Current Federal Tax Developments

Week of December 13, 2021

Edward K. Zollars, CPA
(Licensed in Arizona)

CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF DECEMBER 13, 2021
© 2021 Kaplan, Inc.
Published in 2021 by Kaplan Financial Education.

Printed in the United States of America.

All rights reserved. The text of this publication, or any part thereof, may not be translated, reprinted or reproduced in any manner whatsoever, including photocopying and recording, or in any information storage and retrieval system without written permission from the publisher.

Current Federal Tax Developments

Table of Contents

Section: 66 Taxpayer Not Eligible for Relief from Paying Tax on S Corporation Income for Year of Divorce 1

Section: 3134 Guidance Provided for Employers to Make Deposits for Payroll Tax Deposits Reduced Due to ERC They No Longer Qualify for and to Repay Advances on that Credit ... 7

Section: 6031 Special Relief for Filing Schedules K-2 and K-3 for Short-Year Partnerships Published in FAQ by IRS 12

SECTION: 66
TAXPAYER NOT ELIGIBLE FOR RELIEF FROM PAYING TAX ON S CORPORATION INCOME FOR YEAR OF DIVORCE

Citation: Wheeler v. Commissioner, TC Summary Opinion 2021-42, 12/9/21

In the case of *Wheeler v. Commissioner*,[1] the Tax Court did not find persuasive a taxpayer's argument that she should be granted innocent spouse relief for taxes related to income from an S corporation she held an interest in during the year before the Court, which also was the year her divorce was finalized late in the year.

The taxpayer and her ex-spouse resided in Texas, one of the nine community property states in the U.S. The spouses had filed for divorce on September 21, 2015 and the divorce was finalized by decree on December 9, 2015. The decree that was signed by the taxpayer and her ex-spouse contained the following provision related to tax issues, entitled "Treatment/Allocation of Community Income for Year of Divorce."

> IT IS ORDERED AND DECREED that, for the calendar year 2015, each party shall file an individual income tax return in accordance with the Internal Revenue Code.
>
> IT IS ORDERED AND DECREED that for calendar year 2015, each party shall indemnify and hold the other party and his or her property harmless from any tax liability associated with the reporting party's individual tax return for that year unless the parties have agreed to allocate their tax liability in a manner different from that reflected on their returns.
>
> IT IS ORDERED AND DECREED that each party shall furnish such information to the other party as is requested to prepare federal income tax returns for 2015 within thirty days of receipt of a written request for the information, and in no event shall the available information be exchanged later than March 1, 2016. As requested information becomes available after that date, it shall be provided within ten days of receipt.[2]

One of the assets owned by the couple while married were shares in Turner Investments & Consulting, Inc., an S corporation. The opinion notes:

> In October 2006 Turner Investments & Consulting, Inc. (Turner Investments), was organized as an S corporation; petitioner and Mr. Turner were each designated 50% shareholders. Income reported on

[1] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021, https://www.taxnotes.com/research/federal/court-documents/court-opinions-and-orders/individual-denied-relief-from-taxes-on-income-allocated-to-her/7cp60 (retrieved December 11, 2021)

[2] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

> Schedule K-1, Shareholder's Share of Income, Deductions, Credits, etc., from Turner Investments was included on petitioner's joint return with Mr. Turner for the three years (2012-14) before the year in issue. She was also issued Forms W-2, Wage and Tax Statement, reporting income from Turner Investments in years before 2015 and during that year, and she signed several checks for Turner Investments in 2013.[3]

The final decree provided that the taxpayer "shall execute any and all documents necessary to remove her name from the corporation and/or business within 5 days of receipt of same."[4]

The Court then describes the items reported and not reported on the taxpayer's tax return for 2015 related to the corporation:

> For 2015 Turner Investments issued to petitioner a Form W-2; she reported this wage income on her 2015 Form 1040. For 2015 Turner Investments also reported for petitioner, as a 37.44856% shareholder for that year, on Schedule K-1, ordinary business income of $63,083 and a net rental real estate loss of $1,681; she did not report this net Schedule K-1 income.[5]

The IRS noticed the omission of the S corporation income from Ms. Wheeler's 2015 return and issued a notice of deficiency for taxes related to that omitted income.

