

LB&I International Practice Service Transaction Unit

IPS Level	Number	Title	UIL Code	Number
Shelf	N/A	Individual Outbound	–	–
Volume	12	Pass-Through Entities	Level 1 UIL	9434
Part	12.1	Partnerships	Level 2 UIL	9434.01
Chapter	12.1.1	Taxability of Income from Foreign Partnerships	Level 3 UIL	9434.01-01
Sub-Chapter	12.1.1.1	Foreign Partnership - Taxation	–	–

Unit Name	Foreign Partnership – Taxation
------------------	--------------------------------

Document Control Number (DCN)	FEN/9434.01_08(2015)(a)
Date of Last Update	6/04/15

Table of Contents

(View this PowerPoint in “Presentation View” to click on the links below)

General Overview

- [Issue and Transaction Overview](#)

[Summary of Potential Issues](#)

[Audit Steps](#)

[Training and Additional Resources](#)

[Glossary of Terms and Acronyms](#)

[Index of Related Issues](#)

Issue and Transaction Overview

Foreign Partnership - Taxation

A United States Person (USP) that owns an interest in a Foreign Partnership (FP) is required to report their share of the partnership's distributive items. This IPS Unit will cover methods to identify whether a USP owns an interest in a FP. The FP may be required to file a Form 1065, *U.S. Return of Partnership Income* and thus provide its partners Forms 1065, (Schedule K-1) - *Partner's Share of Current Year Income, Deductions, Credits and Other Items*. If not, there may be indications on your USP's return that the USP owns an interest in a FP. This IPS Unit will detail audit steps to take if your USP reports an ownership interest in a FP and steps to take if the USP is required, but fails to report its ownership interest in a FP.

Form 1065 is an information return used to report the partnership's items of income, gains, losses, deductions, credits, etc. A partnership does not pay tax on its income but "passes through" these items to its partners. Like domestic partnerships, foreign partnerships are bound by the rules of Subchapter K (IRC §§701 through 777). This IPS Unit will explain when a FP is required to file a Form 1065.

As part of the package audit requirements of related returns, examiners should consider whether the FP meets the definition of a related return, and if so, whether the FP filed, or was required to file, a Form 1065.

A USP that owns an interest in a FP may be required to attach to its Form 1040 a Form 8865, *Return of U.S. Persons With Respect to Certain Foreign Partnerships* to report the activities of the FP. The USP's acquisition, disposition, and changes of interest in a FP, as well as transfers of property to a FP are reported on Form 8865. This IPS Unit will discuss how to use the information contained in a filed Form 8865 and any accompanying schedules in your examination. In addition, this IPS Unit covers the audit steps to take where the USP owns an interest in a FP but does not have a Form 8865 filing requirement.

The Form 8865 filing requirements and penalties associated with the failure to file the form are covered in other IPS Units.

Issue and Transaction Overview (cont'd)

Foreign Partnership - Taxation

Form 8938, *Statement of Specified Foreign Financial Assets*, is filed by certain USPs to report their interest in the FP. Form 8938 is filed with the USP's Form 1040. Reporting is required if the aggregate value of the USP's specified foreign financial assets exceeds a reporting threshold. This threshold varies based on whether the USP files a joint tax return or resides abroad. Simplified reporting on Form 8938 is provided with respect to interests in FPs also reported on Form 8865. Note: an interest in a FP not required to be reported on Form 8865 will be reported on Form 8938, provided the USP satisfies the Form 8938 filing thresholds.

Reporting on Form 8938 is governed by IRC §6038D. Penalties may apply for failure to file Form 8938 as well as extend the statute-of-limitations on then USP's return.

Unless an exception applies, the following individuals are required to file Form 8938 to report their interest in a FP:

- A U.S Citizen
- A resident alien of the United States for any part of the tax year
- A nonresident alien who makes an election to be treated as a resident alien for purposes of filing a joint income tax return
- A nonresident alien who is a bona fide resident of American Samoa or Puerto Rico.

Domestic entities (corporations, trusts and partnerships) are not yet required to file Form 8938 to report interests in FPs or other specified foreign financial assets.

Finally, this IPS Unit covers the books and records that can be requested from the USP to verify the USP's distributive share of items that flow through from the FP when the FP has not filed a Form 1065. Specifically, this Unit will address the use of Form 4564, *Information Document Request (IDR)* and, if necessary, a Formal Document Request (FDR) to secure information from the USP.

Summary of Potential Issues

Foreign Partnership - Taxation

[Issue 1](#)

How to identify whether a USP owns an interest in a Foreign Partnership.

[Issue 2](#)

Does the FP, in which my USP owns an interest, have a Form 1065 filing requirement?

[Issue 3](#)

What audit steps should be taken if the USP has filed a Form 8865?

[Issue 4](#)

What audit steps should be taken if a USP holds an interest in a FP but was not required to file Form 8865?

