November 30, 2022

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Mr. Cliff Scherwinski
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Re: Schedule K-2 and Schedule K-3 2022 Draft Instructions

Dear Ms. Cate and Mr. Scherwinski:

The American Institute of CPAs (AICPA) is pleased to submit comments regarding the draft instructions for Schedules K-2 (Form 1065), *Partners' Distributive Share Items - International* and Schedule K-3 (1065), *Partners' Share of Income, Deductions, Credits, etc. – International* (hereinafter referred to as Schedules K-2 and K-3, or Schedules). We appreciate the opportunity provided by the Internal Revenue Service (IRS) to provide such comments and acknowledge the ongoing effort to revise these instructions with feedback from practitioners.

While guidance to date has been welcome, the reporting requirements of Schedules K-2 and K-3 continue to create significant costs and administrative burdens for partnerships, subchapter S corporations and disregarded entities (collectively "PTEs") and their partners, members, and shareholders (collectively "PTE owners"). We respectfully submit these comments in a continued effort to reduce these costs and burdens while improving the information provided by the Schedules. Our comments are comprised of the following areas:

I. Domestic Filing Exception
   1. Foreign Income Tax Threshold
   2. Pass-through and Disregarded Entities Held by Eligible Partners
   3. Notification Requirements

II. Allow BBA Partnerships to Amend 2021 Schedules K-2 and K-3

III. Address the Receipt of Foreign Activity Sourced to "Various" or "Other Country"

IV. Reapportionment of Interest Expense

V. Gross Income for Purposes of Determining Foreign Derived Intangible Income

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VI. Miscellaneous Clarifications and Recommendations
1. Relevance Exception
2. Determination of Amounts Reported on Schedule K-2
3. Clarify the Reporting of Excess Business Interest Expense on Parts II and X

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We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Cory Perry, Chair, AICPA Foreign Partnership Reporting Task Force, at (202) 521-1509, or Cory.Perry@us.gt.com; Arlene Schwartz, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9218, or Arlene.Schwartz@aicpa-cima.com; Jonathan Williamson, AICPA Senior Manager- Tax Policy & Advocacy at (216) 509-2972 or Jon.Williamson@aicpa-cima.com or me, at (601) 326-7119, or JanLewis@HaddoxReid.com

Sincerely,

Jan Lewis
Chair, AICPA Tax Executive Committee

cc:

Ms. Holly Paz, Acting Commissioner, Large Business and International Division, Internal Revenue Service
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AMERICAN INSTITUTE OF CPAs
Schedule K-2 and Schedule K-3 2022 Draft Instructions
November 30, 2022

I. Domestic Filing Exception

Overview

In the 2021 tax year, PTEs were required to begin reporting items of international tax relevance on Schedule K-2, while providing their partner's and shareholder's share of such items on Schedule K-3. While Schedules K-2 and K-3 did not create new information reporting requirements, it did provide a format to provide information previously reported in a more informal manner; generally, on whitepaper statements or upon request. The Schedules K-2 and K-3 encompass most potential international reporting requirements. The Schedules also contain several supplemental schedules and parts that may need to be completed based on the taxpayer's activities and PTE owner needs.

Prior to the release of the form instructions, many practitioners had an understanding that these schedules would only be required in situations where either the (1) taxpayer had foreign operations, or (2) taxpayer had reason to know that it had a direct or indirect foreign partner. The 2021 *Schedules K-2 and K-*3 instructions, however, make clear that most taxpayers must comply with these information reporting requirements, regardless of their lack of foreign operations or foreign partners. This information included identification and sourcing of gross receipts and expenses for purposes of Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)* or Form 1118, *Foreign Tax Credit - Corporations*, and reporting of effectively connected income.

On February 18, 2022, the AICPA submitted comments[1] to the IRS stating that these requirements were too broad and would place an undue administrative burden on taxpayers without items of international tax significance. The IRS issued post-release guidance in the form of Schedules K-2 and K-3 Frequently Asked Questions (Form 1065, 1120S, and 8865) (the "FAQs").[2] Included in the FAQs was FAQ #15, which provided an additional exception to filing for tax year 2021. To qualify for the exception, a partnership or S corporation was required to have no:

1) Foreign partnerships, corporations, individuals, estates or trusts as partners,
2) Foreign activity, including foreign taxes paid or accrued or assets that generate foreign source income,
3) Requirement in tax year 2020 to provide its partners or shareholders items of international relevance, and
4) Knowledge that partners or shareholders would require information on items of international relevance in tax year 2021.

