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NEW SCHEDULES K-2 AND K-3 REPORTING FOR FORM 1065, FORM 1120-S, AND FORM 8865 – WHAT YOU NEED TO KNOW

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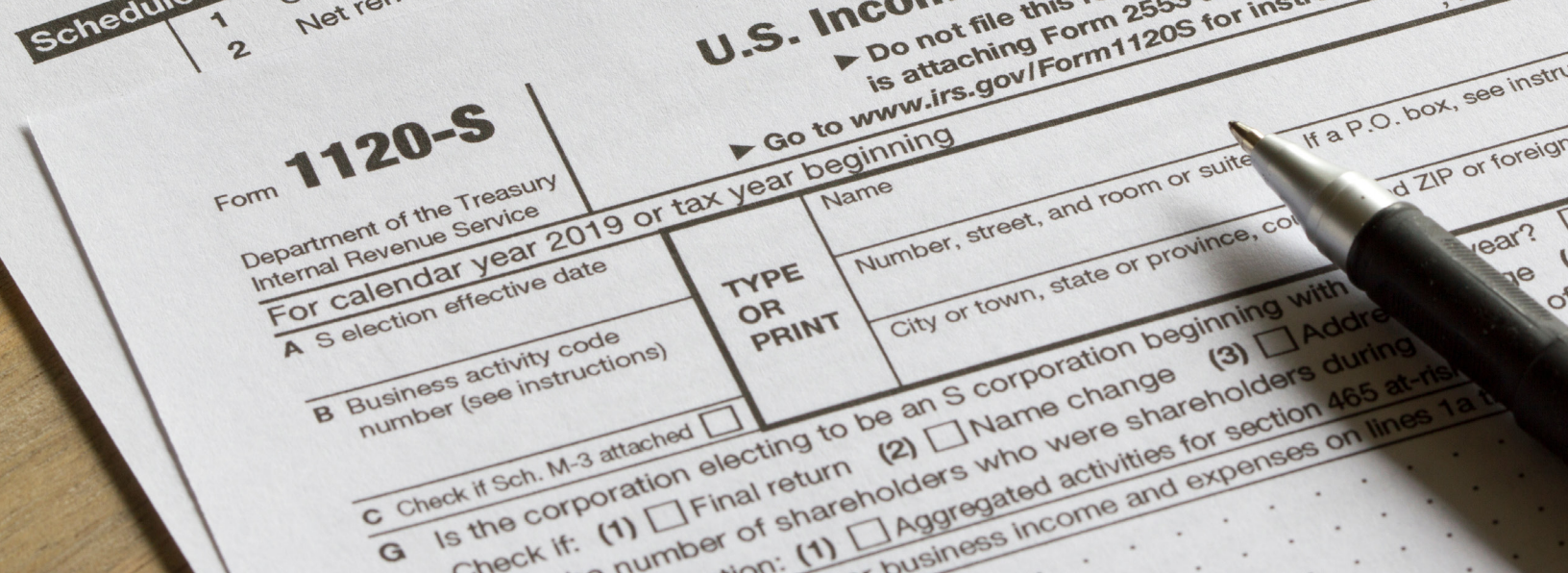
The IRS has implemented a new reporting requirement for partnerships, S corporations, and filers of Form 8865 to include Schedules K-2 and K-3 with their returns.

For the tax year beginning in 2021, the IRS has implemented a new reporting requirement for partnerships, S corporations, and filers of Form 8865 to include Schedules K-2 (Partner's Distributive Share Items – International) and Schedules K-3 (Partner's Share of Income, Deductions, Credits, etc. – International) with their returns.

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WHAT ARE SCHEDULES K-2 AND K-3 REPORTING?

Schedules K-2 and K-3 are extensions of the current Schedules K and K-1 for:

- Form 1065 (U.S. Partnership Tax Return)
- Form 1120-S (U.S. S-Corporation Tax Return)
- Form 8865 (U.S. Return of U.S. Persons With Respect to Certain Foreign Partnerships)

Schedule K-2 is used to report a partner or shareholder's total distributive share of international items from the operation of the entity. Schedule K-3 is generally used to report a partner or shareholder's distributive share of items reported on Schedule K-2. The information reported on Schedule K-3 is used to report information on a partner or shareholder's tax or information returns. The schedules replace either Line 16 on Form 1065 or Line 14 on Form 1120-S, portions of Line 20 on Form 1065 or Line 17 on Form 1120-S, as well as numerous unformatted statements attached to prior versions of the Schedule K and K-1.

