

Schedules K-2 and K-3: In-Depth Analysis



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Today's Presenter

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Agenda

- ▶ Introduction and IRS guidance
- ▶ Filing requirements
- ▶ Parts II and III: information for Foreign Tax Credit
- ▶ Parts IV and IX: information for corporate partners
- ▶ Part X: information for foreign partners

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Introduction and IRS Guidance

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Schedules K-2 and K-3

- ▶ For 2021 tax year, the IRS introduced new Schedules K-2 and K-3 for:
 - ▶ Partnerships (Form 1065)
 - ▶ S corporations (Form 1120-S)
 - ▶ Foreign partnerships (Form 8865)
 - ▶ Does not apply to trusts (Form 1041)
- ▶ The entity needs to file only one Schedule K-2 (report entity totals)
- ▶ The entity needs to file separate Schedule K-3 for each partner/shareholder

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Goals of the IRS and Treasury

- ▶ TCJA made international reporting a whole lot more complicated
- ▶ Schedule K-1 had only a couple boxes for foreign transactions; partnerships were required to attach footnotes/whitepaper statements for all additional information which may be incomplete, inconsistent, and/or difficult to interpret resulting in incorrect reporting by the partner
- ▶ The new forms are intended to standardize the reporting of international tax items and reduce the number of free-form footnotes
- ▶ IRS/Treasury position is that these new schedules do not impose any new reporting requirements (all of this was already required to be provided to the partners) just offer a consistent format to provide the information

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IRS Guidance: Forms

- ▶ Schedule K-2
 - ▶ Partnerships: <https://www.irs.gov/pub/irs-pdf/f1065sk2.pdf>
 - ▶ S corporations: <https://www.irs.gov/pub/irs-pdf/f1120sk2.pdf>
- ▶ Schedule K-3
 - ▶ Partnerships: <https://www.irs.gov/pub/irs-pdf/f1065sk3.pdf>
 - ▶ S corporations: <https://www.irs.gov/pub/irs-pdf/f1120sk3.pdf>

IRS Guidance: Instructions

- ▶ Entity's Schedule K-2 and K-3 instructions
 - ▶ Partnership: <https://www.irs.gov/pub/irs-pdf/i1065s23.pdf>
 - ▶ S corporation: <https://www.irs.gov/pub/irs-pdf/i1120s23.pdf>
- ▶ Partner's/Shareholder's Schedule K-3 instructions
 - ▶ Partnership: <https://www.irs.gov/pub/irs-pdf/i1065sk3.pdf>
 - ▶ S corporation: <https://www.irs.gov/pub/irs-pdf/i1120s23.pdf>

IRS Guidance: Revisions to Instructions

- ▶ IRS published changes to instructions on January 18, 2022
 - ▶ Partnership: <https://www.irs.gov/forms-pubs/changes-to-the-2021-partnership-instructions-for-schedules-k-2-and-k-3-form-1065>
 - ▶ S corporation: <https://www.irs.gov/forms-pubs/changes-to-the-2021-s-corporation-instructions-for-schedules-k-2-and-k-3-form-1120-s>
- ▶ Quite substantial revisions, in particular:
 - ▶ Filing requirements for Parts II and III
 - ▶ Clarification when foreign forms (e.g. 5471 or 8865) need to be attached

IRS Guidance: FAQ and Filing Relief

- ▶ IRS issued FAQ on February 16, 2022
 - ▶ <https://www.irs.gov/businesses/schedules-k2-and-k3-frequently-asked-questions-forms-1065-1120s-and-8865>
- ▶ Defends and justifies IRS position on Schedules K-2 and K-3
- ▶ Discusses e-file issues
- ▶ Provides filing relief for tax year 2021 (FAQ #15)
- ▶ IRS added 7 more FAQs on mostly minor technical clarifications on April 11

IRS Guidance: Penalty Relief

- ▶ IRS Notice 2021-39 issued on September 27, 2021
 - ▶ <https://www.irs.gov/pub/irs-drop/n-21-39.pdf>
- ▶ First-year transition penalty relief for “good faith effort”
 - ▶ No “good faith effort” = no penalty relief
 - ▶ IRS listed factors in determining “good faith effort”:
 - ▶ The extent to which a partnership has made changes to its systems, processes, and procedures for collecting and processing information
 - ▶ The extent to which a partnership has obtained information from partners or applied reasonable assumptions when information is not obtained
 - ▶ The steps taken by a partnership to modify the partnership agreement to facilitate the sharing of information

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IRS Guidance: Penalty Relief

- ▶ Penalty for the failure to file complete tax return
 - ▶ \$210 per partner per month (up to 12 months so max \$2,520 per partner)
 - ▶ IRC Sec. 6698 (partnerships) and 6699 (S corporations)
- ▶ Penalty for the failure to report all required information on Schedules K-1 and K-3
 - ▶ Non-intentional: \$280 per partner (max \$3,426,000)
 - ▶ Intentional disregard: greater of
 - ▶ \$570 per partner, or
 - ▶ 10% of the aggregate amount of items required to be reported
 - ▶ IRC Sec. 6721 (partnerships) and 6722 (S corporations)
- ▶ Reasonable cause exceptions apply

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IRS Guidance: Short Period 2021 Returns

- ▶ IRS issued FAQ on December 7, 2021
 - ▶ <https://www.irs.gov/businesses/partnerships/frequently-asked-questions-faqs-for-2021-short-tax-year-pass-through-entity-returns-and-schedules-k-2-and-k-3>
- ▶ Are final versions of tax year 2021 forms (i.e. Forms 1065/1120S and Schedules K and K-1) available at least 30 days before the return due date?
 - ▶ Available: use tax year 2021 forms and attach Schedules K-2 and K-3
 - ▶ Not available: use tax year 2020 forms, but incorporate any tax law changes that are effective for the 2021 tax year and include the information required by Schedules K-2 and K-3
 - ▶ I.e. The schedules themselves are not required, but information is required to be provided

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Filing Requirements

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Filing Requirements

- ▶ Schedule K-2 instructions read:
 - ▶ The partnership need not complete this schedule if the partnership does not have items of international tax relevance (typically, international activities or foreign partners)
- ▶ This is very misleading as IRS has interpreted “items of international tax relevance” extremely broadly
- ▶ Each part of Schedules K-2 and K-3 has its own filing requirements and exceptions
- ▶ There are no general *de minimis* or dollar threshold exceptions for filing the schedules

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Filing Requirements

- ▶ On February 16, 2022, the IRS posted FAQ #15 with filing relief
- ▶ For tax year 2021, Schedules K-2 and K-3 are not required if:
 - ▶ For 2021, direct partners are not foreign individuals or entities
 - ▶ For 2021, partnership or S corporation has no foreign activity, no foreign assets, and paid no foreign tax
 - ▶ For 2020, the partnership did not report anything in Schedule K-1, box 16 (S corps: box 14) or other foreign-related information nor did the partners request the information, and
 - ▶ The partnership or S corporation has no knowledge that partners or shareholders are requesting such information
- ▶ If partner or shareholder later requests info, it must be provided

