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PROPOSED CHANGES TO THE PENALTY FOR FAILURE TO REPORT FOREIGN GIFTS RECEIVED BY A UNITED STATES PERSON UNDER IRC SECTION 6039F

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[1] The comments contained in this paper are the individual views of the authors who prepared them, and do not represent the position of the California Lawyers Association.

[2] Although the authors, presenters and/or reviewers of this paper might have clients affected by the rules applicable to the subject matter of this paper and have advised such clients on applicable law, no such participant has been engaged by a client to participate on this project.

EXECUTIVE SUMMARY[3]

Enacted as part of the Small Business Job Protection Act of 1996, Internal Revenue Code (IRC) Section 6039F imposes a penalty upon United States taxpayers who fail to report large gifts received from foreign persons. Under Section 6039F, a United States taxpayer who receives foreign gifts with an aggregate value of more than $10,000 during the tax year must report such gifts. To report such gifts, a taxpayer is required to file Form 3520, Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts. Form 3520 has the same due date as the taxpayer's Form 1040, Individual Income Tax Return, but is filed separately from the taxpayer's income tax return.

The penalty for failing to timely file Form 3520 is two-fold. First, Section 6039F(c)(1)(A) allows the Service to determine the tax consequences of a foreign gift if a taxpayer does not adequately furnish the information as required.[4] Second, section 6039F(c)(1)(B) allows the Service to penalize taxpayers five percent of the value of the gift for each month the gift is not reported, up to twenty-five percent of the value of the gift. The degree of the penalty imposed by Section 6039F is excessive and concerning for multiple reasons.

The penalty imposed under Section 6039F is excessive given the nature of the transaction being reported. Like domestic gifts, foreign gifts are generally not taxable to the recipient in the United States and may not be taxable in the foreign jurisdiction. Further, many taxpayers and tax return preparers are not aware of Form 3520 reporting requirements as it is a niche form and reporting requirement. Additionally, the United States otherwise has no financial interest in the gift the recipient receives because these gifts are generally not taxable. Regardless, failure to report the gift can result in a penalty of up to twenty-five percent of the gift value, a potentially substantial financial burden for taxpayers.

This paper proposes a statutory change to the penalty imposed by Section 6039F. First, this paper proposes that Section 6039F(c)(1)(A) allowing the Service to determine the tax consequences of a foreign gift be stricken. Second, this paper proposes that Congress change the current penalty to the lesser of (1) five percent of the value of the gift for each month the gift is unreported not to exceed twenty-five percent of the gift value, or (2) $10,000. This paper also proposes that section 6039F be changed to include a continuation provision similar to IRC Section 6038(b)(2). Such statutory changes would make the penalty more comparable to other penalties for international information returns, minimize the financial burden for non-willful taxpayers, and allow the United States to enforce section 6039F against taxpayers who fail to report after they are informed of their filing requirement.

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[4] *See* IRC § 6039F(C)(1).

DISCUSSION

I. INTRODUCTION

This proposal addresses the inequities of the penalty imposed under section 6039F and proposes a resolution that will serve as an effective deterrent for intentional wrongdoers while reducing the financial harm to innocent U.S. taxpayers. This paper proposes a statutory change to bring Section 6039F in line with other penalties for international informational returns. This paper should be narrowly construed to discuss transactions which are, between the Internal Revenue Service ("Service") and the taxpayer, undisputedly gifts.

The authors acknowledge that there are some instances in which tax is imposed on the recipient of a gift. For example, IRC Section 2801 imposes a tax on the recipient of a "covered" gift or bequest from a covered expatriate. Additionally, IRC Section 6901 imposes a tax on the recipient of a gift or inheritance through the theory of transferee liability in relation to the transferor's tax liability. Notwithstanding these instances, this proposal addresses gifts that fall within IRC section 102, and to which the taxability of such gifts to the recipient is not modified by a separate Code provision.