Ms. Wheeler, after filing her petition with the Tax Court in this case, filed for innocent spouse relief from liabilities related to the S corporation income. She argued that she is entitled to relief under IRC §66(c). IRC §66(c) reads as follows:

> (c) Spouse relieved of liability in certain other cases
>
> Under regulations prescribed by the Secretary, if—
>
>> (1) an individual does not file a joint return for any taxable year,
>>
>> (2) such individual does not include in gross income for such taxable year an item of community income properly includible therein which, in accordance with the rules contained in section 879(a), would be treated as the income of the other spouse,
>>
>> (3) the individual establishes that he or she did not know of, and had no reason to know of, such item of community income, and

[3] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[4] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[5] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

> > (4) taking into account all facts and circumstances, it is inequitable to include such item of community income in such individual's gross income,
>
> then, for purposes of this title, such item of community income shall be included in the gross income of the other spouse (and not in the gross income of the individual).
>
> Under procedures prescribed by the Secretary, if, taking into account all the facts and circumstances, it is inequitable to hold the individual liable for any unpaid tax or any deficiency (or any portion of either) attributable to any item for which relief is not available under the preceding sentence, the Secretary may relieve such individual of such liability.

Note that this provision provides for two separate methods for the taxpayer to be able to avoid reporting community income. The first method, which is explained in all but the last paragraph, outlines what the court refers to as the "traditional relief" under this section, which provides four requirements a taxpayer must meet to be granted relief.

But the final paragraph offers a second offer of "equitable relief" if a taxpayer did not qualify for the traditional relief, so long as it would be inequitable to require the requesting former spouse to take the income into account.

Traditional Relief – S Corporation Flow-Through Income Not Covered by IRC §879(a)

The court noted that the S corporation income would have been treated as Ms. Wheeler's under the rules of IRC §879(a), making it her income. The rules of IRC §879(a), which apply to dividing income of nonresident alien spouses, are used to determine how to divide otherwise community income when the §66(c) traditional relief is sought and provides:

> (a) General rule
>
> In the case of a married couple 1 or both of whom are nonresident alien individuals and who have community income for the taxable year, such community income shall be treated as follows:
>
> > (1) Earned income (within the meaning of section 911(d)(2)), other than trade or business income and a partner's distributive share of partnership income, shall be treated as the income of the spouse who rendered the personal services,
> >
> > *(2) Trade or business income, and a partner's distributive share of partnership income, shall be treated as provided in section 1402(a)(5),* (emphasis added)
> >
> > (3) Community income not described in paragraph (1) or (2) which is derived from the separate property (as determined under the applicable community property law) of one spouse shall be treated as the income of such spouse, and

> (4) All other such community income shall be treated as provided in the applicable community property law.

The Court, applying the rules for trade or business income, found:

> Under section 879(a), community income that is trade or business income is treated as provided in section 1402(a)(5). Under section 1402(a)(5)(A), gross income and deductions attributable to a jointly operated trade or business are treated as the gross income and deductions of each spouse on the basis of their respective distributive shares of the gross income and deductions. Therefore, the rules contained in section 879(a) treat income from Turner Investments, a jointly operated trade or business, as the income of petitioner and Mr. Turner on the basis of their respective distributive shares. The income from petitioner's 37.44856% ownership of Turner Investments and reported on her 2015 Schedule K-1 would not be treated as income of a nonrequesting spouse, and she therefore does not satisfy section 1.66-4(a)(1)(ii), Income Tax Regs.[6]