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Filing Requirements

- ▶ Observations on filing relief
 - ▶ IRS FAQ #15 addressed the entire schedule, not its parts – if you have to file Schedule K-2, this FAQ does not provide you with any additional relief from filing any of the sections
 - ▶ This appears to be a begrudgingly given temporary transition relief that does not modify any of the underlying filing requirements. No indication that any filing relief will apply for 2022 tax year.
 - ▶ There are no dollar thresholds for foreign activity or foreign taxes paid
 - ▶ Accounting firms have taken very broad interpretation of “has no knowledge”

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Filing Requirements

- ▶ Common question on filing relief: A partner in my partnership claims foreign tax credit on their Form 1040. Do I have to file Schedule K-2 and K-3?
 - ▶ IRS FAQ #15 lays out four criteria for filing relief: No foreign partners; No foreign activities, taxes paid, or assets; Box 16 blank on 2020 Schedule K-1; You have no knowledge that anyone is requesting Schedule K-3.
 - ▶ It is up to each firm to decide whether knowing that partners are claiming foreign tax credit constitutes “having knowledge” that partners are requesting Schedule K-3.
 - ▶ If this relief applies, Schedule K-2 does not need to be filed and you don't have to look further.
 - ▶ If for whatever reason this relief does not apply, then the partnership needs to look into the filing requirements of each section of Schedule K-2 separately. Parts II and III are required if there is a partner eligible to claim foreign tax credit. Thus, if the filing relief does not apply and there is a partner that you know is filing Form 1116, the partnership is required to complete Parts II and III of Schedule K-2.

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Filing Requirements

Do you qualify for the filing relief under IRS FAQ #15?

Must meet all four requirements:

- No foreign partners
- No foreign activities, taxes paid, or assets
- Box 16 blank on 2020 Schedule K-1
- No knowledge that anyone is requesting Schedule K-3

Yes

Congratulations! You don't have to file Schedules K-2 and K-3 (for 2021)

No

Need to evaluate filing requirements for each part of Schedule K-2 to determine what parts are required to be filed

Parts II & III

Does the partnership have a partner eligible to claim foreign tax credit?

Parts IV & IX

Does the partnership have a C corporation partner?

Parts X & XIII

Does the partnership have a foreign partner?

Etc.

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Parts of Schedules K-2 and K-3

Part	Title	Topic	S corp?
I	Partnership's Other Current Year International Information	All other	✓
II	Foreign Tax Credit Limitation	FTC	✓
III	Other Information for Preparation of Form 1116 or 1118	FTC	✓
IV	Information on Partners' Section 250 Deduction With Respect to Foreign-Derived Intangible Income (FDII)	FDII	
V	Distributions From Foreign Corporations to Partnership	PTEP distributions	✓
VI	Information on Partners' Section 951(a)(1) and Section 951A Inclusions	Subpart F and GILTI	✓
VII	Information to Complete Form 8621	PFIC	✓
VIII	Partnership's Interest in Foreign Corporation Income (Section 960)	Deemed FTC	✓
IX	Partners' Information for Base Erosion and Anti-Abuse Tax (Section 59A)	BEAT	
X	Foreign Partners' Character and Source of Income and Deductions	ECI & FDAP	
XI	Section 871(m) Covered Partnerships	PTP	
XII	Reserved for Future Use		
XIII (Sch K-3 only)	Foreign Partner's Distributive Share of Deemed Sale Items on Transfer of Partnership Interest	1040NR/1120F	

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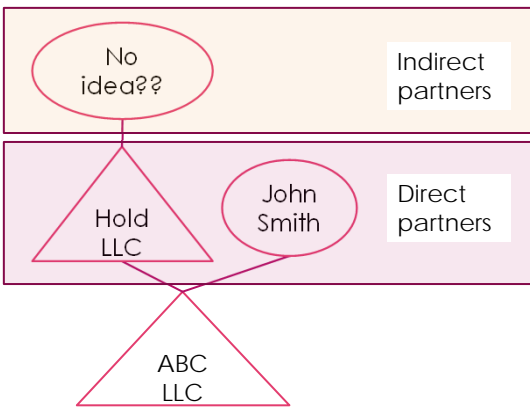
Filing Requirements

Part	Topic	Based on partner's status	Based on partnership's activities
I	All other		
II & III	FTC	Direct or indirect partner eligible for foreign tax credit (i.e. individuals, corporations, trust, and estates)	
IV	FDII	Direct or indirect domestic C corporation partner	
V	PTEP distributions		Directly or indirectly received distributions from PTEP of a foreign corporations (i.e. files Form 5471, Schedule P)
VI	Subpart F and GILTI		Directly or indirectly owns Controlled Foreign Corporation (CFC)
VII	PFIC		Directly or indirectly owns Passive Foreign Investment Company (PFIC)
VIII	Deemed FTC	Direct or indirect domestic C corporation partner or partner eligible to make Section 962 election	Directly or indirectly owns Controlled Foreign Corporation (CFC)
IX	BEAT	Direct or indirect large domestic C corporation partner (10% or \$25 million value)	
X	ECI & FDAP	Direct or indirect foreign partner	
XI	PTP		Partnership is a Publicly Traded Partnership (PTP)
2 XIII	1040NR/1120F	Direct or indirect foreign partner that sold or transferred partnership interest	

Partner Status

- ▶ Generally, a partnership is not required to obtain information from its direct or indirect partners to determine its filing requirements
- ▶ Partnerships can rely on Forms W-9 and W-8 to determine domestic/foreign status of a partner
- ▶ If partnership does not have sufficient information to determine partner's status, the partnership must presume that it has corporate or foreign partners and must complete all applicable sections
 - ▶ This applies to indirect partners in tiered partnership structures

Partner Status



- ▶ ABC LLC, a partnership, is owned by an individual and another partnership, Hold LLC
- ▶ ABC LLC has no idea who owns Hold LLC and is not required to find out
- ▶ ABC LLC needs to presume that Hold LLC is owned by individuals, domestic C corporations, and foreign persons
- ▶ ABC LLC needs to complete parts of Schedules K-2 and K-3 that are applicable to individual, C corporations, and foreign partners
- ▶ It might be in the best interest of ABC LLC to find out who owns Hold LLC to minimize its filing obligations

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Parts II and III: Foreign Tax Credit Information

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Part II: Foreign Tax Credit Limitation

- ▶ Current PDF instructions read:
 - ▶ Parts II and III must be completed unless the partnership does not have a direct or indirect partner that is eligible to claim a foreign tax credit
 - ▶ A partner that is eligible to claim a foreign tax credit includes a domestic corporation, a U.S. citizen or resident, certain U.S. trusts and estates, certain foreign corporations, and certain nonresident individuals
 - ▶ This requirement applies regardless of whether the partnership pays or accrues foreign taxes because other information, such as the source of the partnership's income and the value of its assets, are relevant in determining the partner's foreign tax credit

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Part II: Foreign Tax Credit Limitation

- ▶ On January 18, 2022, IRS clarified filing requirements:
 - ▶ A partnership 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 the partnership to complete Form 1116.
 - ▶ Provided an example that Parts II and III do not need to be completed if:
 - ▶ The domestic partnership has no foreign source income, no assets that generate foreign source income, and pays no foreign tax, and
 - ▶ The partnership knows that its partners are not filing Form 1116 to claim the foreign tax credit on their personal income tax returns
- ▶ On February 16, 2022, the IRS published FAQ with reporting relief, but that applies to the entirety of Schedule K-2, not its parts

