

Self-Employment Tax Limited Partner Exception, *K Alain, L.L.L.P. v. Commissioner*, 2026 WL 2333930 (5th Cir. Aug. 12, 2026); *Soroban Capital Partners LP v. Commissioner*, 2026 WL 2751819, 2026 TNTF 180-23 (2d Cir. Sept. 17, 2026)

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The Self-Employment Tax Limited Partner Exception Is Confined to Limited Partners Not Involved in Managing or Running a Business According to Fifth and Second Circuits; Application to LLCs; Alternative Planning With S Corporations

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1. “Limited Partner” Exception to Self-Employment Tax

The self-employment tax, sometimes referred to as the SECA tax, is essentially the counterpart for self-employed persons of the Social Security and Medicare taxes imposed on employee compensation. The basic rate is 15.3%—12.4% for Social Security and 2.9% for Medicare. For 2026, the Social Security portion applies only up to the \$184,500 Social Security wage base, while the 2.9% Medicare component has no wage ceiling. An additional 0.9% Medicare tax can apply above statutory income thresholds. FICA (Federal Insurance Contributions Act) applies to wages from employers to employees; the taxes are divided between the employer and employee. SECA (Self-Employment Contributions Act) applies to self-employment income; it generally imposes the economic equivalent of both the employee and employer shares of Social Security and Medicare taxes on net self-employment income, subject to similar Social Security wage-base limitations.

The Internal Revenue Code generally includes a partner’s distributive share of partnership trade or business income in the partner’s net earnings from self-employment, §1402(a). Section 1402(a)(13), however, provides an important exception for a limited partner. It excludes from net earnings from self-employment “the distributive share of any item of income or loss of a limited partner, as such,” other than “guaranteed payments . . . for services actually rendered.” The statute does not define “limited partner.” That omission has produced an increasingly important dispute over whether the exception turns on a partner’s formal status under state law, the partner’s activities in the business, or some combination of the two.

2. Fifth Circuit Case, *K. Alain, L.L.L.P. v. Commissioner*

- a. **Facts and Procedural Background.** *K. Alain, L.L.L.P. v. Commissioner*, 2026 WL 2333930 (5th Cir. Aug. 12, 2026), involves Sirius Solutions, L.L.L.P., now known as K Alain, L.L.L.P., a Delaware limited liability limited partnership operating a business consulting firm. In 2014 Sirius had nine individual limited partners and an LLC general partner that owned less than 1% of the partnership; after several partners departed, five individual limited partners remained in 2015 and 2016. Sirius allocated all of its ordinary business income—approximately \$5.8 million in 2014 and \$7.2 million in 2015—to the individual limited partners and, relying on § 1402(a)(13), reported no net earnings from self-employment with respect to those allocations. The IRS determined that the individual partners did not qualify as “limited partners” for § 1402(a)(13) purposes and increased Sirius’s net earnings from self-employment to approximately \$5.9 million for 2014 and \$7.4 million for 2015. The Tax Court sustained the IRS based on its 2023 decision in *Soroban Capital Partners LP v. Commissioner*, 161 T.C. 310 (2023).
- b. **Original Sirius Solutions Opinion.** In its original January 16, 2026 opinion, *Sirius Solutions, L.L.L.P. v. Commissioner*, 165 F.4th 374 (5th Cir. 2026), the Fifth Circuit rejected what has been referred to as the Tax Court’s “passive investor” test and adopted what was essentially a bright-line rule: a “limited partner” under §1402(a)(13) was a partner in a state-law limited partnership who had limited liability. State law determined whether the relevant legal interests—a limited partnership and limited liability—existed, while federal law determined the tax consequences. Under that approach, the extent to which a limited partner actively worked in or helped operate the partnership generally did not determine whether the exception applied.
- c. **Revised August 12, 2026 Opinion.** On August 12, 2026, the panel denied rehearing en banc but treated the government’s filing as a request for panel rehearing, granted that request, withdrew the original opinion, and substituted the revised per curiam opinion under the *K Alain* caption. The revised opinion again vacated and remanded, but it materially changed the governing analysis. On rehearing, the same two-judge majority abandoned that bright-line limited-liability test. The revised opinion treats “limited partner” as a federal-law term and holds that its original public meaning in 1977 was a partner who **“plays no significant role in managing or running a business.”** The court relied on

