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Foreign Gifts, Forms 3520, Big Penalties, and a Pending Case

by Hale E. Sheppard

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In this article, Sheppard examines *Wrzesinski*, a pending U.S. district court case about penalties for failure to report receipt of foreign gifts, and its broader implications for U.S. taxpayers with international issues.

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Introduction

Receiving a significant gift of money from a foreign person is a good news/bad news situation for a U.S. person. On the positive side, receipt of cash from abroad generally does not trigger U.S. income tax; the recipient gets the money tax free. On the negative side, he must disclose the gift by filing a timely Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." If a U.S. person fails to submit this obscure international information return, the IRS penalizes him. Sanctions can reach 25 percent of the total unreported gift. This situation has recently gotten worse thanks to IRS enforcement efforts focused on several items, including unfiled Forms 3520. Under a 2018 compliance campaign, the IRS has been quick to penalize — and slow (or outright unwilling) to forgive.

This article explains common information reporting duties, special rules applicable to foreign gifts, traditional justifications for penalty waiver, the 2018 compliance campaign, various disclosure programs, reasons why taxpayers file late information returns, the long-standing IRS prohibition against so-called nuisance settlements, and the recent notice granting taxpayers Form 3520 penalty relief under narrow circumstances. Then, exploring what might be a case of first impression, *Wrzesinski*, this article examines how all these pieces fit together.[1]

International Information Reporting Duties

To appreciate this article, readers need to understand the common duties of U.S. individuals who own foreign assets, engage in foreign activities, or receive foreign gifts. Those fitting this description must do several things, including, but not limited to, the following:

- declare on Form 1040, "U.S. Individual Income Tax Return," income derived from all sources, including passive and active income generated abroad;
- disclose on Form 1040's Schedule B, "Interest and Ordinary Dividends," the existence and location of foreign accounts;
- file a Financial Crimes Enforcement Network Form 114, "Report of Foreign Bank and Financial Accounts," to provide details about foreign accounts;
- report foreign financial assets, as this term is broadly defined, on Form 8938, "Statement of Specified Foreign Financial Assets";
- in situations in which a taxpayer holds interests in or has some other links to foreign entities, they must report these relationships to the IRS on the appropriate international information return, such as Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations," and Form 8865, "Return of U.S. Persons With Respect to Certain Foreign Partnerships";
- file a Form 8833, "Treaty-Based Return Position Disclosure Under Section 6114 or 7701(b)," if they are claiming that the

[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.

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application of a treaty between the United States and another country overrules or modifies normal tax treatment; and
- most importantly for this article, if they receive gifts from a foreign individual or estate totaling more than $100,000 in a single year, they must reveal them on Form 3520.

Receipt of Foreign Gifts

The special rules regarding foreign gifts warrant further attention.

If a U.S. individual receives a gift of property (including money) from an individual who is not a U.S. person totaling more than $100,000 during a given year, then he generally must file a Form 3520 with the IRS providing data about the event.[2] The receipt of the foreign gift does not trigger immediate federal income tax for the recipient; it is solely an event that needs to be reported.

It is also noteworthy that Form 1040, which all U.S. individuals ordinarily must file, does not raise the potential need to submit 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 they receive foreign gifts.[3]

The penalty for filing a delinquent Form 3520 is 5 percent of the value of the unreported gift for each month it is late, with a maximum penalty of 25 percent.[4] However, the IRS has the authority to waive the penalty if the taxpayer can demonstrate that there was reasonable cause for the violation.[5] The legislative history indicates that determinations by the IRS about Form 3520 penalties are subject to review by the courts, which will examine whether the IRS acted arbitrarily and capriciously.[6]

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. The IRS said the following in a recent training guide for personnel addressing issues in the context of a voluntary disclosure:

> 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.[7]

Justifications for Penalty Mitigation

As noted, a showing of reasonable cause can help taxpayers avoid penalties. This sounds good in theory, but the key rests in the definition of reasonable cause. In determining the appropriateness of international information return penalties like those associated with Form 3520, the IRS and the courts often deal with the concept of reasonable cause in the following scenarios.[8]

First, a taxpayer may establish reasonable cause by providing facts and circumstances showing that he exercised ordinary business care and prudence, but nevertheless was unable to comply with the law.[9]

Second, a taxpayer's confusion might constitute reasonable cause. The regulations provide that "circumstances that may indicate reasonable cause and good faith include an honest misunderstanding of fact or law that is reasonable in light of all of the facts and circumstances,

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

[3] Form 1040 Schedule B, "Interest and Ordinary Dividends," Part III (foreign accounts and trusts), question 8 (2021); 2021 instructions for Schedule B at B-2; 2021 instructions for Form 1040 and Form 1040-SR at 23.

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

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

[6] House Conference Report 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").

[7] IRS, "Voluntary Disclosure Practice Examiner Guide," at 44 (July 9, 2022); *see also* INFO 2013-0015.

[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. *See, e.g.*, ILM 200645023; *James v. United States*, 366 U.S. 213 (1961); *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 section 20.1.1.3.2.1.