All Issues, Step 1: Initial Factual Development

Foreign Partnership - Taxation

The first step in his process is to determine whether the USP owns an interest in a FP. The USP may have disclosed their ownership interest in a FP on their return or an agent may discover the ownership interest during the course of the examination. Below are documents and information to review to determine whether the USP owns an interest in a FP

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ First, review the Form 1040 for indications that your USP has an interest in a FP. The FP ownership information may be disclosed on the return on Schedule E or other areas of the return. This information should be used to develop your initial IDR and tailoring questions for the Initial Interview of the USP. 	<ul style="list-style-type: none"> ▪ Form 1040 and all attached Schedules (including Schedule E, Supplemental Income and Loss), Information Returns ▪ Form 8865, Form 8938, and Statements 	
<ul style="list-style-type: none"> ▪ Second, additional indications that your USP has an interest in a FP can be identified during the interview, review of the books and records or by requesting documents regarding all partnerships. 		

Issue 1, Step 2: Review Potential Issues

Foreign Partnership - Taxation

Issue 1

How to identify whether a USP owns an interest in a Foreign Partnership.

Fact Element	Resources	6103 Protected Resources
<p>It is important to look for indications of interests in a FP during your examination. Pre-plan to properly develop your initial IDR, tailor your Initial Interview questions to the USP, and identify related returns as part of your package audit. Required filing checks are necessary to ensure voluntary compliance. Agents should determine that Taxpayers (TPs) are in compliance with all federal tax return filing requirements and that all returns are substantially correct.</p> <p>The next slides will discuss areas on the Form 1040 where indications your USP owns an interest in a FP may be found, as well as research options such as IDRS and FinCEN Query. There will be a discussion on questions to ask the USP during the Initial Interview, and areas to focus on during your review of books and records where indications of an ownership interest in a FP may be identified.</p>	<ul style="list-style-type: none">▪ IRM 4.10.5.4 – Related Returns▪ Integrated Data Retrieval System (IDRS)▪ FinCEN Query .	

Issue 1, Step 3: Additional Factual Development

Foreign Partnership - Taxation

Issue 1

How to identify whether a USP owns an interest in a Foreign Partnership

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ During the Pre-Plan of a Form 1040 examination, the agent identifies a FP listed on Schedule E, Part II, <i>Income or Loss From Partnerships and S Corporations</i>, or an entity without an Employer Identification Number (EIN) listed. No EIN reported for an entity is a possible indicator of a foreign entity. Also an agent should review Schedule B, <i>Interest and Ordinary Dividends</i>, Form 4797, <i>Sales of Business Property</i>, Form 8949, <i>Sales and other Dispositions of Capital Assets</i>, which supports Schedule D, <i>Capital Gains and Losses</i> for indications of a FP. Information from a FP may be reported on these forms even if nothing is reported on Schedule E. 	<ul style="list-style-type: none"> ▪ Form 1040, attached Schedule E, and all attached statements ▪ Form 4797 ▪ Form 8949 ▪ Form 1040, Schedule B ▪ Form 1040, Schedule D 	
<ul style="list-style-type: none"> ▪ Research FinCEN Query for any and all FBARs filed by the USP. Review the FBARs for any foreign entities listed where the USP has signature authority over the foreign entity's bank account. 	<ul style="list-style-type: none"> ▪ FinCEN Query 	

Issue 1, Step 3: Additional Factual Development (cont'd)

Foreign Partnership - Taxation

Issue 1

How to identify whether a USP owns an interest in a Foreign Partnership

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Research Integrated Data Retrieval System (IDRS) for related entities and Form 1065 filed by FP as part of your package audit. ▪ yK1 Link Analysis Tool may show a link between the USP and Form 1065s filed by FPs. 	<ul style="list-style-type: none"> ▪ Integrated Data Retrieval System ▪ yK1 Link Analysis Tool ▪ IRM 4.10.5.4 – Related Returns 	
<ul style="list-style-type: none"> ▪ Research Accurint and the World Wide Web (Internet) for your USP for indications of an ownership interest in a FP. 	<ul style="list-style-type: none"> ▪ Accurint 	
<ul style="list-style-type: none"> ▪ During the Initial Interview, ask the USP if they have an interest or ownership in any foreign entities, such as partnerships, corporations, trusts, private equity funds, and joint ventures. 	<ul style="list-style-type: none"> ▪ IRM 4.10.4.3.2(2) – Minimum Income Probes – (Nonbusiness Returns) ▪ IRM 4.10.5.4.2 – Initial Interview 	

Issue 1, Step 3: Additional Factual Development (cont'd)

