

US IRS releases new draft partnership Schedules K-2 and K-3 for international tax reporting

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The United States (US) Internal Revenue Service (IRS) has [released](#) for comment new draft Schedules K-2 and K-3 for the 2021 tax year IRS Form 1065, *U.S. Return of Partnership Income*. The new IRS schedules and accompanying instructions are designed to help partnerships report certain US international tax information to their partners in a standardized format. This information should assist partners in computing and reporting their corresponding US income tax liability, including under the new US international tax regimes enacted as part of the *Tax Cuts and Jobs Act of 2017*.

The new draft 2021 tax year IRS Schedules and instructions include:

- ▶ [Schedule K-2 \(Form 1065\), Partners' Distributive Share Items – International](#)
- ▶ [Schedule K-3 \(Form 1065\), Partner's Share of Income, Deductions, Credits, etc. – International](#)
- ▶ [Partnership Instructions for Schedule K-2 \(Form 1065\) and Schedule K-3 \(Form 1065\)](#)
- ▶ [Partner's Instructions for Schedule K-3 \(Form 1065\)](#)

The IRS plans similar revisions to the 2021 IRS Forms 1120-S, *U.S. Income Tax Return for an S Corporation*, and 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships*, and invites comments on changes to these forms.

Affected partnerships and timeline

Partnerships must complete the new schedules beginning in tax year 2021 (filing season 2022) if they (1) must file a US partnership tax return (IRS Form 1065) and (2) have items of US international tax relevance (in general, certain specified non-US activities or non-US person partners). The new draft schedules do not affect partnerships with no US international tax items to report.

Comment period

Partnerships and other affected stakeholders may review the proposed changes and submit comments. The IRS will consider comments submitted through 14 September 2020. The IRS plans to finalize the forms later in 2020.

What's changing

Partnerships – including private equity funds and alternative asset management funds (i.e., fund of funds, hedge funds, real estate funds, energy funds and venture capital funds) – currently report international tax information across various forms and schedules, and pass much of the information onto their partners in the form of supplemental statements, whitepaper disclosures, *pro-forma* forms and/or footnotes attached to or provided with Schedules K-1. These statements and disclosures lack any standardized format, so partners receiving them may have difficulty translating the information across various partnership investments to report the required information on the partners' tax returns. The new Schedules K-2 and K-3 offer partnerships a standardized format for reporting US international tax information to their partners, including withholding and sourcing details for foreign partners and US international inclusions or foreign attributes relevant for domestic partners.

The IRS intends the new forms to streamline tax reporting and filing for partners (and make it easier for IRS to verify the returns). The information to be reported on the new schedules is expected to be information that partnerships are already providing to their partners or that is otherwise available to the partnership. The new schedules would replace some reporting currently provided on the existing Schedule K-1 (IRS Form 1065). Specifically, Schedule K-2 would replace portions of Schedule K lines 16(a) through 16(r), and new Schedule K-3 would replace portions of Schedule K-1, Part III, Boxes 16 and 20.

The draft Schedules K-2 and K-3 include reporting of the following items, with consistent parts on each of the schedules:

- ▶ Part I: Partnership's share of current tax year international transactions (e.g., gain on personal property sale, foreign oil and gas taxes, splitter arrangements, high-taxed income, Internal Revenue Code (IRC) Section 267A disallowed deductions)
- ▶ Part II: Foreign Tax Credit Limitation (e.g., US or foreign-source income, foreign branch income, etc.)
- ▶ Part III: Other information for preparation of Form 1116 or 1118
- ▶ Part IV: Other foreign transaction information for US partners, including, *inter alia*, (i) information on partner's IRC Section 250 deduction for foreign-derived intangible income (FDII) and distributions from foreign corporations to partnerships (e.g., earnings & profits (E&P) distributions in functional currency, functional currency to USD, qualified foreign corporation information)
- ▶ Part V: Controlled Foreign Corporation (CFC) and Global Intangible Low-Taxed Income (GILTI) inclusions, etc.
- ▶ Part VI: PFIC and QEF Information (e.g., information needed by partners to file IRS Form 8621)
- ▶ Part VII: Partner's share of partnership's interest in foreign corporation income (IRC Section 960)
- ▶ Part VIII: Base Erosion and Anti-Abuse Tax (BEAT) IRC Section 59A information
- ▶ Part IX: Non-US, foreign partners' character and source of income and deductions of the partnership (e.g., deductions, losses, gross income, effectively connected income (ECI))

The Schedule K-3 is intended to operate similarly to a Schedule K-1 in the sense that it is completed for each partner and reflects each partner's allocable share of the international tax items that the partnership reports on the Schedule K-2.

Implications

The new draft schedules present additional complexities in reporting for private equity and alternative asset management funds with international activities. The additional detail required may create an increased tax compliance burden for funds, investor-relations issues and timing issues related to

delivering Schedule K-1s (and now also Schedule K-2 and K-3s) to their investors, as compared to pre-2021 tax years. Funds may want to revise the timeline and deadlines associated with providing investor tax packages that include these schedules. Alternatively, partnerships may want to separate the delivery of Schedules K-1 from the new Schedules K-2 and K-3. Additionally, funds may want to allocate the additional costs of preparation specifically to the partners to whom the partnership must provide the new schedules.

Funds should consider addressing these new timing issues and additional costs when revising or entering into new partnership agreements or side letters with their investors. The draft schedules do not replace existing US international tax information reporting requirements of the partnership, such as IRS Forms 5471, 926, 8621, etc. Rather, partnerships, including private equity and alternative asset management funds, would provide the information included on these schedules to their partners, who would use the information to satisfy their existing tax filing obligations.

For additional information with respect to this Alert, please contact the following:

Ernst & Young LLP (United States), Financial Services Office

- ▶ Gerald Whelan, *New York* gerald.whelan@ey.com
- ▶ Morgan K Anderson, *Chicago* morgan.anderson@ey.com

Ernst & Young LLP (United States), International Tax and Transaction Services

- ▶ Dan Farrell, *Chicago* dan.farrell@ey.com
- ▶ Charlene Tsai, *Hoboken* charlene.tsai@ey.com

Ernst & Young LLP (United States), Passthrough Transactions Group

- ▶ Mark Opper, *Washington, DC* mark.opper@ey.com
- ▶ Jeff Helm, *Houston* jeffrey.helm@ey.com

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