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Part II: Foreign Tax Credit Limitation

- ▶ An election to claim foreign tax credit without filing Form 1116
 - ▶ Qualified foreign taxes for the tax year are not more than \$300 (\$600 if MFJ)
 - ▶ Only foreign source gross income for the tax year is passive category income
 - ▶ All of gross foreign income and the foreign taxes are reported on a payee statement (such as Form 1099-DIV, 1099-INT, Schedule K-3)
 - ▶ Benefits: no foreign income limitation is applied, less forms and pages in the return

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Part II: Foreign Tax Credit Limitation

- ▶ Form 1116, page 1 mapping: from 15 boxes to 8 pages

	Form 1116 line description	Form 1116 line:	2020 Schedule K-1 box:	2021 Schedule K-2:
	Foreign gross income	1a	16 E, F, G, H	Part II, Section 1
Less:	Deductions specifically allocated	2	16 K, L, M, O	Part II, Section 2
Less:	Deductions ratably allocated (based on ratio of worldwide vs. foreign gross income)	3	(worldwide gross income in 16 B)	Part III, Sections 1 and 5
Less:	Interest expense allocated	4	16 I	Part III, Section 2
Equal:	Foreign taxable income	7		
	Foreign tax paid or accrued	8	16 P, Q, R	Part III, Section 4

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Part II: Foreign Tax Credit Limitation

Part II Foreign Tax Credit Limitation

Section 1—Gross Income

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____)		
1 Sales							
A							
B							
C							
2 Gross income from performance of services							
A							
B							
C							
3 Gross rental real estate income							
A							
B							
C							
4 Other gross rental income							
A							
B							
C							

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Part II: Foreign Tax Credit Limitation

- ▶ Section 1 breaks out gross income and Section 2 breaks out deductions into different baskets in excruciating detail
 - ▶ Section 1 generally follows the order of Schedule K-1 income items in boxes 1 thru 11
 - ▶ The amounts in those boxes will not be the same as on Schedule K-1
 - ▶ Section 1 reports gross income: do not net income with deductions (e.g. COGS with sales) but net gains and losses
 - ▶ Net gains are reported in Section 1; net losses in Section 2

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Part II: Foreign Tax Credit Limitation

- ▶ Steps in completing Part II of Schedule K-2:
 - ▶ Step 1: Break out income by source (U.S. vs. foreign vs. sourced by partner)
 - ▶ Step 2: Assign foreign income into separate limitation category baskets
 - ▶ Step 3: Split income by each country
 - ▶ Step 4: Re-do steps 1 and 2 for the deductions and losses

Part II Foreign Tax Credit Limitation							
Section 1—Gross Income							
Description	(a) U.S. source	Foreign Source			(f) Sourced by partner	(g) Total	
		(b) Foreign branch category income	(c) Passive category income	(d) General category income			(e) Other (category code)
1 Sales							
A							
B							
C							

Diagram annotations: A pink box labeled "Step 1" is positioned above the table with arrows pointing to columns (a) through (e). A pink box labeled "Step 2" is positioned below the table with arrows pointing to columns (b) through (e). A pink box labeled "Step 3" is positioned to the left of the table with arrows pointing to rows A, B, and C.

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Part II: Foreign Tax Credit Limitation

- ▶ Step 1: Income sourcing U.S. vs. foreign vs. sourced by partner
 - ▶ Very complex area full of exceptions
 - ▶ Code Sections 861 thru 865
 - ▶ Each income type has a different rule, there is no general rule or shortcut
 - ▶ If foreign sourcing cannot be shown, default is to treat income as U.S.-source
 - ▶ Cannot assume there is no foreign-source income just because partnership's business activities are solely located in the U.S.
 - ▶ A handy summary chart by the IRS:
 - ▶ <https://www.irs.gov/individuals/international-taxpayers/nonresident-aliens-source-of-income>
 - ▶ https://www.irs.gov/pub/irs-utl/usb_c_014_02_01_05.pdf

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Part II: Foreign Tax Credit Limitation

- ▶ Step 1: Income sourcing U.S. vs. foreign vs. sourced by partner
 - ▶ Some income might combine two income types
 - ▶ E.g.: sale of equipment combined with implementation or technical support
 - ▶ Some income might be difficult to categorize
 - ▶ Is it royalty for software license? Sale of copyright? Or software as a service?
 - ▶ Software sourcing has two dedicated Regs 1.861-18 and 1.861-19

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Part II: Foreign Tax Credit Limitation

Income type	Generally sourced to
Business income: Personal services	Where services performed
Business income: Sale of inventory - purchased	Where sold (where title passes)
Business income: Sale of inventory - produced	Where produced (allocation may be necessary)
Interest	Residence of payor (not the recipient)
Dividends	Residence of payor
Guaranteed payments: Services	Where partner performed services
Rents	Where property is located
Royalties: Natural resources	Where property is located
Royalties: Patents, copyrights, etc.	Where property is used or permitted to be used
Sale of real property	Where property is located
Sale of personal property: Non-depreciable	Seller's (partner's) tax home (different from residency for tax purposes)
Sale of personal property: Depreciable	Where sold (separate rules for amounts related to depreciation recapture)

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Part II: Foreign Tax Credit Limitation

Income type	Generally sourced to
Salaries, wages, other compensation	Where services performed
Pensions	Where services were performed that earned the pension
Scholarships - Fellowships	Generally, the residence of the payor
Sale of natural resources	Allocation based on fair market value of product at export terminal
Transportation income	100% U.S.-source if begins and ends in U.S.; 50% U.S.-source if begins or ends in U.S.
International communications income	50% U.S.-source

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Part II: Foreign Tax Credit Limitation

- ▶ Step 1: Income sourcing U.S. vs. foreign vs. sourced by partner
 - ▶ Source of some items cannot be determined by the partnership because the source depends on the location partner's tax home which can be different from tax residency
 - ▶ Primarily applicable to sales on non-inventory and non-depreciable personal property
 - ▶ E.g. gains on sale of securities and certain foreign currency gains
 - ▶ Such items should be reported in Part II, column (f)
 - ▶ Partners then need to decide whether the amounts belong in foreign or U.S.-source buckets when preparing their own tax returns
 - ▶ Additional attachments might be needed for Part I, box 1 (gain on personal property sale)

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Part II: Foreign Tax Credit Limitation

- ▶ Step 1: Income sourcing U.S. vs. foreign vs. sourced by partner
 - ▶ **Example:** ABC LLC is owned by two U.S. citizens. It has two brokerage accounts:
 - ▶ U.S.-based Fidelity account which sold Microsoft stock for \$5,000 in long-term capital gains
 - ▶ Japan-based HSBC account which sold Alibaba stock for \$10,000 in long-term capital gains
 - ▶ **Analysis:** ABC's Schedule K-2, Part II, Section 1 would look like this:

Part II Foreign Tax Credit Limitation

Section 1—Gross Income

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____)		
12 Net long-term capital gain							
A US						15,000	15,000
B							
C							

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Part II: Foreign Tax Credit Limitation