Foreign Partnership - Taxation

Issue 1

How to identify whether a USP owns an interest in a Foreign Partnership


Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ If the USP confirms they own an interest in a FP, then follow up with questions to determine the USP's ownership percentage in the FP. This information is required to determine whether the USP is required to File a Form 8865. ▪ Second, ask the USP what the maximum value of the partnership interest was during the year. Also ask if they held other assets required to be reported on Form 8938 and the value of those assets. This information is necessary to determine if the USP is required to file Form 8938. 	<ul style="list-style-type: none"> ▪ IRC 6038 ▪ Form 8865 ▪ Form 8865 Instructions ▪ Form 8938 ▪ Form 8938 Instructions ▪ IRC 6038D 	
<ul style="list-style-type: none"> ▪ Review the books and records for transactions between the USP's domestic entities and foreign entities. # [REDACTED] 	<ul style="list-style-type: none"> ▪ IRM 4.10.3.5 – Examination of the taxpayer's books and records 	
<ul style="list-style-type: none"> ▪ [REDACTED] # 	<ul style="list-style-type: none"> ▪ IRM 4.10.4.3.2.1 – Nonbusiness Returns Examination of Bank Records ▪ IRM 4.10.4.3.3.7 – Bank Account Analysis (Individual Business Returns) 	

Issue 1, Step 4: Develop Arguments

Foreign Partnership - Taxation

Issue 1

How to identify whether a USP owns an interest in a Foreign Partnership.

Fact Element	Resources	6103 Protected Resources
 <p>DECISION POINT: At this point in the examination if, USP owns interest in FP: The USP disclosed a FP ownership on Form 1040 or if it has been determined that the USP owns an interest in a FP. Determine whether the FP is indeed a partnership for U.S. tax purposes (Refer to the IPS Unit entitled “Check-the-Box Rules for Foreign Entities.”)</p> <ul style="list-style-type: none"> ▪ FP has filed Form 1065: Follow the same procedures during the examination that you would follow when you are auditing a taxpayer who received a K-1 from a domestic partnership. ▪ Form 8865 is attached to Form 1040: Go to Issue #3 for audit considerations. 	<ul style="list-style-type: none"> ▪ Practice Unit, “Check-the-Box Rules for Foreign Entities”, DCN: FEN/9433.01_TBD ▪ Treas. Reg. 301.7701-1 through 301.7701-3 ▪ Treas. Reg.301.7701-1 ▪ Treas. Reg.301.7701-2 ▪ Treas. Reg.301.7701-3 ▪ Issue 3 	

Issue 1, Step 4: Develop Arguments (cont'd)

Foreign Partnership - Taxation

Issue 1

How to identify whether a USP owns an interest in a Foreign Partnership.

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Not sure whether Form 8865 is required to be filed by your USP? See the IPS Unit entitled “Failure to File Form 8865 – Category 1 and 2 Filers – Monetary Penalty” which covers the filing requirements for Form 8865 and penalties associated with failure to file Form 8865. ▪ USP owns interest in FP, USP does not have a Form 8865 filing requirement, and FP does not have Form 1065 filing requirement: Refer to Issue #4 for audit considerations. 	<ul style="list-style-type: none"> • Practice Unit, “Failure to File Form 8865 – Category 1 and 2 Filers – Monetary Penalty,” DCN :FEN/9434.01_10 • “Failure to File Form 8865 – Category 3 Filer – Monetary Penalty” DCN: FEN/9434.01_TBD ▪ Practice Unit, “Failure to File Form 8865 – Category 4 Filer – Monetary Penalty” DCN: FEN/9434.01_TBD ▪ Issue 4 	

Issue 2, Step 2: Review Potential Issues

Foreign Partnership - Taxation

Issue 2

Does the Foreign Partnership, in which my USP owns an interest, have a Form 1065 filing requirement?

Fact Element	Resources	6103 Protected Resources
<p>Related Return - Required Filing Checks</p> <p>Related income tax returns are part of the Package Audit requirements per the Internal Revenue Manual (IRM). A FP could meet the definition of a “related return” per IRM 4.10.5.4 and, therefore, the examiner must determine whether the FP was required to file a Form 1065 as part of the package audit.</p> <p>Definition of Foreign Partnership:</p> <p>In general, a partnership is the relationship between two or more persons (or other entities) who join together to carry on a trade or business. IRC §7701 defines a domestic partnership as a partnership that is created or organized in the U.S. or under the laws of the U.S. or of any State. A FP is a partnership that is not domestic.</p>	<ul style="list-style-type: none"> ▪ IRM 4.10.5.4 – Related Returns ▪ IRC 6031 ▪ Treas. Reg. 1.6031(a)-1 ▪ IRC 7701(a)(2) ▪ IRC 7701(a)(5) 	

Issue 2, Step 2: Review Potential Issues (cont'd)

Foreign Partnership - Taxation

Issue 2

Does the Foreign Partnership, in which my USP owns an interest, have a Form 1065 filing requirement?