Based on this factor alone, the Tax Court found that Ms. Wheeler could not qualify for traditional relief. But the Court also noted that Ms. Wheeler also should have been aware of this income (another condition for traditional relief is to be unaware of the income). While Ms. Wheeler argued that the fact that she was not provided with a Schedule K-1 proves she was not aware of the income, the court found that Ms. Wheeler reasonably should have been aware of the existence of the income:

> ..[A] taxpayer's knowledge of an item of community income must be determined by considering her knowledge of the particular income-producing activity. See *McGee v. Commissioner*, 979 F.2d 66, 70 (5th Cir. 1992), *aff'g* T.C. Memo. 1991-510; sec. 1.66-4(a)(2), Income Tax Regs. Petitioner was a shareholder in Turner Investments and reported Schedule K-1 income for the three years before 2015 on her Form 1040 jointly filed with Mr. Turner, received and reported Form W-2 income from Turner Investments for 2015 (and prior years), signed several checks for Turner Investments in 2013, and signed a divorce decree that referenced Turner Investments and required her to execute documents to remove her name from it. See *Felt v. Commissioner*, T.C. Memo. 2009-245 (finding that a requesting spouse knew the source of the income because she knew the name of and had deposited checks from a nonrequesting spouse's business that generated family income), *aff'd*, 433 F. App'x 293 (5th Cir. 2011). Crediting her testimony that she did not receive a Schedule K-1 for 2015 thus would not defeat a finding that she knew of or had reason to know of Turner Investments as an income-producing activity.
>
> Moreover, the divorce decree gave petitioner the right to request information "to prepare federal income tax returns for 2015" from Mr. Turner and required Mr. Turner "to furnish such information to * * * [petitioner]" within a specified period. Petitioner introduced no

[6] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

> evidence that she requested such information or that Mr. Turner blocked her from doing so; rather, she claims that he failed to provide the Schedule K-1 for 2015. Her right to request information under the divorce decree also was a means by which petitioner could have correctly reported her portion of Turner Investments' estimated tax payments.[7]

The opinion adds a final reason why the taxpayer should have known that there was a K-1 with income that should be reported.

> Petitioner also hired a tax return preparer to assist her, mitigating her lack of tax knowledge.[8]

Tax professionals may be troubled by this statement, since it implies that having hired a tax professional was a negative factor in determining if she had acted reasonably in remaining unaware of the existence of this income. The ruling implies (likely correctly) that a competent tax professional should have noticed the K-1 income reported in prior years and made inquiries to determine if such a K-1 had been issued to Ms. Wheeler for the current year.

As the Court notes, if such inquiries had been made (which the taxpayer conceded had not been made), her former spouse would have been required under the agreement to provide her with such information.

Equitable Relief Not Available Due to the Income Being Hers

The opinion also looks at the option made available for general equitable relief under IRC §66(c) in cases where the taxpayer cannot meet the conditions for traditional relief.

The Court notes that the IRS has outlined procedures for obtaining equitable innocent spouse relief in Revenue Procedure 2013-34. And the opinion notes that the relief can normally only be made available for income that is wholly that of the nonrequesting spouse:

> The requesting spouse must satisfy five threshold conditions to be eligible to submit a request for equitable relief under section 66(c). Rev. Proc. 2013-34, sec. 4.01, 2013-43 I.R.B. at 399-400. One threshold condition is that "[t]he income tax liability from which the requesting spouse seeks relief is attributable (either in full or in part) to an item of the nonrequesting spouse or an underpayment resulting from the nonrequesting spouse's income." Id. sec. 4.01(7), 2013-43 I.R.B. at 399.[9]

---

[7] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[8] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[9] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

In this case, the problem was that the income from her shares in the S corporation was her income:

> The income tax liability from which petitioner seeks relief is not attributable (either in full or in part) to an item or underpayment of another individual. See *id*. Rather, the liability from which she seeks relief is attributable to her status as a 37.44856% shareholder in Turner Investments (distinct from Mr. Turner's status as a 62.55144% shareholder).[10]

The opinion continues on to note why this is not one of the special cases where Ms. Wheeler could obtain relief even though the income was her own:

> The exceptions for which "the Service will consider granting relief regardless of whether the * * * deficiency * * * is attributable * * * to the requesting spouse" under Rev. Proc. 2013-34, sec. 4.01(7), 2013-43 I.R.B. at 399-400, are (a) attribution solely due to operation of community property law, (b) nominal ownership, (c) misappropriation of funds, (d) abuse, and (e) fraud committed by the nonrequesting spouse.
>
> Petitioner does not meet any of these exceptions because: (a) the Schedule K-1 income from Turner Investments is attributable to her under section 1366, not solely by the operation of community property law; (b) the Schedule K-1 is in her name, and she did not rebut the consequent presumption that the income is attributable to her; (c) her failure to claim estimated tax payments (and the IRS' subsequent refund of those excess payments to Mr. Turner pursuant to section 6402 and section 1.6654-2(e)(5)(ii), Income Tax Regs.) does not constitute misappropriation of funds; (d) she filed an individual return and did not establish how any prior abuse by Mr. Turner would result in her inability to challenge the treatment of items on a return that she filed individually after her divorce was finalized and with the help of her own return preparer; and (e) she did not argue or establish that fraud is the reason for an erroneous item. Nor are we persuaded that her failure to claim the estimated tax payments and the subsequent refund to Mr. Turner provided sufficient ground for equitable relief independent of these factors. While the facts here are unfortunate, they were not unavoidable. We therefore hold that petitioner is not entitled to equitable relief under section 66(c).[11]

Lessons from the Case

In my career as a tax professional in Arizona (a community property state), I've noticed that recently divorced spouses, or even those going through a divorce, do not appreciate the impact of community property rules on how income must be reported on either returns with a married filing separate status or those for a tax year during which the divorce decree was granted. A former (or soon to be former) spouse often

[10] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

[11] *Wheeler v. Commissioner*, TC Summary Opinion 2021-42, December 9, 2021

believes he/she just has to report his/her income based on how items were divided in the divorce or on general non-community property law views of what income belongs to each spouse.

In many cases, even after being made aware of the requirements to report income based on state law ownership of the income unless the special requirements of IRC §66(c) are met, the client will strongly resist such reporting, either finding it "unfair" or, more often, simply not wanting to interact with the other spouse as necessary to obtain the information.

Similarly, in looking over returns prepared by other preparers, it appears often preparers either are also unaware of these rules or simply decide to prepare the return ignoring community property rules when the client balks at getting the proper information. As well, even some preparers that are generally aware of the community property rules and special rules for IRC §66(c) are unaware of the limitations on the types of income to which such relief applies under the traditional rule.

Most often such reporting does not lead to problems with the IRS, resulting in an unfortunate reinforcement for all parties that such reporting is "fine" and there's no need to worry about proper reporting. To be honest, if the corporation had not issued a K-1 in the ex-spouse's name, rather erroneously preparing a K-1 showing all income as the ex-husband's, it's highly likely nothing would have happened here.

But as is often the case with such "practical" decision making ("I've been doing it this way for decades and never had an issue with the IRS on this!"), if the IRS does become aware of the issue and starts looking to collect tax, the taxpayer has no practical defense against paying the tax. And, as this case made clear, the fact the client sought professional help makes the situation worse, as the taxpayer's lack of sophistication no longer is a factor that might have shown it was reasonable to conclude the taxpayer wasn't aware of her error.

SECTION: 3134 GUIDANCE PROVIDED FOR EMPLOYERS TO MAKE DEPOSITS FOR PAYROLL TAX DEPOSITS REDUCED DUE TO ERC THEY NO LONGER QUALIFY FOR AND TO REPAY ADVANCES ON THAT CREDIT

Citation: Notice 2021-65, 12/6/21

Notice 2021-65[12] has been released by the IRS, providing guidance on the repeal of the employee retention credit (ERC), effective as of September 30, 2021, for all employers except those that are recovery startup businesses. This retroactive change was part of the Infrastructure Investment and Jobs Act (IIJA)that was signed into law on November 15. Prior to the enactment of the IIJA, employers who faced certain

[12] Notice 2021-65, December 6, 2021, https://www.irs.gov/pub/irs-drop/n-21-65.pdf (retrieved December 6, 2021)

reductions in gross receipts or were subject to certain full or partial suspensions of their business due to COVID-19 governmental orders could qualify for the credit.

