

New 2022 Instructions

Schedules K-2 & K-3 for Passthrough Entities



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Schedules K-2 and K-3 Explained

Final 2022 instructions for Forms 1065 and 1120-S were announced by the Internal Revenue Service (IRS) in December 2022.

Schedule K-2 is an extension of Schedule K for these forms and is used to report items of international tax relevance from a partnership or S corporation. Schedule K-3 is an extension of Schedule K-1 for these forms and is generally used to report to partners or shareholders their share of the items reported on Schedule K-2.

Throughout this discussion, S corporation, Form 1120-S and shareholders can be substituted for references to Partnership, Form 1065, or partners. Partners must include the information reported on Schedule K-3 on their tax or information returns, if applicable.

2022 Filing Requirements

A partnership with no foreign source income, no assets generating foreign source income, no foreign partners, and no foreign taxes paid or accrued may need to file or furnish Schedules K-2 and K-3 regardless of how small or local the partnership is to report information needed by a partner. For example, if a partner claims a credit for foreign taxes paid or accrued by the partner, the partner may need certain information from the partnership to complete Form 1116 or Form 1118. Accordingly, the IRS issued additional filing requirements for 2022 partnerships.

Any partnership required to file Form 1065 that has relevant items for U.S. tax, certain withholding tax, or reporting obligations of its partners under the international provisions of the Internal Revenue Code must complete the relevant parts of Schedules K-2 and K-3. A section does not need to be completed if there is nothing to report on that section.



Domestic Filing Exception

All four conditions below must be met to be exempt from filing Schedules K-2, K-3.

1. Limited Foreign Activity

No foreign activity such as foreign taxes paid, or accrued, no foreign source income or foreign loss either directly or through foreign partnership, foreign corporation, foreign branch, or foreign disregarded entity. Note that a partnership selling property and has one of its U.S. citizen partners living in a foreign country has foreign source income as personal property (not inventory) is sourced according to partner residence. Foreign activity is allowed for passive category foreign income, with a maximum of \$300 of foreign income taxes paid or accrued and the income and foreign taxes are from a payee statement received (e.g., Form 1099, K-1, K-3).

2. U.S. Citizen/Resident Alien Partners

All partners in the domestic partnership are U.S. citizens or resident alien individuals or domestic decedent estates (not foreign estates) with U.S. citizen and/or resident alien individual beneficiaries, or domestic grantor trusts (not foreign trusts) with U.S. citizen and/or resident alien individual grantors and U.S. citizen and/or resident alien individual beneficiaries, or domestic non-grantor trusts (not foreign trusts) with U.S. citizen and/or resident alien individual beneficiaries. A single-member LLC that is a disregarded entity can also be a partner if the LLC's sole member is one of the persons listed elsewhere under this paragraph.

An S Corporation with a sole shareholder can also be a partner in a partnership since it is one of the allowed owners under the Domestic Filing Exception criterion. An S Corporation is only allowed to have individuals, certain trusts, and estates (no non-resident alien shareholders) as shareholders, so this criterion is consistent to include S Corporations as a partner.

An S Corporation can have from one to one hundred shareholders, as the number of shareholders is not relevant for the Domestic Filing Exception for S Corporations. The S Corporation must meet the conditions specified in this section for **Limited Foreign Activity, Partner Notification** and **No Requests by the One-Month Date for Schedule K-3**.

3. Partner Notification

For those partnerships that meet the first two criteria, the partnership sends a notice electronically or by mail at the latest when the partnership furnishes the Schedule K-1 to the partner. The notice can be attached to the Schedule K-1. The notification must state the partners will not receive Schedule K-3 unless requested.

4. No Requests by the One-Month Date for Schedule K-3

The partnership does not receive a request (response) from a partner for the Schedule K-3 information on or before the one-month date. The one-month date is one month before the partnership files the Form 1065. For a calendar year partnership, the latest one-month date is August 15, 2023, if an extension is filed.

Owner Disqualifiers to the Domestic Filing Exception

A C Corporation partner disqualifies an entity from the Domestic Filing Exception.

If the partnership does not have or receive sufficient information or notice regarding a partner must presume the partner is a domestic corporate partner or a partnership that has a direct or indirect domestic corporate partner. Therefore, the Domestic Filing Exception is not met.

Partnerships with an S Corporation as a partner with more than one shareholder do not qualify for the Domestic Filing Exception. If you are not aware of the number of S Corporation shareholders, then it is presumed more than one shareholder exists and the Domestic Filing Exception is not met, therefore, Schedules K-2, K-3 filing are required.

Providing K-3 to Timely Requesters

If a partner requests K-3 information on or before the one-month date (see above), then Schedules K-2 and K-3 must be filed with the IRS and a K-3 furnished to the requesting partner. Completion is required only for the relevant parts and sections that impact the requesting partner. The K-3 should be furnished to the requesting partner on the date the Form 1065 is filed. Sections and parts of K-2 and K-3 not relevant do not need to be filed with the IRS or provided to any partner, including the requesting partner.

