

Part III - Administrative, Procedural, and Miscellaneous

Transition Period Penalty Relief for New Schedules K-2 and K-3 for Forms 1065, 1120-S and 8865

Notice 2021-39

SECTION 1. PURPOSE

This notice announces transition relief for taxable years that begin in 2021 with respect to new Schedules K-2 and K-3 required for Forms 1065, U.S. Return of Partnership Income, 1120-S, U.S. Income Tax Return for an S Corporation, and 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships. Section 2 provides background on these new schedules and the penalties that may apply for failure to furnish complete and correct information with respect to such schedules. Section 3 provides transition relief from these penalties for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the Commissioner that it made a good faith effort to comply with the new reporting requirements.

SECTION 2. BACKGROUND

.01 Longstanding Filing and Reporting Requirements

Section 6031 of the Internal Revenue Code (“Code”) and §§ 1.6031(a)-1 and 1.6031(b)-1T of the Income Tax Regulations generally require a partnership to do the following:

- make a return for each taxable year stating the items of its gross income and deductions allowable by subtitle A of the Code and any other information as prescribed by forms and instructions for the purpose of carrying out the provisions of subtitle A of the Code, and
- furnish to its partners statements containing each partner's distributive share of the partnership's items of income, gain, loss, deduction, or credit required to be shown on the partnership return and any additional information required to apply particular provisions of subtitle A of the Code to the partner with respect to items related to the partnership as prescribed by form or accompanying instructions.

Section 6037(a) and (b) provide similar requirements with respect to an S corporation.

Section 6038(a)(1) and (a)(5) and §1.6038-3 of the Income Tax Regulations generally require a United States person that controls a foreign partnership or holds at least a 10-percent interest in a foreign partnership that is controlled by United States persons holding at least 10-percent interests (a U.S. partner) to furnish information relating to the partnership (a controlled foreign partnership or CFP), including information relating to the U.S. partner's ownership interests in the partnership and allocations to the partner of partnership items. A U.S. partner that controls a CFP may also need to provide information relating to another U.S. partner's ownership interest in the partnership and allocations to that partner of partnership items.

Pursuant to sections 6031, 6037, and 6038 and the accompanying Income Tax Regulations, the Internal Revenue Service (IRS) has, in forms and instructions, long

required that any partnership, S corporation, or U.S. partner in a CFP report information of international tax relevance.

.02 New Schedules K-2 and K-3

Form 1065, Schedules K-2, Partners' Distributive Share Items—International, and K-3, Partner's Share of Income, Deductions, Credits, etc.—International, are new for taxable years beginning in 2021. These schedules replace, supplement, and clarify the reporting of certain amounts formerly reported on Form 1065, Schedule K, Partners' Distributive Share Items, line 16, Foreign Transactions, and Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., Part III, Partner's Share of Current Year Income, Deductions, Credits, and Other Items, line 16, Foreign Transactions. Schedules K-2 and K-3 also replace, supplement, and clarify reporting of certain amounts formerly reported on Form 1065, Schedule K, line 20c, Other items and amounts, and Schedule K-1 (Form 1065), Part III, line 20, Other information. The new standardized format assists partnerships in providing partners with the information necessary to complete their returns with respect to the international tax aspects of the Code and allows the IRS to more efficiently verify tax compliance.

For the same reasons, for taxable years beginning in 2021, Form 1120-S includes new Schedules K-2, Shareholders' Pro Rata Share Items—International, and K-3, Shareholder's Share of Income, Deductions, Credits, etc.—International. These schedules replace, supplement, and clarify the reporting of certain amounts formerly reported on line 14, Foreign Transactions, of both Form 1120-S, Schedule K, Shareholders' Pro Rata Share Items, and Schedule K-1 (Form 1120-S), Shareholder's Share of Income, Deductions, Credits, etc. Part III, Shareholder's Share of Current Year

Income, Deductions, Credits, etc. Schedules K-2 and K-3 also replace, supplement, and clarify the reporting of certain amounts formerly reported on Form 1120-S, Schedule K, line 17d, Other items and amounts, and Schedule K-1 (Form 1120-S), Part III, line 17, Other Information.

Finally, for the same reasons, for taxable years beginning in 2021, Form 8865 includes new Schedules K-2, Partners' Distributive Share Items—International, and K-3, Partner's Share of Income, Deductions, Credits, etc.—International. These schedules replace, supplement, and clarify the reporting of certain amounts formerly reported on line 16, Foreign Transactions, of both Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships, Schedule K, Partners' Distributive Share Items, and Schedule K-1 (Form 8865), Partner's Share of Income, Deductions, Credits, etc., Part III, Partner's Share of Current Year Income, Deductions, Credits, and Other Items. Schedules K-2 and K-3 also replace, supplement, and clarify the reporting of certain amounts formerly reported on Form 8865, Schedule K, line 20c, Other items and amounts, and Schedule K-1 (Form 8865), Part III, line 20, Other information.