Fact Element	Resources	6103 Protected Resources
<p>Foreign Partnership Filing Requirements: Generally, a FP is required to file a Form 1065 if it has either:</p> <ul style="list-style-type: none"> ▪ Gross income derived from sources within the United States, such as interest, dividends, rents and royalties or ▪ Gross income which is effectively connected with the conduct of a trade or business within the United States. <p>Exception: A return is not required if: The partnership had no ECI during its tax year, had U.S.-source income of \$20,000 or less, less than 1% in the aggregate of any items of gain, income, loss, deduction or credit allocated in the aggregate to direct USPs, and is not a withholding foreign partnership as defined in Treas. Reg. §1.1441-5(c)(2)(i).</p>	<ul style="list-style-type: none"> ▪ IRC 6031 ▪ Treas. Reg. 1.6031(a)-1(b) ▪ Treas. Reg. 1.6031(a)-1(b) 	

Issue 2, Step 2: Review Potential Issues (cont'd)

Foreign Partnership - Taxation

Issue 2

Does the Foreign Partnership, in which my USP owns an interest, have a Form 1065 filing requirement?

Fact Element	Resources	6103 Protected Resources
<p>Return Due Date:</p> <p>Generally, partnership returns are due on the 15th day of the fourth month following the close of the partnership's taxable year. If its books and records are located outside of the U.S., a FP has an automatic extension of time to file to the 15th day of the 6th month following the close of its taxable year. The FP may request a further extension until the 15th day of the 9th month following the close of its taxable year.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.1441-5(c)(2)(i) ▪ Treas. Reg. 1.6081-5 	

Issue 2, Step 3: Additional Factual Development

Foreign Partnership - Taxation

Issue 2

Does the Foreign Partnership, in which my USP owns an interest, have a Form 1065 filing requirement?

Fact Element	Resources	6103 Protected Resources
<p>Related Returns Package Audit</p> <ul style="list-style-type: none"> ▪ What issues can be identified by reviewing the FP's filed Form 1065? Questions that need to be answered to address issues would include, but are not limited to: ▪ What does the FP do? Does the FP have any U.S. business activity? These questions will identify whether the FP has Effectively Connected Income (ECI). ▪ Is the FP's income generated in the U.S. or in a foreign country? This question will identify where the income should be sourced. ▪ Is the FP involved in real estate or rental activity? If so, passive activity rules may apply. In addition, a disposition of a U.S. real property interest would cause ECI resulting in a Form 1065 filing requirement. ▪ Research IDRS for Form 1065- MFT 06 to confirm whether a return has been filed. 	<ul style="list-style-type: none"> ▪ IRM 4.10.5.4 – Related Returns ▪ Use Command Code NAMEE for EIN research ▪ Use Command Code BRTVUE for preliminary research of filed Form 1065 	

Issue 2, Step 3: Additional Factual Development (cont'd)

Foreign Partnership - Taxation

Issue 2

Does the Foreign Partnership, in which my USP owns an interest, have a Form 1065 filing requirement?




Fact Element	Resources	6103 Protected Resources
<p>Related Returns Package Audit – Filed Form 1065</p> <ul style="list-style-type: none"> ▪ # [REDACTED] # Ask, “What does the FP do (to determine whether it has ECI)?” and “Where does the FP do business or derive its income not connected to its trade or business (to investigate sourcing of income)?” ▪ Review the required Schedule K and attached Schedules K-1. Research domestic and foreign partners on IDRS to insure they have reported the income. ▪ Has the USP reported the correct amount of their share of the FP’s distributive items? 	<ul style="list-style-type: none"> ▪ IRM 4.10.5.4 – Related Returns 	
<ul style="list-style-type: none"> ▪ Who are the other partners? Are they foreign or domestic? Have the foreign partners filed U.S. tax returns to report their U.S.-sourced income from the FP? Have U.S. partners reported their worldwide income from the FP? These questions are necessary to complete the package audit. 	<ul style="list-style-type: none"> ▪ IRM 4.10.5.4 – Related Returns 	

Issue 2, Step 4: Develop Arguments

Foreign Partnership - Taxation

Issue 2

Does the Foreign Partnership, in which my USP owns an interest, have a Form 1065 filing requirement?