The Notice explains this law change as follows:

> Section 80604 of the Infrastructure Act amended section 3134(n) of the Code to provide that the employee retention credit under section 3134 shall apply only to wages paid after June 30, 2021, and before October 1, 2021 (or, in the case of wages paid by an eligible employer which is a recovery startup business, January 1, 2022). Additionally, effective for calendar quarters beginning after September 30, 2021, section 80604 of the Infrastructure Act amended the definition of recovery startup business under section 3134(c)(5) of the Code to remove the requirement that a recovery startup business not otherwise be an eligible employer due to a full or partial suspension of operations or a decline in gross receipts.[13]

The Notice modifies previously issued guidance to take into account the termination of the employee retention credit for other than recovery startup businesses for the fourth quarter of 2021, as well as providing certain penalty relief for employers who had reduced payroll tax deposits, received advance payments of the ERC or both prior to the retroactive repeal of the credit for the fourth quarter of 2021.

There is a significant oddity in this guidance—while an employer has until the due date of its employment tax return for the fourth quarter of 2021 to pay back any advances the employer received, any amounts that offset payroll tax deposits must be repaid by the date a payroll tax deposit would be due for wages paid on December 31, 2021—and if that amount is $100,000 or more, the One-Day Deposit Rule will be triggered for that payment.

Updating Prior IRS Guidance to Take Into Account Repeal of Most of the ERC for the Fourth Quarter

Section III.A. of the Notice provides the following guidance related to rules related to a decline in gross receipts or full or partial suspension of the employer's business:

> Due to the amendments made by section 80604 of the Infrastructure Act, rules for determining whether an employer is an eligible employer due to a full or partial suspension of operations (section III.D. of Notice 2021-20) or a decline in gross receipts (section III.C. of Notice 2021-23) no longer apply for the fourth calendar quarter of 2021. Any rules based upon the determination that an employer is an eligible employer due to a full or partial suspension of operations or a decline in gross receipts, such as rules relating to "severely financially distressed employers" discussed in section III.E. of Notice 2021-49, also no longer apply for the fourth calendar quarter of 2021. Further, references in Notice 2021-49 to eligible employers claiming the employee retention credit for qualified wages paid in the fourth

[13] Notice 2021-65, December 6, 2021, Section II BACKGROUND

> calendar quarter of 2021 no longer apply unless the employer is a recovery startup business.[14]

The Notice removes the requirement that a recovery startup business not otherwise have a qualifying reduction in gross receipts or a full or partial suspension of business in the fourth quarter:

> The rules related to recovery startup businesses in section III.D. of Notice 2021- 49 include the requirement that a recovery startup business not otherwise be an eligible employer due to a full or partial suspension of operations or a decline in gross receipts. Section 80604 of the Infrastructure Act removes this requirement for the fourth calendar quarter of 2021. Accordingly, this requirement no longer applies to recovery startup businesses in the fourth calendar quarter of 2021.[15]

However, aside from the above changes, prior guidance will continue to apply to the fourth quarter employee retention credit:

> All other rules set forth in Notice 2021-20 and Notice 2021-23 addressing CARES Act provisions that are the same as those provided under section 3134 of the Code continue to apply for the fourth calendar quarter of 2021 to recovery startup businesses. Similarly, all other rules set forth in Notice 2021-49 continue to apply for the fourth calendar quarter of 2021 to recovery startup businesses.[16]

Repayment of Advances for the Fourth Quarter

Employers that expected to qualify for the employee retention credit may have used Form 7200 to apply for and have received advance payments on the fourth quarter employee retention credit, a credit they no longer qualify for unless the employer is a recovery startup business.