[1] See AICPA comment letter, "Additional Comments Regarding Schedule K-2 and Schedule K-3", submitted February 18, 2022.
[2] Schedules K-2 and K-3 Frequently Asked Questions (Forms 1065, 1120S, and 8865) | Internal Revenue Service.

The AICPA appreciated this additional exception, as it aligned the new reporting more closely with the original filing requirements understood by the tax practitioner community.

On October 25, 2022, the IRS released *2022 Schedules K-2 and K-3 (Form 1065)* draft instructions (the "2022 Instructions"). The 2022 Instructions consolidated guidance in post-release changes to the 2021 instructions and the FAQs, while also incorporating select comments made by the AICPA [3] that were not previously included in the guidance. The 2022 instructions include clarifications and illustrative examples of new reporting concepts and exceptions. The 2022 Instructions replaced the prior FAQ #15 exception with a new exception for domestic partnerships (the "domestic filing exception").

To qualify for the domestic filing exception, a partnership must:

1) Have either no, or limited foreign activity,
2) Be owned only by domestic individuals, estates, and trusts ("eligible PTE owners"),
3) Notify its partners that the partnership meets and is utilizing such exception no later than two months before the due date of the return, without extension, and
4) Not receive a request for Schedule K-3 by any of its partners no later than one month before the due date of its return, without extension.

Limited foreign activity may only include passive category foreign income, upon which not more than $300 of foreign income taxes is allowable as a credit under section 901[4] and such income and taxes are shown on a payee statement furnished to the partnership.

1. *Foreign Income Tax Threshold*

Recommendation

The AICPA recommends that the IRS modify the definition of limited foreign activity under the domestic filing exception to apply to partnerships where no **partner was allocated** more than $300 of foreign income taxes allowable as a credit under section 901 and treated as paid or accrued by the partnership. Furthermore, the AICPA recommends that the instructions specify that the threshold amount is equal to the exception from filing Form 1116 under section 904(j).

Analysis

It is the understanding of our membership that the threshold of limited foreign activity under the domestic filing exception is derived from the exception for individuals to claim a foreign tax credit without filing Form 1116 under section 904(j). While the AIPCA appreciates the allowance for a *de minimis* amount of foreign activity, applying this threshold at a partnership level doesn't align

[3] See AICPA comment letter, "Urgent Request for Immediate Guidance Regarding New International Reporting Requirements, Schedule K-2 and Schedule K-3 for Tax Year 2021," submitted August 31, 2022.
[4] Unless otherwise indicated, hereinafter, all section references are to the Internal Revenue Code of 1986, as amended, or to the Treasury Regulations promulgated thereunder.

this allowance with the criteria of section 904(j). A partnership's foreign activity should be considered "limited" so long as any individual partner's share of such activity is below thresholds.

For example, a partnership with $5,000 of foreign taxes treated as paid or accrued allocated equally to 50 partners should be treated the same as a partnership with $200 of foreign taxes allocated equally to 2 partners. In both situations, all partners receive an allocation of $100 of foreign taxes and would consider the foreign activity of the partnership to be limited.

The definition of limited foreign activity in the instructions should also reference the exception under section 904(j) for single taxpayers to make clear how this amount is determined. Additionally, should the amount excepted under section 904(j) be increased for inflation, this exception should mirror such increase.

2. Pass-through and Disregarded Entities Partners Held by Eligible Partners

Recommendation

The AICPA recommends that the IRS include domestic PTEs (including domestic disregarded entities) as eligible PTE owners for the domestic filing exception, so long as such entities are only held, directly or indirectly, by eligible PTE owners.

As a secondary recommendation, PTEs that have ineligible PTE owners, but meet all other domestic filing exception requirements, should be given the ability to apply that exception to all other PTE owners, and only provide Schedule K-3 to ineligible PTE owners.

Analysis

The domestic filing exception is more restrictive when compared to previous guidance under FAQ #15 regarding which type of PTE owners are required to meet such exceptions. While knowledge of the ownership of PTE owners is not guaranteed, PTEs that possess such knowledge should be provided the opportunity to utilize that knowledge and reduce their filing requirements when possible. Furthermore, the AICPA advises against any restriction of previously available exceptions, given the outreach of our members on the burden these forms have placed on the profession, even under prior exceptions.

A common situation where this expanded exception may apply is a closely held business enterprise which spans several PTEs, including upper tier holding companies and family PTEs. While no direct or indirect PTE owners require information on Schedule K-3, the lower tier PTEs cannot utilize the domestic filing exception due to the existence of ineligible upper tier PTE owners. Some domestic enterprises may include over one hundred lower tier PTEs with upper tier holding company PTE owners. Without expanding the exception, none of these lower tier PTEs would qualify for the domestic filing exception and those PTEs would be required to file Schedules K-2 and K-3 unless they met another exception. Further, the upper tier PTEs would qualify, and would not need or use any of the lower tier PTE Schedules K-3 that were furnished as a result of not meeting the exception.