Fact Element	Resources	6103 Protected Resources
<p> DECISION POINT: Based on the evidence, determine whether or not the FP has a U.S. filing requirement. If it does, verify the FP filed the required Form 1065. To determine whether the FP is indeed a partnership for U.S. tax purposes, refer to the IPS unit entitled “Check-the-Box Rules for Foreign Entities” for assistance in this determination.</p> <ul style="list-style-type: none"> ▪ Foreign Partnership: If the research indicates the FP has not filed a Form 1065 and there are indications the FP has a filing requirement, consider expanding the examination to include the delinquent Form 1065. See Consultation below. <p> CAUTION: A Form 1065 with more than 10 partners, a nonresident alien or partnership that is a partner is automatically a TEFRA (Tax Equity and Fiscal Responsibility Act of 1982) partnership, and you must follow TEFRA procedures (refer to IRM 4.31 and IRC §6231). If a partner is a grantor trust that is deemed to be a pass-through entity, or a single member LLC treated as a disregarded entity, it would also be considered a TEFRA partnership</p>	<ul style="list-style-type: none"> ▪ Practice Unit, “Check-the-Box Rules for Foreign Entities” DCN: FEN/9433.01_TBD ▪ tefra.web.irs.gov ▪ Pass-Through Entity Handbook, TEFRA Examinations - Field Office Procedures IRM 4.31.2 ▪ IRC 6231(a)(1) ▪ Rev. Rul. 2004-88 	
<p> CONSULTATION: Consult with your manager to expand the audit to include the delinquent Form 1065 and any partner that has a filing requirement and has not filed or correctly reported their FP’s distributive share of FP items.</p>		

Issue 3, Step 2: Review Potential Issues

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

Fact Element	Resources	6103 Protected Resources
<p>Review of the Form 8865:</p> <p>Refer to IPS Units, “Failure to File Form 8865 – Category 1 and 2 Filers – Monetary Penalty” and “Failure to File Form 8865 – Category 3 and 4 Filers – Monetary Penalty” for information on who is required to file Form 8865.</p> <p>This next section will address the audit issues to consider when the Form 8865 is attached to the USP’s tax return, or if the USP files the Form 8865 during the examination.</p> <p>Did the FP file a Form 1065?</p> <p>One of the first items to review on a Form 8865 is Box G2 (on Page 1), which indicates whether the FP must file a Form 1065.</p> <p>If the FP filed a Form 1065, then your review will be similar to the review of a Schedule K-1 from a domestic partnership.</p> <p> DECISION POINT: Review the Form 1065, if it warrants examination, discuss the matter with your manager to determine if the Form 1065 should be examined.</p>	<ul style="list-style-type: none"> ▪ Form 8865 Instructions ▪ IRC 6038, IRC 6038B ▪ IRC 6046A ▪ Practice Unit, “Failure to File Form 8865 – Category 1 and 2 Filers – Monetary Penalty” DCN: FEN/9434.01_10 • Practice Unit, “Failure to File Form 8865 – Category 3 Filers – Monetary Penalty” DCN: FEN/9434.01_TBD • Practice Unit, “Failure to File Form 8865 – Category 4 Filers – Monetary Penalty” DCN: FEN:9434.01_TBD 	

Issue 3, Step 2: Review Potential Issues (cont'd)

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

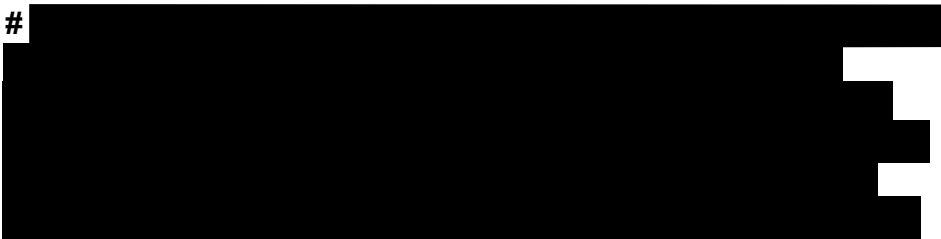

Fact Element	Resources	6103 Protected Resources
<p>Form 8865 – General Information</p> <p>There are 4 basic Categories of Filers, and based on the particular category, the USP would be required to attach certain schedules to the Form 8865. The instructions to Form 8865 contain a chart that indicates which schedules are required to be filed for each category of filers. Review all attached schedules for potential audit issues. Depending on the schedules attached, some areas to consider are as follows: (Note: this list is not all inclusive.)</p> <p>Review Form 8865 - Page 1</p> <ul style="list-style-type: none"> ▪ Section F - Entity information about the partnership, such as principle business activity, where it conducts business and the country in which the entity was organized. # [REDACTED] ▪ [REDACTED] # ▪ Section G – Line 2 – Indicates whether the partnership must file a Form 1065. ▪ # [REDACTED] ▪ [REDACTED] # 	<ul style="list-style-type: none"> ▪ Form 8865 Instructions ▪ Form 8865 and all attached statements filed by USP ▪ IRC 704 	

Issue 3, Step 2: Review Potential Issues (cont'd)

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

Fact Element	Resources	6103 Protected Resources
<p>Review of Form 8865</p> <p>Schedule A – Check which box is marked to determine whether your USP has (a) direct or (b) constructive ownership in the FP. This section may also indicate other related possible returns to consider during the examination.</p> <p># </p> <p># </p> <p>Schedule K – This is a summary schedule of a partners' share of partnership income, expenses, credits, etc. It is similar to the Schedule K of Form 1065.</p>	<ul style="list-style-type: none"> ▪ Form 8865 and all attached statements filed by USP ▪ Form 8865 Instructions 	

