taxnotes federal

Volume 179, Number 3 ■ April 17, 2023

IRS Concedes Foreign Gift Penalties: A Bittersweet Victory

by Hale E. Sheppard

Reprinted from *Tax Notes Federal*, April 17, 2023, p. 419

For more *Tax Notes* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

IRS Concedes Foreign Gift Penalties: A Bittersweet Victory

by Hale E. Sheppard

Hale E. Sheppard (hale.sheppard@chamberlainlaw.com) is a shareholder in the tax controversy and litigation section of Chamberlain Hrdlicka in Atlanta.

In this article, Sheppard explains why *Wrzesinski*, a case involving tax penalties imposed on unreported foreign gifts, was an unsatisfying win for taxpayers as a whole.

Copyright 2023 Hale E. Sheppard.
All rights reserved.

Introduction

Taxpayers were so close to finally getting some guidance from a court on critical issues about the reporting of foreign gifts and the large penalties for not doing so. Unfortunately, because the government elected to quickly concede a case of first impression, taxpayers must now await future opportunities.

This article, which is the second in a series, examines the duties and sanctions associated with U.S. individuals receiving some foreign gifts, current standards for penalty mitigation, the relevant compliance campaign by the IRS, recent public criticism of the foreign gift regime, and the main facts, issues, and resolutions in a novel case, *Wrzesinski*.[1] The victory for the taxpayer in that case, as well as for all other taxpayers confronting steep international information-return penalties, is bittersweet.[2]

Receipt of Foreign Gifts — Duties and Penalties

U.S. individuals who own foreign assets, engage in foreign activities, or receive foreign gifts have various tax and information-reporting obligations with the IRS. One duty is triggered by getting a foreign gift: If a U.S. individual receives a gift of property (including money) from an individual who is not a U.S. person and the gift totals more than $100,000 during a given year, then he generally must file a Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts," providing data about the event.[3] The receipt of the foreign gift does not cause an immediate U.S. income tax liability for the recipient; it is solely an information-reporting duty.

It is noteworthy that Form 1040, "U.S. Individual Income Tax Return," which all U.S. individuals ordinarily must file with the IRS, does not raise the potential need to submit a Form 3520 upon receipt of a foreign gift. Schedule B to Form 1040 expressly warns individual taxpayers that they might have to file Form 3520 if they get a distribution from, transfer anything to, or serve as a grantor of a foreign trust. It makes no mention, however, of possible Form 3520 duties in situations in which U.S. individuals receive foreign gifts.[4]

The penalty for filing a delinquent Form 3520 is 5 percent of the unreported gift for each month it is late, with a maximum penalty of 25 percent.[5] The IRS has authority to waive the penalty,

[1] *Wrzesinski v. United States*, No. 2:22-cv-03568 (E.D. Pa. 2022); Andrew Velarde, "Son of Polish Lottery Winner Challenges Foreign Gift Penalty," *Tax Notes Federal*, Sept. 12, 2022, p. 1777.

[2] For earlier coverage of this case and foreign gift matters, see Hale E. Sheppard, "Foreign Gifts, Forms 3520, Big Penalties, and Pending Case," *Tax Notes Federal*, Oct. 3, 2022, p. 57.

[3] Section 6039F(a); Notice 97-34, 1997-25 IRB 22, Section VI.

[4] Schedule B (Interest and Ordinary Dividends), Part III (Foreign Accounts and Trusts), Question 8 (2021); 2021 Instructions for Schedule B, p. B-2; 2021 Instructions for Form 1040 and Form 1040-SR, p. 23.

[5] Section 6039F(c)(1)(B); Notice 97-34, Section VI.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

however, if the taxpayer can demonstrate that the violation was the result of reasonable cause.[6] Legislative history indicates that IRS determinations about Form 3520 penalties will be subject to review by the courts, which will decide whether the IRS acted "arbitrarily and capriciously."[7]

Possibility of Penalty Mitigation

As explained, a showing of reasonable cause can help taxpayers avoid penalties. This sounds good in theory, but the key rests in the definition of that term. In determining the appropriateness of international information return penalties like those associated with Form 3520, the IRS and the courts often turn to the concept of reasonable cause in various scenarios,[8] which clarifies the following important points.

