

February 5, 2025

Ms. Holly O. Paz
Acting Commissioner
Large Business & International (LB&I) Division
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

Mr. Jeffrey Erickson
Associate Chief Counsel, Office of Chief Counsel
Passthroughs, Trusts and Estates
Internal Revenue Service
1111 Constitution Avenue, NW
Washington, DC 20224

RE: Domestic Filing Exception (Exception to Filing Schedules K-2 and K-3)

Dear Commissioner Paz and Mr. Erickson:

The Federal Tax Policy Committee of the Texas Society of Certified Public Accountants (TXCPA) has suggestions that we believe will assist the IRS in reducing taxpayer burden associated with filing Schedules K-2 and K-3 without reducing the ability to identify returns with foreign activity tax compliance risk. We offer three recommendations: the first is a modification of the existing domestic filing exception; the second is setting a threshold for filing Schedules K-2 and K-3; and the third is a request to include gross income information in Schedule K-1.

Background

The filing requirements for Schedules K-2 and K-3 impose a great burden on businesses. The 2021 Statistics of Income (SOI)¹ states that 4,467,584 partnerships filed returns in 2021. These 4.4 million partnerships had 30,624,451 partners. If each of these partnerships prepared a Schedule K-3, then 459,366,765 pages of Schedules K-3 would be generated. Each page of Schedule K-3 must be prepared, reviewed and potentially reviewed again. We have a report of one partnership with 80 partners (with no foreign partners and no foreign income) that, before the Schedules K-2 and K-3 requirements, filed a 400-page return. With the Schedule K-3 for each partner, the return is approximately 885 pages. Our members consistently report preparing and reviewing numerous partnership returns having Schedules K-3 with minimal or no information.

These relatively small domestic partnerships incur significant costs issuing Schedules K-3, including professional fees, expenses associated with communicating with partners about the Schedule K-3 and tracking partners' responses. Partners in domestic partnerships who receive Schedules K-3 often do not understand why they are receiving the forms and often contact the partnership with questions. Responding to those questions adds to the compliance burden.

¹ <https://www.irs.gov/pub/irs-soi/soi-a-copa-id2305.pdf>



Accordingly, we offer the following recommendations:

1. Modify the existing domestic filing exception.
2. Set a higher filing threshold for Schedules K-2 and K-3.
3. Include foreign source gross income and gross income from all sources in the Schedule K-1.

Recommendation 1 – Modify the Existing Domestic Filing Exception

We note and appreciate that the most recent instructions provide a domestic filing exception to filing Schedules K-2 and K-3. The domestic filing exception is available if each of the following four criteria is met:

1. The flow-through entity has no or limited foreign activity.
2. For partnerships only, all the direct partners are individuals who are U.S. citizens or resident aliens, domestic decedents' estates, domestic grantor trusts (with only U.S. citizens or resident aliens as grantors and beneficiaries), domestic non-grantor trusts (with only U.S. citizens or resident aliens as beneficiaries), S corporations with a sole owner, or single member LLCs whose sole owner is an individual who is a U.S. citizen, resident alien or domestic trust or estate.
3. Owners are notified they will not receive a Schedule K-3 unless requested.
4. The flow-through entity receives no request for a Schedule K-3 within one month before its return is filed.

Under the current instructions, if a partner requests Schedule K-3, the partnership must complete and file Schedules K-2 and K-3 with respect to the requesting partner for all subsequent years in which the partner is an owner in the partnership.

We recommend modifying the domestic filing exception as follows:

- a. Criterion 2 of the domestic partnership exception should be expanded to include domestic partnerships having domestic partnerships or multi-shareholder S corporations as partners.
- b. An owner requesting a Schedule K-3 should be required to renew his/her request annually.

Recommendation 1 will greatly expand the number of partnerships that otherwise qualify for the domestic filing exception.

The purpose of our recommendations a and b, above, is to provide relief to the partnerships from the excessive administrative costs and professional fees for compliance.

Recommendation 2 – Set a Higher Threshold for a Requirement to File Schedules K-2 and K-3

In achieving a reasonable balance between the IRS's legitimate information needs and taxpayer burden, consideration should be given to the size and complexity of the partnership when establishing filing criteria. The IRS should consider applying these existing criteria to the requirement for filing Schedules K-2 and K-3.

