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Kirkland Alert

Fifth Circuit Rejects Tax Court’s “Passive Investor” Standard for the “Limited Partner Exception” to Self-Employment Tax in Context of Management Company Income

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On January 16, 2026, the U.S. Court of Appeals for the Fifth Circuit issued a split (2-1) decision in favor of the taxpayer in *Sirius Solutions, L.L.L.P. v. Commissioner*, reversing the U.S. Tax Court on the meaning of “limited partner” for purposes of the “limited partner exception” to self-employment taxes in respect of individual limited partners’ distributive shares of management company income.

Kirkland Tax partners Richard Husseini, P.C., David Foster, P.C., and JoAnne Mulder Nagjee filed an amicus brief on behalf of the Managed Funds Association in support of Sirius’s position in the appeal.

Key Holding and Reasoning

The Fifth Circuit held that the limited partner exception applies to a “limited partner in a state-law limited partnership that is afforded limited liability,” squarely rejecting the Tax Court’s “passive investor” standard and accompanying functional analysis test.

The majority also ruled that simply being labeled a “limited partner” is not enough to qualify for the exception. Thus, courts applying the Fifth Circuit’s taxpayer-favorable standard may still conduct a factual inquiry to determine whether a state law limited partner was so actively involved in the partnership as to lose their limited liability protections under state law.¹

Scope and Limitations

The Fifth Circuit expressly limited its holding to partners in state law limited partnerships, stating in a footnote that it was not addressing whether members of other entity types – such as LLPs or LLCs treated as partnerships for federal income tax purposes – may qualify for the exception if they are afforded limited liability under applicable state law.

Once final, the decision will be binding only with respect to taxpayers whose cases would be appealable to the Fifth Circuit, which encompasses Louisiana, Mississippi and Texas. The Tax Court may continue applying its passive investor standard and functional analysis test to taxpayers in other jurisdictions.

What's Next?

The Fifth Circuit's decision is a significant taxpayer victory, but it is not the final word on the scope of the limited partner exception.

The government has until March 2, 2026, to petition for a rehearing *en banc*. Additionally, the Fifth Circuit's decision is squarely at odds with two other Tax Court decisions with appeals currently pending – *Denham Capital Management LP v. Commissioner* (First Circuit) and *Soroban Capital Partners LP v. Commissioner* (Second Circuit). Decisions in those appeals are expected later this year. If a circuit split emerges, the U.S. Supreme Court may ultimately be called upon to decide the issue.

If you have any questions about this decision, please reach out to a member of your Kirkland Tax team.

1. Under state laws generally applicable to limited partnerships, a limited partner generally loses its limited liability protection when they participate in the control of the partnership's business. Most state laws contain a safe harbor for certain types of activities, and thus the protection is usually only forfeited when a limited partner engages in activities with respect to the limited partnership that are not permitted under the limited partnership law of the state in which the partnership is organized. ↪

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