



February 18, 2022

Mr. John Hinding
Director
LB&I Cross Border Activities Practice Area
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Cliff Scherwinski
Director
LB&I Passthrough Entities Practice Area
Internal Revenue Service
1111 Constitution Ave, NW
Washington, DC 20224

Ms. Karen Cate
Senior Advisor
Office of Associate Chief Counsel
International, Branch 2
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Ronald M. Gootzeit
Attorney
Office of Associate Chief Counsel
International, Branch 4
1111 Constitution Avenue, NW
Washington, DC 20224

Re: Additional Comments Regarding Schedule K-2 and Schedule K-3

Dear Messrs. Hinding, Scherwinski, and Gootzeit, and Ms. Cate:

The American Institute of CPAs (AICPA) acknowledges the substantial efforts of the Department of the Treasury (“Treasury”) and the Internal Revenue Service (IRS) in developing a redesigned international tax reporting passthrough form, releasing final instructions, and providing certain transition relief for tax year 2021.¹ The AICPA appreciates the consideration given to, and incorporation of, our prior 2020 recommendations² and this opportunity to provide additional comments on international changes to Form 1065, *U.S. Return of Partnership Income*, Form 1120-S, *U.S. Income Tax Return for an S Corporation*, and the Schedule K-2 and Schedule K-3 series (the “Schedules”).³ The below comments also specifically address the recent “transition relief” with regards to the Schedules K-2 and K-3:

- I. Request to Delay Implementation of Schedules K-2 and K-3 to at Least 2023
- II. Request for Further Guidance
 1. Definition of “International Tax Relevance”
 2. Entity-Owner Certification Regarding the Communication Versus the Timing of Filing
 3. Instructions Regarding Schedules K-2 and K-3, Part I, Box 8
- III. Additional Concerns Regarding the Paperwork Reduction Act (PRA)

¹ See [Notice 2021-39](#) (limited penalty relief), [IR-2022-38](#) (Feb. 16, 2022), [Schedule K-2 and K-3 Frequently Asked Questions](#) (FAQs) (rev. Feb. 16, 2022).

² See AICPA comment letter, “[Comments on Proposed International Changes to Form 1065, Schedule K-2, and Schedule K-3](#)” (Sept. 14, 2020).

³ See Schedule K-2 (Form 1065), *Partners’ Distributive Share – International*, Schedule K-2 (Form 1120-S), *Shareholders’ Pro Rata Share Items – International*, Schedule K-3 (Form 1065), *Partner’s Share of Income, Deductions, Credits, etc. – International*, Schedule K-3 (Form 1120-S), *Shareholder’s Share of Income, Deductions, Credits, etc. – International*. Updates to the final instructions for passthrough entities were issued on January 18, 2022, and February 16, 2022.

Mr. John Hinding
Mr. Cliff Scherwinski
Ms. Karen Cate
Mr. Ronald M. Gootzeit
February 18, 2022
Page 2 of 8

Specific Comments

I. Request to Delay Implementation of Schedules K-2 and K-3 to at Least 2023

The AICPA appreciates the importance of IRS's foreign passthrough reporting requirements. Filing complete and accurate returns are essential elements to a well-functioning and voluntary tax system. The Schedules K-2 and K-3 Frequently Asked Questions (FAQs)⁴ and IR-2022-38⁵ raise additional questions,⁶ and appears counterproductive to the goals of filing a complete and accurate return and standardizing international reporting. Further modifying the applicable scope of the new Schedules amidst tax filing season leaves the tax system confused and in disarray.

Recommendation

The AICPA urges the IRS to delay implementation of the Schedules K-2 and K-3 to 2023 (the 2022 tax year filing season). If the IRS is not prepared to electronically accept the new Schedules K-2 and K-3 in time for the 2023 initial filing dates of these Schedules, the filing requirement should apply for tax years beginning after the date the IRS and software providers are able to properly provide and process the new Schedules in an electronic format.⁷

Delay is essential until e-filings can be accepted and uncertainty regarding taxpayer filing obligations is resolved. Further, the AICPA recommends no assessment of penalties against partnerships or S corporations for failing to file or failing to timely provide Schedules K-2 and K-3 for the 2021 tax year.⁸ The 2022 filing season has commenced and the IRS as well as taxpayers are still unclear on *who must file the required Schedules*.