Issue 3, Step 2: Review Potential Issues (cont'd)

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

Fact Element	Resources	6103 Protected Resources
<p>Schedule K-1 – This is the USP that filed the Form 8865's share of partnership income, deductions, credits, etc. This is similar to a K-1 that a partner receives from a US partnership. You should verify the items on the K-1 are reported on the USP's income tax return. If partnership reported losses, consider issues such as basis limitation, at risk, and passive losses.</p> <p># [REDACTED] #</p> <p>Schedule N – Review the FP's related party transactions for any arm's-length transaction issues.</p>	<ul style="list-style-type: none"> ▪ IRC 469 ▪ IRC 465 	

Issue 3, Step 2: Review Potential Issues (cont'd)

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

Fact Element	Resources	6103 Protected Resources
<p>Form 8938 – Statement of Specified Foreign Financial Assets</p> <p>For taxable years starting in 2011, if a USP individual is required to file a Form 8938, an interest in a FP would be required to be disclosed in Part II of the Form 8938. Note: The filing requirements for the Form 8938 are beyond the scope of this practice unit.</p> <p>A USP individual who reports a FP interest on Form 8865 does not also report the partnership interest in Part II of the Form 8938. Instead, the USP should indicate in Part IV of the Form 8938 how many Forms 8865 the USP filed for the year. A USP's distributive share of partnership income from a partnership reported on Form 8865 is not shown in Part III of the Form 8938.</p>	<ul style="list-style-type: none"> ▪ Form 8938 ▪ Form 8938 Instructions 	

Issue 3, Step 3: Additional Factual Development

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Form 8865 Schedule O - Must be filed by a USP to report the transfer of property to a FP as an IRC §721 contribution in exchange for an interest in the FP. Schedule O is required if, immediately after the contribution, the person owns (directly, indirectly, or by attribution) at least a 10% interest in the FP <u>OR</u> the value of the property contributed during a 12-month period exceeds \$100,000. 	<ul style="list-style-type: none"> ▪ IRC 6038B ▪ Practice Unit, “Failure to File Form 8865 – Category 3 Filer – Monetary Penalty” DCN: FEN/9434.01_TBD ▪ IRC 721 	
<ul style="list-style-type: none"> ▪ Form 8865 Schedule P - Must be filed by a USP who acquires or disposes of an interest in a FP, or whose proportional direct interest in a FP changed substantially. Schedule P is required if the USP’s direct interest in the FP increases to more than a 10% interest, decreases to less than 10% interest or changes by 10%. For example, a change from 20% to 30% or from 30% to 20% would require reporting. 	<ul style="list-style-type: none"> ▪ IRC 6046A ▪ Practice Unit, “Failure to File Form 8865 – Category 4 Filer – Monetary Penalty” DCN: FEN/9434.01_TBD 	

Issue 3, Step 3: Additional Factual Development (cont'd)

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?


Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Form 8865 - Schedule O -. What are the possible issues? Confirm what type of property was transferred and verify the transaction in the USP's books and records to substantiate the amount and date reported on Schedule O. 	<ul style="list-style-type: none"> ▪ Form 8865 Schedule O ▪ Pracice Unit, "Failure to File Form 8865 – Category 3 – Monetary Penalty," DCN: FEN/9434.01_TBD 	
<ul style="list-style-type: none"> ▪ Form 8865 – Schedule P - Is the change of interest in the FP properly reported? Look for this transaction in the USP's books and records. How is the transaction reflected on the return? Is it on Form 8949, which supports Schedule D? Is it on Form 4797? Are the basis and gain or loss accurately reflected? 	<ul style="list-style-type: none"> ▪ Form 8865 Schedule P ▪ Practice Unit, "Failure to File Form 8865 – Category 4 – Monetary Penalty," DCN: FEN/9434.01_TBD 	
<ul style="list-style-type: none"> ▪ # [REDACTED] # You can request the FP's books and records to verify amounts reported on the Form 8865. 	<ul style="list-style-type: none"> ▪ See Issue 4 Step 3 	

Issue 3, Step 4: Develop Arguments

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

Fact Element	Resources	6103 Protected Resources
 <p>DECISION POINT: If the USP did not properly report its distributive share of the partnership items (income, loss, credit, etc.) from the FP, then adjustments should be made accordingly.</p> <p>A USP's distributive share of a FP's partnership items falls under the same rules of Subchapter K as if the USP were a partner in a domestic partnership. Use the Form 8865 Schedule K-1 (if one was required to be filed) to ensure that your USP has reported the correct amounts of their distributive share items. Review Schedule N for any transactions with related parties that may not be at arms' length and could warrant further examination.</p> <p>Failure to comply with the reporting requirement under IRC §6038B (Schedule O) will incur a penalty under IRC §6038B(c)(1).</p>	<ul style="list-style-type: none"> ▪ Form 8865 attached to Form 1040 filed by the USP ▪ Practice Unit, "Failure to File Form 8865 – Category 1 and 2 Filers – Monetary Penalty," DCN: FEN9434.01_10 ▪ Practice Unit, "Failure to File Form 8865 – Category 3 Filer – Monetary Penalty," DCN: FEN/9434.01_TBD ▪ Practice Unit, "Failure to File Form 8865 – Category 4 Filer – Monetary Penalty" DCN:FEN/9434.01_TBD 	

Issue 3, Step 4: Develop Arguments (cont'd)

Foreign Partnership - Taxation

Issue 3

What audit steps should be taken if the USP has filed a Form 8865?

