the Fifth Circuit may be entitled to exclude more income from self-employment tax.
- **Refund opportunities:** Taxpayers who previously paid self-employment tax on their distributions, based on the IRS's or Tax Court's passive investor interpretation, should consider potential refund claims, subject to any applicable statute of limitations.
- **Possible circuit split:** Appeals pending in the First and Second Circuits could lead to differing interpretations, increasing the likelihood of U.S. Supreme Court or Congressional actions.

Recommended Next Steps

Businesses, sponsors, and investors should consider the following planning opportunities:

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- **Structuring**: Review current partnership structures and self-employment tax exposure. For instance, consider a new business entity as a limited partnership under state law. If your business is already an LLC or LLP, consider converting it into a limited partnership. This can help bring the operational aspects into alignment with the facts in *Sirius Solutions*. Always consider whether restructuring into a limited partnership entity aligns with both your tax and business-purpose objectives.
- **Tax refunds**: Assess potential refund claims, subject to applicable statutes of limitations. If you have already paid self-employment tax on limited partner distributions, you should evaluate the opportunity to claim a refund based on your circumstances and determine how much time you have left.

Looking Ahead

The Fifth Circuit's decision represents a big win toward providing clarity and predictability for the limited partner exception, as well as a meaningful shift toward a more formal, state law-based approach. While the ruling provides clarity for limited partnerships within the Fifth Circuit, it also highlights the need for careful planning and monitoring as other courts consider the same issue. On February 5, 2026, the First Circuit is slated to hear arguments in *Denham*, and *Soroban* is ongoing in the Second Circuit.

If you would like assistance in evaluating the impact of this decision on your current structure or exploring potential planning opportunities, please contact the author or any attorney with our tax team. You can also visit our Tax Law Defined® Blog for more insight into the latest developments in federal, state, and local tax planning and tax administration.

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