Analysis

A streamlined and expanded reporting tool of complex matters through fiscally transparent entities was undeniably necessary. The AICPA appreciates the stated intent of the IRS to “provide certain additional transition relief for this year from the Schedule K-2 and K-3 reporting for certain domestic partnerships and S corporations with no foreign activities, foreign partners or shareholders, and without knowledge of partner or shareholder need for information on items of international relevance.”⁹

⁴ [Updated](#) February 16, 2022.

⁵ [Issued](#) February 16, 2022.

⁶ For example, the “know or reason to know” standard regarding indirect partners included in FAQ 15 is inconsistent under current statutes and guidance (e.g., section 6031). Additionally, FAQ 15 lacks a bright-line standard by conflating direct and indirect partner reporting obligations.

⁷ If taxpayers are able to and wish to file the Schedules K-2 and K-3, they should not be precluded from doing so.

⁸ [Notice 2021-39](#) provided penalty relief for good faith compliance efforts. However, this relief is insufficient given the 2022 updates to the final instructions.

⁹ [IR-2022-38](#) (Feb. 16, 2022).

Mr. John Hinding
Mr. Cliff Scherwinski
Ms. Karen Cate
Mr. Ronald M. Gootzeit
February 18, 2022
Page 3 of 8

Delaying the filing of Schedules K-2 and K-3 until 2023 will provide the IRS with additional time to properly complete the Modernized e-File (MeF) acceptance of these Schedules in XML format and allow the tax professional community to appropriately apply the updated guidance and scope recently announced pertaining to the final instructions (“the Instructions”).

Specifically, the January 18, 2022 changes to the Instructions, announced at the start of tax filing season, significantly expanded the applicable scope of the Schedules. The final instructions included only a vague reference to “items of international tax relevance.” This belated, specific expansion of the applicable scope does not align with previous understanding based on the final instructions issued in August of 2021. The changes announced on February 16, 2022 further modifying the applicable filing requirements created more confusion and whipsawed taxpayers as to their filing obligations.

The AICPA acknowledges this needed change pertaining to applicable scope; however, the timing of the change is not sufficient for practitioners to become aware of, properly apply, and communicate new requirements to taxpayers. Further, there is not sufficient time for passthrough entities to adapt their processes to comply with this new requirement, where the requested reporting likely will not be available for the 2022 filing season, nor was this expanded applicability contemplated when preparing systems based on the August 2021 instructions.¹⁰ The new Schedules K-2 and K-3 are large and complex forms, requiring significant adjustments to taxpayers’ processes and documentation.

While tax professionals and taxpayers scramble to properly file based on IRS changes to the Instructions, the IRS simultaneously is not yet positioned to accept filings in a usable or sustainable fashion.¹¹ Currently, the IRS is unable to accept electronically filed returns containing the Schedules K-2 or K-3 via the MeF System for partnership returns until March 20, 2022, and for S corporations returns until mid-June. These tentatively planned dates are past the original due dates for all passthrough returns, which – given the continual updates regarding applicable scope – will presumptively necessitate filing extensions for significantly more partnership, S corporation, and owners’ individual income tax returns than prior years.

An extension of these returns is essential as paper filing is unquestionably an undesirable option.¹² Consequently, the only option to timely file an electronic return is to PDF-attach the new Schedules K-2 and K-3. However, tax software providers and the IRS have technical limitations regarding transmitting PDF files over certain sizes. The PDF attachment option is only feasibly available to certain small passthrough entities that fall within the page and file size limits – and many of these

¹⁰ Based on AICPA member feedback, this information will generally not be available due to the abrupt changes.

¹¹ The impetus for the new Schedules was to replace the current international reporting whitepaper statements into a standardized format. However, the delayed XML system cannot yet accept the correct files and tax software providers are equally unable to provide timely updates to correct the previously anticipated Schedules and filing requirements.

¹² The IRS’s public struggle to manage intake of additional paper mail is well documented. *See, e.g.*, the 2021 [National Taxpayer Advocate Annual Report to Congress](#) (Jan. 12, 2022).