Providing K-3 to Late Requesters

If all the exceptions above are met, but a partner requests the information after the one-month date, a K-3 must be furnished only to the requesting partner by the later of the partnership filing of the Form 1065 or one month from the date on which the partnership receives the request from the partner. Schedules K-2 and K-3 do not need to be filed with the IRS because of the late requester (late responder) or provided to non-requesting partners. The partnership must record this partner request and file the next year's return which includes 2023 Schedules K-2, K-3 for the requesting partner and complete this by the 2023 Form 1065 due date (including extensions).

Dealing with Both Timely & Late Requesters

A partnership separates the two and uses the timely and late requester procedures above.



Form 1116 Exemption Exception if Domestic Filing Exception Not Met

A domestic partnership is not required to complete Schedules K-2 and K-3 if all partners are eligible for the Form 1116 exemption (discussed below) and the partnership receives notification of the partners' eligibility by the one-month date. If a partnership receives notification from some of the partners that they are eligible for the Form 1116 exemption, the partnership only needs to complete the Schedule K-2 and Schedule K-3 for other nonexempt or non-notifying partners to the extent the partnership does not qualify for the domestic filing exception. The Form 1116 exemption exception may allow for partial or complete non-filing of Schedules K-2 and K-3 if partnership foreign taxes are greater than \$300.

If notice or information is not received regarding a direct or indirect partner and the Form 1116 exemption, then it is presumed the partner would file Form 1116 or Form 1118 to claim the passthrough credit and the partnership must complete the relevant portions for the partner of Schedules K-2 and K-3, including Parts II and III.



Form 1116 Exemption

1. All foreign source gross income is passive category income (dividends, interest, high-taxed income, for example) and income and foreign taxes paid were reported on a qualified payee statement, such as Form 1099-Div, Form 1099-Int., Form K-1, or Form K-3.
2. The foreign taxes are \$600 or less for married filing joint return (\$300 or less for singles).
3. Individual filers (Form 1040) only.

If a partner is exempt from filing Form 1116, the foreign taxes paid or accrued are entered on Schedule 3 of Form 1040.

Schedule K-2, K-3, Foreign Tax Credit Information

Schedule K-2, K-3, Parts II and III must be completed unless the partnership has zero direct or indirect partners eligible to claim a foreign tax credit or no direct or indirect partner is required to file Form 1116, or Form 1118 to claim the foreign tax credit.

Domestic Corporate Partner Requirements

If a domestic partnership with no foreign activity or no foreign partners but has direct or indirect domestic corporate partners, certain parts of Schedules K-2, K-3 must be completed.

Additional reporting requirements apply to C Corporations or a partner that is a partnership with a direct or indirect domestic C Corporation partner. If the partnership does not have or receive sufficient information or notice regarding a partner, it must be presumed the partner is a domestic corporate partner or a partnership that has a direct or indirect domestic corporate partner.

Any partnership with a direct or indirect domestic corporate partner must complete:

1. Part III and IV, Foreign Derived Intangible Income (FDII)

Schedules K-2 and K-3, Parts III, and Part IV, should be completed, even though the domestic partnership does not have foreign partners or foreign derived gross receipts and no foreign activities (no foreign derived deduction eligible income) to enable the corporate partner to calculate its FDII deduction.

2. Part IX, Base Erosion Payments (BEAT)

The partnership is required to prepare Part IX of Schedules K-3 unless an owner exception exists below:

1) A BEAT calculation is not required for Individuals or S Corporations.

The partnership is not required to prepare Part IX of Schedule K-3 for small partners, defined as meeting all three of the following requirements (Include direct interest, related party, indirect, and constructive ownership interest)

2) Partners interest in the partnership represent less than 10% of the capital and profits during the tax year.

3) The partner is allocated less than 10% of the partnership item of income, gain, loss, deduction, and credit for the tax year.

4) The partner's interest in the partnership has a fair market value of less than \$25 million on the last day of the partner's tax year, determined using a reasonable method.

A partnership making certain deductible payments to foreign related parties of its domestic partners, unless an owner exception exists (as defined above), is required to complete Part IX of Schedules K-2, K-3. This information will assist a domestic corporate partner in determining the amount of base erosion (BEAT) payments made through the partnership and in determining if the partner is subject to BEAT. The partnership should communicate with its partners to identify the foreign related parties of each partner (generally, a 25% owner or related to 25% owner).

3. Part VIII, CFC, Foreign Tax Credit

If the partnership has a direct or indirect interest in a CFC, or a partner eligible to make a section 962 election to claim a deemed paid foreign tax credit for the CFC, then Schedule K-2, K-3, Part VIII must be completed. Part VIII is not required for dormant foreign corporations.

Recordkeeping

In all cases, records should be kept of dates, notifications, responses, no responses, and information requested, provided, or filed.

Summary

New requirements from the 2022 Passthrough entity instructions will require adherence to new filing requirements and/or exceptions for Schedules K-2 and K-3.



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