



# Current Federal Tax Developments

February 21, 2022

Kaplan Financial Education



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## This Week We Look At:

Schedules K-2 and K-3: the 2021 tax return relief package;

- How important is this relief?
- When doesn't it apply?
- What happens next year?



## The Week the IRS Backed Down (Some)



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- Began the week following the IRS's attempt at defending the K-2 and K-3 situation in statement to *Tax Notes Today Federal*
- First news of an IRS change came in the early evening of February 15, confirmed with a "to come" announcement
- On February 16 the IRS first posted revisions to the FAQ on K-2 and K-3, followed by a news release late in the day

# General Rules for Filing K-2 and K-3

First we review the rules that applied before this new relief and still apply if a partnership or S corporation does not meet the tests for relief

# The Original Need to File Rules

**Form 1116 Foreign Tax Credit**  
 (Individual, Estate, or Trust)  
 Attach to Form 1040, 1040-SR, 1040-NR, 1041, or 990-T.  
 Go to [www.irs.gov/Form1116](http://www.irs.gov/Form1116) for instructions and the latest information.

OMB No. 1545-0121  
**2021**  
 Attachment Sequence No. 19

Name \_\_\_\_\_ Identifying number as shown on page 1 of your tax return \_\_\_\_\_

Use a separate Form 1116 for each category of income listed below. See *Categories of Income* in the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

Section 951A category income     Passive category income     Section 901(j) income     Lump-sum distributions  
 Foreign branch category income     General category income     Certain income re-sourced by treaty

**h Resident of (name of country) ▶**  
**Note:** If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

**Part I Taxable Income or Loss From Sources Outside the United States** (for category checked above)

	Foreign Country or U.S. Possession			Total (Add cols. A, B, and C.)
	A	B	C	
<b>i Enter the name of the foreign country or U.S. possession ▶</b>				
<b>1a</b> Gross income from sources within country shown above and of the type checked above (see instructions): _____				<b>1a</b>
<b>b</b> Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is \$250,000 or more, and you used an alternative basis to determine its source. See instructions . . . ▶ <input type="checkbox"/>				

- For domestic partnerships and S corporations with no foreign operations or partners, information needed by partners for the following forms created the issue:
  - Form 1116
  - Form 1118
- Lines 1, 3 & 4 require information about U.S. activities in order to properly complete the computations



# Schedules K-2 and K-3 Must Be Completed

- Any partner or shareholder
  - Has foreign taxes for which a foreign tax credit may be claimed *and*
  - Is not eligible to make the election to not compute the limit on creditable foreign taxes (and thus not file Form 1116). An individual can elect if
    - Have only passive category foreign income
    - Taxes reported on qualified payee statements (1099INT, 1099DIV, K1 (Form 1041), Schedule K-1 (Forms 1065 and 1120-S)) and
    - No more than \$300 of such taxes (\$600 if married filing jointly)

## Limits on Use of This Option



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- Only works for individuals, so if have a corporate, trust or estate partner with foreign taxes you must complete the K-2 and related K-3s
- While there's no foreign income limit, even a dollar of non-passive category income (aside from high-taxed income) eliminates the option
- May require waiting until the partner has all information to know if he/she can use this option.

# Presumption of Need for Information



- Partnership K-2/K-3 instructions contain a presumption that all partners need this information and so Schedule K-2 and associated K-3 by default must be prepared
- Can only avoid the schedules if partnership has information from every partner that he/she doesn't need this information
- That includes all indirect partners

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# Presumption of Need for Information



- S corporation instructions don't have that presumption
- Still must prepare the schedules if any shareholder requires the information
- But do not have any requirement to inquire
- May not be as useful as you think if signing shareholder or preparer is aware of the issue for any shareholder

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# 2021 Relief from Filing

The IRS offered relief from filing Schedules K-2 and K-3 in certain situations in an updated FAQ published on February 16

# The FAQs of (K-2/K-3 Tax) Life

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IRS

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## Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865)

Individuals

Businesses and Self-Employed

Small Business and Self-Employed

Large Business

Corporations

Partnerships

Centralized Partnership Audit

1. What are the Schedules K-2 and K-3? (added February 16, 2022)
2. Why is the IRS creating Schedules K-2 and K-3 for Forms 1065, 1120S, and 8865? (added February 16, 2022)
3. Why is the IRS creating Schedules K-2 and K-3 now? (added February 16, 2022)
4. What are the benefits of the Schedules K-2 and K-3 for taxpayers? (added February 16, 2022)

- Released the morning of February 17
- Added question 15 which provided specific relief
- But must first meet three criteria to use the relief
- And then essentially end up with a presumption no partner needs the information unless become aware a partner will ask for this information
- <https://www.irs.gov/businesses/schedules-k-2-and-k-3-frequently-asked-questions-forms-1065-1120s-and-8865>



# The IRS Apparently is Working Late – Between 6 and 7 pm EST on February 15 This Was Issued by the National Public Liaison

The IRS intends to provide certain additional transition relief for this year from the Schedule K-2 and K-3 reporting for certain domestic partnerships and S corporations with no foreign activities, foreign partners or shareholders, and without knowledge of partner or shareholder need for information on items of international relevance. For 2021, these qualifying domestic partnerships and S corporations will not have to file the new schedules. We are taking this step in response to feedback we received from the tax community and our stakeholders. The IRS will provide full details of this relief soon.