The Notice points out that these employers will need to repay these advances:

> Employers may have requested advance payments of the employee retention credit for wages paid in the fourth calendar quarter of 2021 prior to the enactment of the Infrastructure Act. An advance payment of any portion of the employee retention credit to a taxpayer in excess of the amount to which the taxpayer is entitled is an erroneous refund that the employer must repay. Accordingly, if an employer requested and received an advance payment of the employee retention credit for wages paid in the fourth calendar quarter of 2021, and the employer is

[14] Notice 2021-65, December 6, 2021, Section III GUIDANCE, A. Termination of Employee Retention Credit for Employers other than Recovery Startup Businesses

[15] Notice 2021-65, December 6, 2021, Section III GUIDANCE, A. Termination of Employee Retention Credit for Employers other than Recovery Startup Businesses

[16] Notice 2021-65, December 6, 2021, Section III GUIDANCE, A. Termination of Employee Retention Credit for Employers other than Recovery Startup Businesses

> not a recovery startup business, the employer is not eligible for an employee retention credit and must repay the amount of the advance.[17]

The IRS is going to allow these employers to repay the advances with the payroll tax return that includes the fourth quarter of 2021 (normally the fourth quarter Form 941):

> Employers who need to repay these excess advance payments of the employee retention credit must do so by the due date for the applicable employment tax return that includes the fourth calendar quarter of 2021. Employers should refer to the instructions to the applicable employment tax form for additional information.[18]

If an employer fails to make this payment timely, the IRS warns the employer may face penalties:

> Failure to repay the advance payment by the due date of the applicable employment tax return may result in the imposition of failure to pay penalties under section 6651.[19]

Failure to Deposit Penalties for Employers Retroactively Ineligible for the Employee Retention Credit

Before applying for an advance payment of the employee retention credit, employers were to first reduce their payroll tax deposits. Obviously, employers that reduced their deposits by a credit they will no longer qualify to take are behind on their payroll tax payments and, without special relief, would be subject to penalties for late payment of such deposits.

The IRS had previously announced in Notice 2021-24, issued prior to the repeal of the fourth quarter ERC for most employers, that the agency would waive failure to deposit penalties for those that offset their deposits by the ERC. The IRS now indicates they will no longer waive such penalties for deposits after December 20, 2021 (except for recovery startup businesses):

> Due to the termination of the employee retention credit for wages paid in the fourth calendar quarter of 2021 for employers that are not recovery startup businesses, the IRS will no longer waive failure to deposit penalties for employers that reduce deposits in anticipation of the employee retention credit after December 20, 2021, unless the employer is a recovery startup business.[20]

---

[17] Notice 2021-65, December 6, 2021, Section III GUIDANCE, B. Repayment of Advance Payments for Employers other than Recovery Startup Businesses

[18] Notice 2021-65, December 6, 2021, Section III GUIDANCE, B. Repayment of Advance Payments for Employers other than Recovery Startup Businesses

[19] Notice 2021-65, December 6, 2021, Section III GUIDANCE, B. Repayment of Advance Payments for Employers other than Recovery Startup Businesses

[20] Notice 2021-65, December 6, 2021, Section III GUIDANCE, C. Failure to Deposit Penalties for Employers other than Recovery Startup Businesses

For deposits due on or before that date, the employer will not face penalties if the following requirements are met (note the date the deposit must be made by):

