

Second Circuit affirms treatment of limited partners for self-employment tax purposes

September 25, 2026

In brief

What happened?

The US Court of Appeals for the Second Circuit issued an opinion in *Soroban v. Comm’r* (No. 25-2079) on September 17 holding that a limited partner for purposes of Section 1402(a)(13) (the SECA limited partner exclusion) is a partner who has limited liability and who does not run, manage, or control the partnership’s business. The opinion affirmed the Tax Court’s 2023 determination (*Soroban I*) that status as a limited partner under state law is not dispositive and that Section 1402(a)(13) requires a functional inquiry into the partner’s role in the partnership. The Second Circuit, however, did not adopt the Tax Court’s formulation that the exclusion is limited to “passive investors.” Instead, the Second Circuit held that a partner may provide some services to the partnership and still qualify as a limited partner, provided those activities do not constitute controlling, managing, or running the business. Applying that standard, the Second Circuit affirmed the Tax Court’s 2025 determination (*Soroban II*) that Soroban’s limited partners did not qualify for the SECA limited partner exclusion based on the Tax Court’s factual findings that the Soroban limited partners exercised managerial control over the partnership and played an essential role in generating its income.

Why is it relevant?

The decision is the latest in extensive and ongoing litigation between the IRS and taxpayers addressing the meaning of the term “limited partner” for purposes of the SECA limited partner exclusion. The opinion

upholds the IRS position that status as a state law limited partner is not determinative in applying the SECA limited partner exclusion. Instead, an inquiry must be made into the limited partner's activities related to running, managing, or controlling the partnership.

Actions to consider

Limited partners, including those in state law limited partnerships, who participate in the managing or running the partnership's business or who otherwise control the partnership should continue to monitor developments in this area and discuss tax reporting implications with their advisors.

Limited partners who have no significant role in management or control of the partnership also should monitor developments in this area and consider the applicability of the SECA limited partner exclusion in consultation with their advisors.

In detail

Soroban Capital Partners LP (Soroban) is an investment firm organized as a Delaware limited partnership and classified as a partnership for US federal tax purposes. Soroban's limited partners received guaranteed payments in exchange for providing services to Soroban and received allocations of Soroban's ordinary business income. Soroban excluded its limited partners' shares of ordinary business income from its computation of net earnings from self-employment. The IRS disallowed this treatment in a Notice of Final Partnership Administrative Adjustment, increasing Soroban's net earnings from self-employment. Soroban's general partner petitioned the Tax Court for review.

Under Sections 1401(a) and 1401(b), individuals are subject to tax on self-employment income, which generally includes a partner's distributive share of partnership income. Section 1402(a)(13), however, provides an exclusion for limited partners that excludes from "net earnings from self-employment"

[t]he distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in Section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services.

The term "limited partner, as such" is not defined by the statute or the legislative history. Soroban argued that a state law limited partner in a state law limited partnership was a "limited partner, as such" based on the plain meaning of the statutory language.

In *Soroban I*, (161 T.C. 310), the Tax Court denied Soroban's motion for summary judgment, concluding that state-law limited partner status alone does not determine whether a partner qualifies for the SECA limited partner exclusion. The Tax Court stated that Congress intended the exclusion to apply to partners that are passive investors and held that a determination of eligibility requires an inquiry into the function and roles of the limited partner. Under the Tax Court's formulation, active participation in the partnership's business could prevent the partner from qualifying for the exclusion. On May 28, 2025, the Tax Court issued its second opinion in the case (*Soroban II*, T.C. Memo. 2025-52), holding that Soroban's limited partners did not qualify for the SECA limited partner exclusion because of their essential roles in managing the partnership's business and generating its income. Soroban's general partner then appealed the Tax Court's decision to the Second Circuit.

In the interim, the Tax Court separately ruled that the *Soroban I* order was controlling with respect to the facts of another taxpayer, Sirius Solutions (Sirius), allowing Sirius to appeal the Tax Court's order in *Soroban I* to the US Court of Appeals for the Fifth Circuit. The Fifth Circuit, in *Sirius v. Comm'r (Sirius I*,

165 F.4th 374), issued an opinion in January 2026 rejecting *Soroban I*'s functional analysis test and holding that a limited partner's eligibility for the SECA limited partner exclusion depends solely on whether the partner has limited liability. In August 2026, the Fifth Circuit withdrew *Sirius I* and issued a new opinion, (*K. Alain v. Comm'r*, No. 24-60240) (*Sirius II*). *Sirius II* concluded that the ordinary public meaning of "limited partner" at the time the SECA limited partner exclusion was enacted was "a partner who plays no significant role in managing or running a business." The Fifth Circuit did not provide a standard for determining significance, instead remanding the case to the Tax Court to interpret and apply its new test to the *Sirius* facts (which are essentially identical to those of *Soroban*).

Like the Fifth Circuit in *Sirius II*, the Second Circuit concluded that state-law limited partner status is not dispositive and focused its analysis on the ordinary meaning of the term "limited partner" when Section 1402(a)(13) was enacted in 1977. The Second Circuit determined that a "limited partner" was a partner whose liability was limited to the amount of the partner's contribution and who did not take part in running the business. In doing so, the Second Circuit agreed with the Tax Court that a partner's actual functions and role must be considered, but it did not adopt the Tax Court's suggestion that only a passive investor can qualify. Rather, the Second Circuit explained that a partner may provide some services to the partnership and still qualify as limited: "[s]o long as the activities in question do not constitute controlling, managing, or running the business, a partner may play a role in the partnership and still qualify as 'limited' under section 1402(a)(13)." In reaching this conclusion, the Second Circuit noted that while the Fifth Circuit did not explain what it meant by "nonsignificant," it agreed with the determination to the extent that it allowed for the provision of some services.

