

Current Federal Tax Developments

Week of January 31, 2022

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CURRENT FEDERAL TAX DEVELOPMENTS
WEEK OF JANUARY 31, 2022
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SECTION: 6011

SCHEDULE K-2 AND K-3 WILL BE REQUIRED TO BE PROVIDED UNLESS PARTNERSHIP KNOWS IT WILL NOT BE NEEDED EVEN IF PARTNERSHIP HAS NO FOREIGN ACTIVITIES OR PARTNERS

Citation: “Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065),” IRS Website, 1/18/22

The IRS made modifications to the instructions for new partnership Schedules K-2 and K-3 (Form 1065)¹ that will require partnerships to either have all partners certify that certain information will not be necessary to complete some international tax related items on their return (including the Foreign Tax Credit) or complete the relevant portions of Schedule K-2 and K-3 and provide them to all partners that they are not aware will not need the information.

A similar statement and revision has been made to the instructions for the new S Corporation Schedules K-2 and K-3 (Form 1120S).²

Not all of the changes will cause increased reporting—in fact, some changes result in less work than would have been needed under the original instructions. But the changes made to the reporting of information that could impact a foreign tax credit calculation will create significant additional paperwork for many partnerships and S corporations.

In both cases the PDF with the instructions originally issued in September has not been updated to reflect these changes. Rather, taxpayers are expected to read these changes in addition to the PDF instructions.

In this article we’ll concentrate on the partnership revisions, but similar language is found on the S corporation revision page.

Who Must File

The original instructions, published in September, led many to conclude that only partnerships that had international activities or foreign partners would have to file the

¹ “Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065),” IRS Website, January 18, 2022, <https://www.irs.gov/forms-pubs/changes-to-the-2021-partnership-instructions-for-schedules-k-2-and-k-3-form-1065> (retrieved January 29, 2022)

² “Changes to the 2021 S Corporation Instructions for Schedules K-2 and K-3 (Form 1120-S),” January 18, 2022, <https://www.irs.gov/forms-pubs/changes-to-the-2021-s-corporation-instructions-for-schedules-k-2-and-k-3-form-1120-s> (retrieved January 29, 2022)

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forms or provide them to equity holders. The “Who Must File” section began with the following:

The partnership need not complete this schedule if the partnership does not have items of international tax relevance (typically, international activities or foreign partners).³

The section did not indicate that there would often be cases where partnerships with neither international activities nor foreign partners would have to complete the forms. But the revised language makes it very clear that a large number of, if not most, partnerships will be required to file these forms even though the partnership does not have any foreign partners, nor any foreign activities.

The following paragraph is now added to the end of the “Who Must File” section:

Note. A partnership with no foreign source income, no assets generating foreign source income, and no foreign taxes paid or accrued may still need to report information on Schedules K-2 and K-3. For example, if the partner claims a credit for foreign taxes paid by the partner, the partner may need certain information from the partnership to complete Form 1116. Also, a partnership that has only domestic partners may still be required to complete Part IX when the partnership makes certain deductible payments to foreign related parties of its domestic partners. The information reported in Part IX will assist any domestic corporate partner in determining the amount of base erosion payments made through the partnership, and in determining if the partners are subject to the Base Erosion and Anti-Abuse Tax. See each part for applicability.

As should be clear, only the individual partners will know if they will or will not need this information to prepare their tax returns. And, as we’ll discover, unless the partners inform the partnership that they will not need the information, the partnership must assume it will be needed and supply that information in most cases.

Foreign Tax Credit Issues

The foreign tax credit creates the largest number of cases where partners who may have believed they did not need to prepare Schedule K-2 and K-3 will find they have been mistaken.

³ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 1, <https://www.irs.gov/pub/irs-pdf/i1065s23.pdf> (retrieved January 29, 2022)

Partnership Without Any Foreign Tax Payments or Foreign Income

The original instructions for Schedules K-2 and K-3 did provide information on page 7 that warned partnership advisers who didn't stop reading after the "Who Must File" section that the foreign tax credit created problems.

The "Note" found in the beginning of the section entitled "Schedule K-2, Parts II and III, and Schedule K-3, Parts II and III" told partnerships that partners who were claiming the foreign tax credit due to other items reported on their returns could require the partnership to complete these parts:

Certain partners will use the following information to claim and figure a foreign tax credit on Form 1116 or 1118. Schedules K-2 and K-3, Parts II and III, must be completed unless the partnership does not have a direct or indirect partner that is eligible to claim a foreign tax credit and such partner would have to file a Form 1116 or Form 1118 to claim a credit.⁴

The note continued to point out that the information will have to be provided by the partnership even if the partnership itself has no foreign activity:

This requirement applies regardless of whether the partnership pays or accrues foreign taxes because other information, such as the source of the partnership's income and the value of its assets, are relevant in determining the partner's foreign tax credit. A partner that is eligible to claim a foreign tax credit includes a domestic corporation, a U.S. citizen or resident, certain U.S. trusts and estates, certain foreign corporations, and certain nonresident individuals. See sections 901 and 906.⁵

As well, the note reminds the partnership of the parties that may be treated as indirect partners who may require this information:

An indirect partner includes a partner that owns the partnership through a pass-through entity (for example, a partnership, S corporation, or a trust (see Regulations section 1.904-5(a)(4)(iv) for the definition of pass-through entity). An indirect partner also includes a partner that owns the partnership through a foreign corporation.⁶

⁴ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 7

⁵ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 7

⁶ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 7

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Then the note imposes the requirement that a partnership must provide this information unless it has sufficient information to be sure that no partner (direct or indirect) will need access to this foreign tax credit information:

A partnership that does not have or receive sufficient information or notice regarding a direct or indirect partner must presume such partner is eligible to claim a foreign tax credit and such partner would have to file a Form 1116 or Form 1118 to claim a credit. As such, the partnership must complete the Schedule K-2 and K-3, accordingly.⁷