- ▶ Step 1: Income sourcing U.S. vs. foreign vs. sourced by partner
 - ▶ **Example:** DEF LLC imports raw materials from Mexico to manufacture component parts of a precision equipment in its plant in Michigan. It sells one part to a customer in Canada for \$1,000. It also charges a one-time installation fee of \$200 (work done by DEF employee on customer's premises in Canada). What is the source of \$1,200 of DEF revenue?
 - ▶ **Analysis:**
 - ▶ Source of materials and supplies is irrelevant
 - ▶ Since DEF produced inventory in the U.S., the sale of the part for \$1,000 is U.S.-source income
 - ▶ Since DEF performed installation services in Canada, the service fee of \$200 is Canada-source income

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Part II: Foreign Tax Credit Limitation

- ▶ Step 2: break-out foreign-source income into foreign tax credit baskets

Foreign Source			
(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____)

- ▶ There are 5 different foreign tax credit baskets (in order of application):
 - ▶ Section 901(j) – no foreign tax credit is allowed
 - ▶ Four sanctioned countries: Iran, North Korea, Sudan, Syria (proposals to add Russia and Belarus)
 - ▶ The only input currently allowed in Schedule K-2, Part II, column (e)
 - ▶ GILTI or Section 951A – does not apply to Schedule K-2
 - ▶ Foreign branch
 - ▶ Applies if there are foreign disregarded entities or Qualified Business Units (QBU)
 - ▶ QBU = any separate and clearly identified unit of a trade or business of a taxpayer provided that separate books and records are maintained
 - ▶ Generally, should agree to Form 8858

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Part II: Foreign Tax Credit Limitation

- ▶ Step 2: There are 5 different foreign tax credit baskets (in order of application):
 - ▶ Passive category
 - ▶ Passive income = foreign personal holding company income
 - ▶ Generally: interest, dividends, rents, royalties, gains on property producing passive income, commodity transactions, foreign currency gains
 - ▶ Also: income of less-than-10% limited partners that do not hold their interest in the ordinary course of the partner's active trade or business is reclassified as passive category income
 - ▶ General category
 - ▶ Whatever is left after the application of the other categories above
 - ▶ Generally, it is active business income

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Part II: Foreign Tax Credit Limitation

- ▶ Step 3: Split income by each country
 - ▶ Need to report country-by-country
 - ▶ Enter country code in column A (“description”)
 - ▶ Enter “US” for U.S.-source income
 - ▶ “OC” and “XX” codes are not to be used
 - ▶ “RIC” for regulated investment company (i.e. EFTs and mutual funds) is allowed

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Part II: Foreign Tax Credit Limitation

- ▶ **Example:** XYZ LLC, a domestic marketing consulting partnership, has two individual partners actively engaged in XYZ’s trade or business. XYZ generates \$1,000,000 in service income. Largest client of XYZ is located overseas and accounted for \$275,000 of gross revenue, but all staff are U.S.-based.
- ▶ XYZ also has a small investment account with U.S. brokerage which had:
 - ▶ \$1,000 in interest income from a U.S.-based money market fund
 - ▶ \$2,500 in qualified dividends from IBM (U.S. corporation)
 - ▶ \$1,750 in qualified dividends from Alibaba (China corporation)
 - ▶ \$15,000 in long-term capital gain from a sale of Facebook stock (U.S. corporation)

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Part II: Foreign Tax Credit Limitation

► Analysis: The relevant lines of Schedule K-2, Part II would look like this:

Part II Foreign Tax Credit Limitation							
Section 1—Gross Income							
Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____)		
2 Gross income from performance of services							
A US	1,000,000						1,000,000
B							
C							
6 Interest income							
A US	1,000						1,000
B							
C							
8 Qualified dividends							
A US	2,500						2,500
B CH			1,750				1,750
C							
12 Net long-term capital gain							
A US						15,000	15,000
B							
C							

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Part II: Foreign Tax Credit Limitation

Part II Foreign Tax Credit Limitation (continued)							
Section 2—Deductions							
Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____)		
25 Expenses allocable to sales income							
26 Expenses allocable to gross income from performances of services							
27 Net short-term capital loss							
28 Net long-term capital loss							
29 Collectibles loss							
30 Net section 1231 loss							
31 Other losses							
32 Research & experimental (R&E) expenses							
A SIC code							
B SIC code							
C SIC code							
33 Allocable rental expenses—depreciation, depletion, and amortization							
34 Allocable rental expenses—other than depreciation, depletion, and amortization							
35 Allocable royalty and licensing expenses—depreciation, depletion, and amortization							

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Part II: Foreign Tax Credit Limitation

- ▶ Step 4: Allocate deductions and losses
 - ▶ Gross income in Section 1 less deductions in Section 2 should net out to net taxable income reported on Form 1065, Schedule K
 - ▶ Self-check: net income per Part II, line 55 should be the same as Form 1065, page 5, line 1
 - ▶ One difference will be foreign taxes paid on Schedule K, line 21

Section 2—Deductions (continued)		
Description	(a) U.S. source	(g) Total
53 Reserved for future use		
54 Total deductions (combine lines 25 through 53) ▶		
55 Net income (loss) (subtract line 54 from line 24) ▶		

Net income here should agree to taxable income on Form 1065

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Part II: Foreign Tax Credit Limitation

- ▶ Step 4: Allocate deductions and losses
 - ▶ Deductions are generally allocated in the same manner as income that they relate to
 - ▶ First, need to identify and allocate “definitely related” deductions and losses
 - ▶ Such expenses can be incurred without earning related income
 - ▶ It is not a mathematical/formula driven process, but is based on specific client facts
 - ▶ Second, need to apportion remaining expenses
 - ▶ This is a formula-driven pro-rata apportionment
 - ▶ Formula can be based on units sold, amount of gross sales or receipts, amounts of cost of goods sold, amounts of gross profits, salaries paid, time spent, space utilized, etc.
 - ▶ A method of apportionment is generally not a method of accounting within the meaning of Section 446. As a result, a taxpayer does not have a duty of consistency in using a particular apportionment method over consecutive years.
 - ▶ IRS resource: <https://www.irs.gov/pub/irs-utl/expense-allocation-apportionment.pdf>

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Part II: Foreign Tax Credit Limitation

- ▶ Step 4: Allocate deductions and losses
 - ▶ Special rules apply to:
 - ▶ Charitable contributions (boxes 13A thru G on Sch K-1)
 - ▶ Always U.S.-source
 - ▶ Research and experimental (R&E) costs:
 - ▶ To be determined at partner level based on gross receipts
 - ▶ Schedule K-2, Part III, Section 1 provides this info to partner
 - ▶ Interest expenses (including guaranteed payments for the use of capital)
 - ▶ To be determined at partner level based on tax basis in assets
 - ▶ Schedule K-2, Part III, Section 2 provides this info to partner

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Part II: Foreign Tax Credit Limitation

- ▶ Step 4: Allocate deductions and losses
 - ▶ **Example:** Opco resells tangible goods. 20% of sales are shipped to Canada (title passes upon delivery in the foreign country). Otherwise, Opco has no other foreign activities, locations, or employees. Its expense allocation might look like this:

