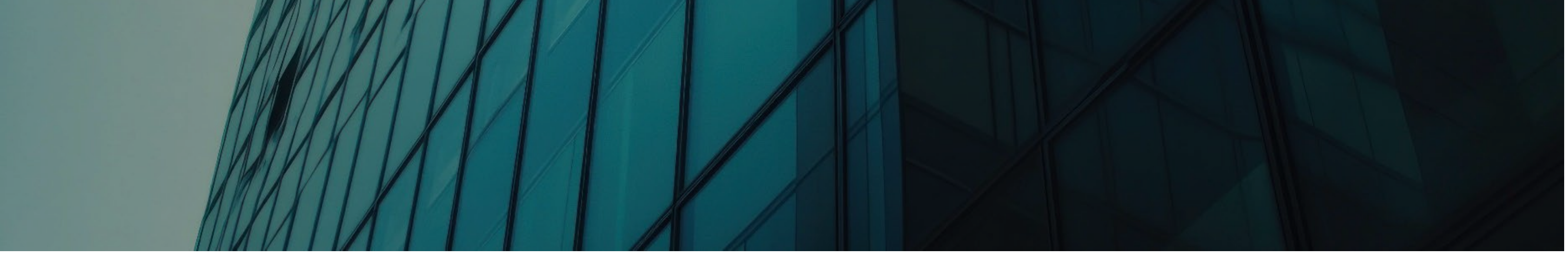

FIFTH CIRCUIT MODIFIES THE DEFINITION OF LIMITED PARTNER FOR SELF-EMPLOYMENT TAX

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1. Overview. IRC §1402(a)(13) provides an exclusion from self-employment tax for income allocated to a limited partner (the "Exclusion"). On January 16, 2026, the Fifth Circuit, in *Sirius Solutions L.L.L.P. v. Commissioner*[1], held that a limited partner is a partner that is not liable for the debts of the partnership. On August 12, 2026, the Fifth Circuit withdrew that opinion and issued a new opinion (the "New Opinion")[2], which added a new condition, discussed below.

2. "Managing or Running" the Business. In the New Opinion, the court defined limited partners as partners with limited liability *and* that are not involved in "*managing or running*" the business. The court held that partners "*managing or running*" the business were partners that had "management or control of the business," such as "managing partners," and the court referred to the "managerial/non-managerial distinction." Thus, "running" the business was equated with "managing" the business. Critically, the court rejected the test advocated by the IRS and applied by the Tax Court, which is that limited partners must be "passive investors." The net result is that partners may be limited partners for purposes of the Exclusion even if they are active in the business as long as they have limited liability and are not managing the partnership.

3. Partnership. For the Exclusion to apply, the entity must be a partnership for tax purposes.[3] An LLC or LLLP will therefore qualify as long as the entity has two or more members or partners and has not elected to be taxed as a corporation.

4. Excluded Income. The Exclusion only applies to income that would otherwise be subject to self-employment tax. (See below for a caveat for those claiming qualified retirement plan deductions.) Thus, rents and investment income are not subject to the Exclusion and may be subject to a separate 3.8% tax on "net investment income."

5. Guaranteed Payments. The Exclusion does not apply to "guaranteed payments" for services under IRC §707(c), which applies to payments for services if the payments are "determined *without regard to the income* of the partnership." *Pratt v. Commissioner*[4] held that payments based on a percentage of gross income are not guaranteed payments because they *are*

determined with reference to the income of the partnership. Thus, a payment to a partner that is based on a percentage of collections is not a "guaranteed payment." There are proposed regulations that would treat gross income allocations as guaranteed payments, but those proposed regulations were never finalized and thus do not apply. In contrast, minimum base compensation should be a "guaranteed payment."

6. Future Cases. This precise issue is on appeal in two other circuits where the IRS is advocating restricting the definition of limited partner to passive investors. So the outcome of those cases may determine if this issue is ultimately resolved by the Supreme Court.

7. Disclosure. One key issue is whether taxpayers should disclose reliance on the New Opinion on Form 8275 on future tax returns in order to avoid penalties in case they lose in Tax Court and on appeal. Under IRC §6662, a 20% penalty can be imposed for an understatement of tax that is due to (as applicable here) (a) negligence, (b) disregard of "rules or regulations," or (c) an understatement of tax over the greater of 10% of the tax required to be shown on the return or $5,000 that is not supported by "substantial authority." The IRS tax form instructions on this issue do not constitute a "rule or regulation,"[5] the New Opinion is "substantial authority," but disclosure does not avoid the penalty if the court rules that the taxpayer was negligent for not following the IRS position as stated in the tax return instructions. The net result is that there is no reason to file a disclosure statement with a return that relies on the New Opinion if the K-1 issued to the taxpayer follows the New Opinion. If the K-1 does not follow the New Opinion, the taxpayer would be well-advised to file a Form 8082 to disclose the inconsistency.

8. Amending Prior Returns. Another key issue is whether it is worth amending prior returns that are open under the three-year statute of limitations. An amended return should be considered for taxpayers residing in the Fifth Circuit, because the Tax Court *must* follow the New Opinion in that circuit. For taxpayers outside the Fifth Circuit, (a) the IRS is almost certain to deny a refund request, (b) the taxpayer will thus have to fight the issue in court, and (c) most importantly, an amended return often triggers an audit. It may therefore not be worth amending prior returns for taxpayers not in the Fifth Circuit. In any case,

the decision on whether to file an amended tax return should be made in consultation with your tax advisor.

9. Loss of Deductions to Retirement Plans. A significant potential detriment of relying on the New Opinion is that deductions for payments to qualified retirement plans are not permitted for income that qualifies for the Exclusion. Thus, taxpayers should quantify the relative tax savings and cost before relying on the New Opinion.

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[1] *Sirius Solutions, L.L.L.P., et al. v. Commissioner of Internal Revenue*, 165 F.4th 374 (5th Cir. 2026).

[2] *K Alain L.L.L.P. v. Commissioner of Internal Revenue*, No. 24-60240 (5th Cir.).

[3] IRC §7701(a)(2); *Joseph v. Commissioner*, T.C. Memo 2020-65 (U.S. Tax Ct. 2020).

[4] *Pratt v. Commissioner*, 64 T.C. 203 (1975), aff'd on this issue, 550 F.2d 1023 (5th Cir. 1977).

[5] Treas. Reg. §1.6662-3(b)(2).