The IRS released on July 14, 2020, for public comment drafts of the Form 1065, Schedules K-2 and K-3 and the associated instructions. At that time, the IRS also requested comments on the Forms 1120-S and 8865 with respect to which the IRS planned to issue similar Schedules K-2 and K-3. After considering the comments received, on June 3 and 4, 2021, the IRS released the final versions of new Schedules K-2 and K-3 for the Forms 1065, 1120-S and 8865 applicable for taxable years beginning in 2021.

.03 Penalties

(a) Failure to File or Show Information on Partnership Return

Section 6698 imposes a penalty for failing to file a return at the time prescribed therefor, or for filing a return that fails to show the information required under section 6031. A return required under section 6031 includes Form 1065 and Schedule K-1 (Form 1065). For partnership taxable years beginning in 2021, it will also include Schedules K-2 and K-3. A failure to file a timely partnership return that shows information required under section 6031 would generally subject a partnership to the section 6698 penalty. A section 6698 penalty will not be imposed if it is shown that the failure is due to reasonable cause.

(b) Failure to File or Show Information on an S Corporation Return

Section 6699 imposes a penalty for failing to file a return required under section 6037 at the time prescribed therefor, or for filing a return that fails to show the information required under that section. A return required under section 6037 includes Form 1120-S and Schedule K-1 (Form 1120-S). For S corporation taxable years beginning in 2021, it will also include Schedules K-2 and K-3. A failure to file a timely S corporation return that shows information required under section 6037 would generally subject an S corporation to the section 6699 penalty. A section 6699 penalty will not be imposed if it is shown that the failure is due to reasonable cause.

(c) Failure to File Correct Information Returns

Section 6721 imposes a penalty for any failure to file an information return on or before the required filing date, and for any failure to include all of the information required to be shown on the return or the inclusion of incorrect information. When regulations under section 6011 require a partnership to file a partnership return

electronically, each schedule required to be included with the return with respect to each partner (that is, Schedules K-1 and K-3) is treated as a separate information return subject to the section 6721 penalty. See section 6724(e). Failure to electronically file a correct Schedule K-1 or K-3 when required would generally subject a partnership to a section 6721 penalty.

(d) Failure to Furnish Correct Payee Statements

Section 6722 imposes a penalty for failure to furnish a payee statement on or before the date prescribed therefor to the person to whom such statement is required to be furnished, and for any failure to include all of the information required to be shown on a payee statement or the inclusion of incorrect information. Section 6724(d)(2) provides a definition for "payee statement" that applies to section 6722. Under section 6724(d)(2)(A), a payee statement includes a statement required to be furnished to each partner under section 6031(b) or (c) and to each S corporation shareholder under section 6037(b). A failure to furnish a correct Schedule K-1 or K-3 as required under section 6031 would generally subject a partnership to the section 6722 penalty. A failure to furnish a correct Schedule K-1 or K-3 as required under section 6037 would generally subject an S corporation to the section 6722 penalty.

Section 6724 provides an exception to a penalty for any failure under sections 6721 and 6722 if it is shown that the failure is due to reasonable cause and not to willful neglect. Under § 301.6724-1 of the Procedure and Administration Regulations, a penalty is waived for reasonable cause only if the filer establishes that either there are significant mitigating factors with respect to the failure or the failure arose from events

beyond the filer's control. In addition, the filer must establish that the filer acted in a responsible manner both before and after the failure occurred.

(e) Failure to furnish information required by section 6038

Section 6038(b) and (c) impose penalties for failing to furnish the information required under that section by its due date. The reporting required under section 6038 includes Form 8865 and each Schedule K-1 (Form 8865). For partnership taxable years beginning in 2021, it will also include Schedules K-2 and K-3. A U.S. partner is generally subject to penalties under section 6038 for failure to file a Form 8865 that shows information required under section 6038. No penalties are applicable under section 6038 for a partner that shows that the failure to file Form 8865 is due to reasonable cause.

SECTION 3. PENALTY RELIEF

This section provides transition relief for taxable years that begin in 2021 (processing year 2022) with respect to Schedules K-2 and K-3 to Forms 1065, 1120-S, and 8865. During this transition period, a partnership required to file Form 1065, an S corporation required to file Form 1120-S, or a U.S. partner required to file Form 8865 (a "Schedule K-2/K-3 filer") will not be subject to the relevant penalties described in section 2 for any incorrect or incomplete reporting on the Schedules K-2 and K-3 if the filer establishes to the satisfaction of the Commissioner that it made a good faith effort to comply with the Schedules K-2 and K-3 filing requirements (and the Schedule K-3 furnishing requirements) per the instructions. A Schedule K-2/K-3 filer that does not establish that it made a good faith effort to comply with the new requirements will not be eligible for penalty relief under this notice.