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including the experience, knowledge, and education of the taxpayer."[10]

Third, a taxpayer's ignorance of the law might give rise to reasonable cause. The IRS penalty handbook acknowledges that in some instances a taxpayer may not be aware of specific obligations to file returns or pay taxes.[11] It further acknowledges 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.[12] The penalty handbook also recognizes that a taxpayer may have reasonable cause if he is unaware of a requirement and could not reasonably be expected to know about it.[13]

Fourth, a taxpayer's reasonable reliance on an independent, informed, qualified tax professional often reaches the level of reasonable cause.[14] 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."[15] The Supreme Court has mandated that the IRS liberally construe the reasonable reliance defense[16]:

> When an accountant or attorney advises a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice. Most taxpayers are not competent to discern error in the substantive advice of an accountant or attorney. To require the taxpayer to challenge the attorney, to seek a "second opinion," or to try to monitor counsel on the provisions of the [Internal Revenue] Code himself would nullify the very purpose of seeking the advice of a presumed expert in the first place.[17]

Like the Supreme Court, 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 actually relied in good faith on the adviser's advice.[18]

Foreign Trust Compliance Campaign

Another matter of note is the IRS's recent focus on Form 3520 and related issues. The IRS has been aggressively targeting various types of international tax noncompliance. For example, in May 2018 it introduced a compliance campaign centered on foreign trusts, Forms 3520, and Forms 3520-A.[19] The compliance campaign was designed to stop shenanigans associated with foreign trusts. Unfortunately, taxpayers failing to file Forms 3520 to report foreign gifts got caught in the IRS's enforcement net, too.

Disclosure Programs With the IRS

To grasp the significance of *Wrzesinski*, readers need to understand how taxpayers resolve (or attempt to resolve) oversights with the IRS.

After learning of their duty to report and the consequences of violations, taxpayers often start exploring ways to correct matters with the IRS on the least painful terms possible. Taxpayers have enjoyed four main options over the past several years in situations involving non-willful violations. Depending on the circumstances, taxpayers could apply to participate in the streamlined foreign offshore procedures (SFOP), streamlined domestic offshore procedures (SDOP), delinquent international information return submission procedures (DIIRSP), or delinquent foreign bank account report submission procedures (DFSP). These four

[10] Reg. section 1.6664-4(b)(1); *see also Kraus v. Commissioner*, T.C. Memo. 2003-10 (when the complex nature of the issue negated the application of accuracy-related penalties under section 6662).

[11] IRM section 20.1.1.3.2.2.6.

[12] *Id.*

[13] *Id.*

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

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

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

[17] *Id.*

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

[19] 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).

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programs share some characteristics but differ in important ways.[20]

To be eligible for the SFOP, taxpayers (who are U.S. citizens or green card holders) must meet the following criteria: (1) they were physically outside the United States for at least 330 days in one or more of the past three years; (2) they did not have an abode in the United States during the relevant year; (3) they either did not file annual Forms 1040 or filed Forms 1040 that did not report all global income; (4) they might have also failed to file international information returns; (5) the violations were the result of non-willful conduct; and (6) the IRS has not initiated a civil examination or criminal investigation of the taxpayers or a related party. Under the SFOP, taxpayers are only required to file Forms 1040 or Forms 1040-X, "Amended U.S. Individual Income Tax Return," for the past three years; international information returns for the past three years; and FBARs for the past six years. Taxpayers must pay all income tax liabilities and interest charges, but the IRS does not impose penalties on taxpayers who successfully resolve matters through the SFOP.

The SDOP is similar to the SFOP, with three critical distinctions. First, participants spent too much time in the United States to meet the foreign residency requirement of the SFOP. Second, SDOP participants must have filed timely Forms 1040 with the IRS each year but neglected to report all worldwide income and/or enclose all required international information returns. Finally, if the IRS accepts taxpayers into the SDOP, they must pay a so-called offshore penalty, which is equal to 5 percent of the highest value of all noncompliant assets during the relevant period.

The DIIRSP provides that taxpayers who have not filed one or more international information returns, such as Form 3520, can now submit them on a penalty-free basis if they meet specific criteria. Taxpayers are eligible if they previously filed Form 1040 annually reporting all income, have reasonable cause for not filing the information returns, are not under a civil examination or a criminal investigation, and have not already been contacted by the IRS.

The DFSP is geared toward taxpayers who previously filed timely Forms 1040 each year reporting all worldwide income yet neglected to file annual FBARs. The DFSP allows those taxpayers to rectify FBAR issues without incurring penalties. The rationale is that taxpayers who willfully hide foreign accounts probably do not report income from those accounts on their annual Form 1040 and pay the resulting taxes.

The taxpayer in *Wrzesinski* proactively approached the IRS under the DIIRSP in hopes of submitting his missing Forms 3520 swiftly and without penalties.

Endless Assessment Periods

Readers must understand what would possess a taxpayer to throw himself at the mercy of the IRS to resolve a violation that occurred many years before. There is a logical, yet obscure, reason for this.