Fact Element	Resources	6103 Protected Resources
<p>Subchapter K rules are beyond the scope of this IPS unit. However, some items to consider are:</p> <ul style="list-style-type: none"> ▪ Has the USP reported capital gains and/or ordinary income (from “hot assets”) from dispositions of interests in the FP? ▪ Has the USP reported a loss from the FP, and if so, has the USP properly followed the basis limitation, passive activity loss and at-risk rules? ▪ Failure to comply with the reporting requirement under IRC §6046A (Schedule P) will incur a penalty under IRC §6679 with a continuation penalty. 	<ul style="list-style-type: none"> ▪ IRM 4.10.4.3.2 – Minimum Income Probes: Nonbusiness Returns ▪ IRC 751 ▪ IRC 469 & IRC 465 ▪ IRC 704(d), IRC 862 	

Issue 4, Step 2: Review Potential Issues

Foreign Partnership - Taxation

Issue 4

What audit steps should be taken if a USP owns an interest in a Foreign Partnership but was not required to file Form 8865?

Fact Element	Resources	6103 Protected Resources
<p>You have reviewed the USP's Form 1040 and interviewed the USP. Upon review of the Form 1040, a Form 8865 was not attached, but during the initial interview, the USP indicated they have an interest in a FP. You have determined the following: the USP did not meet the ownership threshold or engage in any transactions that would require a Form 8865, and the FP did not file a Form 1065. In this case, review the return to determine if the USP properly reported their distributed share of FP items.</p> <p>Did the USP correctly report their Distributive Share Items from the FP?</p> <p>Even though the USP is not required to file a Form 8865, and the FP may not have provided the USP a K-1, the USP is still required to report their distributive share items from the FP and any gains or losses from dispositions. How do you verify the USP's distributive share items of the FP when Information Returns Processing (IRP) information does not exist?</p>	<ul style="list-style-type: none"> ▪ Schedule E filed with Form 1040 ▪ Account statement analysis ▪ IRM 4.10.4.3.2 – Minimum Income Probes – Nonbusiness Returns 	

Issue 4, Step 2: Review Potential Issues (cont'd)

Foreign Partnership - Taxation

Issue 4

What audit steps should be taken if a USP owns an interest in a Foreign Partnership but was not required to file Form 8865?

Fact Element	Resources	6103 Protected Resources
<p>Note –Form 8938 – Statement of Specified Foreign Financial Assets</p> <p>For taxable years beginning in 2011, if an individual USPs is required to file a Form 8938, an interest in a FP is required to be disclosed in Part II of the Form 8938. If the USP is not required to file a Form 8865 then the USP's distributive share of partnership income would be required to be shown in Part III of the Form 8938.</p> <p>Currently, only individuals are required to file Form 8938.</p>	<ul style="list-style-type: none"> ▪ Treas. Reg. 1.6031(a)-1 ▪ IRC 6038D ▪ IRM 20.1.9.22.1 IRC 6038D Information with Respect to Foreign Financial Assets 	

Issue 4, Step 3: Additional Factual Development

Foreign Partnership - Taxation

Issue 4

What audit steps should be taken if a USP owns an interest in a Foreign Partnership but was not required to file Form 8865?

Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Did the USP correctly report its share of the FP's current year income, deductions, credits, and other items? Are the FP's distributive share of the items reported by the USP correct per the Partnership Agreement and/or Operating Agreement? ▪ # [REDACTED] # ▪ Request the supporting documentation to verify the figures shown on the USP's return. If necessary, you may request FP's books and records to verify the amounts reported. 	<ul style="list-style-type: none"> ▪ FP's Schedule K-1 on IDRS or requested from USP. ▪ Partnership Agreement/Operating Agreement ▪ IRC 7602(a) ▪ Treas. Reg. 1.6031(a)-1(b)(4) 	

Issue 4, Step 3: Additional Factual Development (cont'd)

Foreign Partnership - Taxation

Issue 4

What audit steps should be taken if a USP owns an interest in a Foreign Partnership but was not required to file Form 8865?