Taxable income	Total	US-source	Foreign - general	Sourced by partner	Notes/explanations
Gross sales	2,500,000	2,000,000	500,000		20% of sales are Canada-sourced
COGS	(1,450,000)	(1,250,000)	(200,000)		COGS are definitely related to sales and should be specifically traced to sales
Custom duties	(54,000)		(54,000)		Relates only to foreign sales
Salaries	(450,000)	(320,000)	(130,000)		Assumes that there is one employee at \$50,000 specifically handling foreign sales; the rest are pro-rated based on sales %
Employee benefits	(50,000)	(35,556)	(14,444)		Assumes that there are no "definitely related" expenses and applies pro-rata allocation based on salary %
Office expenses	(175,000)	(140,000)	(35,000)		Assumes that there are no "definitely related" expenses and applies pro-rata allocation based on sales %
Interest on credit card	(3,500)			(3,500)	Interest allocation generally determined at partner level
Charitable contribution	(5,000)	(5,000)			Charity is always U.S.-source deduction
Taxable income / (loss)	312,500	249,444	66,556	(3,500)	*** These allocations of U.S. vs foreign-source are highly depended on specific client's facts and circumstances ***

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Part III: Other Information for FTC

- ▶ Section 1: R&E expense apportionment
 - ▶ This section is not required if the partnership has no R&E expenses
 - ▶ R&E expenses are described in Section 174
 - ▶ Section 174 includes all costs incident to the development or improvement of a product, including the costs of obtaining a patent
 - ▶ Section 174 defines “qualified research” which is used under Section 41 which selects only certain expenses (wages, supplies, contract research) as eligible for R&D credit
 - ▶ Therefore, R&E expenses under Section 174 are much broader than expenses qualifying for the R&D credit
 - ▶ However, no guidance how much of indirect and overhead expenses should be included in R&E expenses

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Part III: Other Information for FTC

- ▶ Section 1: R&E expense apportionment
 - ▶ Generally, R&E expenses are allocated based on the source of gross receipts in broad product categories
 - ▶ The product categories are determined by reference to the three-digit classification of the Standard Industrial Classification Manual (SIC code)
 - ▶ 50% of expense gets sourced to the country where research is conducted; the other 50% is then split based on gross receipt ratios
 - ▶ The allocation is not done by the partnership, but by the partner
 - ▶ Detailed rules in Reg. 1.861-17

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Part III: Other Information for FTC

Part III Other Information for Preparation of Form 1116 or 1118

Section 1—R&E Expenses Apportionment Factors

Description	(a) U.S. source	Foreign Source				(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income	(e) Other (category code _____) (country code _____)		
1 Gross receipts by SIC code							
A SIC code 357	1,000,000			500,000			1,500,000
B SIC code 737	600,000						600,000
C SIC code							
D SIC code							
E SIC code							
F SIC code							
2 Exclusive apportionment with respect to total R&E expenses entered on Part II, line 32. Enter the following.							
A R&E expense with respect to activity performed in the United States							
(i) SIC code 357						2A(i)	100,000
(ii) SIC code						2A(ii)	
(iii) SIC code						2A(iii)	
B R&E expense with respect to activity performed outside the United States							
(i) SIC code 357						2B(i)	40,000
(ii) SIC code						2B(ii)	
(iii) SIC code						2B(iii)	

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Part III: Other Information for FTC

- ▶ Section 2: Interest expense apportionment
 - ▶ This section is required even if the partnership has no interest expense
 - ▶ Interest expense does not follow income, but asset values
 - ▶ Generally, for an individual, interest is allocated based on average tax book value of U.S. vs. foreign assets in each of three asset categories:
 - ▶ Business, investment, and passive activity (PAL under Section 469)
 - ▶ Assets are grouped based on what kind of income they produce
 - ▶ Corporations follow similar rules except they don't have the three categories of assets and treat all their assets as business assets

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Part III: Other Information for FTC

- ▶ Section 2: Interest expense apportionment
 - ▶ General partners and greater-than-10% limited partners take into account their share of partnership's business, investment, and passive activity assets when calculating their interest expense apportionment
 - ▶ Less-than-10% limited partners allocate their share of partnership's interest expense based on their share of partnership's gross income
 - ▶ Therefore, even if partnership does not have interest expense, it needs to prepare the section to report its assets
 - ▶ Therefore, if the partnership only has less-than-10% limited partners, this section is not required

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Part III: Other Information for FTC

- ▶ Section 2: Interest expense apportionment
 - ▶ Example how an individual would use this information:
 - ▶ Bob has the following sources of income:

Income source	Income		Average tax basis of assets		Foreign taxes paid	Margin interest paid
	U.S.-source	Foreign-source (passive)	U.S.-source	Foreign-source (passive)		
Form 1099 from Fidelity	12,000	8,000	40,000	10,000	2,000	5,000
Schedule K-1 from ABC LLC (greater than 10% ownership)	107,000		50,000			
Total	119,000	8,000	90,000	10,000	2,000	5,000

- ▶ Bob needs to reduce his \$8,000 in foreign-source income by interest expense
- ▶ \$5,000 of interest expense is apportioned based on asset tax basis
 - ▶ So \$500 ($\$5,000 \times \$10,000 / \$100,000$) would be allocated to foreign-source passive income
- ▶ This reduces his foreign-source income to \$7,500
- ▶ Assuming a 25% U.S. tax rate, Bob may get a foreign tax credit of \$1,875 ($25\% \times \$7,500$) of the \$2,000 of foreign taxes paid

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Part III: Other Information for FTC

Section 2—Interest Expense Apportionment Factors

Description	(a) U.S. source	(b) c
1 Total average value of assets		
2 Sections 734(b) and 743(b) adjustment to assets—average value		
3 Assets attracting directly allocable interest expense under Regulations section 1.861-10(e)		
4 Other assets attracting directly allocable interest expense under Regulations section 1.861-10T		
5 Assets excluded from apportionment formula		
6a Total assets used for apportionment (subtract the sum of lines 3, 4, and 5 from the sum of lines 1 and 2)		
b Assets attracting business interest expense		
c Assets attracting investment interest expense		
d Assets attracting passive activity interest expense		
7 Basis in stock of 10%-owned noncontrolled foreign corporations (see attachment)		
8 Basis in stock of CFCs (see attachment)		

▶ Section 2: Interest expense apportionment

- ▶ Line 1: total annual average inside tax basis in the partnership's assets (this includes all assets from balance sheet)
- ▶ Add: Line 2: annual average of inside basis adjustments under Sections 734(b) and 743(b)
- ▶ Less: Lines 3-5: assets directly allocable or excluded from apportionment
 - ▶ Line 3: Assets from related group indebtedness (e.g. U.S. entity borrows from a bank to lend to a foreign related party)
 - ▶ Line 3: Assets subject to integrated financial transaction indebtedness incurred to make an identified term investment
 - ▶ Line 4: Assets subject to qualified nonrecourse indebtedness incurred to purchase, construct, or improve depreciable tangible personal property or real property
 - ▶ Line 5: Tax-exempt assets (e.g. municipal bonds)
- ▶ Equal: Line 6: total assets to be used in apportionment
- ▶ Lines 6b-6d: total assets broken out into the three categories (business, investment, passive)

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Part III: Other Information for FTC

▶ Section 2: Interest expense apportionment

- ▶ Special rules apply to partner loans and interest
 - ▶ See Reg. 1.861-9(e)(8) and (9)
 - ▶ Separate statement required in Part I, box 10. Partner loan transactions
- ▶ Asset values are reported on inside tax basis
 - ▶ Possible to use tax basis capital to back into it?
- ▶ How should the asset values be allocated to partners?
 - ▶ Are income percentages appropriate?
 - ▶ Should capital percentages be used? Capital account balances?