The revision adds a new example following this note to illustrate a situation when the partnership has such knowledge that its partners do not require this information:

Example. U.S. citizen A and U.S. citizen B own equal interests in domestic partnership. In Year 1, domestic partnership has no foreign source income and no assets that generate foreign source income. Domestic partnership does not pay or accrue foreign taxes. In Year 1, U.S. citizen A pays \$100 of foreign income taxes on passive category income which was reported to U.S. citizen A on a qualified payee statement. U.S. citizen A does not pay or accrue any other foreign taxes and has no other foreign source income. U.S. citizen B does not pay or accrue foreign income taxes. In Year 1, because U.S. citizen B paid no foreign taxes for which it can claim a foreign tax credit and U.S. citizen A qualifies for the exemption from completing Form 1116 to claim a foreign tax credit and such information was provided to domestic partnership by both U.S. citizen A and U.S. citizen B, domestic partnership need not complete Schedules K-2 and K-3, Part I, box 1, box 2, box 3, box 4, box 5, and box 10, Parts II or III.⁸

The election to avoid filing Form 1116 (and thus the partner would not need this information) applies in the following situation as explained in the Form 1116 instructions:

You may be able to claim the foreign tax credit without filing Form 1116. By making this election, the foreign tax credit limitation (lines 15 through 23 of the form) won't apply to you. This election is available only if you meet all of the following conditions.

- All of your foreign source gross income was “passive category income” (which includes most interest and dividends). See c. Passive Category Income, later. However, for this purpose, passive income also includes (a) income subject to the special

⁷ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 7

⁸ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 7

rule for high-taxed income described later, and (b) certain export financing interest.

- All the income and any foreign taxes paid on it were reported to you on a qualified payee statement. Qualified payee statements include Form 1099-DIV, Form 1099-INT, Schedule K-1 (Form 1041), Schedule K-3 (Form 1065), Schedule K-3 (Form 1120-S), or similar substitute statements.
- Your total creditable foreign taxes aren't more than \$300 (\$600 if married filing a joint return).

This election isn't available to estates or trusts.

If you make this election, the following rules apply.

- You can't carry over to or from any other year any foreign taxes paid or accrued in a tax year to which the election applies (but carryovers to and from other years are unaffected). See the instructions for line 10, later.
- You are still required to take into account the general rules for determining whether a tax is creditable. See Foreign Taxes Eligible for a Credit and Foreign Taxes Not Eligible for a Credit, later.
- You are still required to reduce the taxes available for credit by any amount you would have entered on line 12 of Form 1116. See the instructions for line 12, later.

To make the election, just enter on the foreign tax credit line of your tax return (for example, Schedule 3 (Form 1040), Part I, line 1) the smaller of (a) your total foreign tax, or (b) your regular tax. See the instructions for line 20, later, for how to figure your regular tax.⁹

The *Ernst & Young Tax Alert* gives the following summary of the impact of these issues:

The IRS clarified that a partnership with no foreign-source income must file Part II (foreign tax credit limitation) and Part III (information for preparing Forms 1116 or 1118) on Schedules K-2 and K-3 if their partners have items of international tax relevance. An exception from filing Part II and Part III, Section 2, on Schedule K-3 may apply, however, for a partnership that: (i) only has US-source income; (ii) does not have income or deductions that the partners can

⁹ 2021 Instructions for Form 1116, p. 1, <https://www.irs.gov/pub/irs-pdf/i1116.pdf> (retrieved January 29, 2022)

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source or allocate and apportion; and (iii) only has limited partners owning less than 10% of the capital and profits of the partnership at all times during the tax year.

These changes to the instructions highlight the broad application of the Schedules K-2 and K-3 filing requirement. The revised instructions include an example demonstrating how limited exceptions may apply. The example concerns a domestic partnership that has only US citizens as partners, no foreign-source income, and no assets generating foreign-source income. One of the two partners paid no foreign taxes for which it can claim a foreign tax credit, and the second partner qualifies for the exemption from completing Form 1116 to claim a foreign tax credit. The partners provide this information to the partnership. The example concludes that the partnership does not have to complete Boxes 1, 2, 3, 4, 5 or 10 of Part I, or Parts II or III of Schedule K-2 or of Schedule K-3. If the same facts apply, but a partner claims a credit for foreign taxes that it paid and may need certain information from the partnership to complete its Form 1116, then the partnership must file Schedules K-2 and K-3.¹⁰

Partnership Determination of Certain Items

The instructions on page 7 dealing with the source and separate category of certain gross income, gross income and cost of goods sold by the partnership are modified by changing the portion of the instructions entitled “Exception.”

Originally that section of the instructions read:

Exception. If the partnership knows that its only partners are less-than-10% limited partners that do not hold their interest in the ordinary course of the partner’s active trade or business, the partnership’s foreign source gross income and gross receipts should be reported as passive category income and its deductions allocated and apportioned to foreign source income should be reported as reducing passive category income. See Schedule K-2, Part II, column (c); Part III, Section 1, column (c); Part III, Section 3, column (b); and Part III, Section 5, column (d). Report the assets as generating passive category income in Schedule K-2, Part III, Section 2, column (c). Similarly, any foreign taxes paid or accrued on foreign source income should be assigned to passive category income. See Schedule K-2, Part III, Section 4, column (d). The partner’s distributive share of the amounts

¹⁰ “US IRS changes to instructions for 2021 partnership Schedules K-2 and K-3 are relevant to many partnerships, including private equity and private capital funds,” *Ernst & Young Tax Alert*, January 27, 2022, https://www.ey.com/en_gl/tax-alerts/us-irs-changes-to-instructions-for-2021-partnership-schedules-k-2-and-k-3-are-relevant-to-many-partnerships-including-private-equity-and-private-capital-funds (retrieved January 29, 2022)

determined by the partnership are reported on equivalent columns in Schedule K-3, Parts II and III. See Regulations section 1.904-4(n)(1)(ii).¹¹