First, a taxpayer's ignorance of the law might give rise to reasonable cause. The IRS acknowledges that in some instances taxpayers may not be aware of specific obligations to file returns or pay taxes.[9] It further concedes that reasonable cause "may be established if the taxpayer shows ignorance of the law in conjunction with other facts and circumstances," such as whether the taxpayer has been penalized before and the level of complexity of the issue.[10] The IRS also recognizes that a taxpayer may have reasonable cause if he was unaware of a requirement and could not reasonably be expected to know about it.[11]

Second, a taxpayer's reasonable reliance on an independent, informed, qualified, tax professional often constitutes reasonable cause.[12] For purposes of the reasonable-reliance defense, the concept of advice broadly covers "any communication" from an adviser and it "does not have to be in any particular form."[13] The Supreme Court has mandated that the IRS liberally construe this defense in favor of taxpayers.[14] Likewise, the Tax Court has held that reasonable reliance exists when three elements are present: The adviser was a competent professional with sufficient expertise, the taxpayer provided the adviser with necessary and accurate information in a timely manner, and the taxpayer relied in good faith on the adviser's advice.[15]

Lastly, the IRS recently acknowledged that most taxpayers are oblivious to the need to file Form 3520 when they receive a foreign gift, particularly because that event does not trigger a taxable event for U.S. purposes. The IRS said the following in a recent training guide:

> In general, gifts and inheritances are not taxable to the recipient. Many taxpayers and representatives know that basic tenet of tax law but are not aware of the requirement to report large foreign gifts and inheritances under [section] 6039F.[16]

Foreign Trust Compliance Campaign

Another foundational matter of note is the IRS's recent focus on Forms 3520. The IRS has been aggressively targeting various types of international tax noncompliance. Among other things, it introduced a compliance campaign centered on Forms 3520 in May 2018.[17] It was designed to stop shenanigans associated with foreign trusts, but taxpayers failing to file Forms 3520 to report foreign gifts got caught in the enforcement net, too.

---

[6] Section 6039F(c)(2); Notice 97-34, Section VII; Internal Revenue Manual 20.1.9.10.5; IRM 8.11.5.6.3.

[7] Small Business Job Protection Act of 1996, H.R. Rep. No. 104-737, at 337 (1996) (penalty determinations by the IRS will be subject to review by the courts under the "arbitrary and capricious standard, which provides a high degree of deference to [the IRS's] determination").

[8] Because the IRS has not issued regulations explaining the meaning of "reasonable cause" for purposes of forms 3520 and 3520-A, the courts have been receptive to arguments based on the reasonable cause standards found elsewhere in the IRC and IRM. *See, e.g.*, chief counsel advice ILM 200645023; *James v. United States*, No. 8:11-cv-00271 (M.D. Fla. 2012); *Moore v. United States*, No. 2:13-cv-02063 (W.D. Wash. 2015); *In re Wyly*, 552 B.R. 338 (Bankr. N.D. Tex. 2016).

[9] IRM 20.1.1.3.2.2.6 (Nov. 25, 2011).

[10] *Id.*

[11] *Id.*

[12] Reg. section 1.6664-4(c)(1).

[13] Reg. section 1.6664-4(c)(2).

[14] *United States v. Boyle*, 469 U.S. 241, 251 (1985).

[15] *Neonatology Associates P.A. v. Commissioner*, 115 T.C. 43 (2000), *aff'd*, 299 F.3d 221 (3d Cir. 2002).

[16] IRS, "Voluntary Disclosure Practice Examiner Guide," at 44 (July 19, 2022); *see also* INFO 2013-0015.

[17] Frank Agostino et al., "Examination of Large Foreign Gifts and Inheritances: Code Sec. 6039F, Notice 97-34 and Form 3520," 20 *J. Tax Prac. & Proc.* 5 (2018).

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

Recent Public Opinion About Form 3520

The IRS sought input about Form 3520 and related matters in December 2022, and five groups responded.[18] They offered many criticisms and suggestions, the most relevant of which are summarized as follows:

- The IRS should make several changes to its penalty procedures, particularly when it comes to taxpayers voluntarily and proactively filing Forms 3520 through a disclosure program like the Delinquent International Information Return Submission Procedures (DIIRSP). Those changes should include giving a "fair and meaningful reasonable cause review *before* penalties are imposed," ensuring that the IRS personnel conducting that review possess the proper background and training, avoiding the use of "low-level clerks" in making initial penalty determinations, and requiring that a supervisor review and approve all penalties in writing before they are assessed.
- The IRS should issue a revenue procedure or other similar item creating a safe harbor for filing delinquent Forms 3520 on a penalty-free basis.
- The IRS should change its current practice of not applying the first-time abate policy to Forms 3520.
- The IRS should expand the number and types of justifications that it accepts as reasonable cause for waiver of penalties and should also provide many examples.
- The IRS should add a new box to Schedule B to Form 1040 asking taxpayers if they received any gifts or inheritances from foreign sources during the year. If the answer is yes, then taxpayers should be notified of the potential duty to file Form 3520. This would be similar to existing boxes, questions, and cross-references for foreign accounts and foreign trusts.[19]
- The IRS should create a separate return for reporting large foreign gifts because the current multipurpose return, Form 3520, applies to those who made transfers to foreign trusts, owned foreign trusts, received distributions from foreign trusts, or obtained gifts or inheritances from foreign persons.

