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IRS Provides Relief for Filing Schedules K-2 and K-3 for 2021 Tax Year

The IRS has eased filing requirements for pass-through entities required to file two new tax forms—Schedules K-2 and K-3—for the 2021 tax year. Certain domestic partnerships and S corporations won't be required to file the schedules, which are intended to make it easier for partners and shareholders to find information related to "items of international tax relevance" that they need to file their own returns.

Setting the Stage: A Tough Tax Season for the IRS

In 2021, the IRS released guidance providing penalty relief for filers who made "good faith efforts" to adopt the new K-2 and K-3 Schedules. The IRS has now provided additional transition relief in response to continued concern and feedback from the tax community and other stakeholders.

The announcement of additional relief for the 2021 tax year comes as IRS Commissioner Charles Rettig acknowledged that the agency faced "enormous challenges" this past tax season. For example, millions of taxpayers are still waiting for prior years' returns to be processed.

To address such issues, he says, the IRS has taken "extraordinary measures," including mandatory overtime for IRS employees, the creation and assignment of "surge teams," and the temporary suspension of the mailing of certain automated compliance notices to taxpayers. In addition, the partial suspension of the Schedules K-2 and K-3 filing requirements for tax year 2021 might ease the burden for both affected taxpayers and the IRS.

2021 Schedule K-2 and Schedule K-3 Filing Requirements

Provisions of 2017's Tax Cuts and Jobs Act (TCJA) require taxpayers to provide significantly more information to calculate their U.S. tax liability for items of international tax relevance. The Schedule K-2 reports such items, and the Schedule K-3 reports a partner's distributive share of those items. These schedules replace portions of Schedule K and numerous unformatted statements attached to earlier versions of Schedule K-1.

Schedules K-2 and K-3 generally must be filed with other forms, depending on your tax status:

- Partnership: Form 1065, "U.S. Return of Partnership Income"
- S corporation: Form 1120-S, "U.S. Income Tax Return for an S Corporation"

Previously, partners and S corporation shareholders could obtain the information that's included on the schedules through various statements or schedules provided by the respective entity, if they opted to provide any. The new schedules require more detailed and complete reporting than entities may have provided in the past.

In January 2022, the IRS surprised many in the tax community when it posted changes to the instructions for the schedules. Under the revised Schedules K-2 and K-3 instructions, an entity may need to report information on the schedules even if it had no foreign partners, foreign source income, assets generating such income, or foreign taxes paid or accrued.

For example, if a partner claims a credit for foreign taxes paid, the partner might need certain information from the partnership to file their own tax return. Although some narrow exceptions apply, this change substantially expanded the pool of taxpayers required to file the schedules.

Good Faith Exception

Earlier guidance exempted affected taxpayers from penalties for the 2021 tax year if they made a good faith effort to comply with the filing requirements for Schedules K-2 and K-3. When determining whether a filer has established such an effort, the IRS considers, among other things:

- The extent to which the filer has made changes to its systems, processes, and procedures for collecting and processing the information required to file the schedules.
- The extent the filer has obtained information from partners, shareholders, or a controlled foreign partnership or, if not obtained, applied reasonable assumptions.
- The steps taken by the filer to modify the partnership or S corporation agreement or governing instrument to facilitate the sharing of information with partners and shareholders that's relevant to determining whether and how to file the schedules.

The IRS won't impose the relevant penalties for any incorrect or incomplete reporting on the schedules if it determines the taxpayer exercised the requisite good faith efforts.

Latest Relief

Now, relief from filing these schedules for tax year 2021 applies for domestic partnerships and S corporations, as long as specified requirements are met. Under the latest guidance, partnerships and S corporations do not need to file the schedules if they satisfy all the following requirements:

- For the 2021 tax year:
 - The direct partners in the domestic partnership aren't foreign partnerships, corporations, individuals, estates, or trusts, **and**
 - The domestic partnership or S corporation has no foreign activity, including:
 - Foreign taxes paid or accrued, **or**
 - Ownership of assets that generate, have generated, or may reasonably be expected to generate foreign-source income.
- For the 2020 tax year, the domestic partnership or S corporation didn't provide its partners or shareholders—nor did they request—information regarding any foreign transactions.

- The domestic partnership or S corporation has no knowledge that partners or shareholders are requesting such information for the 2021 tax year.

Entities that meet these criteria generally aren't required to file Schedules K-2 and K-3. But there's an important caveat. If such a partnership or S corporation is notified by a partner or shareholder that it needs all or part of the information included on Schedule K-3 to complete its tax return, the entity must provide that information.

Moreover, if the partner or shareholder notifies the entity of this need before the entity files its own return, the entity no longer satisfies the criteria for the exception. As a result, it must provide Schedule K-3 to the partner or shareholder and file the schedules with the IRS.

Temporary Reprieves

The IRS guidance on the exceptions to the Schedules K-2 and K-3 filing requirement explicitly refers to 2021 tax year filings. In the absence of additional or updated guidance, partnerships and S corporations should expect and prepare to file the schedules for current and future tax years.

In the meantime, the American Institute of CPAs (AICPA) and other professional accounting groups have formally requested IRS Commissioner Chuck Rettig and Lily Batchelder, the Treasury Department's assistant secretary for tax policy, to delay for a year its new requirement that some partnerships report foreign income, because filing Schedules K-2 and K-3 is too burdensome and overly broad and the rules for compliance are unclear. In seeking a postponement to 2023 of foreign-income reporting on either of the two schedules, the CPA groups also cited ongoing burdens on pass-through filers and their tax preparers from COVID-19.

Questions?

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