Now the instructions are expanded to read:

Exception. If the partnership knows that its only partners are less-than-10% limited partners that do not hold their interest in the ordinary course of the partner's active trade or business, the partnership's foreign source gross income and gross receipts should be reported as passive category income and its deductions allocated and apportioned to foreign source income should be reported as reducing passive category income. See Schedule K-2, Part II, column (c); Part III, Section 1, column (c), Section 3, column (b); and Part III, Section 5, column (d). Any foreign taxes paid or accrued on foreign source income should be assigned to passive category income and reported on Schedule K-2, Part III, Section 4, column (d).

If the partnership has only U.S. source income and none of the partnership's income or deductions must be sourced or allocated and apportioned by the partner, and the partnership knows that its only partners are less-than-10% limited partners, do not complete Part II. If the partnership knows that its only partners are less-than-10% limited partners, do not complete Part III, Section 2. See Regulations section 1.861-9(e)(4)(i).

The partner's distributive share of the amounts determined by the partnership are reported accordingly on equivalent columns in Schedule K-3, Parts II and III. See Regulations section 1.904-4(n)(1)(ii).¹²

The Schedule K-3 segment has its instructions also changed. The instructions originally said:

Schedule K-3. If the partnership knows or has reason to know that some partners are less-than-10% limited partners (and their partnership interest is not held in the ordinary course of the partner's active trade or business), but not all partners meet this description, when completing the Schedule K-3 for the less-than-10% limited partners, report the partner's foreign source income as passive category income. See Part II, column (c); Part III, Section 1, column (c); Part III, Section 3, column (b); and Part III, Section 5, column (d). Report

¹¹ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 7

¹² "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

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the assets as generating passive category income in Part III, Section 2, column (c). Similarly, report the foreign taxes paid or accrued on foreign source income as passive category income in Part III, Section 4, column (d).¹³

These instructions are modified to read as follows:

Schedule K-3. If the partnership knows or has reason to know that some partners are less-than-10% limited partners (and their partnership interest is not held in the ordinary course of the partner's active trade or business), but not all partners meet this description, when completing the Schedule K-3 for the less-than-10% limited partners, report the partner's foreign source income as passive category income. See Part II, column (c); Part III, Section 1, column (c); Part III, Section 3, column (b); and Part III, Section 5, column (d). Report the foreign taxes paid or accrued on foreign source income as passive category income in Part III, Section 4, column (d).

For these less-than-10% limited partners, do not complete Part III, Section 2. See Regulations section 1.861-9(e)(4)(i).

If the partnership only has U.S. source income and none of the partnership's income or deductions must be sourced or allocated and apportioned by the partner, do not complete Part II for its partners that are less-than-10% limited partners.¹⁴

Country Code Information

Section 1 of Part II information on country code information has its instructions modified as well. The original instructions provide:

Forms 1116 and 1118 require the taxpayer to report the foreign country or U.S. possession with respect to which the gross income is sourced. On lines 1 through 24, for each gross income item, enter on a separate line (A, B, or C) the two-letter code from the list at [IRS.gov/CountryCodes](https://www.irs.gov/CountryCodes) for the foreign country or U.S. possession within which the gross income is sourced. If a type of income is sourced from more than three countries, attach a statement with the information required on Schedule K-2, Part II, and Schedule K-3, Part II, for that type of income.

¹³ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 7

¹⁴ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

Note. Do not enter “various” or “OC” for the country code.¹⁵

The revised instructions read as follows to add information on reporting countries on line 24:

Country code. Forms 1116 and 1118 require the taxpayer to report the foreign country or U.S. possession with respect to which the gross income is sourced. On lines 1 through 24, for each gross income item, enter on a separate line (A, B, or C) the two-letter code from the list at [IRS.gov/countrycodes](https://www.irs.gov/countrycodes) for the foreign country or U.S. possession within which the gross income is sourced. If a type of income is sourced from more than three countries, attach a statement with the information required on Schedule K-2, Part II, and Schedule K-3, Part II, for that type of income.

If income is U.S. source, enter “US.” Do not enter “various” or “OC” for the country code.

Each gross income item (for example, sales vs. interest income) may have different countries listed on “A, B, C, etc.” given that the partnership might not have sales income and interest income, for example, from the same country. Line 24 should sum each country’s total income reported on Part II, regardless of the line on which such income is reported, whether A, B, C, etc.¹⁶

Foreign Taxes

Section 4 of Part III on Foreign Taxes has its instructions for line 3 changed to add information regarding the partnership BBA audit rules:

Exception. Partnerships subject to subchapter C of chapter 63 of the Code (BBA Partnerships) are generally required to file an administrative adjustment request (AAR) under Regulations section 1.905-4(b)(2)(ii) to account for a foreign tax redetermination. If an AAR is filed with respect to a foreign tax redetermination (or if an AAR will be timely filed), do not report the foreign tax redetermination on Line 3.¹⁷

¹⁵ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 8

¹⁶ “Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065),” IRS Website, January 18, 2022

¹⁷ “Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065),” IRS Website, January 18, 2022

Gain on Personal Property Sales

The revision replaces entirely the instructions on reporting the gain on personal property sales in Box 1 of Schedule K-2, Part I (Partnership's Other Current Year International Information) and Schedule K-3 (Partner's Share of Partnership's Other Current Year International Information). Originally the instructions provided:

Box 1. Gain on personal property sale. In general, income from the sale of personal property is sourced according to the residence of the seller. See section 865. For sourcing purposes, personal property sold by the partnership is treated as sold by the partners. See section 865(i)(5). A U.S. citizen or resident alien individual with a tax home (as defined in section 911(d)(3)) in a foreign country is treated as a nonresident with respect to the sale of personal property only if an income tax of at least 10% of the gain derived from the sale is actually paid to a foreign country with respect to that gain. See section 865(g). In addition, if a U.S. resident maintains an office or other fixed place of business in a foreign country, income from the sale of personal property attributable to such office or other fixed place of business is foreign source only if an income tax of at least 10% of the income from the sale is actually paid to a foreign country with respect to such income.