Reference:

<https://www.irs.gov/newsroom/help-for-taxpayers-and-tax-professionals-special-filing-season-alerts>

# The Three Hurdles to Clear to Use This Method

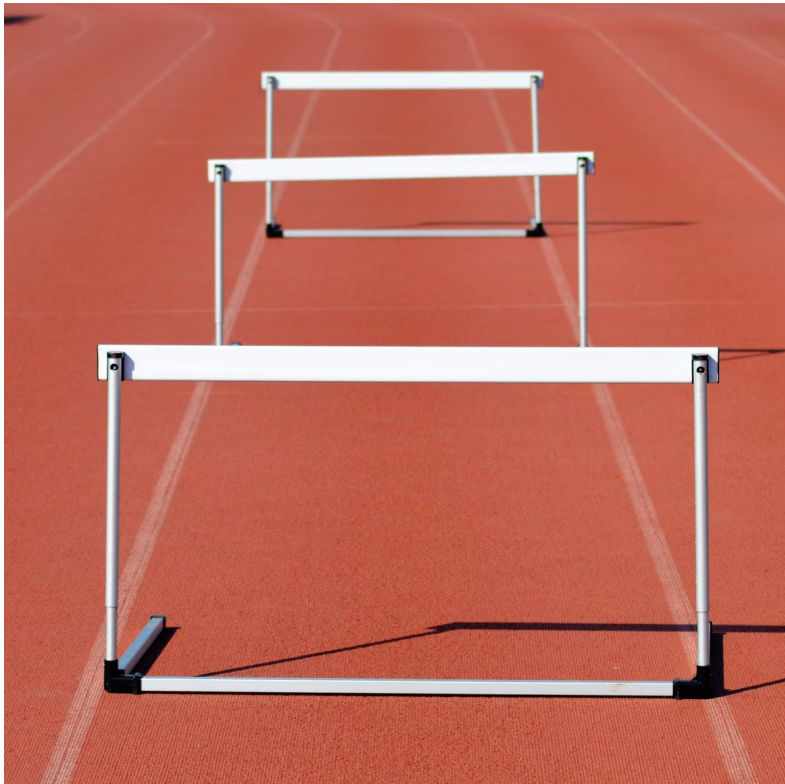


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- In tax year 2021, the direct partners in the domestic partnership are not
  - Foreign partnerships,
  - Foreign corporations,
  - Foreign individuals,
  - Foreign estates or
  - Foreign trusts.

# The Three Hurdles to Clear to Use This Method

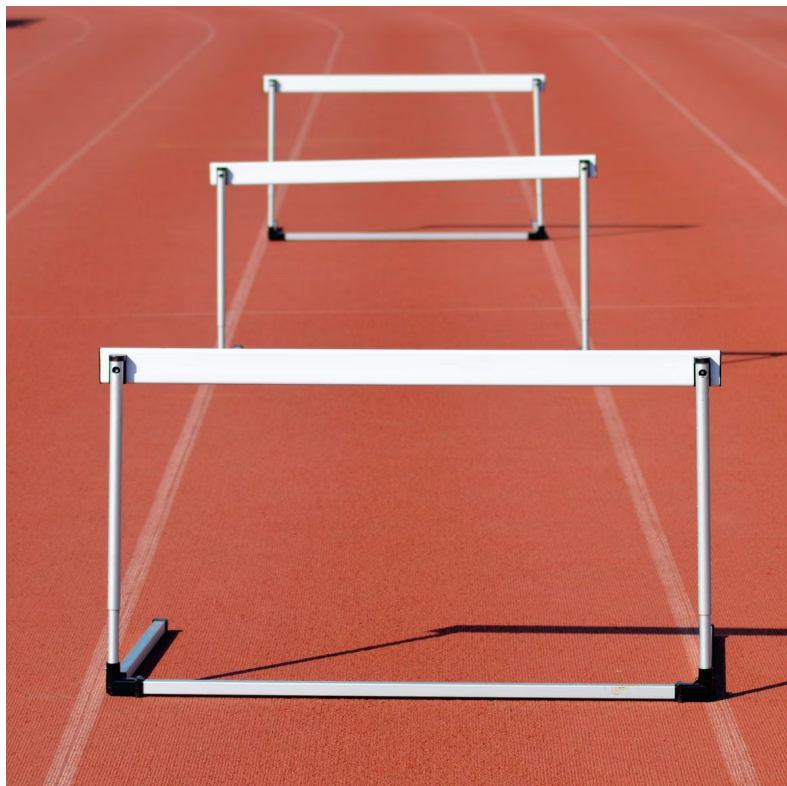


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- In tax year 2021, the domestic partnership or S corporation has no foreign activity, including
  - Foreign taxes paid or accrued or
  - Ownership of assets that generate, have generated or may reasonably expected to generate foreign source income (see section 1.861-9(g)(3)).