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Part III: Other Information for FTC

▶ Section 2: Interest expense apportionment

▶ **Example:** Rental LLC rents out a property in the U.S. has the following investments:

Balance sheet recap (TAX basis)	Beg of year	End of year	Average tax value
Cash (operating account)	8,000	12,000	10,000
Building	650,000	650,000	650,000
Accumulated tax depreciation	(100,000)	(120,000)	(110,000)
Mortgage loan	(458,000)	(436,000)	(447,000)
Partner equity	(100,000)	(106,000)	(103,000)
Net Dr/(Cr)	-	-	-

Section 2—Interest Expense Apportionment Factors		
Description	(a) U.S. source	(b) Foreign
1 Total average value of assets	550,000	
2 Sections 734(b) and 743(b) adjustment to assets—average value		
3 Assets attracting directly allocable interest expense under Regulations section 1.861-10(e)		
4 Other assets attracting directly allocable interest expense under Regulations section 1.861-10T	540,000	
5 Assets excluded from apportionment formula		
6a Total assets used for apportionment (subtract the sum of lines 3, 4, and 5 from the sum of lines 1 and 2)	10,000	
b Assets attracting business interest expense		
c Assets attracting investment interest expense		
d Assets attracting passive activity interest expense	10,000	

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Part III: Other Information for FTC

▶ Section 2: Interest expense apportionment

▶ **Example:** Fund LLC has the following investments:

Balance sheet recap (TAX basis)	Beg of year	End of year	Average tax value	US-source	Foreign - passive
Cash	8,000	12,000	10,000	10,000	
Brokerage account:					
U.S. stocks	265,000	285,000	275,000	275,000	
Foreign stocks	425,000	400,000	412,500		412,500
Foreign bonds	220,000	230,000	225,000		225,000
Municipal bonds	50,000	60,000	55,000	55,000	
Total assets from balance sheet	968,000	987,000	977,500	340,000	637,500

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Part III: Other Information for FTC

Section 2—Interest Expense Apportionment Factors

Description	(a) U.S. source	Foreign Source			(f) Sourced by partner	(g) Total
		(b) Foreign branch category income	(c) Passive category income	(d) General category income		
1 Total average value of assets	340,000		637,500			977,500
2 Sections 734(b) and 743(b) adjustment to assets—average value						
3 Assets attracting directly allocable interest expense under Regulations section 1.861-10(e)						
4 Other assets attracting directly allocable interest expense under Regulations section 1.861-10T						
5 Assets excluded from apportionment formula	55,000	← Municipal bonds				55,000
6a Total assets used for apportionment (subtract the sum of lines 3, 4, and 5 from the sum of lines 1 and 2)	285,000		637,500			922,500
b Assets attracting business interest expense						
c Assets attracting investment interest expense	285,000		637,500			922,500
d Assets attracting passive activity interest expense						

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Part III: Other Information for FTC

- ▶ Section 3: Foreign-Derived Intangible Income (FDII) Apportionment
 - ▶ FDII applicable to C corporate partners only
 - ▶ FDII deduction information is reported in Part IV
 - ▶ This section reports information on how to apportion the FDII deduction for foreign tax credit purposes
 - ▶ Requires to break out FDII-eligible gross receipts and related costs into the separate categories of income

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Part III: Other Information for FTC

- ▶ Section 4: Foreign taxes
 - ▶ Breaks out foreign taxes paid or accrued by country, tax type, separate category, and source
 - ▶ Tax types:

Code	Type of Tax	ECI	Taxes paid or accrued to foreign countries or possessions on certain effectively connected income
WHTD	Withholding tax on dividends		
WHTP	Withholding tax on distributions of PTEP		
WHTB	Withholding tax on branch remittances		
WHTR	Withholding tax on rents, royalties, and license fees		
WHTI	Withholding tax on interest		
		OTHS	Other foreign taxes paid or accrued on sales income
		OTHR	Other foreign taxes paid or accrued on services income
		OTH	Other foreign taxes paid or accrued

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Part III: Other Information for FTC

Section 4—Foreign Taxes	
Description	(a) Type of tax
1 Direct (section 901 or 903) foreign taxes: <input checked="" type="checkbox"/> Paid <input type="checkbox"/> Accrued	
A FR	WTHD
B ES	WTHD
C	
D	
E	
F	
2 Reduction of taxes (total)	
A Taxes on foreign mineral income	
B Reserved for future use	
C International boycott provisions	
D Failure-to-file penalties	
E Taxes with respect to splitter arrangements	
F Taxes on foreign corporate distributions	
G Other	
3 Foreign tax redeterminations	
A	
Related tax year ▶	
Date tax paid ▶	

- ▶ Section 4: Foreign taxes
 - ▶ Line 1: foreign income taxes paid or accrued per partnership's books
 - ▶ Should be after book-to-tax adjustments (e.g. not including deferred tax expense)
 - ▶ Additional statement is required to be attached (see Part I, box 4. Foreign tax translation)
 - ▶ Line 2: reductions in foreign tax available for credit
 - ▶ Line 3: redeterminations (n/a for cash basis partnerships)
 - ▶ Generally relates to prior year liabilities or refunds (e.g. audits or notices, differences in accrued vs. actually paid amounts, or FX rate fluctuations between the date of accrual and the date of payment)
 - ▶ Generally, amended returns are required (10-year statute of limitations)

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Part III: Other Information for FTC

- ▶ Section 4: Foreign taxes
 - ▶ Much more granular detail is required to be reported
 - ▶ Must understand what foreign taxes were paid on what income
 - ▶ Obtain and analyze foreign tax accrual workpapers
 - ▶ Obtain and analyze foreign tax returns
 - ▶ Obtain dates and amounts of actual tax payments

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Part III: Other Information for FTC

- ▶ Section 5: Other tax information
 - ▶ Break out Section 743(b) positive (Sch K-1, box 11F) and negative (Sch K-1, box 13V) income adjustments by separate category
 - ▶ Section 743(b) income adjustments should be included as relevant in other parts of Schedule K-2. For example, Section 743(b) income adjustments should be reflected as part of the total depreciation reported on Part II, Section 2.
 - ▶ Attach a statement showing each Section 743(b) basis adjustment making up the total and identify the assets to which it relates and the separate category and source of the income generated by the assets. Make sure to include the class of gross income or deduction, for example, sales income, interest income, or depreciation deduction.

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Part I: Other Information

- ▶ Checkboxes to indicate what additional information is attached to Schedule K-2

Part I Partnership's Other Current Year International Information

Check box(es) for additional specified attachments. See instructions.

