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Analysis

Pass-Throughs Face Added Costs To Sort Out Int'l Reporting

By Dylan Moroses · Feb 24, 2022, 6:19 PM EST ·

New tax schedules for partnerships and other pass-through entities with foreign interests have practitioners spending significant time this filing season to accurately fill out the new forms, which will likely lead to increased compliance costs for businesses.

Tax practitioners told Law360 the new schedules require a granular level of detail from those clients with international ties, and the exercise to complete the new forms is more intensive than what the Internal Revenue Service previously required from partnerships with foreign interests.

Schedules K-2 and K-3, finalized by the IRS last year, require any pass-through entities and S corporations that may claim foreign tax credits, deductions or other tax treatment tied to international activity to report that information on the new forms.

Schedule K-2 covers a partner's total share of any international distributions, and the K-3 form details a partner's share of any international taxable income, credits or deductions.

Tax professionals at larger accounting firms, or those with significant international tax experience and larger pass-through clients, may be better prepared to fill out the schedules and have the information required more readily available. However, smaller accounting firms could face growing pains as their practitioners try to complete the new forms, said Andre Benayoun, a partner at Marcum LLP.

"Your average everyday CPA who has a small shop may not understand the rules, and then they get 20 pages of forms and 40 pages of instructions," Benayoun said. Many of the clients those practitioners deal with are likely to be subject to the new reporting requirements, he added.

The new schedules, which expound upon a line item found on Schedule K-1, could pose significant challenges for those companies and accountants that may have never filled out international tax forms or don't have detailed data on their foreign interests readily available, Benayoun said.

The information required for the schedules K-2 and K-3 should have been collected prior to the new reporting requirements since foreign taxable income has to be reported on other forms, but oftentimes that information wasn't gathered comprehensively, he said.

"When you look at the form as it existed before, there were a couple of lines where you would just put a number down and the idea was you would do all these behind-the-scenes calculations," Benayoun said. "But now, the form says show me all those behind-the-scenes calculations."

For Brian Lovett, a tax partner at Withum Smith & Brown PC, the schedules require more "due diligence and fact-finding in making sure you have the right data, country by country."

Mishkin Santa of The Wolf Group PC told Law360 he and his firm have some early experience working with schedules K-2 and K-3 for clients that file taxes on a fiscal year basis. The new schedules require information in a fashion similar to IRS Form 5471 for foreign corporate reporting, Santa noted.

"It's almost like a mini corporate return inside a bigger individual return: It's got a lot of tie-ins, a lot of schedules, and it's probably going to be fairly clunky inside tax software," Santa said. "This is going to create a lot of man-hours of work if the partnership or S corp. or foreign partnership is required to file these and present them to their various shareholders or partners."

The process to comply with the new schedules involves more than just filling out the forms, which are comprehensive themselves, Santa said. The work includes ensuring that tax software is generating results that match the information being provided, Santa said.

"The reason why the data input into the tax software is really critical is because that will roll forward and make the next year easier, and so forth and so forth," Santa said.

The IRS clarified this month that domestic businesses that believe they have no foreign tax items or interests wouldn't be required to fill out the new schedules this filing season. In an updated FAQ, the IRS said partnerships with direct partners that are foreign estates and trusts, as well as foreign corporations, individuals or partnerships, would not qualify for the relief. The FAQ also specified that disqualifying foreign activity includes having foreign taxes paid or accrued, or assets that generate foreign source income.

Santa said the IRS guidance may provide some relief, but ultimately it's just for this filing season, and the exceptions to filing the schedules will be eliminated next year.

"We're not really doing our clients any favor by not doing this for them this year, not getting used to it," Santa said. Eventually, Santa said, businesses that may qualify for the relief this year will need to grow comfortable collecting and reporting the new data required on the schedules K-2 and K-3.

For some clients where that relief is available, Lovett said the best option may be to forgo filling out the new schedules and better prepare for next filing season.

"It certainly seems like there's going to be a fair amount of partnerships that don't need to worry about this for now, so we get to kick that can down the road another year before we have to dig into it for those fully domestic partnerships with fully domestic partners," Lovett said.

Nevertheless, Lovett noted his firm has several clients that will be required to submit the new schedules this filing season, "so we're going to have to figure it out this year," he said.

As of now, the process to complete the schedules is a more manual exercise because the information isn't always easily transported into the forms, Lovett said. He added that he hopes the firm can develop systems and controls to make reporting with the new forms more efficient.

In general, accounting firms working through the new reporting obligations are in many cases still determining what fees might be appropriate, practitioners said.

"Obviously, compliance could take longer [and] we probably need to talk to clients about fee adjustments and things like that," Lovett said. "More disclosure, more transparency requires more time."

Looking ahead, Santa said schedules K-2 and K-3, in addition to a number of other international tax reporting obligations, could benefit from a "light version" of the forms for smaller clients that may not have a significant amount of foreign ties. To go a step further, Santa suggested a reporting exclusion could be set up for smaller entities below a certain income threshold.

"There's no difference between a foreign small business and a large Amazon or Google; they all have to report these crazy schedules and forms," Santa said.