contemporaneous legal dictionaries, the Uniform Limited Partnership Act and Revised Uniform Limited Partnership Act, partnership treatises, and related case law. It rejected both an automatic state-law-label rule and the Tax Court's formulation that the partner must be a purely passive investor. Under the revised standard, a partner may engage in some nonmanagerial participation, but may not play a significant role in managing or running the business.

- d. **Petition for Rehearing En Banc.** On September 28, 2026, K Alain LLLP petitioned the Fifth Circuit for rehearing en banc, asking the full court to restore the original state-law/limited-liability test or, at minimum, clarify the revised "no significant role in managing or running a business" standard. The petition argues that the revised standard is inconsistent with the legal understanding of limited partnerships in 1977 and creates an unworkable facts-and-circumstances inquiry, offering no factors, safe harbors, or meaningful line between permissible nonmanagerial participation and impermissible management. *See* Kristen Parilla, *Sirius Seeks En Banc Rehearing in Limited Partner Case*, 193 TAX NOTES FEDERAL 207 (Oct. 5, 2026).
- e. **Unusual Revised Opinion.** The procedural development is unusual because the same panel did not merely correct a typographical or limited analytical error; it withdrew its prior published opinion and replaced it with a substantially different interpretation while leaving the disposition—vacatur and remand—unchanged.
- f. **Practical Difficulties With the New Standard.** The revised opinion does not specify how much management is "significant," identify a quantitative test, or establish a definitive list of permissible activities. Difficult questions may involve authority over ordinary-course decisions, personnel, contracts, investment or client matters, voting and governance rights, participation in day-to-day operations, and whether the partner's activities materially contribute to the partnership's income. The Fifth Circuit supplied no hours test, percentage test, safe harbor, or detailed list of permissible and impermissible functions. It is unclear, for example, whether a senior professional who generates substantial revenue but has little institutional decision-making authority is "running" the business; whether voting on major strategic matters is enough; or how to treat a CFO, head of tax, investment-committee member, or other senior officer who has important responsibilities but does not control the enterprise. The question therefore becomes intensely factual, and partnership agreements, voting arrangements, committee memberships, job descriptions, actual conduct, and perhaps the degree to which the enterprise depends on a particular partner may all assume greater importance. The September 28 petition for rehearing en banc sharpens these practical concerns. K Alain argues that the standard will require hundreds of thousands of limited partners to determine each year whether their activities cross an undefined line, inviting litigation and inconsistent and unpredictable results. It emphasizes that the revised opinion identifies no factors or safe harbors and does not explain what decision-making authority amounts to "managing or running" the business or what participation remains merely "non-managerial."

3. Second Circuit Case, *Soroban Capital Partners LP v. Commissioner*

- a. **Brief Summary of Facts.** The three principals of Soroban Capital Partners LP were its founders and senior executives—the Managing Partner and Chief Investment Officer, Co-Managing Partner, and Head of Trading and Risk Management. Each worked approximately 2,300 to 2,500 hours annually. They managed the investment portfolio, played essential roles in producing the firm's income, served on all four governing committees in 2016 and all but one in 2017, participated in hiring, firing, promotion, termination, and employee evaluation decisions, and exercised substantial managerial authority over Soroban's operations. Their capital contributions, by contrast, were relatively modest: one principal had contributed approximately \$4.3 million, and the other two had contributed nothing. Nevertheless, the principals received approximately \$141.5 million of distributive shares in 2016 and 2017, compared with approximately \$2.5 million of guaranteed payments.

