

Exploring the Beyond: An introduction to Schedule K-2 and K-3

SCOTT AHRONI, ESQ., LL.M.
POLSINELLI P.C.
600 Third Avenue, 42nd Floor
New York New York 10016
sahroni@polsinelli.com
Tel: (212) 413-2890

Overview of Seminar

- Provide an overview of the new Schedules K-2/K-3
- Detail Exceptions for Filing Schedules K-2/K-3
- Discuss Parts I, II and III of the Schedules K-2/K-3
- Discuss Penalty abatements and resolution options

Introduction

- Beginning with the 2021 tax year, the IRS began requiring ALL Partnerships and S-corps to file Schedule Form K-2 and K-3 UNLESS an exception applies
- Prior to 2021, items of international relevance were reported on Form K-1, with white paper explanations or supplemental statements
 - Schedules K-2/K-3 were instituted to:
 - Help standardize reporting of items of international tax relevance
 - Help taxpayers and their preparers in computing their tax liabilities
 - Give the IRS more information

What are Schedules K-2 and K-3?

- Schedule K-2 reports items of international tax relevance from the operation of the partnership/S-corp and is an extension of Form 1065/Form 1120-S/Form 8865
 - Schedules K-2/K-3 replace Form 1065 Schedule K lines 16 and 20c and Schedule K-1 lines 16 and 20
 - For S corporations – Schedules replace Form 1120-S lines 14, 17, and 17d
- Schedule K-3 reports a partner's/shareholder's distributive share of items of international tax relevance and is an extension of the Schedule K-1

What are Schedules K-2 and K-3?

- Line 16 of the Schedule K (Forms 1065 and 8865) now has a box for the filer to check and then complete Schedules K-2 and K-3 for a partnership that has items of international tax relevance
 - No longer requires reporting of “Foreign Transactions” on line 16
- Similarly, line 16 of the Schedule K-1 (Forms 1065 and 8865) has a check box for the filer to indicate to the partner the attachment of Schedule K-3
- Line 14 of Schedules K and K-1 of the Form 1120-S have the same check boxes

Quiet Beginnings

- IRS introduced Schedules K-2 and K-3 in July, 2021
- Initial K-2 and K-3 Instructions (08/25/21): “Partnerships need not complete this schedule if partnership does not have items of international tax relevance (typically, international activities or foreign partners)”
- This was interpreted by many practitioners that so long as the entity did not have international activities or foreign partners, K-2 and K-3 was not required

Panic Ensues!



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Panic Ensues

- In January 2022 final K-2/K-3 Instructions released:
“A partnership [or S-corporation] with no foreign source income, no assets generating foreign source income and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3”

“For example, if the partner claims a credit for foreign taxes paid by the partner, the partner may need certain information from partnership to complete Form 1116”

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Transition Relief

- Verify with all partners that Form 1116 (or Form 1118) was not needed
- Meet four prong test that seems very similar to Domestic Filing Exception (see below) – but there are differences; see, **FAQ 15 – Only applies to 2021 Tax Year**

Transition Relief – FAQ # 15

- The direct partners in a domestic partnership/S-corp are not foreign partnerships, foreign corporations, foreign individuals, foreign estates, or foreign trusts.
- The domestic partnership/S-corp has no foreign activity, including foreign taxes paid or accrued or ownership of assets that generate, have generated, or may reasonably expected to generate foreign source income

Transition Relief – FAQ # 15

- In tax year 2020, the domestic partnership/S-corp did not provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):
 - Line 16, Form 1065, Schedules K and K-1 (line 14 for Form 1120-S), and
 - Line 20c, Form 1065, Schedules K and K-1 (Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, section 250, section 864(c)(8), section 721(c) partnerships, and section 7874) (line 17d for Form 1120-S).
- The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021.