1. Exclude domestic partnerships from filing Schedules K-2 or K-3 in cases where such partnerships are not required to file Schedule M-3, regardless of whether criteria 2-4 of the current domestic filing exception are met. This would exempt domestic SBSE-sized partnerships with assets of less than \$10 million. The 2021 SOI report indicates that 3.7 million partnerships had less than \$10 million in total assets and no foreign transactions. Application of this exclusion would relieve approximately 83% of all partnerships from filing Schedules K-2 and K-3.
2. Alternatively, apply the current criteria set forth in Form 1065 instructions for requiring a partnership to prepare Schedules L, M-1 and M-2 (total receipts of less than \$250,000 and total assets of less than \$1 million) to partnerships meeting Criterion 1 of the current domestic filing exception. This would eliminate the need for approximately 24% of all partnerships to file Schedules K-2/K-3.
3. Consider a "middle ground" - exempt domestic partnerships having \$5 million or less in assets. This standard would relieve 67% of all partnerships from the filing requirements.

This information is presented in graphic form (source is the 2021 Statistics of Income):

	M-3 Filing Requirement-- \$10mm in Assets	\$5mm or less in Assets	Schedule L Filing Requirement-- \$1mm in Assets
Number of Partnerships under Threshold	3,997,428	3,189,791	1,140,908
Less Partnerships with Foreign Activity	306,049	178,671	46,363
Potential Number of Partnerships Relieved of Filing K-3s	3,691,379	3,011,120	1,094,545
Total Number of Partnerships Filed	4,467,584	4,467,584	4,467,584
Percentage	82.63%	67.40%	24.50%

Recommendation 3 – Include Foreign Source Gross Income and Gross Income from all Sources in Schedule K-1

Partners need to know the amount of gross income from all sources to calculate their foreign tax credits. For partnership returns with limited foreign activity, Box 20 of Schedule K-1 could report this information.

The implementation of these recommendations will help relieve the extraordinary burden that the Schedules K-2 and K-3 filing places on small businesses.

In addition, we believe in most cases that Schedules K-2 and K-3 could be greatly simplified. We leave the criteria to the IRS to develop, but a short-form information return, when appropriate, would be better received than the overwhelming volume and complexity of the current forms and might encourage greater compliance by being more understandable.

Summary

We want to make it clear that we support the IRS in efforts to collect taxes on income being diverted from the U.S. through illegal partnership activity. However, we believe that the current Schedules K-2 and K-3 requirements have not set the right balance between enforcement and administrative burden.

TXCPA is a nonprofit, voluntary professional organization representing more than 28,000 members. One of the expressed goals of the TXCPA is to speak on behalf of its members when doing so is in the best interest of its constituency and serves the cause of the CPAs of Texas, as well as the public interest. TXCPA has established a Federal Tax Policy Committee to represent those interests on tax-related matters. The committee also has the discretion to comment on reporting and disclosure requirements under Title 31 of the U.S. Code of Federal Regulations. The committee has been authorized by the TXCPA Leadership Council to submit comments on such matters of interest to the committee membership. The views expressed herein have not been approved by the Leadership Council or Board of Directors and, therefore, should not be construed as representing the views or policies of the TXCPA.

Thank you for the opportunity to provide our recommendations. We would be pleased to further discuss this issue with you or your staff. Feel free to contact me at 214-373-8900 or at jsmith@dallascpas.com or TXCPA Staff Liaison Patty Wyatt at 817-656-5100 or pw Wyatt@tx.cpa.

Sincerely,



James A. Smith, CPA, CGMA
Chair, Federal Tax Policy Committee
Texas Society of Certified Public Accountants

Principal responsibility for drafting these comments was exercised by William Wilson, CPA, Josh Whitworth, CPA, David Donnelly, CPA, Julie Dale, CPA, and Vibha Kejriwal, CPA.

cc: Aviva Aron-Dine, Assistant Secretary for Tax Policy (PDO), U.S. Department of the Treasury