If the partnership has income from the sale of personal property (other than inventory, depreciable personal property, and certain intangible property excepted from the general rule of section 865(a)), it must check box 1 and attach a statement to Schedule K-2 and Schedule K-3 (for distributive share) reflecting all the information shown in Table 1, Information on Personal Property Sold. Do not combine sales of property. Each item of property sold must be listed separately with the information shown in Table 1. For column (g), enter the two-letter code from the list at IRS.gov/CountryCodes. Do not enter "various" or "OC" for the country code. If the property sale is taxed by more than one country, complete a separate line for that country, but indicate in some manner (for example, a footnote) that the property entered on both lines is the same property.¹⁸

Ernst & Young, in a *Tax Alert*, notes the revised instructions now no longer require reporting on all sales of personal property other than those specifically exempted (inventory, depreciable personal property, and certain intangible property excepted from the general rule of section 865(a)), rather requiring reporting only when:

- The partnership pays income tax to a non-US country on income from the sale of that property or

¹⁸ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 3

- The income from the sale is eligible for resourcing under an applicable tax treaty.¹⁹

The revised instructions now read:

Box 1. Gain on personal property sale. In general, income from the sale of personal property is sourced according to the residence of the seller. See section 865. For sourcing purposes, personal property sold by the partnership is treated as sold by the partners. See section 865(i)(5). A U.S. citizen or resident alien individual with a tax home (as defined in section 911(d)(3)) in a foreign country is treated as a nonresident with respect to the sale of personal property only if an income tax of at least 10% of the gain derived from the sale is actually paid to a foreign country with respect to that gain. See section 865(g). In addition, if a U.S. resident maintains an office or other fixed place of business in a foreign country, income from the sale of personal property attributable to such office or other fixed place of business is foreign source only if an income tax of at least 10% of the income from the sale is actually paid to a foreign country with respect to such income.

If the partnership has income from the sale of personal property (other than inventory, depreciable personal property, and certain intangible property excepted from the general rule of section 865(a)) and the partnership pays income tax to a foreign country with respect to income from the sale or the income is eligible for resourcing under an applicable treaty, it must check box 1 and attach a statement to Schedule K-2 and Schedule K-3 (for distributive share) reflecting all the information shown in Table 1, Information on Personal Property Sold. Do not combine sales of property. Each item of property sold must be listed separately with the information shown in Table 1. For column (g), enter the two-letter code from the list at [IRS.gov/countrycodes](https://www.irs.gov/countrycodes). Do not enter “various” or “OC” for the country code. If the property sale is taxed by more than one country, complete a separate line for that country, but indicate in some manner (for example, a footnote) that the property entered on both lines is the same property.²⁰

Attachment of Certain Forms to Schedules K-2 and K-3

The revised instructions replace the instructions found on page 5 of the original instructions related to attaching Forms 8858 and 5471 to Schedules K-2 and K-3. The

¹⁹ “US IRS changes to instructions for 2021 partnership Schedules K-2 and K-3 are relevant to many partnerships, including private equity and private capital funds,” *Ernst & Young Tax Alert*, January 27, 2022

²⁰ “Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065),” IRS Website, January 18, 2022

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original instructions related to Form 8858, *Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs)* read:

Box 7. Form 8858 information. If the partnership filed one or more Forms 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs), check box 7 and attach the form(s) to Schedule K-2 and K-3.²¹

The revised instructions provide an exception to attaching the Form 8848 to Schedule K-3 in certain cases:

Box 7. Form 8858 information. If the partnership filed one or more Forms 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities (FDEs) and Foreign Branches (FBs), or if another person filed the Form(s) 8858 on behalf of the partnership, check box 7 and attach the form(s) to Schedule K-2. With respect to Schedule K-3, the partnership should check box 7 if the partnership checked box 7 on the Schedule K-2. The partnership need not attach Form 8858 to the Schedule K-3.²²

The original instructions related to Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations* read:

Box 8. Form 5471 information. If the partnership filed one or more Forms 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, check box 8 and attach the form(s) to Schedules K-2 and K-3.²³

The revised instructions now provide:

Box 8. Form 5471 information. If the partnership filed one or more Forms 5471, Information Return of U.S. Persons With Respect to Certain Foreign Corporations, or if another person filed the Form(s) 5471 on behalf of the partnership, or if the partnership received Form(s) 5471 as an attachment to a Schedule K-3 issued to the partnership, check box 8 and attach the form(s) to Schedules K-2 and K-3. The Form 5471 does not need to be attached to the Schedule K-3 if the partnership knows or has reason to know that its direct partner (and any indirect partners) does not need the information on Form 5471 to prepare its tax return. For example, the partnership would not need to attach the Form 5471 to Schedules K-3 for certain tax-exempt partners. A pass-through entity partner that receives a Form 5471 with

²¹ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 5

²² "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

²³ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 5

a Schedule K-3 must provide the Form 5471 to its partner unless the pass-through entity knows or has reason to know that its direct partner (and any indirect partners) does not need the information on the Form 5471 to prepare its tax return.²⁴

Changes are also made to other forms that must be attached. The original instructions provided:

Box 9. Other forms. If the partnership filed any other international tax forms, check box 9, and attach those form(s) to Schedules K-2 and K-3. This includes, but is not limited to, the following forms.