Transition Relief – FAQ # 15

- If a domestic partnership or S-corporation qualifies for the exception, no Schedules K-2 and K-3 are required to be filed
- If domestic partnership/S-corp is notified by a partner **BEFORE** filing of entity return that K-3 information is needed, the FAQ# 15 relief is not met and K-3 must be provided to the partner and K-2/K-3 must be filed with the IRS
- If notification by partner is **AFTER** filing of entity return, the entity must provide such information to the partner



Who is required to file:

- Form 1065 filers, Form 1120-S filers, and Form 8865 filers
 - Form 1065 - any partnership required to file Form 1065 and that has items relevant to the determination of the U.S. tax or certain withholding tax or reporting obligations of its partners under the international provisions of the IRC
 - Form 1120-S - any S corporation that is required to file Form 1120-S and that has items relevant to the determination of the U.S. tax or reporting obligations of its shareholders under the international provisions of the IRC
 - Form 8865 – any person required to file Form 8865, Schedule K with respect to a partnership that has items relevant to the determination of U.S. tax under the international provisions of the IRC

Items of “international tax relevance”

- Partnership/S corporation instructions provide that an entity need not file Schedules K-2 and K-3 if they have no items of “international tax relevance”
 - “International tax relevance” not specifically defined for reporting purposes; Schedule K-2 instructions reference “international activities” and foreign partners (with “international activity” not thereafter mentioned in the instructions)
 - Scope really determined by reference to Parts of Schedules K-2 (12 Parts) and Schedule K-3 (13 Parts) – most every Code provision covering international tax incorporated into reporting

Breakdown of Form

- Form 1065 - Schedule K-2 has 12 Parts (with Part XII reserved for future use); Schedule K-3 has 13 Parts
- Form 1120-S - Schedules K-2 and K-3 each have 7 Parts
- Form 8865 Schedules K-2 and K-3 has 8 Parts
- Parts 1, 2 and 3 of each entities K-2 Form are essentially the same and those will be the Parts that we review
- Schedule K-2 and K-3 is attached to the entity's substantive return (Form 1065 for partnership, Form 1120-S for S corporations)
- Schedule K-3 is filed with partners/stakeholders of the entity according to the timeline for filing Schedule K-1

Exceptions to Filing – K-2/K-3

- For 2022 tax year onward
 - The “domestic filing exception” provides a significant exclusion to reporting
 - Form 1116 exclusion may also exclude K-2/K-3 reporting
 - This exclusion may allow tiered-partnership structures to avoid K-2/K-3 reporting

Domestic Filing Exception

- A domestic partnership/s-corp does not need to complete and file with the IRS the Schedules K-2 and K-3 or furnish to a partner the Schedule K-3 (except where requested by a partner) if each of the following four criteria are met with respect to the partnership's tax year (only three requirements for S-corps):
 - Entity has no or limited foreign activity
 - All partners/SHs must be U.S. citizens or resident aliens, including certain trusts and estate
 - Partner notification
 - No 2022 Schedule K-3 requests by the 1-month date before filing of entity return



No or limited foreign activity

- During a domestic partnership's tax year 2022, the domestic partnership either has no foreign activity or a limited amount meeting specified limitations
 - For purposes of the domestic filing exception, what does it mean to have no foreign activity:
 - No Foreign income taxes paid or accrued
 - No Foreign source income or loss
 - No Ownership interest in a foreign partnership
 - No Ownership interest in a foreign corporation
 - No Ownership of a foreign branch
 - No Ownership interest in a foreign disregarded entity
 - Limited to passive category foreign income upon which not more than \$300 of foreign income taxes allowable as a credit are treated as paid or accrued by the partnership, and such income and taxes are shown on a payee statement furnished or treated as furnished to the partnership.



Who can be a partner? (NOT S-CORPS)

- All partners must be U.S. citizens or resident aliens
 - Any direct or indirect foreign partners will trigger a K-2, K-3 filing obligation, Part X (effectively connected income), and Part XIII (section 864(c)(8))
- All the direct partners in the domestic partnership are:
 - Individuals that are U.S. citizens;
 - Individuals that are resident aliens;
 - Domestic decedent's estates with solely U.S. citizen and/or resident alien individual beneficiaries;
 - Domestic grantor trusts that have solely U.S. citizen and / or resident alien individual grantors and solely U.S. citizen and / or resident alien individual beneficiaries;
 - Domestic non-grantor trusts with solely U.S. citizen and/or resident alien individual beneficiaries;
 - S corporations with a sole shareholder; or
 - Single-member LLCs, where the LLC's sole member is one of the persons above and the LLC is disregarded as an entity separate from its owner
 - No direct or indirect domestic C-corporate partners (Triggers K-2,K-3, Part IV (Foreign-derived intangible income) and Part IX (base erosion anti-abuse tax reporting) (FAQ 14 02/16/22))