<input checked="" type="checkbox"/> 1. Gain on personal property sale	<input checked="" type="checkbox"/> 4. Foreign tax translation
<input type="checkbox"/> 2. Foreign oil and gas taxes	<input checked="" type="checkbox"/> 5. High-taxed income
<input type="checkbox"/> 3. Splitter arrangements	<input type="checkbox"/> 6. Section 267A disallowed deduction

<input type="checkbox"/> 7. Form 8858 information	<input checked="" type="checkbox"/> 10. Partner loan transactions
<input type="checkbox"/> 8. Form 5471 information	<input type="checkbox"/> 11. Dual consolidated loss
<input type="checkbox"/> 9. Other forms	<input type="checkbox"/> 12. Other international items (attach description and statement)

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Part I: Other Information

- ▶ 1. Gain on personal property sale
 - ▶ If the partnership has income from the sale of personal property (other than inventory, depreciable personal property, and certain intangible property) and
 - ▶ The partnership pays income tax to a foreign country with respect to income from the sale or
 - ▶ The income is eligible for resourcing under an applicable tax treaty
 - ▶ Personal property in this case is, for example, securities and cryptocurrency
 - ▶ Need to attach the table as follows:

Information on Personal Property Sold (For use with Sch. K-2 (Form 1065), Part I, box 1; also for use with Sch. K-3 (Form 1065), Part I, box 1)

(a) Property description	(b) Date of sale	(c) Proceeds	(d) Basis	(e) Amount of tax paid in local currency	(f) Amount of tax paid in U.S. dollars	(g) Taxing country (enter two-letter country code)

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Part I: Other Information

- ▶ 1. Gain on personal property
 - ▶ In general, income from the sale of personal property is sourced according to the residence of the seller (i.e. the partner)
 - ▶ In general, the gain is U.S.-source income for U.S. citizens or resident alien individuals; therefore, foreign tax credit is not available
 - ▶ Exception in Section 865(g)(2) applies if
 - ▶ U.S. tax resident has a tax home in a foreign country and
 - ▶ Income tax of at least 10% is imposed by and paid to a foreign country regarding such sale
 - ▶ The statement is intended to provide information to determine if a foreign country imposed a tax of at least 10% on the gain from each sale

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Part I: Other Information

- ▶ 4. Foreign tax translation
 - ▶ If the partnership reports any foreign taxes paid or accrued, for each of the tax amount listed in Schedules K-2, Part III, Section 4 attach a statement with:
 - ▶ The dates on which the taxes were paid or accrued
 - ▶ The exchange rates used
 - ▶ The amounts in both foreign currency and U.S. dollars

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Part I: Other Information

- ▶ 5. High taxed income
 - ▶ If the partnership has passive income, attach a statement with Worksheet 1 and/or Worksheet 2 to help determine if passive income is subject to high tax
 - ▶ Requirement applies if there is any passive income (whether or not actually high taxed)
 - ▶ There is an example in the instructions
 - ▶ Passive income subject to high foreign tax is reclassified from passive limitation basket to another (usually, the general) limitation basket (i.e. HTKO on Form 1116)
 - ▶ Passive income = foreign personal holding company income
 - ▶ Generally: interest, dividends, rents, royalties, gains on property producing passive income, commodity transactions, foreign currency gains
 - ▶ High-taxed income is income if the foreign taxes paid on the income (after allocation of expenses) exceed the highest U.S. tax that can be imposed on the income

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Part I: Other Information

- ▶ 10. Partner loan transactions
 - ▶ Need to attach a statement with details of loans and interest income/expense from or to a partner (or a member of the partner's affiliated group)
 - ▶ Generally, such loans are disregarded when computing assets for interest expense apportionment for foreign tax credit purposes
 - ▶ Generally, matching principle applies to interest income and interest expense
 - ▶ I.e. they need to be placed into the same separate category of income

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Parts IV and IX: Information for Corporate Partners

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Part IV: Foreign-Derived Intangible Income

- ▶ FDII is applicable only to C corporations
 - ▶ FDII provides 37.5% deduction for foreign-derived net income
 - ▶ Therefore, this section needs to be completed if there are direct or indirect C corporate partners
- ▶ This section needs to be completed even if partnership does not have foreign-derived gross receipts that would give rise to FDII deduction
 - ▶ Partnership's amounts roll into corporation's calculation of FDII
 - ▶ Section 2 would be blank, but Section 1 and Section 3 still need to be completed

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Part IV: Foreign-Derived Intangible Income

▶ Section 1: DEI and QBAI

Part IV Information on Partners' Section 1—Information To Determine Deductible	
Section 1—Information To Determine Deductible	
1 Net income (loss)	1
2a DEI gross receipts	2a
b DEI cost of goods sold (COGS)	2b
c DEI properly allocated and apportioned deductions	2c
3 Section 951(a) inclusions	3
4 CFC dividends	4
5 Financial services income	5
6 Domestic oil and gas extraction income	6
7 Foreign branch income	7
8 Partnership QBAI	8

- ▶ DEI gross receipts = partnership's gross receipts less exclusions on lines 3 thru 8
 - ▶ DEI = Deduction Eligible Income
 - ▶ Exclusions: Subpart F income, CFC dividends, financial services income, domestic oil and gas extraction income, foreign branch income
- ▶ COGS and deductions allocable to DEI gross receipts
 - ▶ Absent any exclusions, DEI net income will equal net income shown on line 1
- ▶ QBAI = Qualified Business Asset Investment
 - ▶ QBAI is the average aggregate adjusted basis, determined quarterly based on ADS depreciation method, in any depreciable tangible property that is utilized in the production of gross DEI
 - ▶ Essentially the same definition of QBAI is used for the purposes of GILTI calculation

Part IV: Foreign-Derived Intangible Income

▶ Section 2: Foreign-derived DEI

- ▶ Foreign-derived DEI is what drives the FDII deduction
- ▶ Identifies DEI and related deductions that are derived from foreign sources
 - ▶ These are more stringent rules than the general income sourcing rules to determine U.S. vs. foreign source
 - ▶ Additional substantiation and recordkeeping is required to prove foreign source

Section 2—Information To Determine Foreign-Derived Deduction Eligible Income on Form 8993 (see instructions)				
	(a) Foreign-derived income from all sales of general property	(b) Foreign-derived income from all sales of intangible property	(c) Foreign-derived income from all services	(d) Total (add columns (a) through (c))
9 Gross receipts				
10 COGS				
11 Allocable deductions				
12 Other apportioned deductions			12	

Part IV: Foreign-Derived Intangible Income

▶ Section 3: Other Information

Section 3—Other Information for Preparation of Form 8993

13	Interest deductions
A	Interest expense specifically allocable under Regulations section 1.861-10(e)
B	Other interest expense specifically allocable under Regulations section 1.861-10T
C	Other interest expense
14	Interest expense apportionment factors
A	Total average value of assets
B	Sections 734(b) and 743(b) adjustment to assets—average value
C	Assets attracting directly allocable interest expense under Regulations section 1.861-10T
D	Other assets attracting directly allocable interest expense under Regulations section 1.861-10T
E	Assets excluded from apportionment formula
F	Total assets used for apportionment (the sum of lines 14C, 14D, and 14E subtracted from line 14B)
	R&E expenses apportionment factors
15	Gross receipts by SIC code
A	SIC code
B	SIC code
C	SIC code
16	R&E expenses by SIC code
A	SIC code
B	SIC code
C	SIC code

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- ▶ This section provides data to allocate interest and R&E expenses to foreign-derived DEI
- ▶ The principles are the same as in apportioning interest and R&E in Part III of Schedule K-2
 - ▶ A lot of information will be duplicated from Part III
 - ▶ However, foreign-source items (FDDEI column) are determined under the more stringent definitions used for FDII purposes
- ▶ Confusing column set-up:
 - ▶ DEI = amounts allocable to total DEI (U.S. and foreign-derived DEI)
 - ▶ FDDEI = amounts allocable to foreign-derived DEI
 - ▶ Total = partnership total (might be different from DEI column due to amounts allocable non-DEI)