II. THE LAW CURRENTLY IMPOSES AN EXCESSIVE PENALTY AGAINST U.S. TAXPAYERS WHO DO NOT TIMELY FILE A FORM 3520 REPORTING A LARGE GIFT FROM A FOREIGN PERSON

A. Current Law

Internal Revenue Code (IRC) Section 6039F(a) states:

> If the value of the aggregate foreign gifts received by a United States person (other than an organization described in section 501(c) and exempt from tax under section 501(a)) during any taxable year exceeds $10,000[5], such United States person shall furnish (at such time and in such manner as the Secretary shall prescribe) such information as the Secretary may prescribe regarding each foreign gift received during such year.

For purposes of this section, the term "foreign gift" means any amount received from a person other than a United States person which the recipient treats as a gift or bequest.[6]

United States persons (and executors of estates of U.S. decedents) are required to file Form 3520 with the Service to report, amongst other transactions, "receipts of large gifts or bequests from certain foreign persons.[7]" The current requirement of the Service is that taxpayers file a Form 3520 reporting only those large gifts or bequests from foreign individuals or estates which exceed the threshold amount of $100,000.[8]

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[5] This threshold amount is adjusted for inflation. IRC § 6039F(d).
[6] IRC § 6039F(b).
[7] *See* IRS Notice 97-34, 1997-1 CB 442.
[8] *See id.*, *supra,* note 7.

The threshold calculation aggregates gifts from different foreign individuals and foreign estates that are related to each other, or when one is acting as a nominee or intermediary for the other.[9] Taxpayers are also required to file a Form 3520 when they receive gifts from a foreign corporation or foreign partnership exceeding the statutory threshold as adjusted pursuant to Section 6039F(d).[10] The Service may penalize a U.S. taxpayer five percent of the value of the gift for every thirty days the gift is not reported on Form 3520, up to twenty-five percent of the value of the gift.[11]

In the author's experience, when a U.S. taxpayer does not timely file Form 3520, such failure is generally due to a lack of knowledge of the reporting requirement and/or incorrect tax reporting advice. Also in the author's experience, U.S. taxpayers who were genuinely unaware of the filing requirement at the time of filing their tax return only learn of the requirement after more than five months have passed since the initial filing deadline. Even then, taxpayers learn of the requirements after hearing about it from another individual experiencing similar, unique circumstances.

The reason being is that international reporting requirements are not common knowledge, nor are they widely discussed on social media or in educational institutions in comparison to other "popular" tax subjects such as business deductions. The likelihood of an individual inadvertently coming across literature or having a random discussion about international reporting requirements is minimal due to the unpopular nature of the applicable tax code provisions. As such, the realistic application of Section 6039F is that the Service has the ability to determine the tax consequences of the receipt of foreign gifts and filers are being assessed a penalty of twenty-five percent of the value of their foreign gift without the opportunity to dispute the penalty pre-assessment.

B. Purpose for International Information Return Penalties

International information return penalties are civil penalties assessed on U.S. taxpayers for failing to timely file required international information returns. In the eyes of the Service, international information returns provide a vehicle for verifying that the correct income tax is assessed on U.S. taxpayers.[12] Form 3520 is an information return, not a tax return, which is consistent with the fact that foreign gifts are not generally subject to income tax or otherwise taxed to the recipient. The United States Supreme Court has even recognized that Congress "structured gift transactions to encourage the transfer of property by limiting the tax consequences of a transfer.[13]" This distinction is important when considering the potential amount of the penalty.

The fundamental difference between a tax and a penalty is that a tax is a mandatory contribution to provide support of the government, whereas a penalty is an exaction imposed by statute as punishment for an unlawful act.[14] In the context of foreign gifts, the penalty is not compensatory or remedial in nature to make the United States whole again because the United

[9] *See* Form 3520 Instructions.
[10] *See* I.R.S. Notice 97-34, 1997-1 CB 442; I.R.C. § 6039F(d).
[11] *See* I.R.C. § 6039F(c)(1)(B).
[12] Internal Revenue Manual 20.1.9.1 (01-29-2021).
[13] *See Diedrich v. Commissioner,* 457 U.S. 191, 199 (1982).
[14] *See United States v. La Franca,* 282 U.S. 568, 572 (1931).