The secondary recommendation would allow PTEs to partially apply the domestic filing exception when they meet all the qualification except for the existence of ineligible PTE owners. This change would place the requirements of the domestic filing exception on par with other exceptions in the instructions and permit a PTE to reduce unnecessary Schedule K-3 filings to the highest extent possible.

3. Notification Requirements

Recommendation

The AICPA recommends that the IRS remove the partnership notification requirement of the domestic filing exception and instead require partners to provide notification to the partnership of which parts of Schedule K-3 they require.

Additionally, notifications in any form should be able to span multiple years, until retracted, or for the life the partnership, under specified circumstances.

Analysis

The partnership notification requirement will place an undue burden on taxpayers to provide and retain such notifications on an annual basis. A partnership notification to its partners which can be negated by a partner's notification back to the partnership creates unnecessary work and documentation, as the same result could be achieved by requiring one notification requirement from partners to partnerships when certain information is required. Partners should be required to notify the partnership which sections of Schedule K-3 they require and allow the partnership to determine which filing exceptions it qualifies for based on this information and the activity of the partnership.

In many other situations, Schedule K (Form 1118), *Foreign Tax Carryover Reconciliation Schedule*, and Schedule K-1 (1065), *Partner's Share of Income, Deductions, Credits, etc.,* require that a partner notify the partnership when certain niche information is required to be reported based on the tax attribute of the partner. For example, while section 6031(d) requires a partnership to report information to allow any partner that is a tax-exempt organization to determine their tax, the instructions for Form 1065 indicate that the burden is on the partner to notify the partnership of this need. The requirement of certain items of international relevance is similarly niche in nature, and so the burden of notification should similarly fall to the partner.

Additionally, any notification requirement should be eligible to span multiple tax years to avoid an annual requirement. The facts and circumstances of international relevance of many PTEs and PTE owners do not change from year to year, therefore, providing an option to make such notifications effective until retracted would be prudent.

II. Allow BBA Partnerships to Amend 2021 Schedules K-2 and K-3

Overview

The Bipartisan Budget Act of 2015 (BBA)[5] generally prohibits partnerships subject to the BBA ("BBA Partnerships") from amending the information required to be furnished to their partners after the due date of the return, unless specifically provided by the Secretary of the Treasury or its delegate. Examples of situations where this exception was provided include:

- Revenue Procedure 2020-23 allowed eligible partnerships to file amended returns and to issue amended Schedules K-1 in lieu of filing an administrative adjustment request (AAR). The relief applied to tax years beginning in 2018 and 2019 for which an original partnership return was filed, and Schedules K-1 were issued by April 8, 2020. The relief allowed partnerships to adjust returns to take advantage of the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act")[6] provisions, including changes to section 163(j) and section 168(e), using an amended return and Schedule K-1 in place of the new AAR rules under the BBA. The relief also allowed eligible partnerships to file amended 2018 and 2019 returns for reasons unrelated to the CARES Act.

- Revenue Procedure 2021-29 permitted eligible partnerships to file amended partnership returns for tax years beginning in 2018, 2019, and 2020 to apply a retroactive change under a provision of the "Taxpayer Certainty and Disaster Tax Relief Act of 2020" enacted December 27, 2020, as part of the "Consolidated Appropriations Act, 2021."[7]

The AAR process can be burdensome to practitioners, taxpayers, and partners, and these relief measures were provided in situations where the breadth of potential adjustments outweighed the need to adhere to the BBA procedures. While the AAR process generally has been in effect since 2018, taxpayers and practitioners continue to struggle with the AAR procedures.[8]

Recommendation

The AICPA recommends that the IRS provide relief from the AAR requirement and allow BBA partnerships to file amended partnership returns and issue amended Schedules K-1 and K-3 to reflect adjustments to Schedule K-2 and K-3 items.

If permanent relief is not provided, the AICPA recommends an alternative of providing the same relief, but as a temporary measure which applies to the 2021 tax year.

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[5] P.L. 114-74.
[6] P.L. 116-136.
[7] P.L. 116-260.
[8] "Partnerships Permitted to File Amended Returns, Avoid Potential Stranded Overpayments," Greg Armstrong, Bloomberg, August 20, 2021. See AICPA letter dated May 25, 2021 on "Changes to Simplify and Improve the AAR. Process Under the Centralized Partnership Audit Regime and Proposed "AAR-EZ" Process Framework."