Mr. John Hinding
Mr. Cliff Scherwinski
Ms. Karen Cate
Mr. Ronald M. Gootzeit
February 18, 2022
Page 4 of 8

small passthrough entities likely did not have a Schedule K-2/K-3 filing requirement prior to the change in the Instructions.

The lack of a timely available MeF filing option for these Schedules in electronic format will cause unnecessary hardship to all affected parties who cannot implement the interim PDF attachment solution. If passthrough entities are pressured or obligated to extend their return filing in order to properly meet the new Schedules K-2 and K-3 requirements, this extension will prevent the individual taxpayers (or passthrough owners) from filing income tax returns by the original due date.¹³ Filing extensions will also affect business owners by complicating available lines of credit needed for critical cash flow (due to lack of filed income tax returns for lender substantiation).

A major consequence of not having an MeF option is that the IRS will be tasked with processing unnecessary extensions in addition to the paper-filed returns for those entities who choose not to extend. Furthermore, software providers cannot offer sufficient solutions until after the IRS MeF system is available. At present, most tax software (particularly providers used by smaller passthrough entities) cannot automatically generate the PDF file, which the IRS announced as an acceptable alternative – each affected passthrough return requires additional manual attention to input any missing data, physically attach, and then upload a PDF. This exponentially increases the processing-hours required by the tax system due to the cascading effects on individual returns, tiered structures, and manual review by the IRS.¹⁴

II. Request for Further Guidance

1. Definition of “International Tax Relevance”

The AICPA recommends that the IRS clarify on page 7 of the Instructions to specify that the exception to filing Form 1116, *Foreign Tax Credit (Individual, Estate, or Trust)*, refers to the requirements provided in section 904(j).¹⁵

The AICPA appreciates the IRS’s exception in the Instructions to filing Schedules K-2 and K-3 for partnerships and S corporations (“entities”) with only U.S. sourced income and U.S. individual partners/shareholders (“owners”), where all the owners inform the entities that no Form 1116 is expected to be filed. Specifically, section 904(j) provides that if individuals only have foreign-sourced gross income that is qualified passive income, all foreign-source income and foreign taxes are reported on a qualified payee statement. The Instructions should refer to section 904(j) to provide further clarity on the scope of this exception.

¹³ Individual taxpayers (or passthrough owners) who file by the original due date may be required to amend their returns or file an administrative adjustment request (AAR), thus delaying tax refunds and further exacerbating current IRS backlog issues.

¹⁴ This is a “perfect world” assumption where there are no technical issues affecting each of these touch points.

¹⁵ Unless otherwise indicated, all section references are to the Internal Revenue Code of 1986 (IRC or “Code”), as amended, or to the Treasury Regulations promulgated thereunder.

Mr. John Hinding
Mr. Cliff Scherwinski
Ms. Karen Cate
Mr. Ronald M. Gootzeit
February 18, 2022
Page 5 of 8

For example, this information is reported on the appropriate Form 1099-MISC, *Miscellaneous Income*, Schedule K-1 (Form 1065), *Partner's Share of Income, Deductions, Credits, etc.*, Schedule K-1 (Form 1120-S), *Shareholder's Share of Income, Deductions, Credits, etc.*, Schedule K-3, or other substitute form, and the amount of creditable foreign tax paid or accrued by the individual during the taxable year does not exceed \$300 (\$600 for married filing jointly).

2. Entity-Owner Certification Regarding the Communication Versus the Timing of Filing

Timing challenges arise between when owners certify the need for the Schedules to the entity and the entity's receipt of data supporting that certification. Mechanically, Forms 1065 or 1120-S and any required Schedules K-2 and K-3 are filed with the IRS *before* a Form 1040, *U.S. Individual Income Tax Return*, and corresponding Form 1116 would be filed. Additional clarification is needed pertaining to an entity's filing responsibilities in situations where the owner informs the entity of its need for Schedules *after* the respective Form 1065 or 1120-S is already filed.

The AICPA recommends that the Instructions specify whether the entity is required to amend its return or file an administrative adjustment request (AAR) and include Schedules K-2 and K-3 when the entity receives this certification after the entity's tax filing. Additionally, the Instructions should provide whether the entity is then subject to penalties.