Partner Notification

- Partners must receive a notification of non-filing K2/K3 from the partnership no later than when the partnership furnishes the Schedule K-1 to the partner
- Notification must state that the partner will not receive Schedule K-3 from the partnership because they met the first two criteria for the domestic exception unless the partners requests the schedule
- No 2022 Schedule K-3 requests are made by the 1-month date before filing Form 1065/1120-S
 - For tax year 2022 calendar year partnerships, the latest 1-month date is August 15, 2023, if the partnership files an extension



Partner Notification (Con't)

- If a partner makes a request for Schedule K-3, the entity is required to file Schedules K-2 and K-3 with the IRS but only needs to complete the parts and sections relevant to the requesting partner. On the date K-2/K-3 is filed with the IRS, the entity must also provide a copy of the K-3 to the requesting partner
- Consider
 - Notification language from instructions
 - Partners can always request K-3 information. Therefore, consider:
 - Contacting partners in advance of deadlines
 - What happens when an entity receives a request after the 1-month period?
 - How does a request impact the entities notification obligations in future years?

Form 1116 Exclusion

- In addition to DFE, you can also be exempt from filing under Form 1116 exception. To qualify
 - All partners in partnership must meet the Form 1116 exception, i.e., all partners are not required to file Form 1116
 - The partners only receive qualified passive income
 - All foreign source income and foreign taxes are reported on a qualified payee statement such as a Form 1099
 - The amount of creditable foreign tax paid/accrued by the individual during the taxable year does not exceed \$300 (or \$600 for married filing jointly)
 - All partners/shareholders notify the entity that no K-3 is needed within the "one month date", i.e., no later than one month before the return is filed or one month before the return due date
 - Then the partnership is exempt from filing K-2/K-3

Form 1116 Exclusion

- Example: Partnership has \$1,000 of foreign taxes paid or accrued on passive foreign source income. The partnership itself does not qualify for DFE since it has more than \$300 in foreign taxes paid or accrued on passive income. However the partners may qualify for the Form 1116 exception. Assume the partnership has 4 partners each with 25% interests – then each partner only has \$250 in foreign taxes paid or accrued. Assume that the passive foreign source income is all of the income that the partners receive and they notify the partnership within one month of the partnership's filing of the entity return, no K-2/K-3 is required

Preparing K-2/K-3 - Generally

- On Schedule K-2, Part 1, requires the partnership to report items that are not specifically reported elsewhere on the Schedules K-2 and K-3. If any boxes are checked on Part I, the partnership should have attached statements to the Schedule K-3 with additional information not otherwise reported on the Schedules K-2 and K-3.
- On Schedule K-2, Parts II and III, the partnership reports its gross income, gross receipts, cost of goods sold, certain deductions, and taxes by source and separate category. The partnership also reports information that the partner needs to allocate and apportion expenses and determine the source of certain items of gross income and gross receipts.

Preparing K-2/K-3 - Generally

- The partnership reports on Schedule K-3, Parts II and III, the partner's share of the partnership's gross receipts, gross income, cost of goods sold, certain deductions, and taxes by source and separate category.

Preparing K-2/K-3 - Generally

- The partner adds its share of the partnership's foreign source gross income, gross receipts, cost of goods sold, certain deductions, and taxes by separate category to its other foreign source gross income, gross receipts, cost of goods sold, certain deductions, and taxes in that separate category to figure its foreign tax credit.
- The partnership also reports on the Schedule K-3 the distributive share of expenses and the allocation and apportionment factors so that the partner may determine expenses allocated and apportioned to foreign source income.