States does not have a tax interest in such gifts. Rather, Section 6039F imposes a punishment of up to twenty-five percent for the "unlawful act" of failing to inform the United States of a gift received from a non-U.S. person.

III. PROBLEMS ADDRESSED: INEQUITIES OF SECTION 6039F PENALTY

A. Those Affected by the Current Law

Broadly speaking, the current law affects any U.S. person who receives a gift from a non-U.S. person exceeding the threshold who does not timely file a Form 3520. This includes taxpayers who are not willful in failing to file a Form 3520 or are advised that no such filing is required. In the authors' experience, these taxpayers are often immigrants new to the United States, or U.S.-born citizens with family outside the United States, who receive gifts, bequests, and inheritance from friends and family. Further, the nature and/or receipt of such property is not always known or clear to the U.S. taxpayer.

For instance, there may be a U.S. taxpayer who was born in the United States who has family abroad, like a grandparent. This grandparent may pass away. The U.S. taxpayer may inherit a piece of real property from the grandparent with a value of $500,000. Considering that the U.S. taxpayer is living in the United States, and depending on the inheritance laws of the foreign jurisdiction, they may not learn of the inheritance until after the due date of the Form 3520 and after the maximum penalty has accrued (based on the date the inheritance is deemed compete). This U.S. taxpayer may then learn of their Form 3520 filing requirement and decide to file a delinquent Form 3520. The Service will likely assess this taxpayer with a penalty for $125,000.

In this instance, it would be logical for the taxpayer to attach a reasonable cause statement to their delinquent Form 3520. However, according to the Services' own website, even in these instances, "[d]uring processing of the delinquent information return, penalties may be assessed without considering the attached reasonable cause statement," and "[i]t may be necessary for taxpayers to respond to specific correspondence and submit or resubmit reasonable cause information.[15]"

In this example the inherited asset is not liquid, the filer was not aware of the inheritance until it was communicated to him/her after the filing deadline, and the filer was not willful in their late filing. In fact, the filer filed a delinquent Form 3520 after learning of the inheritance. Regardless, the Service may still determine the tax consequences of the gift regardless of whether it was initially non-taxable, and the filer will more likely than not be assessed with a penalty for $125,000 and suffer the consequences thereafter, including collection actions by the Service like federal tax lien notice filings and levies. The assessment may subject the filer to financial review and necessitate the liquidation of, or loans against, their assets in the United States. As an unintended consequence, the U.S. taxpayer may be forced to liquidate the inheritance received in order to pay the tax. Of course, this new liability reflected in a federal tax lien notice may harm

[15] *See* Internal Revenue Service, Delinquent International Information Return Submission Procedures, https://www.irs.gov/individuals/international-taxpayers/delinquent-international-information-return-submission-procedures.

the filer's finances generally. In the authors' experience, this is not an uncommon situation.

B. Gifts are Generally Not Taxed to the Recipient in the United States and Taxpayers Lack Knowledge about Form 3520

Under IRC Section 102, gross income does not include the value of property acquired by gift, bequest, devise, or inheritance. As such, U.S. taxpayers generally are not subject to federal income tax, federal gift tax, or are otherwise taxed on foreign gifts. Even when domestic gifts are subject to tax, the gift tax liability, if any, falls on the donor of the gift, not the recipient.[16] To that same point, gift taxes typically only become relevant to donors when aggregate taxable gifts exceed the unified estate and gift tax exemption in the donor's lifetime. In 2023, the lifetime exemption amount was increased to $12,920,000.

According to the Congressional Budget Office, relatively few people pay estate and gift taxes. In 2016, the most recent year for which complete data was available for analysis, only approximately 5,500 of 2.7 million decedents had taxable estates. Further, in 2018, only about 2,000 taxpayers paid the gift tax.[17] In the most recent report released by the Service's Statistic of Income Division (SOI), the SOI analyzed data for gifts reported between 2011 and 2017. The Service concluded that the data showed "that very few taxpayers are ever subjected to paying gift taxes.[18]" Further, more than 95 percent of the gift taxes owed were paid by those giving more than $1 million in gifts in any given year.