For purposes of determining whether a Schedule K-2/K-3 filer makes a good faith effort to complete Schedules K-2 and K-3, the IRS will take into account the extent to which a Schedule K-2/K-3 filer has made changes to its systems, processes, and procedures for collecting and processing information relevant to filing the Schedules K-2 and K-3 and the extent to which a Schedule K-2/K-3 filer has obtained information from partners, shareholders, or the CFP, or applied reasonable assumptions when information is not obtained. The IRS will also take into account the steps taken by the Schedule K-2/K-3 filer to modify the partnership or S corporation agreement or governing instrument to facilitate the sharing of information with partners and shareholders that is relevant to determining whether and how to file Schedules K-2 and K-3.

In several instances, certain information about partners, shareholders, or the CFP is relevant for determining the applicability of a part of Schedules K-2 and K-3. For example, if a partnership has a direct or indirect partner that is a nonresident alien individual or a foreign corporation, the partnership must complete Form 1065, Part X of Schedules K-2 and K-3. Information about the partners, shareholders, or the CFP is also relevant for determining how to report some amounts. For example, for taxable years beginning in 2021, the instructions for Form 1065, Part IX of Schedule K-2 and K-3 state that a partnership is expected to collaborate with its partners to identify the foreign related parties of each partner.

The Treasury Department and the IRS are aware that a Schedule K-2/K-3 filer may not currently have systems or procedures in place to obtain information about its partners, shareholders, or the CFP to determine whether it must file a part of Schedules

K-2 and K-3 or how to complete a part that must be filed. In general, in the taxable year 2021 instructions, unless the Schedule K-2/K-3 filer has knowledge to the contrary, it must file or complete certain parts assuming that the information would be relevant to the partner or shareholder. Under this notice, during the transition period, a Schedule K-2/K-3 filer will not be subject to the relevant penalties described in section 2 for any incorrect or incomplete reporting on Schedules K-2 or K-3 if it establishes to the satisfaction of the Commissioner that it made a good faith effort to determine whether it must file a part and how to complete a part that it files.

With respect to information about partners, shareholders, or the CFP that is relevant to determine whether to file and how to complete a part, the IRS will assess the effort the Schedule K-2/K-3 filer made to obtain this information and the reasonableness of any assumptions, taking into account the relationship between the Schedule K-2/K-3 filer and its partners, shareholders or the CFP. For example, the appropriate level of diligence and/or the reasonableness of an assumption may differ with respect to a partner that manages or controls the partnership, or a partnership with a partner with a significant interest in the partnership, such as a partner with a 10-percent interest, as compared to partners holding small interests for which there may not be the same ease of access to information. Nevertheless, a Schedule K-2/K-3 filer may have made a good faith effort despite being unsuccessful in obtaining information from its partners, shareholders, or the CFP.

SECTION 4. REQUEST FOR COMMENTS

The IRS solicits comments on the draft instructions to Schedules K-2 and K-3 for taxable years beginning in 2021 being released the same date as this Notice,

particularly any instances where the instructions do not provide sufficient guidance on how to complete the returns or where additional clarity is needed. The IRS is specifically interested in suggestions for addressing structures and situations that make it difficult to determine certain information (for example, tiered partnership structures or publicly-traded partnerships).

As discussed in section 3, in general, the instructions for taxable years beginning in 2021 for certain parts of the Schedules K-2 and K-3 require the partnership and the S corporation to report information unless the partnership and S corporation know that the information is not relevant to partners, shareholders, or indirect partners. The IRS solicits comments concerning reasonable assumptions Schedule K-2/K-3 filers could make in determining whether and how to complete Schedules K-2 and K-3 for years after the transition period and whether these assumptions may differ between various parts of the Schedules K-2 and K-3.

Comments should be submitted in writing and should include a reference to Notice 2021-39. Comments may be submitted in one of two ways:

(1) Electronically via the Federal eRulemaking Portal at www.regulations.gov (type IRS-2021-0006 in the search field on the regulations.gov homepage to find this notice and submit comments).

(2) Alternatively, by mail to: Internal Revenue Service, Attn: CC:PA:LPD:PR (Notice 2021-39), Room 5203, P.O. Box 7604, Ben Franklin Station, Washington, D.C. 20044.

All commenters are strongly encouraged to submit public comments electronically. The IRS expects to have limited personnel available to process public

comments that are submitted on paper through the mail and these comments, submitted through the mail, may not be processed with enough time before revisions to the instructions need to be prepared. Until further notice, any comments submitted on paper will be considered to the extent practicable. The Treasury Department and the IRS will publish for public availability any comment submitted electronically, and to the extent practicable on paper, to its public docket.

SECTION 5. CONTACT INFORMATION

The principal author of this notice is Ronald M. Gootzeit of the Office of Associate Chief Counsel (International). For further information regarding the issues described in this notice, contact Mr. Gootzeit at (202) 317-6937 (not a toll-free number).