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- b. **Tax Court Opinion.** The Tax Court held that §1402(a)(13) does not automatically exclude the income of every state-law limited partner. The court emphasized the words “as such,” reasoning that they require the partner to function as a limited partner rather than be limited in name only. The court concluded that the exception is directed toward earnings of an investment nature and requires a functional inquiry into the partner’s roles and activities. The focus is on whether the distributive share represents a return on investment or instead reflects the partner’s services, active participation, managerial authority, or role in generating the partnership’s business income. The Tax Court’s standard was announced in 161 T.C. 310 (2023) (*Soroban I*) and the standard was applied to the facts in T.C. Memo. 2025-52 (*Soroban II*).

Soroban II stated that a limited partner is one who acts “generally akin to [a] passive investor.” The Tax Court’s approach was characterized by the Fifth Circuit in *K Alain* as a “passive investor” standard. The Second Circuit does not decide whether the Fifth Circuit’s parsing of the Tax Court’s approach as referring to “passive investors” is correct (n.16) but observes that “there is little daylight between the Fifth Circuit’s position and the Tax Court’s holding”

- c. **Synopsis of Opinion.** In *Soroban Capital Partners LP v. Commissioner*, the Second Circuit affirmed the Tax Court and held that Soroban’s three principals were not “limited partners” for purposes of the limited-partner exception to the self-employment tax under §1402(a)(13). Section 1402(a)(13) generally excludes from net earnings from self-employment a limited partner’s distributive share of partnership income, other than guaranteed payments for services. The court rejected Soroban’s argument that “if Congress had wanted to define ‘limited partner’ to mean a passive investor who exercised no control over the partnership, it would have done so explicitly ... [because] in 1977, the term ‘limited partner’ was itself understood to mean a partner who did not manage the partnership and thus generally functioned as a passive investor. Modifying ‘limited partner’ with ‘passive’ would therefore have been redundant.” Rejecting Soroban’s contention that state-law limited-partner status and limited liability were sufficient, the court held that the federal tax inquiry is functional: for purposes of §1402(a)(13), a “limited partner” is a partner (1) who has limited liability and (2) “does not run, manage, or otherwise exert control or managerial authority over the partnership.”

The court based that conclusion principally on the ordinary meaning of “limited partner” when Congress enacted §1402(a)(13) in 1977. Contemporary dictionaries, partnership treatises, and the Uniform Limited Partnership Act generally described a limited partner as having two defining characteristics— limited liability and an absence of managerial control. The court also relied on the statutory phrase “limited partner, as such,” reasoning that the exclusion applies to income received in the partner’s capacity as a limited partner—that is, generally as a return on investment rather than as a consequence of running the business. The guaranteed-payment provision did not alter that conclusion. The court acknowledged that limited partners may render some services to a partnership and observed that the IRS’s brief agreed. (“It is not the Commissioner’s position – and the Tax Court’s interpretation of §1402(a)(13) does not mean – that providing any services to ... or having any participation in ... a partnership renders the individual not a limited partner.” Appellee’s Brief at 62.) Instead, the court distinguished the performance of services from “running the business”; some participation is permissible so long as the partner’s activities do not amount to controlling, managing, or running the partnership.

The principals met the limited liability test but easily failed the second test of not running, managing, or exerting control or managerial authority over the partnership. *Soroban Capital Partners LP v. Commissioner*, 2026 WL 2751819, 2026 TNTF 180-23 (2d Cir. Sept. 17, 2026).