Fact Element	Resources	6103 Protected Resources
<ul style="list-style-type: none"> ▪ Per IRC §7602(a) and Treas. Reg. §1.6031(a)-1(b)(4), you can request the USP to provide the books and records of the FP so you can verify the USP has reported the correct amount of distributive share items. ▪ Items to request on an IDR include, but not limited to, the FP's prospectus, Partnership and/or Operating Agreement, financial statements (income statement and balance sheet), and all documents provided to the USP for reporting its share of the relevant year's income, deductions, credits, and other items. 	<ul style="list-style-type: none"> ▪ IRC 7602(a) ▪ Treas. Reg. 1.6031(a)-1(b)(4) 	

Issue 4, Step 3: Additional Factual Development (cont'd)

Foreign Partnership - Taxation

Issue 4

What audit steps should be taken if a USP owns an interest in a Foreign Partnership but was not required to file Form 8865?


Fact Element	Resources	6103 Protected Resources
<p>▪ If the USP does not provide the FP's documents as requested, consider issuing a Formal Document Request (FDR) pursuant to IRC §982. The FDR is issued to the USP who owns the interest in the FP. # [REDACTED] # The USP will not be allowed to produce the records at a later date.</p> <p> CONSULTATION: The International Examiner (IE) should work with local counsel to review the FDR Form 4564 for use of enforceable language.</p> <p> TREATY IMPLICATION: If a Tax Treaty or TIEA exists between the U.S. and the FP's country (place of business or formation), contact Exchange of Information to request the FP's books and records and other relevant information.</p> <p> CAUTION: The examiner or investigator must first exhaust all domestic means to obtain the information through IRS administrative procedures.</p> <p>Any line marked with a # is for Official Use Only.</p>	<ul style="list-style-type: none"> ▪ IRC 7602(a) ▪ Treas. Reg. 1.6031(a)-1(b)(4) ▪ IRC 982 ▪ IRM Exhibit 4.61.4-1 – Formal Document Request IRC 982 ▪ Practice Unit, “Issuing a formal document request when a US taxpayer is unresponsive to an IDR” DCN: IGA/9460.02_02 ▪ Practice Unit, “Exchange of Information (Obtaining Taxpayer Information from a Treaty Partner,” DCN:TBD 	

Issue 4, Step 4: Develop Arguments

Foreign Partnership - Taxation

Issue 4

What audit steps should be taken if a USP owns an interest in a Foreign Partnership but was not required to file Form 8865?

Fact Element	Resources	6103 Protected Resources
<p> DECISION POINT: Reconcile items reported on the USP's return to the FP's books and records and verify reported losses are allowable.</p> <p>Step 1 –</p> <ul style="list-style-type: none"> ▪ Reconcile the distributive share items reported on USP's return to the FP's workpapers and/or books and records. Does the partnership agreement provide for allocation of distributive share items, and if so, do the allocations have substantial economic effect? <p>Step 2 –</p> <ul style="list-style-type: none"> ▪ The USP reported a nonpassive loss in Part II of the Schedule E. Confirm that the loss is allowable under the passive activity loss rules. ▪ The USP reported losses from the FP. Request the USP's basis computation in the FP to confirm the USP has sufficient basis in the FP to take the loss. Confirm that the loss is limited to the amount at risk. ▪ Has the USP properly reported capital gains and/or ordinary income (from "hot assets") from dispositions of interests in the FP? 	<ul style="list-style-type: none"> ▪ IRC 704(b) ▪ Treas. Reg. 1.704-1 ▪ IRC 465 ▪ IRC 469 ▪ IRC 704(d) ▪ IRC 862 ▪ IRC 751 	

Training and Additional Resources

Chapter 12.1.1 – Taxability of Income from Foreign Partnership

Type of Resource	Description(s) and/or Instructions for Accessing	References
Podcasts / Videos	LB&I, IIC CPE 2011 – Day 1 – Foreign Corporations and Pass-Throughs	

Glossary of Terms and Acronyms

Acronym	Definition
ECI	Effectively Connected Income
EIN	Employer Identification Number
EOI	Exchange of Information
FDAP	Fixed or Determinable Annual or Periodical
FDR	Formal Document Request
FP	Foreign Partnership
IDR	Information Document Request (From 4564)
IDRS	Integrated Data Retrieval System
IRM	Internal Revenue Manual
TP	Taxpayer
USP	United States Person

Index of Related Issues

Issue	Associated UIL(s)	References
Failure to File Form 8865 – Category 1 and 2 Filers – Monetary Penalty	9434.01	FEN/9434.01_10(2013)(b)
Failure to File Form 8865 – Category 3 and 4 Filers – Monetary Penalty	9434.01	To be developed
Issuing a formal document request when a US taxpayer is unresponsive to an IDR	9460.02	IGA/9460.02_02(2013)
Specific Requests – U.S. Initiated, Field Procedures	9460.01	To be developed
Check the Box Rules for Foreign Entities	9433.01	To be developed