First Case Addressing Foreign Gift Penalties

Wrzesinski was the first federal case dealing with Form 3520 penalties for foreign gifts, which renders it important.[20]

The taxpayer in that case was born, raised, and educated in Poland. He immigrated to the United States when he was 19. He then engaged in public service, working as a police officer for nearly a decade. In 2010 his mother, both a citizen and resident of Poland, won the lottery there and decided to gift the taxpayer $830,000.

The taxpayer called his tax adviser in 2010 to inquire about any U.S. duties triggered by his receipt of the gift. The tax adviser, who is an enrolled agent with the IRS, expressly told the taxpayer that the gift did not cause U.S. income tax liabilities or any other duties. The mother made the gift via four separate transfers from Poland to the United States in 2010 and 2011. Thus, the taxpayer received over $100,000 in cash gifts from a foreign person each year. In early 2011, during the preparation of his Form 1040 for 2010, the taxpayer again asked his tax adviser if he needed to file anything with the IRS in connection with the gifts from his mother. The tax adviser, as before, incorrectly told the taxpayer that nothing was due.

---

[18] *See* IRS request for public comments on Form 3520, 87 F.R. 77167 (Dec. 16, 2022); Texas Society of CPAs comments on foreign trust transaction reporting (Feb. 23, 2023); American Institute of CPAs comments (Feb. 13, 2023); Florida Bar Tax Section comments (Feb. 13, 2023); Law Offices of Daniel N. Price PLLC comments (Feb. 9, 2023); Michael J.A. Karlin comments (Mar. 6, 2023); Velarde, "Commentators Line Up to Critique Foreign Trust Penalty Operation," *Tax Notes Federal*, Mar. 13, 2023, p. 1824.

[19] Part III to Schedule B of Form 1040 presents the following guidance about foreign accounts: "At any time during [relevant year], did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions. If 'Yes,' are you required to file [FBAR] to report that financial interest or signature authority? See [FBAR] and its instructions for filing requirements and exceptions to those requirements." Likewise, Part III to Schedule B presents the following question and warning about foreign trusts: "During [the relevant year], did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If 'Yes,' you may have to file Form 3520. See instructions." *See* Form 1040 for 2022.

[20] Velarde, *supra* note 1; *Wrzesinski*, No. 2:22-cv-03568.

For more *Tax Notes*® *Federal* content, please visit www.taxnotes.com.

The taxpayer did not receive any additional gifts, and the IRS never audited him. Things changed in 2018. The taxpayer wanted to do some regifting, sending a portion of the money that he received from his mother years ago to his godson in Poland. The taxpayer thought that he, as a U.S. person, might have some tax-related duties when sending a gift abroad. He thus did some searches on the internet about foreign gifts. This led him to various articles about the duties of U.S. persons who receive money from, as opposed to giving money to, foreign persons. Shocked by this information, the taxpayer contacted an attorney with experience in international tax matters.

The attorney informed the taxpayer of his duty to file Forms 3520 for 2010 and 2011 to report the cash gifts from his mother. He also explained to the taxpayer that there might be a way for him to rectify matters with the IRS on a penalty-free basis, using the DIIRSP. The taxpayer, with the assistance of the attorney, filed Forms 3520 for 2010 and 2011 under the DIIRSP, along with statements explaining why his violations were attributable to reasonable cause and should not be penalized. This occurred in August 2018. The statements contended several things, the most important of which were that the taxpayer consulted with his tax adviser before filing his Forms 1040, gave the tax adviser details about the foreign gifts, received erroneous advice from the tax adviser, and relied on that advice.

After nearly a year, in May 2019, the IRS sent the taxpayer two notices indicating that he owed penalties totaling $207,500 for the late Forms 3520. That figure represented the highest possible amount, which was 25 percent of the gifts received. In rejecting the DIIRSP application and accompanying statements, the IRS notices concluded that ordinary business care requires taxpayers to make themselves aware of their duties and that ignorance of tax laws was no excuse.

The taxpayer disputed the penalties by filing a protest letter in June 2019. To strengthen his position, the taxpayer later submitted a supplemental protest letter, attaching correspondence from his original tax adviser in which he corroborated the taxpayer's reasonable-reliance defense. The tax adviser fell on his sword, so to speak, by admitting that he had given the taxpayer erroneous advice about the foreign gifts.