# The Three Hurdles to Clear to Use This Method



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- In tax year 2020, the domestic partnership or S corporation did not provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):
  - Line 16, Form 1065, Schedules K and K-1 (line 14 for Form 1120-S), and



# The Three Hurdles to Clear to Use This Method

## Schedule K-1 (Form 1065)

Department of the Treasury  
Internal Revenue Service

# 2020

For calendar year 2020, or tax year

beginning  /  / 2020 ending  /  /

### Partner's Share of Income, Deductions, Credits, etc. ▶ See separate instructions.

Part I Information About the Partnership	
A	Partnership's employer identification number
B	Partnership's name, address, city, state, and ZIP code
C	IRS Center where partnership filed return ▶
D	<input type="checkbox"/> Check if this is a publicly traded partnership (PTP)
Part II Information About the Partner	
E	Partner's SSN or TIN (Do not use TIN of a disregarded entity. See instructions.)

Part III Partner's Share of Current Year Income, Deductions, Credits, and Other Items			
1	Ordinary business income (loss)	15	Credits
2	Net rental real estate income (loss)		
3	Other net rental income (loss)	16	Foreign transactions
4a	Guaranteed payments for services		
4b	Guaranteed payments for capital		
4c	Total guaranteed payments		
5	Interest income		
6a	Ordinary dividends		
6b	Qualified dividends		



# The Three Hurdles to Clear to Use This Method



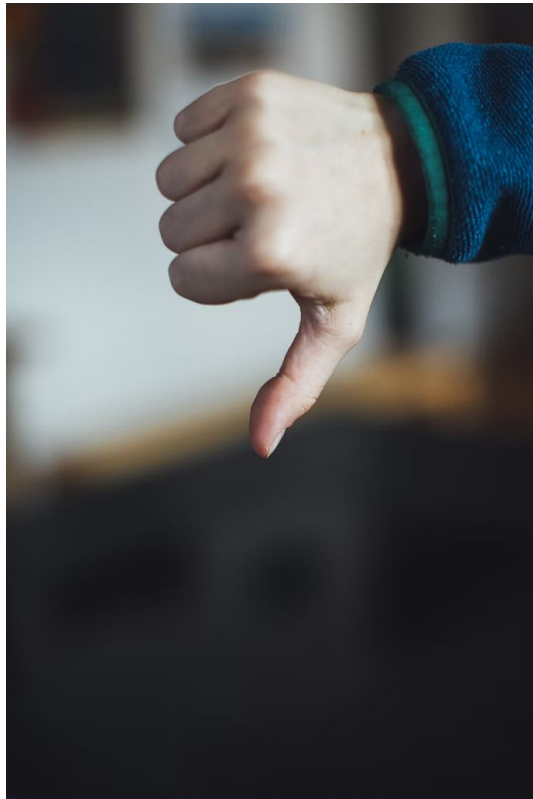
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- In tax year 2020, the domestic partnership or S corporation did not provide to its partners or shareholders nor did the partners or shareholders request the information regarding (on the form or attachments thereto):
  - Line 20c, Form 1065, Schedules K and K-1 (Controlled Foreign Corporations, Passive Foreign Investment Companies, 1120-F, section 250, section 864(c)(8), section 721(c) partnerships, and section 7874) (line 17d for Form 1120-S).

## If Meet All Those Test, Then Get Relief if...

- The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021 then won't need to file the Schedules
  - If a partner or shareholder notifies the partnership or S corporation before the partnership or S corporation files its return, the conditions for the exception are not met and the partnership or S corporation must provide the Schedule K-3 to the partner or shareholder and file the Schedules K-2 and K-3 with the IRS.
  - After the return is filed, if the partnership or S corporation is subsequently notified by a partner or shareholder that all or part of the information contained on Schedule K-3 is needed to complete their tax return, then the partnership or S corporation must provide the information to the partner or shareholder.

# If the Entity Fails to Qualify for Relief



- Go back to the general rules to see if the Schedules must be completed and filed
- May still escape the need to file the forms if have evidence no one need the information, but have to document that fact at the partnership level
- For S corporations, the relief may not actually be that big of a deal due to the lack of the presumption

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<https://www.currentfederaltaxdevelopments.com>

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