



## IRS RELEASES SECOND DRAFT OF FORM 1065 K-2 & K-3 INSTRUCTIONS

On December 2, 2022, the IRS released a revised draft of the Schedule K-2 & K-3 (Form 1065) instructions with additional revisions. This was an update from their previous release on October 26, 2022. The significant change between these releases is seen in the domestic filing exception. As a reminder, this exception was originally offered in the form of a FAQ in February of 2022 and applied to the 2021 tax filing season ONLY. The instructions to the Form 1065 for 2022 have now adopted that exception with some modifications that would apply to the 2022 filing season.

### Key Changes

The following are the key changes made to the domestic filing exception in the newest revised draft instructions:

**Partner Notification Requirement:** The notice to partners previously was required to be issued by January 15, 2023. Under the latest update, it can be issued as late as the date the Schedules K-1 are provided to the partners and even provided as an attachment to the Schedule K-1.

**Partner Request “1-Month Date”:** The 1-month date, for both the domestic filing exception and the Form 1116 exception, will now be one month before the Form 1065 is filed, so as late as August 15, 2023 for a calendar year partnership return placed on extension. This appears to be a much clearer statement than the previous iteration.

**US Citizen/Resident List:** The list of US citizen/resident alien partners is now expanded to include S corporations with a single shareholder and single member LLCs owned whose owner is listed as an eligible US citizen/resident alien partner.

As a reminder to meet the domestic filing exception the organization must meet the following criteria:

1. No or limited Foreign Activity;
2. US Citizen/Resident Alien Partner Test;
3. Partner Notification Requirement; AND
4. Partner Request “1-Month Date”.

### Foreign Activity Test

The first criteria of the domestic filing exception relates to foreign activities:

**No or limited foreign activity:** During a domestic partnership's tax year 2022, the domestic partnership either has no foreign activity (as defined below), or, if it does have foreign activity, such foreign activity is limited to

- passive category foreign income (determined without regard to the high-taxed income exception under section 904(d)(2)(B)(iii));
- upon which not more than \$300 of foreign income taxes allowable as a credit under section 901 are treated as paid or accrued by the partnership; and
- such income and taxes are shown on a payee statement (as defined in section 6724(d)(2)) that is furnished or treated as furnished to the partnership.

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## Foreign Activity Test (cont.)

**Foreign activity:** For purposes of the domestic filing exception, foreign activity means any of the following.

- foreign income taxes paid or accrued (as defined in section 901 and the regulations thereunder);
- (foreign source income or loss (as determined in sections 861 through 865, and section 904(h), and the regulations thereunder);
- ownership interest in a foreign partnership (as defined in sections 7701(a)(2) and (5));
- ownership interest in a foreign corporation (as defined in sections 7701(a)(3) and (5));
- ownership of a foreign branch (as defined in Regulations section 1.904-4(f)(3)(vii));
- ownership interest in a foreign entity that is treated as disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3).



## US Citizen/Resident Alien Partner Test

The second criteria requires that all direct partners must meet certain criteria:

**U.S. citizen/resident alien partners:** During tax year 2022, all the direct partners in the domestic partnership are:

- individuals that are U.S. citizens;
- individuals that are resident aliens (as defined in section 7701(b)(1)(A) and the regulations thereunder);
- domestic decedent's estates (that is, decedent's estates that are not foreign estates as defined in section 7701(a)(31)(A)), with solely U.S. citizen and/or resident alien individual beneficiaries;
- domestic grantor trusts (that is, trusts described under sections 671 through 678) that are not foreign trusts as defined in section 7701(a)(31)(B) and that have solely U.S. citizen and / or resident alien individual grantors and solely U.S. citizen and / or resident alien individual beneficiaries;
- domestic non-grantor trusts (that is, trusts subject to tax under section 641 that are not foreign trusts as defined in section 7701(a)(31)(B)) with solely U.S. citizen and/or resident alien individual beneficiaries;
- [NEWLY INCLUDED DEC 2, 2022] S corporations with a sole shareholder; or
- [NEWLY INCLUDED DEC 2, 2022] single-member LLCs, where the LLC's sole member is one of the persons in subparagraphs (a) through (f), and the LLC is disregarded as an entity separate from its owner (as defined in Regulations section 301.7701-3).

To summarize any partnership with partnership or corporate partners (other than S corporations with a sole shareholder) will be barred from using this exception as they will fail to meet this second criteria.

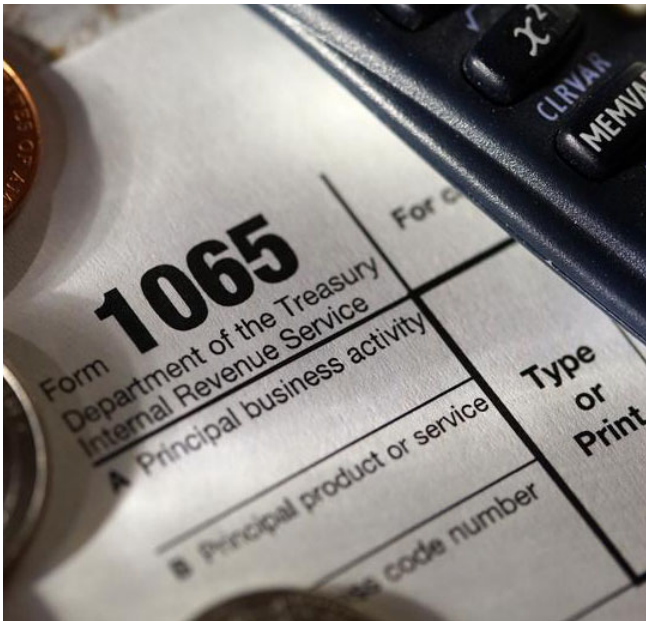
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## Partner Notification Requirement

The December 2, 2022 draft of the instructions made the instructions much more clear and less rigid than the previous iteration. Notice is no longer required by a specific date but rather may be provided with and attached to the Schedule K-1. The instructions provide:

**Partner notification:** *With respect to a partnership that satisfies criteria 1 and 2, partners receive a notification from the partnership at the latest when the partnership furnishes the Schedule K-1 to the partner. The notice can be provided as an attachment to the Schedule K-1. The notification must state that partners will not receive Schedule K-3 from the partnership unless the partners request the schedule.*



## Partner Request Received by the "1-Month Date"

The final test looks to see if any partners return requests to have the form issued by what is referred to as the *1-month date*:

**No 2022 Schedule K-3 requests by the 1-month date:** The partnership does not receive a request from any partner for Schedule K-3 information on or before the 1-month date. The "1-month date" is 1 month before the date the partnership files the Form 1065. For tax year 2022 calendar year partnerships, the latest 1-month date is August 15, 2023, if the partnership files an extension.

The instructions go on to provide information on what is required of the partnership that does receive notification prior to the 1-month date and what a partnership still must do if it receives such a request after the 1-month date.

Have questions or need more information? Please reach out to your Prager Metis professional.

## CONTACT US

On the web: [National Tax Advisory](#)

Email: [nationaltax@pragermetis.com](mailto:nationaltax@pragermetis.com)



by Brittany M. Besler, J.D., CPA, MBA