- Form 5713, International Boycott Report.
- Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).
- Form 8621.
- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.

See *Other Forms, Returns, and Statements That May Be Required* in the Instructions for Form 1065.

If the partnership has filed Form 8990, check box 9 and provide on Schedule K-1 the information needed to complete Form 8990, Schedule A for foreign partners which are required to report their distributive share of excess business interest expense, excess taxable income, and excess business interest income, if any, that is attributable to income effectively connected with a U.S. trade or business.²⁵

The revised line 9 instructions provide:

Box 9. Other forms. If the partnership filed any other international tax forms, or if another person filed these forms on behalf of the partnership, or if the partnership received these forms as an attachment to a Schedule K-3 issued to the partnership, check box 9, and attach those form(s) to Schedules K-2 and K-3. This includes, but is not limited to, the following forms.

- Form 5713, International Boycott Report.

²⁴ “Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065),” IRS Website, January 18, 2022

²⁵ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, pp. 5-6

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- Form 8833, Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b).
- Form 8621.
- Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.

Exception for Forms 8621 and 8865. With respect to Schedule K-3, the partnership should check box 9 if the partnership checked box 9 on the Schedule K-2. Solely with respect to the Forms 8621 and 8865, the partnership should indicate in an attachment to the Schedule K-3 that Forms 8621 and / or 8865 are attached to Schedule K-2. The partnership need not attach Forms 8621 and 8865 to the Schedule K-3.

Nevertheless, if the partnership did not file Schedule O (Form 8865), Transfer of Property to a Foreign Partnership (Under Section 6038B), containing all the information required under Regulations section 1.6038B-2, with respect to a transfer to a foreign partnership, the partnership must provide the necessary information for each partner to fulfill its reporting requirements under Regulations section 1.6038B-2.

See *Other Forms, Returns, and Statements That May Be Required* in the Instructions for Form 1065.

If the partnership has filed Form 8990, check box 9 and provide on Schedule K-1 the information needed to complete Form 8990, Schedule A for foreign partners which are required to report their distributive share of excess business interest expense, excess taxable income, and excess business interest income, if any, that is attributable to income effectively connected with a U.S. trade or business.

Note. If the partnership attached any of the forms to the Form 1065 identified in boxes 7, 8, and 9 in response to questions on Form 1065, the partnership need not attach those forms more than once.²⁶

The *Ernst & Young Tax Alert* summarizes these revisions as follows:

The IRS clarified that, in most instances, a partnership does not need to attach its international IRS forms to each partner's Schedule K-3. In those cases, the partnership should check the appropriate box on Schedule K-3, Part I, to indicate that it files those IRS forms with its Form 1065. If the partnership must file either Form 8865, *Return of*

²⁶ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

U.S. Persons With Respect to Certain Foreign Partnerships, or Form 8621, *Information Return by a Shareholder of a Passive Foreign Investment Company or Qualified Electing Fund*, the partnership must attach a separate statement indicating that the partnership has filed those forms with each partner's Schedule K-3.

Sometimes, however, IRS tax information reporting forms must be attached to a partner's Schedule K-3. If a partnership must file Form 5471, *Information Return of U.S. Persons With Respect to Certain Foreign Corporations*, but the partnership knows, or has reason to know, that a partner (and any indirect partners) does not need this information to prepare its tax return, the partnership is relieved of its obligation to attach the IRS Form 5471 to the Schedule K-3 (for example, the partnership would not need to attach the Form 5471 to Schedules K-3 for certain tax-exempt partners). Otherwise, the partnership must attach the Form 5471 to each partner's Schedule K-3.²⁷

Distributions From Foreign Corporations to Partnership

The instructions for Part V start with the following overall guidance in the original instructions:

Note. Certain partners will use the following information, in combination with other information known to the partners, including Form 5471, Schedule P, to exclude from gross income distributions to the extent that they are attributable to PTEP in their annual PTEP accounts and report foreign currency gain or loss with respect to the PTEP on Forms 1040 and 1120. If eligible, partners will also use this information to figure and claim a dividends received deduction under section 245A on Form 1120.

Use Part V of Schedule K-2 to report the distributions made by foreign corporations to the partnership.

Use Part V of Schedule K-3 to report the partner's share of the amounts reported on Part V of the Schedule K-2.²⁸

²⁷ "US IRS changes to instructions for 2021 partnership Schedules K-2 and K-3 are relevant to many partnerships, including private equity and private capital funds," *Ernst & Young Tax Alert*, January 27, 2022

²⁸ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 16

Two exceptions are added immediately following that section in the revised instructions:

Exception. Part V of the Schedule K-2 is not required to be completed with respect to distributions by a foreign corporation if the partnership knows that (i) none of the distributions by the foreign corporation are attributable to PTEP in annual PTEP accounts of any direct or indirect partner; and (ii) none of the partnership’s direct or indirect partners are eligible to claim a deduction under section 245A with respect to any distribution by the foreign corporation. Nevertheless, the partnership may be required to append Worksheet 3 to the Schedule K-2 (discussed below).

