

EXPANSION OF THE K-1 AND 1065

Schedules K-2 and K-3 Enhanced Reporting of International Tax Matters

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Starting in tax year 2021, the Internal Revenue Service (IRS) will be expanding the foreign reporting for the K-1s and 1065 to two additional schedules, the K-2 and the K-3. With the growth in international activity among partnerships, the additional schedules are designed to provide clarity for partners and shareholders on how to compute their U.S. income tax liability with respect to items of international tax relevance, including claiming deductions and credits. Schedules K-2 and K-3 replace, supplement, and clarify Line 16 and certain line 20 items (Other information) formally reported on Form 1065, Schedule K and Schedule K-1.

To break these down into their comparable forms, the K-2 is an extension of the schedule K of form 1065 and is used to report international tax relevant information at the entity level. The K-3 will be an extension of the Schedule K-1, as this is intended to report partners share of international activity.

A Taxpayer filing a 1065, a 1120-S, or an 8865 (Return of a U.S. persons with respect to certain foreign partnerships) could potentially have a K-2 and K-3 filing requirement starting in 2021. The Taxpayer must have items of U.S. international tax relevance. This could include:

- An entity with international partners or shareholders and/or income/expenses generated from international activities,
- Items that are relevant to determining U.S. tax, withholding tax, or reporting obligations of its partners or shareholders under other international provisions.

In general, if the partnership or S-Corporation has international reporting that would otherwise be required on line 16 or other foreign forms (i.e., forms 5471, 8621, 8865s, etc.), a K-2 and K-3 will need to be furnished.

The timing and filing of the K-2 and K-3 does not create an unnecessary burden on taxpayers. As a rule of thumb, these forms will be due relatively the same time their counterpart is due. For example, the K-1 and the K-3 should be furnished at the same time because the K-3 is an extension of the K-1. The 1065 and the K-2 will be filed during the same period for similar reasons. This methodology at least creates consistency and seems to be practical in theory.

The general layout of the forms could potentially create additional complexity depending on the partnerships level of international activity, as well as some redundancy of reporting that is being completed in other parts of the tax return. Currently, there are a total of 13 sections and an additional 20 pages. The final version has the sections listed as the following.

- Part I, “Partnership’s Other Current Year International Information”
- Part II, “Foreign Tax Credit Limitation”
- Part III, “Other Information for Preparation of Form 1116 or 1118”
- Part IV, “Information on Partner’s Section 250 Deduction with Respect to Foreign-Derived Intangible Income (FDII)”
- Part V, “Distributions from Foreign Corporations to Partnership”
- Part VI, “Information on Partner’s Section 951(a)(1) and Section 951A Inclusions”
- Part VII, “Information to Complete Form 8621”
- Part VIII, “Partnership’s Interest in Foreign Corporation Income (Section 960)”
- Part IX, “Partners’ Information for Base Erosion and Anti-Abuse Tax (Section 59A)”
- Part X, “Foreign Partners’ Character and Source of Income and Deductions”
- Part XI, “Section 871(m) Covered Partnerships”
- Part XII, “Reserved for future use” and
- Part XIII, “Foreign Partner’s Distributive Share of Deemed Sale Items on Transfer of Partnership Interest” (K-3 only)

As with any foreign reporting, the most intimidating factor for taxpayers is the penalties that could arise for not complying with international tax law. The IRS has determined that code sections 6698, 6699, 6721, 6722, and 6038 will be the driving factor for penalties assessed with non-compliance of the K-2 and K-3. In short, these penalties will be assessed if the partnership or S-corporation fails to file or show the correct information on the return, the correct payee statements, or the information about the foreign business entity. The amount and rate of the penalties will differ depending on the circumstance. Luckily, the IRS has granted a “Transition relief from penalties” for tax year 2021. To qualify for the Transition relief, the taxpayer must make a “good faith” effort to comply, and the effort must be satisfactory to the IRS. Some factors that show if a “good faith” effort was made include: The extent to which the filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing the Schedules K-2 and K-3; The extent to which the filer has obtained information from partners, shareholders, or the controlled foreign partnership, or applied reasonable assumptions when information is not obtained; and 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 is relevant to determining whether and how to file Schedules K-2 and K-3. These factors will be determined under facts and circumstances, but this seems to at least be taxpayer friendly for the time being.

As our international relations grow, so will the burden of international reporting. This is a massive undertaking for taxpayers and the IRS alike. However, if all goes to plan, the additional forms could potentially provide much needed clarity for both sides. Looking into the future, as the regime of subpart F income such as Global Intangible Low-Taxed Income (GILTI) and the Base Erosion and Anti Abuse Tax (BEAT) expand, the K-2 and K-3 will grow as well. These forms are here to stay and will only grow in complexity as our tax code does. Adjusting to the reporting on the forms will increase planning for all parties involved.

We will continue to monitor these proposed changes and publish updates as there are new developments that may impact our clients. To view the IRS News Release regarding this update, [click here](#). If you have questions about the upcoming 2021 K-2 and K-3, Richey May’s tax professionals are available to help. Please contact [Steve Vlasak](#) for any questions regarding this summary or the services Richey May provides to the Alternative Investments industry.