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Draft Schedule K-2 and K-3 Instructions Offer Relief, But Still Remain Burdensome to Complete

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Beginning in tax year 2021, partnerships and S corporations (pass-through entities) are required to file Schedule K-2, *Partners' Distributive Share Items – International*, and Schedule K-3, *Partner's Share of Income, Deductions, Credits, etc. – International*.[1] These schedules require a detailed breakdown of all items of international relevance such as foreign source income and taxes. However, these schedules may have to be filed by partnerships having no foreign partners or foreign operations since partnership items of income or deduction may have an impact on a partner having its own item of international relevance (such as foreign tax credits). In response to criticism about the burden imposed in preparation of these complex and long schedules (the K-2 is 19 pages long), *Schedule K-2 and K-3 Frequently Asked Questions* (FAQ) published in February 2022 provided limited relief. Recently released draft instructions for 2022 (Draft Instructions) provide for added relief, which may eliminate or reduce the burden of preparing these schedules.

EXCEPTIONS TO FILING

When originally released, partnerships with no foreign activity and no foreign partners were still required to complete portions of Schedules K-2 and K-3 for tax year 2021, which many taxpayers found surprising and, in many cases, difficult to comply with. In response to criticism around the administrative and compliance-related complexities created by these reporting requirements, FAQ 15 added an exception to filing for 2021 if a partnership had no foreign partners and no foreign activity including no payment of any foreign taxes and met additional guidelines relating to prior or current inquiries from partners about information that is included on the K-2 or K-3.

DOMESTIC FILING EXCEPTION

The Draft Instructions, *Partnership Instructions for Schedules K-2 and K-3 (Form 1065),*, add an exception for 2022 filings, which expands upon the relief afforded by FAQ 15.[2] While helpful, the requirements needed to obtain such exemption may not be possible to meet in many cases. It is hoped the IRS may relax these requirements further to allow for greater usage of this exception.

Pursuant to this new domestic filing exception, a domestic partnership is not required to file Schedules K-2 and K-3 for tax year 2022 if all of the following four conditions are met with respect to the partnership's 2022 tax year.

No or Limited Foreign Activity

The partnership must have no foreign activity or limited foreign activity for the year in which reporting relate to:

- Foreign activity exists if the partnership has any of the following: (a) foreign income taxes paid or

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[1] *See* Michael Hirschfeld and Phillip Hirschfeld, *Partnerships and S Corporations—New Schedules K-2 and K-3 Reporting Burden*, 51 Tax Mgmt. Int. Journal No. 4 (Apr. 1, 2022).

[2] Draft Instructions, General Instructions, Who must file, Domestic Filing Exception.

accrued; (b) foreign source income or loss; (c) ownership interest in a foreign partnership; (d) ownership interest in a foreign corporation; (e) ownership of a foreign branch; (f) ownership interest in a foreign entity that is treated as a disregarded as an entity.

- Limited foreign activity exists if the partnership only has: (1) passive category foreign income (e.g., dividends, interest); (2) no more than $300 of foreign taxes that are eligible for the foreign tax credit repaid or accrued in such year, and (3) such income or taxes are furnished to the partnership or treated as furnished on a payee statement, as defined in §6724(d)(2).[3] This payee statement requirement may be difficult to meet since it refers to U.S. tax law requirements. It is hoped the IRS will relax this requirement so that it can be met be met if a written statement is furnished to the partnership from the foreign payor containing such information or a statement prepared pursuant to foreign tax law is provided to the partnership.

All Partners are U.S. Persons

All direct partners in the partnership are U.S. citizens, resident aliens, domestic decedents' estates (with solely U.S. citizen and/or resident alien individual beneficiaries), domestic grantor trusts (with solely U.S. citizen and/or resident alien individual grantors and solely U.S. citizen and/or resident alien individual beneficiaries), and/or domestic non-grantor trusts (with solely U.S. citizen and/or resident alien individual beneficiaries).

Notification

No later than two months before the unextended due date for filing the partnership's tax year 2022 Form 1065 (January 15, 2023, for calendar-year partnerships), the partners receive notification (electronically or by mail) from the partnership that the partners will not receive Schedule K-3 information, unless requested.

No Requests by One-month Date

The partnership does not receive a request from any partner for Schedule K-3 information on or before the one-month period preceding the unextended due date for filing the partnership's tax year 2022 Form 1065. For calendar year partnerships, the one-month date is February 15, 2023.

