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Developments in Limited Partner Self-Employment Tax

Key takeaways

- *In Sirius Solutions*, the U.S. Court of Appeals for the Fifth Circuit held that a "limited partner" under Section 1402(a)(13) is simply a partner with limited liability under state law, rejecting the "functional analysis" (active participation) test used by the IRS and the Tax Court.
- The decision is not the final or nationwide word. The government has asked the Fifth Circuit to rehear the case en banc, and similar cases are pending in the First Circuit (*Denham*) and Second Circuit (*Soroban*), with recent oral arguments in the Second Circuit suggesting the very real possibility of a circuit split and eventual Supreme Court review.
- Even if the panel decision stands, *Sirius* does not eliminate the statutory rule requiring self-employment tax on guaranteed payments for services, and it does not address limited liability companies (LLCs) or limited liability partnerships (LLPs).
- **Practical takeaway: Existing investment managers or family offices structured as limited partnerships—especially outside the Fifth Circuit—should continue to pay meaningful guaranteed payments to service partners, and new managers should not choose the limited partnership form assuming active principals will automatically avoid self-employment tax.**

In *Sirius Solutions, LLLP v. Commissioner* (now docketed as *K Alain, LLLP v. Commissioner*), decided in January, a Fifth Circuit panel held that the term "limited partner" for purposes of the self-employment tax rules in Section 1402(a)(13) of the Code[1] means what state partnership law says it means: a partner in a limited partnership with limited liability. That approach rejected the functional analysis test advanced by the IRS and the Tax Court, under which a partner's active participation in the partnership's business could prevent the partner from claiming the limited partner exception from self-employment tax. However, the initial taxpayer win thought to be achieved with the *Sirius* decision is not the last word. In April, the government petitioned for rehearing en banc, which, if granted, would vacate the panel opinion until the full court reaches a decision. Most recently, oral arguments held on June 25 in the Second Circuit in a similar case suggest a circuit split is likely.

In addition to the rehearing that may take place in the Fifth Circuit, there are cases pending in other circuit courts on this question, notably *Soroban Capital Partners LP v. Commissioner* in the Second Circuit and *Denham Capital Management v. Commissioner* in the First Circuit. Based on oral arguments in *Soroban*, the Second Circuit seems poised to side with the government. If a circuit split results from the outcomes of those cases, the issue may ultimately be decided by the Supreme Court. As a result, fund managers, family offices, and other similarly situated limited partnerships should treat Sirius as an important development in the debate, but not as settled authority—and certainly not as a nationwide green light to adopt the approach taken by the January panel decision.

For entities outside the Fifth Circuit, the practical advice remains consistent with what it was prior to the *Sirius* decision. Existing fund managers and similar limited partnerships generally should not assume that active manager-owners can simply rely on limited partner status under state law to exclude all their distributive share from self-employment tax. Likewise, new managers considering formation of a limited partnership should not assume that entity choice alone is determinative on the issue. The conservative view remains that the Tax Court's functional analysis approach still poses real risk until the appellate picture becomes clearer or the Treasury Department issues regulations on point.

The statutory setup—and the fight

Section 1402 generally imposes self-employment tax on a partner's share of partnership trade or business income. Section 1402(a)(13), however, excludes the distributive share of income or loss of a limited partner, **as such**, other than guaranteed payments for services actually rendered to or on behalf of the partnership to the extent those payments are remuneration for those services. The IRS's own guidance continues to state that guaranteed payments to a limited partner for services are included in net earnings from self-employment.

The "other than guaranteed payments" language in this provision has always done a lot of work. Most practitioners historically have not advised individuals actively working for an investment management business carried on by a partnership to take the position that none of their management company income should be subject to self-employment tax. Instead, many fund managers use a two-pronged structure: a guaranteed payment intended to represent compensation for services plus a distributive share intended to capture the partner's ownership economics. This approach attempts to strike a balance between fitting within the statute's text and preserving an argument that not all of a working partner's economics should be treated as service compensation. In this area of tax law, as with many other tax rules, the statute speaks softly while the audit risk carries a big stick.

In that sense, *Sirius* is important. But even if the panel decision is upheld, this is not a clean invitation to abandon guaranteed payments altogether. In the Fifth Circuit, some taxpayers will undoubtedly revisit whether the guaranteed payment needs to be as large as it was under a more defensive, pre-*Sirius* posture. However, most practitioners are still unlikely to advise eliminating guaranteed payments entirely for partners who are plainly providing substantial management services. *Sirius* does not eliminate the statutory phrase "other than guaranteed payments," and it does not address the substantive issue that would arise in situations where a fund manager appears to be paying certain partners little or nothing for very substantial services.

How did we get here?

More historical background helps explain how this economic structure became common.

Congress added the limited partner exception in the Social Security Amendments of 1977. As the original *Sirius* panel emphasized, the provision has remained materially unchanged since then. The panel also noted that the exception was enacted against a backdrop in which limited partnership status was strongly associated with limited liability under state law.