Exception. Part V of the Schedule K-3 for a partner does not need to be completed with respect to distributions by a foreign corporation if the partnership knows that (i) none of the distributions by the foreign corporation are attributable to PTEP in annual PTEP accounts of the partner or any U.S. person that is treated as indirectly owning stock of the foreign corporation through the partner (“relevant indirect partners”); and (ii) the partner and relevant indirect partners are not eligible to claim a deduction under section 245A with respect to any distributions by the foreign corporation. Nevertheless, the partnership may be required to append Worksheet 4 to the Schedule K-3 for the partner (discussed below). If this exception is applicable with respect to a foreign corporation, the sum of the amounts reported on Part V of the Schedules K-3 with respect to the foreign corporation may not equal the amounts reported on Part V of the Schedule K-2 with respect to the foreign corporation.²⁹

Information on Partners’ Section 951(a)(1) and Section 951A Inclusions

The portion of the instructions labeled as “Exception” are revised. In the original instructions the section read as follows:

Exception. Schedules K-2 and K-3, Part VI do not need to be completed with respect to a CFC if the partnership knows that it does not have a direct or indirect partner (through pass-through entities only) that is a U.S. shareholder of the CFC required to include in gross income a subpart F income inclusion and/or section 951(a)(1)(B)

²⁹ “Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065),” IRS Website, January 18, 2022

inclusion with respect to the CFC, or figure section 951A inclusions by taking into account GILTI items (defined below) of the CFC.³⁰

The revision reads as follows:

Exception. Part VI of Schedule K-2 does not need to be completed with respect to a CFC if the partnership knows that it does not have a direct or indirect partner (through pass-through entities only) that is a U.S. shareholder of the CFC required to include in gross income a subpart F income inclusion and/or section 951(a)(1)(B) inclusion with respect to the CFC, or figure section 951A inclusions by taking into account GILTI items (defined below) of the CFC.

Part VI of Schedule K-3 for a partner does not need to be completed with respect to a CFC if the partnership knows that (i) the partner is not a U.S. shareholder of the CFC required to include in gross income a subpart F income inclusion and/or section 951(a)(1)(B) inclusion with respect to the CFC, or figure section 951A inclusions by taking into account GILTI items (defined below) of the CFC; and (ii) no U.S. person that indirectly owns (through pass-through entities only) an interest in the CFC through the partner is a U.S. shareholder of the CFC required to include in gross income a subpart F income inclusion and/or section 951(a)(1)(B) inclusion with respect to the CFC, or figure section 951A inclusions by taking into account GILTI items (defined below) of the CFC. If the partnership does not complete Part VI of Schedule K-3 for a partner with respect to a CFC, the sum of each partner's share of the CFC's subpart F income, section 951(a)(1)(B) inclusion with respect to the CFC, and share of the CFC's GILTI items (defined below) reported on all Schedules K-3 may not equal the aggregate share of subpart F income of the CFC, the aggregate section 951(a)(1)(B) inclusion with respect to the CFC, and the aggregate share of the CFC's GILTI items (defined below), respectively, reported on the Schedule K-2.³¹

³⁰ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 17

³¹ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

Information to Complete Form 8621

The instructions for Part IV are changed at the beginning to add an additional paragraph. The original instructions for this Part began with the following two paragraphs:

Note. Partners will use the following information to complete Form 8621 and/or determine income inclusions with respect to the PFICs reported on Schedules K-2 and K-3, Part VII.

Except as otherwise provided, Schedules K-2 and K-3, Part VII must be filed by every partnership that owns PFIC stock, directly or indirectly, unless the partnership knows it has no direct or indirect partners that are U.S. persons, including U.S. persons that own an indirect interest in the partnership through one or more foreign entities. However, a domestic partnership that has elected to treat a PFIC as a pedigreed qualified electing fund (QEF), made a mark-to-market (MTM) election with respect to a PFIC applicable to the partnership's tax year, or made a qualifying insurance corporation (QIC) election with respect to a PFIC for the partnership's tax year is not required to complete Schedules K-2 and K-3, Part VII with information regarding such PFIC if the partnership files Form 8621 for that PFIC. Additionally, a domestic partnership that satisfies the deemed election requirements of Regulations section 1.1297-4(d)(5)(iv) with respect to a PFIC eligible for a QIC election is not required to complete Schedules K-2 and K-3, Part VII with respect to such PFIC.³²

The revision adds the following instructions:

Finally, a partnership is not required to complete Schedules K-2 and K-3, Part VII for a foreign corporation if the partnership knows that all of its direct and indirect partners that are U.S. persons are either: (i) not subject to the PFIC rules with respect to the corporation under section 1297(d) because they are subject to the subpart F rules with respect to the corporation; (ii) tax-exempt entities that are not subject to the PFIC rules with respect to the corporation under Regulations section 1.1291-1(e); or (iii) pass-through entities with no indirect U.S. taxable partners.³³

³² 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 19

³³ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

Partnership's Interest in Foreign Corporation Income (Section 960)

The instructions for Part VIII in the heading "Line 1 through 4"'s first paragraph is expanded to three paragraphs. Originally this paragraph read:

Line 1 through 4. The partnership's share of the CFC's net income in each of the subpart F income groups, tested income group, and residual income group by unit is reported on lines 1 through 4. The CFC has already figured its net income in each of these groups on Form 5471, Schedule Q, and the partnership need only report its share of such amount on Schedule K-2 and the partner's share of such amounts on Schedule K-3.³⁴

The revision expands those instructions to:

Line 1 through 4. The partnership's share of the CFC's net income in each of the subpart F income groups, tested income group, and residual income group by unit is reported on lines 1 through 4.

The CFC's net income and taxes in each of these groups is figured on Form 5471, Schedule Q, and the partnership need only report its share of the income on Schedule K-2 and the partner's share of such amounts on Schedule K-3. See the Instructions for Form 5471, Schedule Q, for the meaning of unit.