If the partnership received a request from a partner for Schedule K-3 information *on or before* the onemonth date, the partnership is required to file the Schedules K-2 and K-3 with the IRS and furnish the Schedule K-3 to *only* the requesting partner. The Schedules K-2 and K-3 are required to be completed only with respect to the parts and sections relevant to the requesting partner. The partnership does not need to complete, attach, file, or furnish any other parts or sections of the Schedules K-2 and K-3 to the IRS, the requesting partner, or any other partner. The partnership should keep records of the information requested by the partner.

If a partnership receives a request from a partner for the Schedule K-3 information *after* the one-month date and has not received a request from any other partner for Schedule K-3 information on or before the one-month date, the domestic filing exception is met, and the partnership is not required to file the Schedules K-2 and K-3 with the IRS or furnish the Schedule K-3 to the non-requesting partners. However, the partnership is required to provide the Schedule K-3, completed with the requested information, to the requesting partner on the later of the date on which the partnership files the Form 1065 or one month from the date on which the partnership receives the request from the partner.

If a partnership receives requests from partners for Schedule K-3 information both on or before the one month date and after the one-month date, the partnership is required to file Schedules K-2 and K-3 as described in the second preceding paragraph only with respect to the partner requests received on or before the one-month date. With respect to requests received after the one-month date, the partnership is required to provide the Schedule K-3, completed with that partner's requested information, as noted in the preceding paragraph, on the later of the date on which partnership files the Form 1065 or one month from the date on which the partnership receives the request from the partner.

FORM 1116 EXEMPTION EXCEPTION

Part II of Schedule K-2 and Schedule K-3 provides detailed information relating to the foreign tax credit (FTC) limitation and Part III of Schedule K-2 and Schedule K-3 provides other information for Preparation of Form 1116 or Form 1118. Form 1116 is the FTC form for individuals, estates or trusts while Form 1118 is the FTC form for corporations.

While a partnership may have no foreign income, a partner may have foreign source income and need to determine its FTC, which may require including its income and loss from the partnership, as disclosed in Parts I and II of the Schedule K-2 and K-3. Form 1116

[3] All section references herein are to the Internal Revenue Code of 1986, as amended (the Code), or the Treasury regulations promulgated thereunder, unless otherwise indicated.

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is required to be filed by an individual to claim a FTC unless such individual is exempt from having to file such form by application of §901(j), as discussed below. If a partnership does not meet the domestic filing exception, it may meet the new Form 1116 Exemption to filing the Schedules K-2 and K-3. Draft Instructions for Schedule K-2, Parts II and III, and Schedule K-3, Parts II and III.

Pursuant to this new exception, a domestic partnership is not required to complete Schedules K-2 and K3 if all partners are eligible for the Form 1116 exemption and the partnership receives notification of the partners' eligibility for such exemption by the one-month date described above, which is February 15, 2023, for a 2022 calendar year partnership. If a partnership receives notification from only some of the partners that they are eligible for the Form 1116 exemption, the partnership need not complete the Schedule K-3 for those exempt partners but must complete the Schedules K-2 and K-3 with respect to the other partners.

The Form 116 exemption is only available for an individual partner whose only source of foreign income is passive foreign source income (e.g., dividends, interest, capital gains from sale of stocks and bonds), and who has paid or accrued $300 or less of foreign tax during the year ($600 in the case of a married individual filing a joint return). These requirements would only be met by an individual partner, which may limit its use. In addition, the partnership must notify each partner by January 15, 2023, for calendar year partnerships whether they will need such information.

EXEMPTION FROM HAVING TO COMPLETE PART V (DISTRIBUTIONS FROM FOREIGN CORPORATIONS)

Part V of Schedule K-2 and K-3 provides for detailed information relating to distributions from foreign corporations to the partnership. Certain partners will use the information in Part V, in combination with other information known to the partners, including Schedule P to Form 5471, to exclude from gross income distributions to the extent that they are attributable to previously taxed earnings and profits (PTEP) in their annual PTEP accounts and report foreign currency gain or loss with respect to the PTEP on Forms 1040 and 1120. If eligible, partners will also use this information to figure and claim a dividends received deduction under §245A on Form 1120.

The draft instructions include exceptions to having to complete Part V, but like the other new exceptions, the path to eliminating having to complete these parts is far from simple.[4]

Part V of the *Schedule K-2* is not required to be completed with respect to distributions by a foreign corporation if the partnership knows that; (i) none of the distributions by the foreign corporation are attributable to PTEP in annual PTEP accounts of any direct or indirect partner, and (ii) none of the partnership's direct or indirect partners are eligible to claim a deduction under §245A with respect to any distribution by the foreign corporation. Nevertheless, the partnership may be required to attach Worksheet 3 to the Schedule K-2.