Analysis

Schedules K-2 and K-3 have created a significant burden to taxpayers for the reasons described in this letter as well as previous AICPA comment letters. Many partnerships were not able to timely file and furnish Schedules K-2 and K-3 due to either the lack of accurate reporting, time constraints, or both.[9] Because Schedules K-2 and K-3 include over 2,000 data fields,[10] many of which are determined by reference to amounts reported on Schedules K and K-1, any change to an item or allocation of any item reported on Schedule K-1 likely would result in "knock-on" adjustments to items reported on the schedules. For example, a mere $100 change to ordinary gross receipts reported on Line 1 of Schedules K and K-1 could impact gross income for foreign tax credit limitation purposes; gross receipts for research and experimental (R&E) apportionment factors; deduction eligible income gross receipts; gross receipts for base-erosion and anti-abuse tax purposes; gross income for foreign partners' character and source of income; and gross income for effectively connected income expense apportionment.

Because each of these knock-on adjustments is treated and reported as a separate adjustment, and given the continued uncertainty with AAR procedures, partnerships may view the effort around the relatively new and uncertain AAR process as not being commensurate with the benefits. The burden of correcting Schedules K-2 and K-3 through AAR is likely greater than the burdens in prior instances of amended return relief.

While there is sufficient rationale to provide taxpayers with permanent relief from BBA AAR procedures related to changes to Schedules K-2 and K-3, the 2021 tax year provided additional reasons to, at a minimum, allow temporary relief for that year. Notably, information providers who had not previously reported required items of international significance were unprepared for Schedules K-2 and K-3, and as such, information provided was often incomplete or contained omissions. Taxpayers used the most accurate information they could obtain, but often could not completely negate the risk of filing Schedules K-2 and K-3 with inaccurate or incorrect information. In addition, uncertainties on whether the schedules needed to be filed, and which parts were required to be completed was common among tax practitioners. This uncertainty led to partners that required Schedules K-3 from their investments not receiving them timely, if they were received at all. Due to the lack of correct, complete information, many taxpayers have filed Schedules K-2 and K-3 for the 2021 tax year that need to be corrected and would benefit from an efficient way to do so.

As an alternative from the primary recommendation to allow amended partnership returns to reflect changes to Schedules K-2 and K-3, we recommend that the IRS provide targeted relief from the AAR requirements for Schedule K-3 items and allow BBA partnerships filing AARs to file/issue Schedules K-3 in lieu of reporting Schedule K-3 adjustments on Form 8985 *Pass-Through Statement-Transmittal/Partnership Adjustment Tracking Report (Required Under Sections 6226 and 6227)* and Form 8986 *Partner's Share of Adjustment(s) to Partnership-Related Items(s) (Required Under Sections 6226 and 6227).*

[9] "Investors Brace for Partnership Tax Logistical Logjam (1)," Bloomberg, August 3, 2022.
[10] By comparison, Schedule K-1 includes approximately 160 data fields.

III. Address the Receipt of Foreign Activity Sourced to "Various" or "Other Country"

Overview

The 2022 Instructions state that country codes of "Various" or "OC – Other Country" should not be used in situations where items of revenue and expenditure are to be sourced by a partnership. However, many partnerships receive information either on payee statements or Schedule K-3 from lower-tier PTEs that source items as such. The 2022 Instructions do not address or provide guidance in this situation.

Recommendation

The AICPA recommends that the IRS provide a specified country code to identify that an item of revenue or expenditure has either (1) not been sourced; or (2) was sourced to "Various" or "OC – Other Country" on a payee statement or Schedule K-3 received by the pass-through entity.

Analysis

PTEs have few options when the sourcing of items of revenue or expenditure are either vague, incorrect, or omitted. The only remedies currently available are either to request corrected information from a provider, or to similarly omit sourcing or report it incorrectly on their Schedules K-2 and K-3. Many providers were inconsistent with the accuracy or timeliness of such requests, leaving taxpayers and practitioners with no alternatives to complete and furnish their Schedules K-2 and K-3. Providing an ability to label the sourcing received as incomplete or inaccurate is a necessary alternative given this situation. As both taxpayers and information providers become more aware of the requirements of Schedule K-2 and K-3, the need for this alternative should diminish as information become more accurate and complete.