4. Comparison of Fifth and Second Circuit Approaches

The practical difference between the Second and Fifth Circuit standards appears relatively narrow. The Second Circuit framed its test as whether the partner runs, manages, controls, or exercises managerial authority over the partnership; the Fifth Circuit asks whether the partner plays a “significant role” in

managing or running the business. The Second Circuit specifically observed that there may be “little daylight” between the two approaches (n.16) and concluded that Soroban’s principals would fail even under the Fifth Circuit’s formulation because they plainly played “significant roles” in managing the firm. Thus, neither circuit treats state-law limited-partner status as dispositive, and both focus on the partner’s actual managerial role. Neither opinion expounds on what it considers to be a “significant role” or what is required to be controlling, managing, or running a partnership. The principal unresolved issue is at the margin: how much participation short of “significant” management or control (as required by the Fifth Circuit) is permissible before the § 1402(a)(13) exclusion is lost.

In any event, the Fifth Circuit’s revised *K Alain* standard and the Second Circuit’s approach seems less demanding than the Tax Court’s analysis. An active partner might fail under the Tax Court’s “passive-investor” *Soroban* analysis but potentially qualify under the Fifth Circuit’s *K Alain* approach and the Second Circuit’s *Soroban* approach if the partner’s participation was not a significant managerial role. However, founders starting a business, who will be involved in managing and running the business, cannot assume that structuring their interest as a limited partner will afford an exception from self-employment taxes.

5. First Circuit Pending Appeal; *Point72 Asset Management*

No appellate opinions other than *K Alain* and *Soroban* have issued a merits decision resolving the meaning of “limited partner” under §1402(a)(13). An appeal is pending in the First Circuit. *Denham Capital Management LP*, No. 25-1349. The resulting uncertainty means that appellate venue may affect the treatment of economically similar limited partners until the conflict is resolved by further appellate decisions, the Supreme Court, or Congress.

The IRS notified the Tax Court of its win in *Soroban* and *K Alain* in a high-profile pending case involving a limited partnership owned by billionaire hedge fund manager Steve Cohen. *Point72 Asset Management L.P., Point72 Capital Advisors, Inc., Tax Matters Partner v. Commissioner*, Docket No. 12752-23, Respondent’s Notice of Judicial Rulings (Sept. 18, 2026). Point72, a Connecticut hedge fund, is challenging adjustments increasing net self-employment earnings by \$125 million for 2015 and \$219 million for 2016. Its two partners for the years at issue were an S corporation general partner owned by Steve Cohen and an LLC limited partner, also owned by Cohen. Point72 argues that the LLC qualified as a limited partner under Delaware law, while the IRS argues that a functional analysis applies and that the LLC should be treated as a general partner under *Soroban*. The IRS urged the Tax Court to follow the Second Circuit’s *Soroban* decision and not the Fifth Circuit’s revised *K Alain* opinion. (*K Alain* rejected the Tax Court’s 2023 *Soroban* opinion, which *K Alain* viewed as meaning that “even the most minor involvement in corporate affairs” would exclude an individual from being a limited partner, whereas the Second Circuit’s *Soroban* opinion did not decide if that interpretation of the Tax Court’s decision was accurate.)

Because any appeal in *Point72* would lie to the Second Circuit, the IRS contends that the Tax Court should follow *Soroban*’s formulation that a limited partner must have limited liability and must not run, manage, or control the partnership’s business. The IRS also pointed to the Second Circuit’s observation that there appears to be “little daylight” between the Tax Court’s *Soroban* standard and the Fifth Circuit’s revised standard, notwithstanding the Fifth Circuit majority’s express rejection of what it characterized as the Tax Court’s “passive investor” test.

6. Application of Limited Partner Exception to LLCs

The Tax Court has applied the limited partner exception in §1402(a)(13) to owners of entities other than traditional limited partnerships by looking to the member’s actual role, rather than simply the state-law label placed on the interest. In *Renkemeyer, Campbell & Weaver, LLP v. Commissioner*, 136 T.C. 137 (2011), the court held that lawyer-partners in a Kansas LLP did not qualify for the exception where their distributive shares arose principally from legal services they performed for the firm. In *Castigliola v. Commissioner*, T.C. Memo. 2017-62, the Tax Court similarly held that members of a professional LLC

could not exclude their distributive shares where they collectively managed the firm and performed the services generating its income. The court specifically rejected the proposition that limited liability under state law was enough.

