

INSIGHTS FROM THE BDO ASSET MANAGEMENT PRACTICE

Final Schedule K-2 and K-3 Instructions Provide Limited Relief for Investment Partnerships

By Joe Pacello

We are now into the second year of the requirement for most partnerships to file Schedules K-2 and K-3, and the compliance challenges continue. Note that the penalty relief in Notice 2021-39 was transitional and only applied for tax year 2021, raising the stakes for 2022 and subsequent years.

BACKGROUND

Schedules K-2 and K-3 report items of international relevance. Schedule K-3 is provided to partners along with their Schedule K-1. The final instructions for the 2022 tax year provide some relief but the K-3 process will continue to be a significant compliance challenge for hedge funds and other investment partnerships. Fund managers can leverage off the foundation they laid in 2021, the initial year of compliance with these requirements, but should consult with their tax advisors to ensure proper reporting given the increased penalty risk.

DOMESTIC FILING EXCEPTION

The final 2022 instructions to Schedules K-2 and K-3 contain a "domestic filing exception" for certain domestic partnerships that have no -- or limited-- foreign activities, and that meet other restrictions related to the types of partners they have and notification requirements. [Partnerships meeting this exception are not required to file Schedules K-2 and K-3.](#)

Importantly, if any partners are themselves partnerships, the domestic filing exception is not available to an investment partnership. Since investment partnerships typically have a general partner that is an LLC or limited partnership entity, this would disqualify them from relying on the exception, regardless of whether they have little or no foreign activities. Note that typical master-feeder funds would also be automatically disqualified due to their tiered partnership structure and the fact that the master fund is foreign.

The domestic filing exception may be available for some general partner entities and management companies. For example, if the members are all domestic individuals and the other requirements are met, the exception may apply.

STREAMLINED FOREIGN CAPITAL GAINS REPORTING

The final instructions include relief from some of the detailed reporting requirements for foreign capital gains. For 2022, high-volume trading partnerships such as hedge funds can combine stock sales by country, instead of reporting each individual transaction. Funds can also simply report the amount of short-term and long-term gains, instead of reporting proceeds, basis and transaction dates for each sale.

CONCLUSION

While the IRS has provided welcome relief from some of the onerous K-3 reporting requirements, the process will continue to be challenging and time-consuming for fund managers. It is therefore critical to coordinate and plan with tax preparers to provide Schedules K-3 to investors in a timely manner.

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