Part IX: Base Erosion and Anti-Abuse Tax

- ▶ BEAT is applicable only to C corporations with average annual gross receipts of at least \$500 million for the prior three tax years
- ▶ Exceptions to filing Part IX:
 - ▶ Partners are individuals or S corporations
 - ▶ Small partners:
 - ▶ The partner's interest in the partnership represents less than 10% of the capital and profits of the partnership at all times during the tax year, and
 - ▶ The partner is allocated less than 10% of each partnership item of income, gain, loss, deduction, and credit for the tax year, and
 - ▶ The partner's interest in the partnership has a fair market value of less than \$25 million on the last day of the partner's tax year

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Part IX: Base Erosion and Anti-Abuse Tax

- ▶ Section 1: gross receipts
 - ▶ Break out gross receipts over the last 3 years into ECI and non-ECI receipts
 - ▶ ECI = Effectively Connected Income (U.S. trade or business income)
 - ▶ These gross receipts will help the corporation to determine if it meets \$500M test
 - ▶ This is not new, required on 2020 Schedule K-1, box 16 AA thru AD

Section 1—Applicable Taxpayer (see instructions)

Description	(a) Total	(b) Total ECI gross receipts	(c) Total non-ECI gross receipts
1 Gross receipts for section 59A(e)			
2 Gross receipts for the first preceding year			
3 Gross receipts for the second preceding year			
4 Gross receipts for the third preceding year			
5 Amounts included in the denominator of the base erosion percentage as described in Regulations section 1.59A-2(e)(3)			

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Part IX: Base Erosion and Anti-Abuse Tax

- ▶ Section 2: payments and deductions
 - ▶ Column a = total amount paid or accrued by the partnership
 - ▶ Column b = amount paid or accrued to a foreign related party of any partner
 - ▶ Column c = tax deduction allowed in relation to amounts reported in column b

Section 2—Base Erosion Payments and Base Erosion Tax Benefits (see instructions)

Description	(a) Total	(b) Total base erosion payments	(c) Total base erosion tax benefits
6 Reserved for future use			
7 Reserved for future use			
8 Purchase or creations of property rights for intangibles (patents, trademarks, etc.)			
9 Rents, royalties, and license fees			
10a Compensation/consideration paid for services not excepted by section 59A(d)(5)			
b Compensation/consideration paid for services excepted by section 59A(d)(5)			
11 Interest expense			
12 Payments for the purchase of tangible personal property			
13 Premiums and/or other considerations paid or accrued for insurance and reinsurance as covered by sections 59A(d)(3) and 59A(c)(2)(A)(iii)			
14a Nonqualified derivative payments			
b Qualified derivative payments excepted by section 59A(h)			
15 Payments reducing gross receipts made to surrogate foreign corporation			
16 Other payments—specify ▶			
17 Base erosion tax benefits related to payments reported on lines 6 through 16, on which tax is imposed by section 871 or 881, with respect to which tax has been withheld under section 1441 or 1442 at the 30% (0.30) statutory withholding tax rate			

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Part X: Information for Foreign Partners

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Part X: Foreign Partners

- ▶ This part needs to be completed if there are direct or indirect foreign partners (non-resident individuals or foreign entities)
- ▶ Section 1 & 2: Gross income and deductions
 - ▶ Déjà vu of Part II – same gross income and deductions just broken down in a different way
 - ▶ Break down income/deductions into ECI (Effectively Connected Income) and FDAP (Fixed, Determinable, Annual, or Periodical)

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Part X: Foreign Partners

Criteria	ECI	FDAP
What kind of income	Income of a U.S. trade or business	Passive and investment-type income
Withholding reporting	Form 8804 / 8805	Form 1042 / 1042-S
Tax rate	Graduated rates (max 37%)	Flat 30%
Deductions allowed	Yes	No
Tax treaty rates	Do not apply	Apply (can reduce 30%)
U.S. tax return required to be filed	Yes	No (if withholding is correct)
Foreign-source income taxable to foreign partner	Limited circumstances (Reg. 1.864-5)	No

Part X: Foreign Partners

Part X Foreign Partners' Character and Source of Income and Deductions

Section 1—Gross Income		Partnership Determination						
Description	(a) Total	(b) Partner determination	ECI		Non-ECI			
			(c) U.S. source	(d) Foreign source	(e) U.S. source (FDAP)	(f) U.S. source (other)	(g) Foreign source	
1 Ordinary business income (gross)								
2 Gross rental real estate income								
3 Other gross rental income								
4 Guaranteed payments for services								
5 Guaranteed payments for use of capital								
6 Interest income								
7 Dividends								
8 Dividend equivalents								
9 Royalties and license fees								
10 Net short-term capital gain								
11 Net long-term capital gain								
12 Collectibles (28%) gain								
13 Unrecaptured section 1250 gain								
14 Net section 1231 gain								

Attempts to reconcile to Forms 8804/8805

Attempts to reconcile to Form 1042

Part X: Foreign Partners

- ▶ FDAP includes interest, OID, dividends, pensions and annuities, alimony, royalties, prizes and awards, certain sales commission
- ▶ Rent can be both ECI and FDAP depending whether the rental activity raises to the level of trade or business
 - ▶ Non-resident aliens can also make an election to treat rent as ECI
 - ▶ See instructions for specific rent reporting issues
- ▶ Capital gains are generally non-ECI and non-FDAP item
 - ▶ Report in column b – partner determination
- ▶ Portfolio interest – U.S.-source non-ECI and non-FDAP
 - ▶ Report in column f

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Part X: Foreign Partners

Section 3—Allocation and Apportionment Methods for Deductions

1 Gross income		
a	Gross ECI	_____
b	Worldwide gross income	_____
2 Assets		
a	Average U.S. assets (inside basis)	_____
b	Worldwide assets	_____
3 Liabilities		
a	U.S.-booked liabilities of partnership	_____
b	Directly allocated partnership indebtedness	_____
4 Personnel		
a	Personnel of U.S. trade or business	_____
b	Worldwide personnel	_____
5 Gross receipts from sales or services by SIC code		
	(i) SIC code	(ii) ECI (iii) Worldwide
a	_____	_____
b	_____	_____

- ▶ Section 3: Apportionment factors for ECI
 - ▶ Line 1: Gross income – mathematical sum of gross income shown in Section 1
 - ▶ Line 2: Average U.S. assets (inside basis) – only to the extent related to ECI
 - ▶ Line 3:
 - ▶ U.S.-booked liabilities of partnership – properly reflected on the books of the U.S. trade or business but only to the extent related to ECI
 - ▶ Directly allocated partnership indebtedness – mainly certain recourse loans to purchase depreciable tangible property or real property
 - ▶ Line 4: Personnel (headcount) under any reasonable method
 - ▶ Line 5: Gross receipts by SIC code for R&E apportionment

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Tips

- ▶ Communicate to clients that their fees might be substantially more and that you will need a lot more information
- ▶ Reach out to indirect partners to figure out their status
- ▶ Create standard request lists
- ▶ Create standard workpapers
- ▶ Read instructions carefully! More sections, items, and statements are needed than one would anticipate