

# Limited Partner Status Determined Under State Law – Not Under Passive Investor Rule

## Cross References

- *Sirius Solutions*, 5th Circuit Court of Appeals, January 16, 2026

In addition to income tax, a partner in a partnership is subject to self-employment tax (SE tax) on his or her distributive share of partnership income. IRC section 1402(a)(13) provides an exception from SE tax in the case of a limited partner's distributive share of income. This SE tax exclusion, however, does not apply to guaranteed payments for services rendered.

IRC section 1402(a)(13) does not define the phrase "limited partner" and the Treasury Department has yet to issue any final regulations defining limited partner status under IRC section 1402(a)(13).

The Tax Court issued a ruling as a matter of first impression in *Soroban*, 161 T.C. No. 12 on November 28, 2023. In that decision, the Tax Court held that for purposes of the IRC section 1402(a)(13) exception, the term "limited partners" only refers to passive investors. Thus, according to that ruling, the limited partner exception to SE tax does not apply to a partner who is limited in name only.

The taxpayer in this case had a similar situation as that in *Soroban*. Based upon that ruling, the Tax Court agreed with the IRS that the limited partner's distributive share of income was subject to SE tax even though under state law, they were classified as limited partners. The taxpayers then appealed the decision to the 5th Circuit Court of Appeals.

Sirius Solutions, L.L.P. (Sirius) is a limited liability limited partnership formed under Delaware state law. It operates a business-consulting firm based in Houston, Texas, with additional offices in Dallas, Texas, and London, England.

In 2014, Sirius was owned by nine limited partners and one general partner. The general partner held a 0.6457% interest in the partnership. Four of the limited partners sold their partnership interests, so that for 2015 and 2016, there were five limited partners alongside the general partner. During those latter two years, the general partner held a 0.7529% interest in the partnership. Sirius allocated all taxable income to its limited partners and excluded that income in the calculation of net earnings from self-employment.

The IRS audited Sirius's tax returns and determined the SE tax exception under IRC section 1402(a)(13) did not apply because none of Sirius's limited partners counted as "limited partners."

The sole issue on appeal is the meaning of "limited partner" under IRC section 1402(a)(13). The court noted that dictionaries at the time IRC section 1402(a)(13) was enacted in 1977

defined “limited partner” as a partner in a limited partnership that has limited liability. For example, Webster’s Third New International Dictionary defined “limited partner” as “a partner whose liability to creditors of the partnership is usually limited to the amount of capital he has contributed to the partnership providing he has not held himself out to the public as a general partner and has complied with other requirements of law.”

In contrast, the same dictionary defined a “general partner,” as one “whose liability for partnership debts and obligation is unlimited.” Other dictionaries around the time of enactment confirm that the key feature of a “limited partner” is limited liability.

In 1978, the first year in which the “limited partner” exception under IRC section 1402(a)(13) could be implemented, the IRS issued partnership tax return instructions that defined a limited partner as one whose potential personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership.

The IRS’s interpretation of a limited partner in its yearly instructions remained constant for well over 40 years. In fact, the IRS partnership instructions for Form 1065 for the 2014 through 2016 tax years (the years at issue in this case) likewise defined a limited partner as a partner in a partnership formed under a state limited partnership law, whose personal liability for partnership debts is limited to the amount of money or other property that the partner contributed or is required to contribute to the partnership.

These IRS instructions made clear that the term “limited partner” in IRC section 1402(a)(13) did not have some hidden, narrower meaning from the rest of the Tax Code. What’s more, the instructions provided by the IRS declared that “limited partners may treat as self-employment income only guaranteed payments for personal services actually rendered to the partnership.” Otherwise, a partner in a limited partnership with limited liability could exclude its distributive share of partnership income (or loss). Thus, there is no such thing as a “passive investor” definition of a limited partner, or any other definition, in IRS tax form instructions for the 40 plus years since 1978.

It was not until January 7, 2022, over 45 years after its first interpretation, that the IRS issued partnership tax instructions suggesting a different view. And even then, these new instructions never contradicted the IRS’s earlier definition. They only added a vague possible caveat: “However, whether a partner qualifies as a limited partner for purposes of self-employment tax depends upon whether the partner meets the definition of a limited partner under IRC section 1402(a)(13).”

The Social Security Administration’s (SSA) contemporaneous and longstanding interpretation of limited partner in the Social Security Amendments of 1977 matches the one provided by the IRS. In 1979, just two years after the limited partner exception was adopted, the SSA proposed a rule concerning that exception. One year later, the proposed rule became final. And it is still in effect today. The rule plainly states: “You are a limited partner if your financial liability for the obligations of the partnership is limited to the amount of your financial investment in the partnership.”

The Tax Court raised a single textual argument. The exception set forth in IRC section 1402(a)(13) refers not just to a limited partner, but to a “limited partner, as such.” So, the

Tax Court concluded, by adding “as such,” Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner. It thus concluded that the exception must apply only to a subset of limited partners, not all limited partners, otherwise the words “as such” would be meaningless. The Tax Court assumed that to function as a limited partner, the limited partner must be a passive investor.