IV. Preventing Reapportionment of Interest Expense

Overview

If the partnership knows or has reason to know that a limited partner owns less than 10% of profits and capital (taking into account attribution rules under section 267(b) or section 707) and does not hold its interest in the ordinary course of the partner's active trade or business, the Schedule K-3 should report such partner's distributive share of foreign source gross income and gross receipts as passive category income and its deductions allocated and apportioned to foreign source income as reducing passive category income.[11] Further, such partner's distributive share of interest expense not specifically allocated under Treas. Reg. § 1.861-10 and Treas. Reg. § 1.861-10T is directly allocated to its distributive share of partnership gross income. To the extent such interest expense is allocated and apportioned to foreign source income, it is reported in the passive category.

[11] Treas. Reg. § 1.904-4(n)(1)(ii).

Recommendation

The AICPA recommends that the IRS allow the interest expense allocated and apportioned to foreign source passive category income under Treas. Reg. § 1.861-9(e)(4) to be reported on the face of Schedules K-3 rather than on whitepaper disclosure.

Analysis

If a partnership is a partner in another partnership, the distributive share of interest expense of a lower-tier partnership that is subject to the rules of Treas. Reg. § 1.861-9(e)(4) should not be reapportioned at any higher-tier partnership, therefore, this new reporting requirement is necessary to prevent the reapportionment of such interest expense.[12] Reporting this information on the face of Schedule K-3 will provide clarity to such higher-tier partnerships that such interest has already been apportioned at a lower-tier and is not subject to reapportionment.

V. Gross Income for Purposes of Determining Foreign Derived Intangible Income

Overview

The foreign derived intangible income ("FDII") regime provides a preferential United States (U.S.) effective tax rate to U.S. corporations on certain income, by means of a deduction under section 250. In determining its deductible eligible income ("DEI"), a domestic corporation starts with gross income and makes certain adjustments. The amount of DEI impacts the amount of FDII and therefore the section 250 deduction.

The 2022 Instructions provide that Line 1 net income (loss) is intended to be used in calculating gross income on Form 8993, Section 250 Deduction for Foreign-Derived Intangible Income (FDII) and Global Intangible Low-Taxed Income (GILTI).

Recommendation

The AICPA recommends that the IRS modify Form 8993, Part IV, Line 1 to report gross income instead of net income.

Analysis

As gross income is required to determine DEI, it is unclear why the 2022 Instructions require a partnership to report net income instead of gross income and why or how a corporate partner can determine gross income to report on Line 1 (gross income) of Form 8993 from net income. Furthermore, a partner's share of gross income is likely presented elsewhere on Schedule K-3, making it readily available for taxpayers to report for FDII purposes.

[12] Treas. Reg. § 1.861-9(e)(4)-(5).

VI. Miscellaneous Clarifications and Recommendations

Overview

The AICPA appreciates the effort made by the IRS to make the instructions as inclusive as possible with many illustrative examples. Due to the natural complexity of pass-through taxation, certain areas of the instructions would benefit from certain filing exceptions and items of clarification.

1. Relevance Exception

Recommendation

The AICPA recommends that the IRS provide guidance adding a relevance exception to each part of Schedules K-2 and K-3.

Analysis

Under the exceptions provided for in 2021 FAQ #15 and the new domestic filing exception, situations exist where PTEs which do not meet the requirements of these exceptions may be required to furnish information not relevant to their partners or shareholders. While select parts of Schedule K-2 and K-3 provide an exception from filing in situations where the taxpayer knows or has reason to know that such part is not required by its PTE owners, this exception does not appear to clearly apply to all parts. While PTEs are not required to possess knowledge of PTE owner international requirements, an exception should be granted in situations where an entity has obtained such information. This recommendation is consistent with comments previously provided by the AICPA.

2. Determination of Amounts Reported on Schedule K-2

Recommendation

The AICPA recommends that the IRS clarify that Schedule K-2 should include amounts for the entire partnership, making this schedule an extension of Schedule K.

Analysis

Due to the availability of Schedule K-3 filing exceptions for select partners, taxpayers may need clarification to understand that all sections of Schedule K-2 should include all partnership information, rather than a combination of all information reported on Schedule K-3s. The instructions clarify this method for certain sections of the form (such as Part X), but not all.

3. Clarify the Reporting of Excess Business Interest Expense on Parts II and X

Recommendation

The AICPA recommends that the IRS clarify how to report excess business interest expense (EBIE) for Parts II and X of Schedules K-2 and K-3.

Analysis

EBIE has unique attributes not common to most distributable items of partnership income or deductions. As such, taxpayers need additional clarification on how and where these items are to be reported on relevant parts of Schedule K-2 and K-3. Part IV clarifies that EBIE should be included in the interest deduction reported on Line 13, however other parts do not contain similar guidance. Without guidance, partners receiving Schedule K-3 may need to make assumptions on how EBIE has been reported.