The Fifth Circuit in *K Alain* expressly discussed *Renkemeyer* and *Castigliola* and recognized that the Tax Court had applied §1402(a)(13) to LLP and LLC-type entities by reference to their owners' functions. An LLC member must satisfy a functional conception of "limited partner," and in light of *K Alain* and *Soroban*, an LLC member who materially manages or runs the business generally will have difficulty doing so.

An important qualification is that neither *K Alain* nor *Soroban* involved LLC members directly, and there still is no Supreme Court decision establishing a comprehensive test for LLCs. Moreover, the Treasury regulations that were proposed in 1997 to define "limited partner" for this purpose—including rules directed specifically at LLC members—were never finalized. Prop. Reg. §1.1402(a)-2(h). Consequently, the law still rests heavily on statutory interpretation and the developing case law.

In a member-managed LLC, the argument is often especially difficult because the members typically possess management rights by virtue of their status. In a manager-managed LLC, a truly nonmanaging member has a better factual position, although merely drafting the operating agreement to call someone "nonmanaging" will not necessarily control if the individual actually exercises managerial authority.

7. Using S Corporations to Minimize Employment Taxes After *K Alain* and *Soroban*

K Alain and *Soroban* narrow the §1402(a)(13) limited partner exception for owners who play a significant role in managing or running a partnership business. For founders and other active principals, the practical result may be that substantially all of their distributive shares or partnerships are subject to self-employment tax.

- a. **S Corporation Pass-Through Income Is Not Self-Employment Income, But Shareholders Must Receive Reasonable Compensation.** One possible alternative is the use of an S corporation. The S corporation technique does not rely on the limited partner exception. A partner's distributive share of trade or business income generally is included in net earnings from self-employment under §1402(a), subject to the limited partner exception in §1402(a)(13). By contrast, an S corporation shareholder's pass-through income under §1366 generally is not treated as self-employment income merely because the shareholder actively participates in the business. See Rev. Rul. 59-221 (S corporation income required to be included by a shareholder is not net earnings from self-employment).

For example, Suppose the founder owns an S corporation that conducts the business—or, importantly, the S corporation itself owns the partnership interest. The corporation might: (1) earn \$1 million; (2) pay the founder \$400,000 of W-2 compensation; and (3) have \$600,000 remaining as S corporation taxable income passing through under §1366.

The \$400,000 salary is subject to FICA employment taxes, but the \$600,000 S corporation pass-through income generally is not subject to either FICA or SECA merely because the shareholder actively participates in the business.

An active S corporation shareholder must, however, receive reasonable compensation for services. That compensation is subject to FICA. Courts have repeatedly permitted the IRS to recharacterize purported distributions as wages where compensation was unreasonably low. See *Joseph Radtke, S.C. v. United States*, 895 F.2d 1196 (7th Cir. 1990) (attorney services for S corporation); *Spicer Accounting, Inc. v. United States*, 918 F.2d 90 (9th Cir. 1990).

David E. Watson, P.C. v. United States, 668 F.3d 1008 (8th Cir. 2012), is particularly instructive. Watson, a CPA, owned an S corporation that held his interest in an accounting partnership. The corporation paid him only \$24,000 of salary while approximately \$200,000 per year flowed to the corporation from the accounting partnership and much of the excess was distributed to Watson as dividends. The IRS successfully increased his compensation to approximately \$91,000, but the court did not treat all of the remaining S corporation income as wages. *Watson* therefore supports the proposition that an active owner's entire economic return need not be treated as compensation.

The planning opportunity is strongest where a meaningful portion of enterprise profits is attributable to employees, capital, technology, customer relationships, intellectual property, or enterprise goodwill rather than solely to the owner's personal labor. It is less compelling for a personal service business in which the owner personally generates substantially all of the income.