The Second Circuit applied its new standard to *Soroban*'s facts, finding that the *Soroban* limited partners managed and controlled the *Soroban* business because they (1) worked full time for *Soroban*, (2) managed *Soroban*'s investments, (3) played critical roles in generating *Soroban*'s income, (4) sat on all (or all but one) of *Soroban*'s governing committees during the years in dispute, and (5) collectively participated in making employee management decisions for *Soroban*. Accordingly, the Second Circuit affirmed the Tax Court decision that the *Soroban* limited partners could not exclude their distributive shares of partnership income from self-employment income.

The court's analysis also comes against the backdrop of proposed regulations under Section 1402(a)(13) issued in 1997. The proposed regulations provide generally that an individual classified as a partner for federal income tax purposes is a limited partner unless the individual has personal liability for partnership debts, has authority to contract on behalf of the partnership, or participates in the partnership's trade or business for more than 500 hours during the tax year. After many commenters raised concerns about the proposed regulations, a temporary moratorium preventing Treasury and the IRS from issuing regulations defining a limited partner under Section 1402(a) was issued over concerns that Treasury had exceeded its regulatory authority. As described in an Engrossed Amendment Senate to the Revenue Reconciliation Act of 1997, the Senate was concerned that the proposed regulations "would effectively change the law administratively without congressional action." The Senate's concern was that a limited partner's income could be subject to self-employment tax even if they were a passive investor; for example, a true passive partner who was personally liable for his share of partnership debts would not be treated as a limited partner under the proposed regulations. The Second Circuit and Fifth Circuit did not rely on or adopt the proposed regulations, but both similarly rejected a rule under which state-law limited partner status alone determines application of the SECA limited partner exclusion.

Observation: The Second Circuit's test prohibits limited partners that run, manage, or control the partnership from qualifying for the SECA limited partner exclusion while the Fifth Circuit's test prohibits partners who play a "significant" role in managing or running the partnership from applying the exclusion. Note that the Fifth Circuit remanded *Sirius II* to the Tax Court, which will have the first opportunity to reconcile the difference, if any, between the two tests. The Second Circuit addressed the Fifth Circuit's

opinion in *Sirius II*, stating that while the Fifth Circuit adopted a somewhat different definition of “limited partner” (a partner who plays no significant role in managing or running the partnership’s business), there seemed to be “little daylight” between the Fifth Circuit’s newly announced test and the Tax Court’s test in *Soroban I*.

Observation: Since 2018, the IRS has maintained a compliance campaign specifically focused on the application of self-employment tax to the entirety of a partner’s distributive share of income. The IRS also continues to raise the issue in the course of broader partnership examinations. The Second Circuit and the Fifth Circuit opinions both seek to establish a common federal definition of “limited partner” based on its ordinary meaning at the time Congress enacted Section 1402(a)(13), thus avoiding a situation in which a state law definition would control a federal tax result.

In doing so, both the Second Circuit and the Fifth Circuit recognized that limited partners may provide some services and still qualify for the SECA limited partner exclusion (a rejection of the Tax Court’s “passive investor” test). Additionally, both Circuits acknowledged that the nature of the services--and particularly whether they involve management, control, or running of the business--may be more important than the amount of time spent providing services. Thus, the opinions suggest that regardless of entity type, a partner with limited liability who provides services could be eligible for the SECA limited partner exclusion if the facts and circumstances demonstrate that such partner does not run or control the partnership or its business and does not have management responsibilities.

Observation: Neither the Second Circuit nor the Fifth Circuit adopted a bright-line test or identified objective criteria for identifying limited partners such as those put forth in proposed regulations issued in 1997. Regulations under Section 1402(a) were included in the Treasury and IRS Priority Guidance Plan released October 3, 2024, but were removed from the 2025-2026 Priority Guidance Plan. It remains to be seen whether future regulatory guidance will be issued.

Observation: The Tax Court also applied the functional analysis test in *Denham Capital Management v. Comm’r* (T.C. Memo. 2024-114), which is currently on appeal to the First Circuit. The facts in *Denham* are similar to those in *Soroban* and *Sirius*. The First Circuit held oral arguments on February 5, 2026, after which the parties filed supplemental briefs on TEFRA procedural issues in response to the court’s request. A circuit split could arise if the First Circuit interprets limited partner differently than the Second and Fifth Circuits. Additionally, the Second Circuit determined that net earnings from self-employment are a partnership item subject to TEFRA partnership-level proceedings such that the Tax Court had jurisdiction to hear the case. This issue is also under consideration by the First Circuit.

Observation: We expect IRS activity to continue, including fact-intensive examinations regarding whether particular partners are limited partners for self-employment tax purposes. Limited partners who control the partnership or who have a role in managing or running the partnership’s business should discuss their circumstances and tax reporting position with their tax advisor.

See also

- [Fifth Circuit creates new definition of “limited partner” for self-employment tax purposes \(Aug. 14, 2026\)](#)
- [Fifth Circuit rejects narrow interpretation of “limited partner” for self-employment tax purposes \(Jan. 22, 2026\)](#)
- [Tax Court limits meaning of “limited partner” for self-employment tax purposes \(Dec. 4, 2023\)](#)

Let's talk

For a deeper discussion of how this issue might affect your business, please contact:

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