Part V of the *Schedule K-3 for a partner* does not need to be completed with respect to distributions by a foreign corporation if the partnership knows that (i) none of the distributions by the foreign corporation are attributable to PTEP in annual PTEP accounts of the partner or any U.S. person that is treated as indirectly owning stock of the foreign corporation through the partner (relevant indirect partners), and (ii) the partner and relevant indirect partners are not eligible to claim a deduction under §245A with respect to any distributions by the foreign corporation. Nevertheless, the partnership may be required to attach Worksheet 4 to the Schedule K-3 for the partner. If this exception is applicable with respect to a foreign corporation, the sum of the amounts reported on Part V of the Schedules K-3 with respect to the foreign corporation may not equal the amounts reported on Part V of the Schedule K-2 with respect to the foreign corporation.

EXEMPTION FROM HAVING TO COMPLETE PART VI (CFCs)

Part VI of Schedule K-2 and K-3 contains information relating to controlled foreign corporations (CFCs) and related inclusions of Subpart F income §951 and global intangible low taxed income (GILT) under §951A. This information is useful for a partner to complete Forms 8982, 1040 and 1120 to compute their Subpart F and GILTI inclusions. Part V must be completed with respect to a CFC if the partnership owns (within the meaning of §958) stock of the CFC, unless the partnership owns stock of the CFC solely by reason of applying §318(a)(3) (providing for downward attribution) as provided in §958(b).

A CFC exists if more than 50% by vote or value of a foreign corporation is owned by U.S. shareholders.[5] A U.S. shareholder is a U.S. person who owns 10%

[4] Draft Instructions to Schedule K-2, Part V, and Schedule K-3, Part V.

[5] §957(a).

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or more of the stock of a CFC, determined by vote or value.[6]

In determining if a foreign corporation is a CFC, regulations adopted earlier this year that are effective for taxable years beginning on or after January 25, 2022, treat a domestic partnership as an aggregate of its partners rather than as an entity.[7]

As a result, a domestic partnership that owns 100% of a foreign corporation no longer makes the foreign corporation into a CFC and the domestic partnership does not have subpart F income or GILTI inclusions with respect to a foreign corporation for tax years of the foreign corporation that begin on or after January 25, 2022. Instead, CFC status and related income inclusions must now be determined by examining the beneficial or constructive ownership in the CFC be each partner or other shareholder of the foreign corporation.

In view of these regulatory changes, the following exceptions were added to having to complete Part VI (Draft Instructions to Schedule K-2, Part VI, and Schedule K-3, Part VI).

Part VI of *Schedule K-2* does not need to be completed with respect to a CFC if the partnership knows that it does not have a direct or indirect partner (through pass-through entities only) that is a U.S. shareholder of the CFC required to include in gross income a subpart F income inclusion and/ §951(a)(1)(B) inclusion with respect to the CFC, or figure §951A inclusions by taking into account GILTI items of the CFC.

Part VI of *Schedule K-3* for a partner does not need to be completed with respect to a CFC if the partnership knows that (1) the partner is not a U.S. shareholder of the CFC required to include in gross income a subpart F income or GILTI inclusion with respect to the CFC, or figure §951A GILTI inclusions by taking into account GILTI items of the CFC; and (2) no U.S. person that indirectly owns (through passthrough entities only) an interest in the CFC through the partner is a U.S. shareholder of the CFC required to include in gross income a subpart F income or GILTI inclusion with respect to the CFC, or figure §951A inclusions by taking into account GILTI items of the CFC. If the partnership does not complete Part VI of Schedule K-3 for a partner with respect to a CFC, the sum of each partner's share of the CFC's subpart F income, §951(a)(1)(B) inclusion with respect to the CFC, and share of the CFC's GILTI items (defined below) reported on all Schedules K-3 may not equal the aggregate share of subpart F income of the CFC, the aggregate §951(a)(1)(B) inclusion with respect to the CFC (defined below), and the aggregate share of the CFC's GILTI items (defined below), respectively, reported on the Schedule K-2.

EXEMPTION FROM HAVING TO COMPLETE PART VII (PFICS)

Part VII includes Information Relating to Completing Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company PFIC) or Qualified Electing Fund (QEF)*.