For example, brokerage statements are frequently corrected in late March, and may affect the owner's previous expectations regarding the need to file a Form 1116. In those situations, the taxpayer's duty to inform the entity of its change in informational needs is unclear.

3. Instructions Regarding Schedules K-2 and K-3, Part I, Box 8

The AICPA recommends that the IRS clarify the Instructions, Part I, Box 8 with respect to required attachments. The instructions for Form 5471, *Information Return of U.S. Persons with Respect to Certain Foreign Corporations*, provide that a person may file Form 5471 and the applicable schedules for other persons who have the same filing requirement, and the filing is considered a joint information return.

Generally, to satisfy this filing obligation, the person on whose behalf the Form 5471 is filed must attach a statement to the person's tax return indicating that the person's filing requirement with respect to the foreign corporation has or will be satisfied ("Alternative Filing"). The IRS's post-release change to the Instructions requires a passthrough entity to check Part I, Box 8 and attach any Forms 5471 to its Schedules K-2 and K-3 if another person filed on behalf of the passthrough entity in addition to two other provided specific fact patterns. However, the Schedule K-3 attachment is not required if the passthrough entity knows or has reason to know that its direct owner (and any indirect owner) does not need the information on Form 5471 ("General Exception"). Unnecessarily attaching the Form 5471 compounds the problem of e-filing via PDF attachments for software programs with attachment size limitations.

Mr. John Hinding
Mr. Cliff Scherwinski
Ms. Karen Cate
Mr. Ronald M. Gootzeit
February 18, 2022
Page 6 of 8

Requiring Form 5471 attachments to Schedule K-2 when the passthrough entity meets the General Exception and provides the “filing on behalf” (FOB) statement would serve no benefit or detriment as it would not affect any owner’s tax amount or filing obligation. Further, requiring Form 5471 attachments would impose an unnecessary hurdle and potentially further delay passthrough entity filings when using the Alternative Filing due to the general unavailability of the Form 5471 information until later in the tax year. If a passthrough entity meets the General Exception, the Instructions should clarify that a passthrough entity satisfies the Schedule K-2 attachment requirement if the passthrough entity includes the Alternative Filing with its return.

The Instructions should also clarify whether attaching a Form 5471 is needed if the passthrough entity is not required to file the form under the domestic constructive ownership exception.¹⁶ For example, this exception could apply in structures involving tiered U.S. partnerships in which an upper-tier U.S. partnership is treated as owning a controlled foreign corporation (CFC) solely by reason of attribution from a lower-tier U.S. partnership that properly files a Form 5471 for the CFC. Under the constructive owner exception, the upper-tier U.S. partnership should not need to attach a Form 5471 because it is not required to file the Form 5471.

III. Additional Concerns Regarding the Paperwork Reduction Act (PRA)

The Paperwork Reduction Act of 1995 (“PRA”)¹⁷ generally requires federal agencies to minimize information collection burdens on the public and also generally requires all federal agencies to obtain approval from the Office of Management and Budget (OMB).¹⁸ Further, the OMB requires that “[t]o the extent feasible and appropriate, especially for complex or lengthy forms, agencies shall engage in advance testing of information collections, including federal forms, in order (1) to ensure that they are not unnecessarily complex, burdensome, or confusing, (2) to obtain the best available information about the likely burdens on members of the public (including small businesses), and (3) to identify ways to reduce burdens and to increase simplification and ease of comprehension.”¹⁹

Each year, the IRS generally provides average time and cost estimates to allow taxpayers to assess their tax compliance burden and an opportunity to provide comments regarding items such as the accuracy of the agency’s information collection burden time estimates and estimates of the associated costs to provide this information. For example, the IRS 2021 Form 1065 time and cost estimates are significantly reduced from the 2020 estimates; in particular, the average time and cost to prepare partnership returns are anticipated to be reduced approximately 60% and 30%, respectively:

¹⁶ See Reg. § 1.6038-2(j)(2)(i).

¹⁷ P.L. 104-13.

¹⁸ The OMB approval process generally includes public comment.