> For deposits due on or before December 20, 2021, with respect to wages paid on or after October 1, 2021, but before January 1, 2022, an employer that is not a recovery startup business will not be subject to a penalty under section 6656 for failing to deposit Employment Taxes for the fourth calendar quarter of 2021 if—
>
> 1. The employer reduced its deposits in anticipation of the employee retention credit, consistent with the rules provided in section 3.b. of Notice 2021-24; and
>
> 2. The employer deposits the amounts initially retained in anticipation of the employee retention credit *on or before the relevant due date for wages paid on December 31, 2021 (regardless of whether the employer actually pays wages on that date).* Deposit due dates will vary based on the deposit schedule of the employer; and
>
> 3. The employer reports the tax liability resulting from the termination of the employer's employee retention credit on the applicable employment tax return or schedule that includes the period from October 1, 2021 through December 31, 2021. Employers should refer to the instructions to the applicable employment tax return or schedule for additional information on how to report the tax liability.[21]

In a footnote, the IRS notes that if an employer has retained an amount of $100,000 or more, the Next-Day Deposit Rule will apply to that December 31 deemed wage payment date deposit:

> If the amounts initially retained in anticipation of the employee retention credit total $100,000 or more with or without any additional liability on that date, then the employer is subject to the $100,000 One-Day rule of § 31.6302-1(c)(3) (also referred to as the "Next-Day Deposit Rule").[22]

---

[21] Notice 2021-65, December 6, 2021, Section III GUIDANCE, C. Failure to Deposit Penalties for Employers other than Recovery Startup Businesses

[22] Notice 2021-65, December 6, 2021, Section III GUIDANCE, C. Failure to Deposit Penalties for Employers other than Recovery Startup Businesses, Footnote 8

If a taxpayer does not qualify for relief under this Notice, the IRS notes that the taxpayer can attempt to obtain reasonable cause relief:

> If an employer does not qualify for relief under this Notice, it may reply to a notice about a penalty with an explanation and the IRS will consider reasonable cause relief pursuant to section 6656(a).[23]

SECTION: 6031
SPECIAL RELIEF FOR FILING SCHEDULES K-2 AND K-3 FOR SHORT-YEAR PARTNERSHIPS PUBLISHED IN FAQ BY IRS

Citation: "Frequently Asked Questions (FAQs) for 2021 Short-Tax Year Pass-Through Entity Returns and Schedules K-2 and K-3," IRS website, 12/7/21

The IRS is requiring partnerships that have international tax information to prepare and attach Schedules K-2 and K-3 to partnerships whose tax year begins in 2021. However, the final versions of these forms are not available currently, which could present a problem for a fiscal year partnership that began operations in 2021, but whose year-end for its first income tax return is before the end of 2021. As well, partnerships that are not in existence at year end may face a similar problem complying with the reporting requirements.

In an FAQ posted on the IRS website,[24] the agency has given guidance to such short-year partnerships. The FAQ begins by noting:

> In summer 2021, the Treasury Department and the IRS finalized Schedules K-2 and K-3 for Forms 1065, 1120-S, and 8865 ("Forms") for tax year 2021. The schedules are designed to provide greater 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. The Treasury Department and the IRS also finalized instructions associated with the Schedules K-2 and K-3. The tax year 2021 Forms, to which Schedules K-2 and K-3 must be attached, have not yet been finalized. Questions have arisen whether the Schedules K-2 and K-3 must be attached to tax year 2020 Forms for partnerships or S corporations with 2021 short tax years; or, in the case of Form 8865, filers of Form 8865 with 2021 short tax years. These FAQs address questions concerning Schedules

---

[23] Notice 2021-65, December 6, 2021, Section III GUIDANCE, C. Failure to Deposit Penalties for Employers other than Recovery Startup Businesses

[24] "Frequently Asked Questions (FAQs) for 2021 Short-Tax Year Pass-Through Entity Returns and Schedules K-2 and K-3," IRS website, 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 (retrieved December 11, 2021)

K-2 and K-3 with respect to 2021 short tax years for pass-through entities and filers of Form 8865.[25]

The first question deals with procedures to be followed if Schedules K-2 and K-3 are not available 30 days before the return is due, providing for a waiver of penalties in that case:

1. Are the Schedules K-2 and K-3 required to be attached to the Forms for the 2021 short tax years? (added December 7, 2021)