- b. **Examples of Wages vs. Distributive Share of Business Profits.** Three principal sources of an S corporation's gross receipts are: (1) services of the shareholder; (2) services of nonshareholder employees; and (3) capital and equipment. To the extent receipts are generated by the shareholder's personal services, payments to the shareholder should be wages; but to the extent earnings are generated by employees or capital, non-wage distributions are more readily justified.

(1) **Example – Solo Professional.** A highly compensated lawyer, physician, consultant, investment adviser, or accountant has no meaningful workforce and little capital. The owner personally creates virtually all of a \$1 million annual profit. It may be difficult to defend a \$150,000 salary coupled with an \$850,000 distribution. A large proportion of the earnings arguably represents the market value of the owner's services.

(2) **Example – Capital- and Workforce-Intensive Business.** A founder owns a company with 75 employees, substantial intellectual property, equipment, customer relationships and enterprise goodwill. The founder is CEO and could reasonably command \$500,000 in the market, but the company generates \$5 million of profit. Paying \$500,000–\$750,000 of reasonable compensation does not mean the remaining millions necessarily become wages. A substantial portion can economically represent return on capital, organization, workforce and enterprise value.

Merely because a shareholder the shareholder founded and manages a business does not mean that all business profits attributable in some causal sense to that shareholder's efforts must be wages. The appropriate inquiry is the **fair value of the services actually rendered**.

- c. **S Corporations Holding Interests in the Operating Limited Partnership or LLC.** One structure likely to receive increased attention after *K Alain* and *Soroban* is for each active founder to own an S corporation, with the S corporations holding the interests in the operating partnership or LLC. The shareholder would receive reasonable W-2 compensation from the S corporation, while residual S corporation income potentially would avoid SECA. The structure should have real substance; the S corporation should actually own the partnership interest, the governing agreements recognize the corporation as the owner, the shareholder should perform services as an employee or officer of the S corporation, payroll should be administered consistently, compensation is established and paid regularly rather than reconstructed after year-end, and reasonable compensation should be supported by contemporaneous market data and the shareholder's actual duties. Planners should confirm that state professional-practice rules permit this ownership structure.
- d. **Summary of the Significance of *K Alain* and *Soroban* for S Corporations.** *K Alain* and *Soroban* do not directly undermine S corporation planning because they construe the limited partner exception under §1402(a)(13), not the self-employment tax treatment of S corporation shareholders under §1366. The principal limitation on the S corporation strategy is the reasonable-compensation requirement. Accordingly, the legitimate planning opportunity is not to disguise compensation as distributions, but to distinguish the value of the owner's services from a genuine return on the business enterprise.

The S corporation structure becomes even more important under *K Alain* and *Soroban* for founders or owners who are active in managing the business. All of their distributive share of partnership profits would likely be subject to the self-employment tax under the "managing or running the business" standard of *K Alain* and *Soroban*. On the other hand, S corporation law imposes employment tax only on the reasonable value of their services, while leaving a genuine entrepreneurial return on the corporation's business potentially outside FICA/SECA.

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- e. **Biden Administration Proposal to Limit Exception for S Corporations.** The Biden administration proposed ending this exception for S corporations with high-income owners who materially participated in the S corporation's business. S corporation owners who materially participated in the trade or business would have been subject to SECA on their distributive shares of ordinary business income, subject to a \$400,000 threshold mechanism. U.S. Dep't of the Treasury, *General Explanations of the Administration's Fiscal Year 2022 Revenue Proposals* 66–68 (May 2021) (proposal entitled "Rationalize Net Investment Income Tax and Self-Employment Contributions Act (SECA) Taxes") (commonly referred to as the "FY 2022 Greenbook"). The proposal was estimated to increase revenues by \$236.5 billion over ten years. The proposal was substantially altered in the FY 2025 Greenbook.