Another year and a half passed. In December 2020 the Appeals officer assigned to review the penalties, protest letter, and supplemental protest letter issued a so-called case memo. The Appeals officer agreed to abate $166,000 of the total $207,500 penalty. That left $41,500, or 5 percent of the total gifts that the taxpayer received from his mother.

The taxpayer paid the remaining $41,500, even though he still disagreed with the IRS. He then filed claims for refund in March 2022, which the IRS swiftly denied. In doing so, the IRS took the position that the claims did not establish reasonable cause and were frivolous. The taxpayer then initiated a refund suit in federal district court in September 2022.

The IRS quickly came under scrutiny for its handling of the Form 3520 penalties in *Wrzesinski*, with commentators warning that an unfavorable decision for the IRS could open the proverbial can of worms.[21] The tax attorneys at the Department of Justice, who are charged with handling refund litigation, swiftly arrived at the same conclusion. They agreed to fully concede the case in favor of the taxpayer before they even filed an answer to the initial complaint.[22] In other words, the Department of Justice fully surrendered before it submitted any pleadings with the district court, engaged in any discovery procedures, filed any legal briefs, or otherwise tried to defend the IRS's earlier position that the taxpayer should be stuck with penalties totaling $41,500 for 2010 and 2011.

Conclusion: Bittersweet Victory

Prevailing against the IRS, and technically against the Department of Justice, must have been satisfying for the taxpayer in *Wrzesinski*. Indeed, he held his ground, obtained judicial vindication in a case of first impression, and eventually managed to rid himself of all penalties. Things were not all positive, though. Achieving these results surely cost the taxpayer considerable time, stress, and legal fees during a battle that lasted

[21] Sheppard, *supra* note 2.

[22] *Wrzesinski*, No. 2:22-cv-03568; Velarde, "DOJ Concedes in Polish Lotto Foreign Gift Penalty Case," *Tax Notes Federal*, Mar. 14, 2023, p. 2024.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

nearly five years. Moreover, the experience undoubtedly generated major disenchantment with the IRS, particularly because the taxpayer tried to get things right by consulting his tax adviser when he received the foreign gifts, and later tried to rectify matters proactively under the DIIRSP. The taxpayer, like thousands of others in his shoes, probably expected to resolve the Form 3520 matters quickly and without penalties, which would be consistent with the terms and spirit of the DIIRSP. Unfortunately, he was wrong.

The taxpayer's victory in *Wrzesinski* is bittersweet for others facing international information return penalties, too. They hoped for a taxpayer victory, of course, but only after a trial and the issuance of a full-blown written opinion by the district court, which might have yielded some assistance to all taxpayers with inadvertent international noncompliance issues. At trial, the IRS would have been forced to clarify its stance regarding what constitutes reasonable cause when it comes to obscure and complex international information returns, like Form 3520. The IRS, moreover, would have found itself obligated to explain the standards and procedures applicable to the DIIRSP. It also might have been required to address the validity of public comments about Form 3520, such as why the first-time abate policy is ignored and what effect the absence of a cross-reference to foreign gift reporting duties on Schedule B to Form 1040 has on reasonable cause. Also, the district court likely would have determined whether the IRS violated its own rules prohibiting nuisance settlements when it compelled the taxpayer to initiate a suit for refund after reducing the penalty by 80 percent.[23]

Because the Department of Justice conceded in *Wrzesinski* before the parties could fully present their positions and the district court could dissect them, taxpayers must await a future case for critical judicial guidance regarding Forms 3520, which just might have implications for a long list of other international information returns. ■

[23] IRS Policy Statement 8-47, IRM 1.2.1.9.6 (Apr. 6, 1987); reg. section 601.106(f)(2); IRM 35.5.2.4 (Dec. 31, 2012); IRM 34.8.2.5.1(10) (Aug. 5, 2014); *Fajardo v. Commissioner*, T.C. Memo. 1999-308 (indicating that the IRS attorney ignored policy and offered the pro se taxpayer a nuisance settlement to dispense with his substantiation case).

taxnotes®
Education | Debate | Fairness | Transparency

We're on a mission.
Creating a marketplace of ideas and an atmosphere that fosters public debate, where exchanges are open, all sides of the aisle are represented, and all ideas are welcome.

We publish world-class news and analysis, host and provide speakers for conferences on topics that matter, provide material for free on our site, and pursue the release of important public information through the Freedom of Information Act.

Find out more at taxnotes.com/free-resources.

© 2023 Tax Analysts. All rights reserved. Tax Analysts does not claim copyright in any public domain or third party content.

For more *Tax Notes® Federal* content, please visit www.taxnotes.com.