Consequences for non-compliance

- Failure to file partnership (IRC §6698) or S-corp (IRC §6699) return
- Failure to timely file complete information returns (IRC § 6721)
- Failure to timely file complete payee statements (IRC § 6722)
- Failure to furnish information required by IRC 6038 related to Form 8865
- Impact on statute of limitations for entity and partner/shareholder

Form 8082

- FAQ# 16 –
 - If a partner believes they should have received a Schedule K-3 but did not, they should use Form 8082, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, to notify the IRS.
 - Consider consequences to partner/shareholder and entity if form is filed/not filed – does this increase audit risk?

Relief from Filing

- Given complexity/scope/new elements required by Schedules K-2 and K-3, the IRS provided additional clarifying information and options for relief from penalty exposure
- Relief specific to the 2021 tax year filings was initially issued (i.e., Notice 2021-39 and IRM 2022-38)
- For 2022 – DFE and 1116 Exclusion – qualifying for exception made easier under finalized 2022 draft instructions

Relief from Penalties

- For 2021 - Notice 2021-39
- For 2022 and forward:
 - Streamline Procedure
 - Delinquent International Information Return Procedure
 - AAR – Administrative Adjustment Request under BBA
 - Updated voluntary disclosure practice

Notice 2021-39 Good Faith Effort

- K-2, K-3 FAQ 10 (updated January 9, 2023):
- Makes clear that the “good faith effort” relief only applies to 2021
- “Taxpayers who make a good faith effort to comply w/ new K-2 and K-3 for 2021 will not be assessed a penalty, per Notice 2021-39”

Notice 2021-39 Good Faith Effort

- a. “Made changes to its systems, processes, and procedures for collecting and processing information relevant to filing K-2 and K-3”
- b. “Extent to which a Schedule K-2/K-3 filer has obtained info from partners or shh or applied reasonable assumptions when info not obtained”
- c. “Steps taken by K-2/K-3 filer to modify pshp or S Corp agreement or governing instrument to facilitate sharing of info w/ partners and shh relevant to determining whether and how to file K-2 and K-3”
- d. “IRS will consider effort made, reasonableness of assumptions and size of partner (smaller partner less serious) info was not obtained from”

How to handle retroactive amendments

- Should consider when amending K-2/K-3 and when learning of reporting issues (income or informational returns when K-2/K-3 are issued)
- For United States taxpayers previously having failed to meet reporting requirements, penalty exposures are significant
- The Internal Revenue Service offers multiple disclosure options for individuals who have previously failed to meet all foreign reporting requirements
- Disclosures generally require some form of narrative regarding the prior failures

General Considerations

- Is the schedule K-1 considered “final” or “provided to partners” without the schedule K-3 attached?
- Partnership agreement timing
- Information gathering from investments and other information you do not control
- Lower tier issues
 - Timing of information provided by lower tiers
 - Quality of information provided by lower tiers
 - Lack of discussions on partner/shareholder tax attributes and required sections
- Allocations
 - Each line of schedule K-3 required to be separately allocated
 - Special allocations (Waterfalls, Side pockets)
 - System limitations in initial year to assist with allocations

Suggestions - Preparing

- Review partnership/shareholder agreements
 - Required timing
 - Does your agreement allow for estimate schedule K-1s and K-3s?
 - If yes, what format are you able to provide these in?
- Talk to your tax advisors/preparers now
 - Will you have a cut off date to ensure compliance with legally required notification requirements
 - Do you qualify for the domestic exception?
- Gather basic information from your owners
 - What parts of the schedules do your partners/shareholders require?

Suggestions - Receiving

- Talk to your investors now
 - Agree to timing of providing schedule K-2 and K-3 information
 - Provide general information as to what parts of the schedules you will require and/or the general tax attributes of your company or partners/shareholders
 - Any domestic corporations?
 - Any foreign partners?
 - Are any partners or shareholders eligible to take foreign tax credits?
- Will you require copies of any international tax forms in addition to schedules K-2 and K-3? (form 5471, form 8865, form 8858, etc.)
- Will you require schedule K-2 and K-3 information even if the investment meets the domestic exception?

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