A. Final version of tax year 2021 Forms not available at least 30 days before the return due date. A 2021 short tax year is a tax year that begins on or after January 1, 2021, and is less than 12 months because the pass-through entity (or in the case of Form 8865, the filer of Form 8865) either is not in existence for an entire tax year or its tax year changes. With respect to a 2021 short tax year that begins and ends in 2021, if the final version of the tax year 2021 Forms (including the Schedules K and K-1) are not available at least 30 days before the due date of the return (or, in the case of Form 8865, not available at least 30 days before the filer's return is required to be filed), tax year 2020 Forms must be filed and must incorporate any tax law changes that are effective for the 2021 tax year. If final tax year 2021 Forms and instructions are not available at least 30 days before the tax year 2021 return is required to be filed (or, in the case of Form 8865, not available at least 30 days before the filer's return is required to be filed), then you will not be subject to penalties for failing to attach Schedules K-2 and K-3 to the tax year 2020 Forms. See Notice 2021-39, 2021-27 I.R. B. 3, for reporting requirements, applicable penalties and transition relief from penalties. The Notice will apply with respect to information that would have been reported on the Schedules K-2 and K-3, but that is provided by completing the tax year 2020 Forms with attachments as described below. Also, you will not be subject to penalties for failing to attach Schedule K-3 to the Schedule K-1 provided to the partner or shareholder. Filers must follow the instructions for the tax year 2020 Forms relating to reporting international transactions and items of international tax relevance on Schedules K and K-1, with required attachments, and include the information required by Schedules K-2 and K-3 and the instructions for those schedules. If you choose, you may attach Schedules K-2 and K-3 (in pdf format) to the tax year 2020 Forms, and these schedules should be completed by following the tax year 2021 instructions for those schedules. If Schedules K-2 and K-3 (in PDF format) are attached, you do not need to complete line 16 of the Form 1065 and Form 8865, Schedules K and K-1, and line 14 of the Form 1120-S, Schedules K and K-1, the tax year 2020, except for:

- Form 1065, Schedule K, line 16p, and Schedule K-1(Form 1065), line 16. Codes P and Q;

---

[25] "Frequently Asked Questions (FAQs) for 2021 Short-Tax Year Pass-Through Entity Returns and Schedules K-2 and K-3," IRS website, December 7, 2021

- Form 8865, Schedule K, line 16p, and Schedule K-1(Form 8865), line 16, Codes P and Q;
- Form 1120-S, Schedule K, line 14p, and Schedule K-1(Form 1120-S), line 14, Codes P and Q.

See Notice 2021-39, 2021-27 I.R. B. 3, for reporting requirements, applicable penalties and transition relief from penalties. Unless you qualify for relief under this Notice, you may still be subject to a penalty for failing to show all information required.

The second question deals with the situation where the final forms are available at least 30 days before the due date, not unexpectedly no longer waiving the requirement to complete and file these forms:

2. When are the Schedules K-2 and K-3 required to be attached to the Forms? (added December 7, 2021)

A. Final version of tax year 2021 Forms available at least 30 days before the return due date. If the tax year 2021 Forms are available at least 30 days before the filing due date, the tax year 2021 Forms must be filed and Schedules K-2 and K-3 are required to be attached to the returns for partnerships and S corporations (or, in the case of Form 8865, the filers of Form 8865) that have an annual accounting period beginning on or after January 1, 2021. The exception from filing Schedules K-2 and K-3 explained in question 1 ONLY applies to 2021 short tax years for which returns are due 30 days or less from when the tax year 2021 Forms become available (or, in the case of Form 8865, question 1 only applies to 2021 short tax year returns of filers of Form 8865 that are due 30 days or less from when the tax year 2021 Form 8865 becomes available).[26]

[26] "Frequently Asked Questions (FAQs) for 2021 Short-Tax Year Pass-Through Entity Returns and Schedules K-2 and K-3," IRS website, December 7, 2021