A PFIC is a foreign corporation if either (1) 75% or more of the corporation's gross income for its tax year is passive income (e.g., dividends, interest, capital gains from sale of stocks or bonds), or (2) at least 50% of the average percentage of assets held by the foreign corporation during the tax year are assets that produce passive income or that are held for the production of passive income.[8]

Unlike investing in a CFC that can subject a U.S. shareholder to immediate taxation on Subpart F income or a GILTI inclusion, investment in a PFIC does not generate federal income tax liability until a distribution is made or the interest in the PFIC is sold. However, a U.S. person receiving a distribution or selling the stock may be subject to both ordinary income tax liability and an interest charge imposed for the privilege of getting tax deferral through ownership of a PFIC.[9] A qualified electing fund (QEF) can be made with respect to a PFIC by filing Form 8621, which eliminates the interest charge rule. In its place, a QEF election results in treating the PFIC as if it is a partnership for U.S. tax purposes, which results in immediate taxation to the U.S. shareholder.[10]

- Part VII provides information to assist a partner in completing Form 8621, and determining the impact of investing in a PFIC. Part VII must be completed by every partnership that owns PFIC stock, directly or indirectly subject to certain exceptions contained in the draft instructions below:[11] A partnership that knows it has no direct or indirect partners that are U.S. persons, including U.S persons that own an indirect interest in the partnership through one or more foreign entities, is not required to complete Part VII.
- A domestic partnership that has elected to treat a PFIC as a pedigreed qualified electing fund

[6] §951(b).

[7] Reg. §1.958-1(d)(1). *See* Draft Instructions for Schedules K-2 and K-3, What's New, Final Regulations Apply Aggregate Treatment to Domestic Partnerships for Certain Purposes.

[8] §1297(a).

[9] §1291(a).

[10] §1295.

[11] Draft Instructions, Schedule K-2, Part VII, and Schedule K-3, Part VII.

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(QEF) or made a mark to market (MTM) election under §1296 with respect to a PFIC may not be required to complete Part VII, with information regarding such PFIC if the partnership files Form 8621 for that PFIC. The term ''pedigreed QEF'' is defined in Reg. §1.1291-1(b)(2)(ii) as meaning an investment in a PFIC where the QEF election is made after the first year PFIC status was relevant. With respect to marketable PFIC stock, the MTM election eliminates the interest charge imposed on distributions or sales proceeds and replaces that with annual income or loss recognition determine by the increase or decrease in the fair market value of such stock during such year.

- A partnership that owns stock of a foreign corporation that is treated as a qualifying insurance corporation (QIC is defined in §1297(f)(1)) and which is not treated as a PFIC by reason of §1298(b)(1), or a domestic partnership that satisfies the deemed election requirements of Reg. §1.1297-4(d)(5)(iv) with respect to a foreign corporation eligible to be treated as a QIC may not be required to complete Part VII with respect to such foreign corporation.
- A partnership that knows that all of its direct and indirect partners that are U.S. persons are either (i) not subject to the PFIC rules with respect to the corporation under §1297(d) because they are subject to the subpart F rules with respect to the corporation, (ii) tax-exempt entities that are not subject to the PFIC rules with respect to the corporation under Reg. §1.1291-1(e), or (iii) pass-through entities with no direct or indirect U.S. taxable owners is not required to complete Part VII with respect to the corporation.
- A partnership that marks to market stock of a PFIC may not need to report information about the PFIC on Schedules K-2 and K-3, Part VII. The partnership should report its MTM gain or loss on Schedule K (Form 1065) and report the partners' shares of such amounts on Part III of Schedule K-1 (Form 1065).

OTHER CHANGES

The draft instructions contain numerous other changes designed to simplify or clarify preparation of these schedules. Clarification of apportionment of research and development expenses as well as interest expense and stewardship expense apportionment are added.[12]

However, not all changes simplify. New box 12 is added to Schedule K-3, Part I, for Form 8865. This box is relevant if the partnership transferred property to a foreign partnership that would subject one or more domestic partners to reporting under §6038B, but did not file Schedule O (Form 8865), Transfer of Property to a Foreign Partnership (Under §6038B), containing all the required information, the partnership must provide the necessary information for each partner to fulfill its reporting requirements under this new box. New box 13 is added to Part I for other items of international tax relevance. The instructions indicate this is a catch-all provision intended to report items of international relevance that are not otherwise covered in these very long schedules.[13]

CONCLUSION

The IRS and Treasury have moved the ball forward by adding helpful exceptions and clarifications intended to lessen the burdensome task of completing Schedules K-2 and K-3. Nonetheless, the schedules remain very complex and very long, which presents not only a burden in preparation but a burden to partners seeking to harvest, understand, and use this wealth of information. Given the increasing amount of tiered partnership arrangements involving an upper tier partnership investing in a lower-tier partnership, this complexity has made it very difficult for an upper tier partnership to timely digest K-3 data received from a lower-tier partnership to complete its own filing obligations. Relief for this situation would be especially welcome to ensure penalties may not apply.

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[12] Draft Instructions for Schedules K-2 and K-3, What's New.

[13] Draft Instructions, Schedule K-2, Part I, and Schedule K-3, Part I, Boxes 12 and 13.

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