The Court of Appeals agreed with the Tax Court that the phrase “as such” in the Tax Code means a limited partner functioning as a limited partner, or a limited partner in the capacity of a limited partner.

The Court of Appeals, however, disagreed with the Tax Court’s conclusion. “As such” does not restrict or narrow the class of limited partner, nor does it upset the term’s ordinary meaning. The Tax Court was mistaken to assume that the phrase “as such” was without meaning unless it somehow severely restricted the scope of the term. People, including limited partners, can have multiple functions or capacities. At the time the statute was enacted, an individual could serve as both a limited partner and a general partner. The phrase “as such,” therefore, clarifies how individuals who serve as both a limited and general partner are to be taxed. Without the qualification, a dual-status partner might think his entire distributive share is not subject to SE tax. So, the words “as such” avoid ambiguity by clarifying that when functioning as a limited partner, a taxpayer’s distributive share of partnership income is excluded from SE tax. But when functioning as a general partner, his distributive share is included in net earnings from self-employment.

The Court of Appeals ruled that a limited partner under IRC section 1402(a)(13) is a limited partner in a state-law limited partnership that is afforded limited liability. The court rejected the IRS’s newly adopted passive investor rule.

#### **Author’s Comment**

It should be noted that most states did not start adopting LLC or LLP laws until years later. The first LLC law in the United States was enacted in Wyoming in 1977, the same year IRC section 1402(a)(13) was enacted. It took over a decade for most other states to follow suit with their own LLC laws, with Florida becoming the second state in 1982 to enact an LLC law. By 1996, all states had adopted legislation allowing for the formation of LLCs. The historical definition of a limited partner is more applicable to a traditional limited partnership, where a general partner manages the business and the limited partners provide the capital investment for the business. Prior to state LLC and LLP laws, if a limited partner took part in managing the business, they risked becoming liable as a general partner. So even under the historical definition of a limited partner, a partner could not be a limited partner in name only if performing management services meant the loss of his or her limited liability status. The purpose behind the original LLC and LLP laws was to provide some form of limited liability protection for members who performed services for the business, a concept that did not exist when IRC section 1402(a)(13) was enacted.

**Dissenting opinion.** One of the circuit judges for the Court of Appeals offered a dissenting opinion, agreeing with the Tax Court that the limited partner exception should only apply to limited partners acting as passive investors. The dissenting opinion highlighted the history of tax court rulings.

In *Renkemeyer*, (2011), the Tax Court considered the issue of whether income allocated to partners of a law firm organized as a limited liability partnership (LLP) under the laws of Kansas was subject to self-employment tax. The LLP partners were not limited partners because it was clear that the partners' distributive shares of the law firm's income did not arise as a return on the partners' investment and were not earnings which are basically of an investment nature. The court instead found that the distributive shares arose from legal services they performed on behalf of the law firm and that they were subject to self-employment taxes.

About six years later, the Tax Court considered the case of *Hardy* (2017). Dr. Hardy was a plastic surgeon who owned a minority interest in one of several surgery centers in which he performed surgeries. Hardy had no day-to-day management or operational responsibilities in the center, which was organized as a limited liability company (LLC) in Montana. The issue was whether Hardy's income from the center was passive which would allow the deduction of a passive activity loss for the year in which the loss was incurred. The Tax Court repeatedly referenced the fact that the surgeon was a passive investor and found his income from the surgery center was passive because he received the distributions as a limited partner acting in his capacity as an investor.

Later that year, the Tax Court again applied the functional analysis test and found that member-managers of a law firm organized as a professional limited liability company (PLLC) under Mississippi law were not limited partners for purposes of the self-employment income exclusion. In that case, the court considered the Uniform Limited Partnership Act (ULPA) of 1916 and the revised ULPA of 1976 which states: "A limited partner shall not become liable as a general partner unless, in addition to the exercise of his rights and powers as a limited partner, he takes part in the control of the business."

The dissenting opinion then considered what the Tax Court stated in *Denham Capital* (2024) in which the court stated: "Our caselaw has continuously reinforced our position that determinations under IRC section 1402(a)(13) require a factual inquiry into how the partnership generated the income in question and the partners' roles and responsibilities in doing so. Petitioner's position that the Partners are eligible for the limited partnership exception merely because the Partners complied with formalities prescribed by state partnership law does not comport with our caselaw."

And in the *Soroban* decision (2023), the court stated: "Congress intended for this limited partner exception to apply to earnings of an investment nature. To determine whether earnings allocated to limited partners are of an investment nature necessarily requires an inquiry into the functions and rolls of the limited partners...If Congress had intended that limited partners be automatically excluded, it could have simply said limited partner. By adding "as such" [to the language in the code], Congress made clear that the limited partner exception applies only to a limited partner who is functioning as a limited partner."

**Author's Comment**

The Tax Code makes clear that guaranteed payments are subject to SE tax, even when paid to a limited partner. But nothing in the law requires a partnership to pay its limited partners guaranteed payments for the services they perform. There is no reasonable compensation rule, similar to the reasonable compensation paid to a shareholder for services performed as an employee of a corporation. The court ruling allows a partnership to simply label all payments to limited partners as partnership distributions instead of guaranteed payments in order to avoid SE tax. It is clearly an unintended tax loophole.