Note. If a partnership is reporting information with respect to a PFIC with a QEF inclusion on this Part VIII, attach a statement that includes all of the information on Form 5471, Schedule Q, with respect to the PFIC, including the functional currency of the PFIC. See section 1293(f) with respect to QEF inclusions from a PFIC.³⁵

The instructions for "Columns (i) and (ii)" are revised to add the following sentence:

Enter "US" for income sourced in the United States.³⁶

The instructions for "Line A" are revised as well. The original instructions provided:

Line A. On line A, enter the EIN or reference ID number of the CFC as listed on Form 5471. Do not enter "FOREIGNUS" or "APPLIED FOR." The partnership must check box 8 on Part I and attach to the

³⁴ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 22

³⁵ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

³⁶ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

Schedules K-2 and K-3 a Form 5471 for each CFC with respect to which it has a direct or indirect interest.³⁷

The revision reads:

Line A. On line A, enter the EIN or reference ID number of the CFC as listed on Form 5471. Do not enter "FOREIGNUS" or "APPLIED FOR." The partnership must check box 8 on Part I and attach to the Schedules K-2 and K-3 a Form 5471, page 1, and Schedule Q for each CFC with respect to which it has a direct or indirect interest. Form 5471, page 1, reports the functional currency of the CFC.³⁸

Changes Made to the 2021 Partner's Instructions for Schedule K-3 (Form 1065)

There are two changes made to the *2021 Partner's Instructions for Schedule K-3 (Form 1065)*³⁹ in the revision.

Part I. Partner's Share of Partnership's Other Current Year International Information

The instructions for Part I Box 7-9 is revised. The original instructions provided:

Items 7 through 9. The partnership will attach Form 5471; Form 8858; Form 8865; Form 5713, International Boycott Report; and other relevant international tax forms. If the partnership has filed Form 8990, Limitation on Business Interest Expense Under Section 163(j), the partnership will also provide on Schedule K-1 the information needed to complete Form 8990, Schedule A for foreign partners which are required to report their distributive share of excess business interest expense, excess taxable income, and excess business interest income, if any, that is attributable to income effectively connected with a U.S. trade or business.⁴⁰

The revision reads:

Boxes 7-9. If applicable, the partnership will attach Form 5471; Form 8858; Form 8865; Form 5713, International Boycott Report; and other relevant international tax forms. If the partnership has filed Form 8990, Limitation on Business Interest Expense Under Section

³⁷ 2021 Partnership Instructions for Schedules K-2 and K-3, August 26, 2021, p. 23

³⁸ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

³⁹ 2021 Partner's Instructions for Schedule K-3 (Form 1065), <https://www.irs.gov/pub/irs-pdf/i1065sk3.pdf> (retrieved January 29, 2022)

⁴⁰ 2021 Partner's Instructions for Schedule K-3 (Form 1065), p. 3

163(j), the partnership will also provide on Schedule K-1 the information needed to complete Form 8990, Schedule A for foreign partners which are required to report their distributive share of excess business interest expense, excess taxable income, and excess business interest income, if any, that is attributable to income effectively connected with a U.S. trade or business.⁴¹

The one change you'll note is that the instruction clarifies that these forms will only be attached if required.

Partner's Share of Partnership's Interest in Foreign Corporation Income (Section 960)

The instructions for Part VIII have the following paragraph added at the end of the instructions for the Part:

Note. If a partnership reported information with respect to a PFIC on this Part VIII, it attached a statement that includes all of the information on Form 5471, Schedule Q, with respect to the PFIC. See section 1293(f) with respect to QEF inclusions from a PFIC.⁴²

SECTION: 6011

AICPA RELEASES RESPONSE TO IRS ANNOUNCEMENT ON RELIEF FOR AUTOMATED NOTICES

Citation: "AICPA Comments on Recent IRS Statement: 'We Believe That There Is More They Can Do'," AICPA News Release, 1/27/22

The AICPA released what is, fundamentally, a critical response to the IRS statement on offering relief to taxpayers for automated notices,⁴³ stating "[t]he American Institute of CPAs (AICPA) believes this action is a positive first step, but believes that more should

⁴¹ "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

⁴² "Changes to the 2021 Partnership Instructions for Schedules K-2 and K-3 (Form 1065)," IRS Website, January 18, 2022

⁴³ Edward K. Zollars, CPA, "IRS Will Suspend the Mailing of Automated Notices About Taxpayers Not Filing a 2020 Return for Which the IRS Has a Payment," *Current Federal Tax Developments* website, January 27, 2022, <https://www.currentfederaltaxdevelopments.com/blog/2022/1/27/irs-will-suspend-the-mailing-of-automated-notices-about-taxpayers-not-filing-a-2020-return-for-which-the-irs-has-a-payment> (retrieved January 27, 2022)

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be and could be done by the IRS, without the need for congressional action, to reduce erroneous automated notices and unnecessary taxpayer contact with the Service.”⁴⁴

The Institute begins their release by noting the recent requests made to the IRS to provide significant relief to taxpayers regarding IRS notices and other burdens:

The AICPA joined a diverse group of stakeholders to form this Coalition representing Latinos, African Americans, small businesses, tax practitioners and low-income taxpayers in an effort to compel the IRS to take immediate action to meaningfully reduce unnecessary burdens for taxpayers and practitioners during this upcoming tax filing season. Twenty-five Members of the Senate, led by Senators Bob Menendez (D-NJ) and Bill Cassidy (R-LA), and 191 Members of the House, led by Representative Linda Sanchez (D-CA) also expressed their desire to see the IRS adopt the recommendations of the Coalition and reduce the strain on both taxpayers and on the agency.⁴⁵

The release then moves on to a statement made by AICPA President & CEO, Barry Melancon, CPA, CGMA:

“The actions taken today by the IRS signals their desire to help taxpayers, but we believe that there is more they can do and respectfully disagree with the IRS’s assertion that congressional action is needed to suspend the *automatic issuance of notices*,” said AICPA President & CEO, Barry Melancon, CPA, CGMA. “All of the recommendations put forth by the AICPA and the Coalition are actions that we believe the IRS can legally take right now to provide immediate relief to taxpayers – but we would welcome more details from the Commissioner on what he believes the IRS can do and what might require congressional action. Congress has demonstrated that it is more than ready to advocate for taxpayers and practitioners, and we are confident that lawmakers would act swiftly to assist. We appreciate the strain the IRS is under and continue to urge them to fully implement all of our recommendations to alleviate unnecessary stress on the agency and the taxpayers.”⁴⁶