U.S. taxpayers often are unfamiliar with the provisions of the Internal Revenue Code, particularly with respect to foreign gifts, and may not fully understand the legal nature of the property they receive. This means they do not have the knowledge required to address the Form 3520 with a tax return preparer who may also not be aware of the filing requirement. In the authors' experience, many tax return preparers lack knowledge of Form 3520 and the section 6039F reporting requirements. These tax return preparers often advise taxpayers that there is no filing requirement for the gifts they receive and are not aware that there is a reporting requirement for foreign gifts, bequests, and inheritances. These taxpayers are thus lacking the substantive knowledge that a foreign gift may be reportable and are being advised by a tax professional that no reporting requirement exists. Needless to say, because the penalties are frequently twenty-five percent of the foreign gift, bequest, or inheritance, this creates substantial additional exposure for accountants when the supply of accounting students are already dwindling.

The nature of the transaction as a gift may also be in conflict with the foreign jurisdiction, and as such, decreases the likelihood that donor will prompt the recipient to inquire about the reporting requirements of the gift. Again, in the authors' experience the typical taxpayer lacks the knowledge to reconcile these issues and often receive incorrect advice from tax return preparers who also lack the knowledge and experience to advise on the issue.

In sum, U.S. taxpayers and many return preparers are often not aware of the filing

[16] IRC § 2502(d)
[17] Congressional Budget Office, Understanding Federal Estate and Gift Taxes, https://www.cbo.gov/publication/57272.
[18] Holland, Jessica, Internal Revenue Service, 2010-2016 Gifts, https://www.irs.gov/pub/irs-soi/soi-a-ingf-1906.pdf.

requirement, and taxpayers often receive incorrect advice from tax professionals. Further, if the transaction is a gift, and not otherwise taxable through other provisions of the Code, such as Section 2801 or Section 6901, then there is no tax levied on the gift received. Regardless, taxpayers are still subject to a penalty of upwards of twenty-five percent of the aggregate value. For these reasons, the penalty as currently imposed on all filers is excessive.

IV. PROPOSED REMEDY – ELIMINATING EXCESSIVE PENALTY AND MAINTAINING ENFORCEMENT

This paper proposes that Congress eliminate Section 6039F(c)(1)(A) allowing the Service to decide the tax consequences of such gift regardless of whether the gift was originally non-taxable, and that Congress amend Section 6039F(c)(1) to state:

> If a United States person fails to furnish the information required by subsection (a) with respect to any foreign gift within the time prescribed therefor (including extensions)—such United States person shall pay (upon notice and demand by the Secretary and in the same manner as tax) an amount equal to the lesser of 5 percent of the amount of such foreign gift for each month for which the failure continues (not to exceed 25 percent of such amount in the aggregate), or $10,000.

The $10,000 is already a significant penalty. This paper also proposes that Section 6039F be changed to include a continuation provision similar to Section 6038(b)(2) and Section 6677(a)(2) to address willful and recalcitrant taxpayers who fail to file even after given notice. As of now, the penalty under Section 6039F accrues as of the due date of Form 3520, which again, is the same due date as the U.S. taxpayers income tax return including extensions, and the penalty "caps" at twenty-five percent just five months after this due date.

Changing the law as proposed would maintain enforcement because it provides the Service with a mechanism to enforce the filing requirement while not overburdening taxpayers who were ignorant of the law. The proposed change to the statute still asserts a penalty against taxpayers who voluntarily file a delinquent Form 3520 after learning of the requirement, though the proposed change would instate a more manageable penalty for taxpayers. And the proposed change institutes a continuation penalty provision for taxpayers who are notified of their filing requirement allowing the Service to enforce the filing requirements forcefully against taxpayers who learn of their filing requirement but take no action.

The current penalty and lack of avenues for reduction breeds non-compliance or leaves taxpayers financially over-burdened. A limited penalty may increase percentage of taxpayers seeking voluntary filing and collection compliance.

V. CONCLUSION

In conclusion, the penalty currently imposed by section 6039F is excessive. The penalty imposed should be changed to limit the financial burden on delinquent filers while maintaining enforcement of Section 6039F against taxpayers who learn of their filing requirement.