However, over time, the tax issue became more complicated than the statutory text suggests. As business entities evolved and fund sponsors and family offices increasingly used limited partnerships and LLCs with highly active principals, the IRS took the view that a formal title should not control where a partner was plainly performing substantial services. That enforcement posture was reflected in the Tax Court's decision in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023), which applied a functional analysis focused on whether the partner was genuinely acting like a passive investor. In *Sirius*, the taxpayer stipulated that *Soroban* was precedential and that the partners would not satisfy that functional analysis test.

From a market perspective, this uncertainty about whether self-employment tax applies to partnership distributions to service providers produced a familiar compromise. Many advisors recommended that senior investment principals take a meaningful guaranteed payment—often in a range such as $200,000 to $400,000—with the balance of their economics received through partnership allocations. That range is not statutory, regulatory, or judicially blessed. It is much better understood as a market convention shaped by optics, economics, and risk tolerance. The idea was to put enough compensation into a category that clearly looks like payment for services while preserving the argument that the remaining economics are a distributive share of partnership income rather than disguised salary.

The economics behind that convention are obvious. Self-employment tax generally consists of a 12.4 percent Social Security tax up to the annual wage base and a 2.9 percent Medicare tax, with an additional 0.9 percent Medicare tax applying above certain income thresholds. For 2026, the Social Security wage base is $184,500. In practice, this helps explain why guaranteed payment amounts were often calibrated to be substantial but not exhaustive.

What *Sirius* changes

The significance of *Sirius* is that the panel decision runs counter to the Tax Court's position that "limited partner" in Section 1402(a)(13) requires a functional inquiry into passivity. The panel opinion held that a limited partner is a partner in a limited partnership with limited liability under state law, expressly disagreeing with the Tax Court's passive-investor reading. It also noted that the case concerned limited partnerships and did not resolve whether members of an LLC or LLP could also qualify for the limited partner exception.

If this reasoning ultimately prevails, it could materially strengthen the argument that a working partner in a state-law limited partnership may exclude distributive share income from self-employment tax even if the partner is active in the business. For investment managers, that would be a major development because many management entities are owned by service partners whose economics are currently split between guaranteed payments and distributive share precisely to manage this uncertainty.

What *Sirius* does not change

As of now, *Sirius* does not justify a wholesale rewrite of compensation structures—especially outside the Fifth Circuit.

First, the favorable panel opinion may be vacated if an en banc hearing is granted. While practitioners believe it is more likely the rehearing will not be granted, this remains a risk.

Second, the panel opinion did not erase the statutory carveout for guaranteed payments. Section 1402(a)(13) still excludes only the distributive share of a limited partner, and specifically does not exclude guaranteed payments for services. IRS guidance still reflects that point. Thus, even under a taxpayer-favorable reading of who counts as a limited partner, guaranteed payments are likely still required.

Third, *Sirius* does not answer the question for LLCs or LLPs. That limitation is especially important because many investment entities use LLCs for operational reasons. It may be tempting to read more into the case than it actually says, but the panel opinion expressly reserved that issue.

Advice for existing limited partnership investment managers outside the Fifth Circuit

For investment entities already operating through limited partnerships outside the Fifth Circuit, the advice is still fundamentally conservative.

They generally should not revise compensation arrangements or tax reporting positions solely because of the *Sirius* panel decision. A manager who has historically paid service partners meaningful guaranteed payments and treated the balance of the economics as distributive shares is still in a more defensible position than one who abruptly decides those partners need little or no guaranteed payment at all.

Further, particularly in light of the posture taken by the Second Circuit at the *Soroban* oral arguments, it is possible—even likely—that the Fifth Circuit's view will not control outside the Fifth Circuit.

Advice for new managers seeking to form a limited partnership

For new managers considering whether to organize the management entity as a limited partnership, the answer is more nuanced than "yes" or "no."

A limited partnership may still be attractive. If the taxpayer-favorable reading of Section 1402(a)(13) eventually prevails, the limited partnership form could become more helpful than an LLC from a self-employment tax perspective because the statutory language and the Sirius analysis are tied directly to limited partnership status under state law.

However, outside the Fifth Circuit, a new manager should not choose the limited partnership form on the assumption that active fund manager principals will clearly qualify as limited partners for self-employment tax purposes. That is not where the law stands today. The question remains live, and taxpayers outside the Fifth Circuit do not have a controlling appellate decision rejecting the Tax Court's functional analysis.

Accordingly, new managers outside the Fifth Circuit generally should assume that, if they use a limited partnership, they will still need to structure compensation for service partners conservatively. In practice, that usually means continuing to use meaningful guaranteed payments for working principals rather than assuming that all economics can safely flow through as exempt distributive share. The limited partnership may still be the right entity for governance, economics, or state-law reasons, but it should not be marketed internally as a magic cloak of self-employment tax invisibility.

Bottom line

For investment managers outside the Fifth Circuit, Sirius is best viewed as an argument, not an answer. Until the appellate dust settles, existing limited partnership managers generally should maintain meaningful guaranteed payments for service partners, and new managers should not adopt the limited partnership form expecting a clean self-employment tax exemption for active principals. For now, conservative structuring remains the market position while the market waits to see how the First and Second circuits will decide the cases before them or if—as one of the Second Circuit judges in *Soroban* proposed during oral arguments—the Treasury Department issues regulations addressing this point.

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[1] All section references herein and references to the "Code" are to the U.S. Internal Revenue Code of 1986, as amended.

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