

REVISED - Exception for Submitting Schedules K-2 and K-3 for Tax Year 2022

We started sending out an email on this topic about a week ago. Then IRS released revised draft instructions on December 2, 2022, so we stopped the emails from going out and have now revised the article. If you received our prior article, you may want to delete it and focus on this REVISED version.

For tax year 2021 income tax returns, IRS released Schedules K-2 & K-3 to be filed with partnership and S corporation tax returns. IRS also provided an exception to filing these Schedules.

For tax year 2022 returns, IRS's December 2, 2022, draft instructions for the K-2 provide a different exception (with four provisions) to filing the K-2/K-3s with this year's return. The exception is slightly different for the two entities when it comes to ownership, mainly because of the different owners that can exist under regular tax law. We may not know if provisions 1, 2 and 4 are met until the entity's return is prepared, BUT if provision 3 is not met, the entity is REQUIRED to include K-2/K-3 with its return. And provision 3 is one that we can be involved in, by informing our entities about it.

FIRST, THE RULE FOR GIVING A SCHEDULE K-3 TO AN OWNER. The draft instructions say the entity MUST provide a K-3 to every owner who requests one, regardless of when the request is received. This makes sense, since the entity has the information needed by any owner who has to complete a Form 1116, Foreign Tax Credit, for the owner's personal return.

Here is a summary of the exception to including Schedules K-2/K-3 with the entity's return as we read it.

There are FOUR provisions. If ANY of the four provisions is NOT met, the entity is REQUIRED to include K-2/K-3 with its tax return.

1) The entity has no or limited foreign activity for the year. "Limited" means:

-- a) The foreign taxes paid or accrued total \$300 or less,

-- b) All foreign income is from the foreign "passive" category (interest, dividends, capital gain distributions, rents, royalties, etc.), except the entity cannot have "high taxed income".

-- c) All income and taxes are shown on payee statements (as defined in section 6724(d)(2)) that are furnished or treated as furnished to the entity.

2) ALL owners are individuals who are U.S. citizens or residents, trusts with only beneficiaries who are U.S. citizens or residents, a domestic decedent's estate, and an S corporation with only one shareholder. An ownership by a disregarded entity, such as a single member LLC or and revocable trust, is considered owned directly by the disregarded entity's owner.

3) The entity notifies each owner, no later than the date the owner receives the K-1, that the entity will not be providing the owner a K-3 unless the owner requests it. The notice can be an attachment to the K-1. (The October 24, 2022, draft had stated this notification had to take place no later than January 15, 2023. This date does not appear in the December 2, 2022, draft. But remember these instructions are still draft instructions,)

4) No owner requests a Schedule K-3 by the date that is ONE MONTH before the date the entity's return is filed. (The October 24, 2022, draft had stated a February 15, 2023, date for this provision.) For calendar year 2022 entity returns, the latest this ONE MONTH date can be is August 15, 2023, if the entity files an extension.

If ALL of these four provisions are met, the entity does not have to include K-2/K-3 with the entity's tax return filed with IRS.

If the entity meets provisions 1-3, but fails provision 4, the exception is NOT met and the entity is required to include K-2/K-3 with its tax return. The entity only has to complete the parts of the K-2 & K-3 that have been requested by the requesting owner(s) and only for those owners who made such requested by the ONE MONTH date.

If the entity DOES NOT meet provision 3, (i.e., doesn't notify the owners that the entity will not be issuing K-3 unless requested), the entity must include K-2/K-3 for ALL owners.

We recommend the draft instructions be read for complete details. Also, the final instructions should be read when they come out, in case IRS changes them.

Because the revised provisions state the notification (provision 3) can be provided to the owner as late as the date the K-1 is provided to the owner, it is easy for provision 4 to be met. Many tax professionals give the entity the K-1s to distribute to the owners on the same date the entity is given the signature form for e-filing the entity return, and the return is often filed within a day or two. Therefore, including the notification with the K-1 means an owner is extremely unlikely to request a K-3 by the one month date (unless the owner has a time travel machine). In a way, this is similar to the 2021 exception in results – it just requires the entity to send out the notification.

This text has been shared courtesy of: David & Mary Mellem, EAs & Ashwaubenon Tax Professionals, 920-496-1065 (fax 920-496-9111).

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