¹⁹ [Testing and Simplifying Federal Forms \(whitehouse.gov\)](#). See also [A Guide to the Paper Reduction Act](#).

Estimates as of November 2021

Table 1—Taxpayer Burden for Partnerships

Forms 1065, 1066, and all attachments				
Primary Form Filed or Type of Taxpayer	Total Number of Returns (millions)	Average Time (hours)	Average Cost	Average Monetized Burden
All Partnerships	4.8	85	\$3,900	\$7,900
Small	4.5	75	\$2,800	\$5,300
Large*	0.3	245	\$20,600	\$45,900

Estimates as of October 2020

Table 1—Taxpayer Burden for Partnerships

Forms 1065, 1066 and all attachments				
Primary Form Filed or Type of Taxpayer	Total Number of Returns (millions)	Average Time (hours)	Average Cost	
All Partnerships	4.5	290	\$5,800	
Small	4.2	270	\$4,400	
Large*	0.3	610	\$29,000	

The Schedules K-2 and K-3 involve the application of complicated international rules and with regards to passthrough entity application there are further nuances²⁰ and uncertainty. As mechanical application and reporting begins, subsequent revisions of the Schedules and associated instructions may be necessary. The recent Schedules K-2 and K-3 guidance updates will likely result in an increase in the overall reporting burden, as opposed to a decrease.²¹

The expanded scope of the updated instructions did not account for the additional information reporting burden on taxpayers who are now required to file Schedules K-2 and K-3. As a result, the initially published Federal Register public notice and comment period required by the PRA pertaining to the Form 1065 and Form 1120-S is likely dramatically understated.²² Consequently, the reporting burden initially provided to the public and OMB is likely no longer accurate due to the practical effect of the updated instruction changes, and therefore should be subject to another period of public notice and comment in the Federal Register to conform with the requirements of the PRA before the updated changes are implemented.

* * * * *

The AICPA is the world’s largest member association representing the accounting profession, with more than 428,000 members in the United States and worldwide, and a history of serving the public interest since 1887. Our members advise clients on federal, state, and international tax matters and

²⁰ See, e.g., section 951 and section 958 (application of the 10% U.S. shareholder rules).

²¹ Fees for preparing these new Schedules increased by approximately 15-50% and require further reassessment in light of these updated changes.

²² See [86 Fed. Reg. 51955](#) (Sept. 17, 2021).

Mr. John Hinding
Mr. Cliff Scherwinski
Ms. Karen Cate
Mr. Ronald M. Gootzeit
February 18, 2022
Page 8 of 8

prepare income and other tax returns for millions of Americans. Our members provide services to individuals, not-for-profit organizations, small and medium-sized businesses, as well as America's largest businesses.

We appreciate your consideration of these comments and welcome the opportunity to discuss these issues further. If you have any questions, please contact Amy Miller, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9264 or Amy.Miller@aicpa-cima.com; Alexander Scott, AICPA Senior Manager – Tax Policy & Advocacy, at (202) 434-9204 or Alexander.Scott@aicpa-cima.com; or me at (601) 326-7119 or JanLewis@HaddoxReid.com.

Sincerely,



Jan F. Lewis, CPA
Chair, AICPA Tax Executive Committee

cc: The Honorable Charles P. Rettig, Commissioner, IRS
The Honorable William M. Paul, Principal Deputy Chief Counsel, IRS
Ms. Lily Batchelder, Assistant Secretary, Office of Tax Policy, U.S. Department of the Treasury
Mr. Jose E. Murillo, Deputy Assistant Secretary of Tax Policy, U.S. Department of the Treasury
Ms. Erika Nijenhuis, Senior Counsel, Office of Tax Policy, U.S. Department of Treasury
Ms. Kamela Nelan, Attorney-Advisor, Office of Tax Policy, U.S. Department of Treasury
Mr. Peter Blessing, Associate Chief Counsel, International, IRS
Mr. Peter Merkel, Branch Chief, Office of Associate Chief Counsel International, IRS
Ms. Margaret O'Connor, Director, Treaty Administration, Large Business & International, IRS
Ms. Cindy Kim, Program Manager – Practice Network, Large Business & International, Cross Border Activities Practice Area, IRS