



ARTICLE

# A Guide to the New Schedules K-2 and K-3 for Pass-through Entities

Starting with **tax year 2021**, the IRS requires two **new schedules – K-2 and K-3** – to be prepared with Forms 1065, 1120-S and 8865.

Schedules K-2 and K-3 are intended to replace, supplement and standardize parts of the existing international tax reporting sections in Schedule K and Schedule K-1.

They are designed to provide greater clarity for non-U.S. partners and U.S. partners who claim foreign tax credits on how to compute their U.S. income tax liability with respect to items of international tax relevance, including claiming deductions and credits. The schedules will also allow the IRS to verify taxpayer compliance on international matters with more ease.

- Schedule K-2 is an extension of Schedule K
- Schedule K-3 is an extension of Schedule K-1

**Schedule K-2** summarizes all partners' shares of the partnership's items of international tax relevance, and:

- functions much like Schedule K,
- has 12 parts (one part is reserved),
- is a 19-page schedule (additional statements and schedules may be required if not specifically identified within the Schedule K-2).

**Schedule K-3** reports each partner's share of the partnership's items of international tax relevance (i.e., each partner's allocable share of Schedule K-2) and:

- functions much like Schedule K-1,

- has 13 parts that mirror Schedule K-2, along with additional parts to provide information for a foreign partner to figure its distributive share of deemed sale items on a transfer of the partnership interest,
- is a 20-page schedule.

It is important to note that certain information must be reported on Schedule K-2 and K-3 if a partnership has direct or indirect partners that are foreign persons and/or C corporations and/or individuals. The instructions to Schedules K-2 and K-3 provide that a partnership that does not have or receive sufficient information or notice regarding a partner should presume the partner is foreign (or that a foreign person has a U.S. income tax reporting obligation with respect to a partnership item) or is eligible to claim a foreign tax credit, and the partnership should complete the schedules accordingly. This was also confirmed by the revisions to the 2021 instructions for Schedules K-2 and K-3 that were issued in January 2022.

As a result, the identity and type of partners in a partnership, especially tiered partnership structures, are critical pieces of information for a partnership's ability to comply with the new Schedule K-2/K-3 filing requirements.

## Transition Penalty Relief

The IRS has announced [transition penalty relief](#) in Notice 2021-39 for certain failures related to the filing of the new K-2/K-3 for taxable years that begin in 2021 if the filer establishes that it made a [good faith effort to comply](#) with the new requirements to the satisfaction of the Commissioner.

Additionally, the IRS is providing [another exception](#) for 2021 to filing Schedules K-2/K-3 for certain domestic partnerships and S corporations. To qualify for this exception, all of the following conditions must be met (up to and including the filing date):

- In tax year 2021, the direct partners in the domestic partnership are not foreign individuals or entities.
- In tax year 2021, the domestic partnership or S corporation has no foreign activity (including foreign taxes paid or accrued).
- In tax year 2020, the domestic partnership or S corporation did not provide, nor did partners or shareholders request, certain gross receipts or other information on lines 16 or 20c of Schedule K and K-1 (line 14 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 relies on this exception and a partner subsequently requests such information, the partnership must provide.

## Action Items

Here are some items to consider for the current year:

- Consider whether the partnership is eligible for the exception by meeting the criteria.
- Identify any changes needed to partnership agreements, side letters, subscription agreements and/or investor questionnaires to facilitate the sharing of information with partners or shareholders that is relevant to determining whether and how to file Schedules K-2 and K-3.
- Consider the timing of K-1 and K-3 deliverables.
- Collaborate with investors to gather necessary information regarding indirect partners and related parties (include a questionnaire with projections to be completed and returned to the partnership).

- Review new data needs — perform analysis between current footnote reporting and data requirements of Schedules K-2/K-3 and decide how to address data that is not currently maintained.

## Sample Roadmap for Preparation of Schedules K-2 and K-3

- If a partner has provided a Form W-8, this confirms that the partner is foreign. If there is information of indirect foreign ownership, Schedules K-2 and K-3 also will be needed. A partnership that does not have information as to whether a partner is foreign or not should assume that the partner is foreign and complete Schedules K-2 and K-3.
- If there are corporate partners in any of these partnerships, there are certain sections of Schedules K-2 and K-3 that need to be completed (Part II, Part III, Part IV, Part VIII, Part IX). In case any of the corporate partners provide a representation that they do not need to compute the foreign tax credit at their level, you may not be required to fill part II and part III of Schedules K-2 and K-3, but part IV still needs to be completed. There are exceptions to this requirement for partners that are REITs, RICs and S corporations.
- If there are partners that are partnership entities with no ownership details, certain sections of K-2/ K-3 may need to be completed under the presumption that these partnerships have indirect corporate partners.
- If there is any kind of foreign investments outside the United States, certain other sections of K-2/K-3 relating to outbound investments may apply.

## Quick Round-up

In summary, partnerships should understand the additional reporting requirements for Schedules K-2 and K-3 as applicable to their investments and ownership structures. It is critical to discuss with tax advisors to determine the changes needed to the tax reporting and compliance process and identify the additional information needs. Also, the timing of delivering Schedules K-2 and K-3 will be of utmost importance, especially for tiered partnership structures that need additional time to process all the new Schedule K-3 disclosures provided by lower-tier partnerships. Proactive planning of the tax compliance process to embrace Schedules K-2 and K-3 by identifying and assigning the right resources is the best way to tackle this new compliance requirement.

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