WHAT IS THE PURPOSE OF SCHEDULES K-2 AND K-3?

The new format is intended to standardize the way flow-through entities report international tax information to partners and shareholders. It will provide clarity and bring consistency to how foreign activity will be reported. These new schedules will help partnerships and their partners, as well as S corporations and their shareholders, on how to calculate their U.S. income tax liabilities and credits with respect to international tax matters.

Schedules K-2 and K-3 provide detailed information to better facilitate the preparation of other international informational returns, such as:

- Form 5471 (Controlled Foreign Corporations)
- Form 8621 (Passive Foreign Investment Companies)
- Form 8991 (Base Erosion Payments)
- Form 8993 (Foreign Derived Intangible Income)

These new schedules require more detailed and complete reporting than the entities may have provided in the past. It will also help to increase the efficiency of the IRS's processing of taxpayers' information.

WHO MUST FILE SCHEDULES K-2 AND K-3?

The IRS's original instructions on these new schedules apply to flow-through entities that have items of international tax relevance, which typically include international activities or foreign partners. Partnerships and S corporations must file these schedules if they have any foreign partners, shareholders, or other foreign activities, including, but not limited to:

- Holding assets located in a foreign jurisdiction
- Employing remote employees who reside in a foreign country
- Investing in foreign businesses, either directly or indirectly, by investing in a U.S. partnership or corporation that has foreign investments
- Investing in any mutual funds that have international investments
- Contracting for any research activities outside the U.S.
- Partnerships that have any partners/spouses who are non-resident aliens
- Partnerships/S corporations with any direct or indirect partners/shareholders that have any direct foreign investments or investments in any mutual fund with any international investments (unless the partners/shareholders are all individuals and they all qualify and elect out of filing Form 1116)

With the revision to the instructions that the IRS posted on January 18, 2022, flow-through entities with no foreign source income, no assets generating foreign source income, no foreign taxes paid or accrued, or no foreign partners may still need to have a reporting requirement.



WHO QUALIFIES FOR TRANSITIONAL RELIEF?

To ease the changes of these new schedules, the IRS provided an additional exception for tax year 2021 to filing Schedules K-2 and K-3 for certain domestic partnerships and S corporations. To qualify for this exception, the following must be met:

- In tax year 2021, the direct partners in the domestic partnership are not foreign partnerships, foreign corporations, foreign individuals, foreign estates, or foreign trusts
- 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 be expected to generate foreign source income (see Section 1.861-9(g)(3))
- 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)
 - 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)
- The domestic partnership or S corporation has no knowledge that the partners or shareholders are requesting such information for tax year 2021.

If a partnership or S corporation qualifies for this exception, the domestic partnership or S corporation does not need to file Schedules K-2 and K-3 with the IRS or its partners and shareholders. However, 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 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.





The transition filing relief is outlined in [FAQ #15, IRS Schedules K-2 and K-3 Frequently Asked Questions](#) on the [IRS website](#).

The IRS released [Notice 2021-39](#), which provides transition penalty relief with respect to Schedules K-2 and K-3. Under this notice, taxpayers will not be subject to various penalties for incorrect or incomplete reporting if they can show good faith effort was rendered in obtaining and processing all required information to be in compliance with the new filing. For purposes of determining whether a filer made a good faith effort to complete Schedules K-2 and K-3, the IRS will take into account:

- The extent to which a filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing Schedules K-2 and K-3
- The extent to which a filer has obtained information from partners, shareholders, or the controlled foreign partnership, or applied reasonable assumptions when information is not obtained
- The steps were 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 are relevant to determining whether and how to file Schedules K-2 and K-3.

While there was transitional relief for tax year 2021, we know that the filing requirement is coming. It will be forced for 2022, so we should become familiar and consider filing Schedules K-2 and K-3 for ALL partnerships and S corporations for current and future tax years.

If you have any questions about these new schedules, KROST is here to answer your questions and can assist you with all your tax and financial planning needs. [Contact us](#) today.

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About the Author

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Elvira Frencillo is a Senior Tax Manager at KROST. She has 25 years of Accounting, Financial, and Taxation experience in both public and private industries. She has been in public accounting for over 11 years. Her areas of focus include tax planning, tax compliance, and financial reporting for individuals and their closely-held businesses, partnerships, corporations, and trusts. [» Full Bio](#)