⁴⁴ “AICPA Comments on Recent IRS Statement: ‘We Believe That There Is More They Can Do’,” AICPA News Release, January 27, 2022

⁴⁵ “AICPA Comments on Recent IRS Statement: ‘We Believe That There Is More They Can Do’,” AICPA News Release, January 27, 2022

⁴⁶ “AICPA Comments on Recent IRS Statement: ‘We Believe That There Is More They Can Do’,” AICPA News Release, January 27, 2022

The statement repeats the recommendations that had been made by the Tax Professionals United for Taxpayer Relief Coalition, a group the AICPA is a member of, recently:

Those recommendations submitted to the IRS are:

1. Discontinue automated compliance actions until the IRS is prepared to devote the necessary resources for a timely resolution – similar recommendation also included in the 2021 National Taxpayer Advocate report
2. Align requests for account holds with the time it takes the IRS to process any penalty abatement requests – similar recommendation also included in the 2021 National Taxpayer Advocate report
3. Offer a reasonable cause penalty waiver, similar to the procedures of first time abate administrative waiver
4. Provide taxpayers with targeted relief from the underpayment and the late payment penalty for the 2020 and 2021 tax year⁴⁷

SECTION: 6011

IRS WILL SUSPEND THE MAILING OF AUTOMATED NOTICES ABOUT TAXPAYERS NOT FILING A 2020 RETURN FOR WHICH THE IRS HAS A PAYMENT

Citation: “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, 1/27/22

The IRS has responded to growing pressure to provide some automated notice relief to taxpayers in a post to their website dated January 27, 2022.⁴⁸ The page provides a statement that both attempts to defend what the agency has done to date and provide information on actions being taken or that may be taken to reduce the automated notice issues that have drawn attention recently.

⁴⁷ “AICPA Comments on Recent IRS Statement: ‘We Believe That There Is More They Can Do’,” AICPA News Release, January 27, 2022

⁴⁸ “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, January 27, 2022 version, <https://www.irs.gov/newsroom/irs-statement-providing-meaningful-assistance-to-taxpayers-in-the-current-environment> (retrieved January 27, 2022)

The statement begins by describing the situation the IRS has faced:

The IRS entered this historic pandemic without the funding that it needs to serve the American people. As part of our ongoing efforts during the pandemic, and within these limited resources, the IRS has aggressively pursued every available option to better serve taxpayers this filing season. This includes, where appropriate and possible, requiring overtime by IRS employees, the redeployment of employees between functions, transfer of inventories among posts of duty, deployment of experienced surge teams – all aimed at returning our processing and correspondence inventories to a healthy level and improving our overall services to taxpayers and tax professionals. The IRS also developed and deployed important technology allowing employees to review and process tax returns filed with errors at many times the rate in the past. We are clearly not where we want to be at present. But our employees have been hard at work to develop innovative processes to expedite inventory reductions during the past year. Despite substantial progress thus far, another challenging filing season is ahead.⁴⁹

The statement then notes the IRS is looking to take various actions, including dealing with automated notices:

As part of this ongoing effort and balancing the importance of protecting the interests of tax administration, the IRS has also been taking important steps to modify our operations and provide additional taxpayer relief. These efforts include suspending issuance of certain automated notices and related actions. We are looking at the suggestions that have come in, and we will continue modify and adjust our efforts going forward to help taxpayers and the tax community.⁵⁰

The statement then provides information on relief that the IRS has begun providing—to stop issuing notices to taxpayers stating they have not filed a return while the IRS claims to hold a credit not applied to any return—a credit that, quite often, perfectly matches the check the taxpayer sent in with the return the agency claims they failed to file:

For example, we have already decided to suspend notices in situations where we have credited taxpayers for payments but have no record of the tax return being filed. In many situations, the tax return may be part of our current paper tax inventory and simply hasn't been

⁴⁹ “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, January 27, 2022 version

⁵⁰ “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, January 27, 2022 version

processed. Stopping these letters — which could have otherwise been sent to thousands of taxpayers — will help avoid confusion.⁵¹

But the agency then goes on to explain why other notices will likely continue to be issued, first arguing some notices must go out by a certain date per the statute:

It is important to appreciate that many IRS notices are statutorily required to be issued within a certain timeframe to be legally valid. This means they must be sent, absent congressional action.⁵²

The agency then indicates it is looking at other notices, but then argues that issues with its IT systems will get in the way of providing rapid relief:

We will continue to explore areas where the IRS can make changes and are in the process of reviewing the full set of notices that we send to determine where we can make adjustments while we continue to work through unprocessed returns and taxpayer correspondence.

Making significant operational changes to our systems, including stopping certain notices from being printed and mailed, may require programming and other operational changes. With an outdated technological ecosystem, these are changes that cannot be made as efficiently as they should be — and that is part of the reason why investing in IRS IT modernization is so important. While we will make every effort to find improvements to help taxpayers, we will have to do so in the constraints of an outdated system, where a seemingly simple modification could run the risk of jeopardizing the overall operating system critical to the current tax season — and the more than 160 million returns we anticipate receiving.⁵³

The statement then concludes by indicating that the agency is working on additional changes:

The IRS is continuing to assess other changes and system modifications it may be able to implement to assist taxpayers on an array of issues. We will continue to make information available to taxpayers throughout the filing season.⁵⁴

⁵¹ “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, January 27, 2022 version

⁵² “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, January 27, 2022 version

⁵³ “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, January 27, 2022 version

⁵⁴ “IRS Statement — Providing meaningful assistance to taxpayers in the current environment,” IRS website, January 27, 2022 version