Failure to timely file nearly any international information return (including Form 3520) not only triggers penalties, but also gives the IRS an unlimited period to audit and assess penalties and interest, as well as taxes in some instances. A relatively unknown provision contains a powerful procedural tool for the IRS.[21] It generally states that, when a taxpayer does not properly file any of a long list of international information returns, the assessment period remains open "with respect to any tax return, event, or period" to which the information returns relate until three years after the taxpayer ultimately files the information returns.[22] Consequently, if a taxpayer never files, say, a Form 3520 to reveal receipt of a foreign gift, then the assessment period never begins to run against the IRS.[23] This obligates taxpayers with international violations to act, because keeping a low profile and hoping that the IRS's clock will run out is no longer a viable option.

[20] Hale E. Sheppard, "Alarming U.S. Tax Rules and Information-Reporting Duties for Foreign Retirement Plans and Accounts: Analyzing Problems and Solutions," 129(4) *J. Tax'n* 14 (2018) (explaining the remaining international disclosure programs, as well as the now-defunct offshore voluntary disclosure program).

[21] Section 6501(c)(8)(A).

[22] Section 6501(c)(8)(B).

[23] *See* ECC 201402010.

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Overview of Tax Refund Actions

Another item that readers must comprehend is the refund. Taxpayers sometimes overpay taxes, penalties, or other amounts, and they want their money back. Seeking a refund from the IRS is a surprisingly complicated process. Only the aspects pertinent to this article are set forth below.

The first step to recouping money from the IRS is for a taxpayer to file a timely claim for refund.[24] A taxpayer normally must file a claim for refund within three years of the time that he filed the relevant tax return (regardless of whether that return was filed timely or late) or within two years of the time that he paid the relevant amount, whichever period expires later.[25]

If the IRS denies a claim for refund by issuing a notice of disallowance, the taxpayer can seek judicial help by initiating a suit for refund in the proper federal court.[26] The taxpayer can also file a suit for refund if the IRS simply ignores him, failing to respond to his claim for refund for at least six months.[27] Notably, a prerequisite to filing a suit for refund with the courts is previously submitting a valid claim for refund with the IRS. Relevant law expressly states that a taxpayer cannot file a suit for refund "until a claim for refund or credit has been duly filed" with the IRS.[28]

Prohibition Against Nuisance Settlements

Additional groundwork for readers is an explanation of "nuisance settlements" and why the IRS should not employ them.

The IRS is not supposed to extract money from taxpayers by proposing settlements that are designed to get taxpayers to surrender solely to avoid the additional costs and burdens of battling with the IRS. For example, in a situation in which a taxpayer demonstrates to an IRS Appeals officer that he would have an 85 percent chance of prevailing against the IRS if he were forced to litigate his case in Tax Court, logic and basic economics dictate that the Appeals officer should grant the taxpayer a complete victory. Put differently, if the taxpayer proves the overwhelming strength of his factual, tax, and legal positions, an Appeals officer should not obligate him to pay 15 percent of the amount sought by the IRS based on a risk-versus-reward analysis.

The preceding example is consistent with a long-standing IRS policy statement that unequivocally establishes that "no settlement will be made if it is based on nuisance value to either party."[29] In this context, the term "nuisance value" means "any concession made solely to eliminate the inconvenience or cost of further negotiations or litigation, and is unrelated to the merits of the issues."[30] The guidance that the IRS provides to its personnel offers other important instructions. It says, for instance, that "no case is to be settled on a so-called nuisance basis, either for or against the government."[31] In case that directive was not strong enough, the IRS also instructs its troops as follows:

> Nuisance settlements are disfavored and should be rejected. The practice of conceding a very small percentage of a case without regard to the merits is to be thoroughly discouraged. If the [IRS's] chances of success in litigation are extremely small (for example, less than 10 percent), the [IRS] should not attempt to elicit a settlement from the taxpayer because of cost of litigation to the taxpayer. Where the [IRS's] case is extremely weak, serious consideration should be given to recommending concession of the case [in favor of the taxpayer].[32]

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[24] Section 6511(a).

[25] *Id.*; reg. section 301.6511(a)-1(a).

[26] Section 6532(a)(1); reg. section 301.6532-1(a); section 7422(a).

[27] *Id.*

[28] Section 7422(a); reg. section 301.6402-2(a)(1).

[29] IRS Policy Statement 8-47, IRM section 1.2.1.9.6; reg. section 601.106(f)(2).

[30] *Id.*

[31] IRM section 35.5.2.4.

[32] IRM section 34.8.2.5.1(10); *see also 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).

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Abatement of Form 3520 Penalties

The IRS came under fire for its mishandling of international information returns during the past few years — both those filed in the normal course and those filed under one of the many international disclosure programs offered by the IRS, such as the DIIRSP.[33] The IRS attempted to cast the blame on COVID-19, explaining that it "had an unprecedented effect on the IRS's personnel and operations" and that "the IRS has been working aggressively to process backlogged returns and taxpayer correspondence to return to normal operations."[34] In what some have interpreted as a tacit acknowledgment of past errors and problems, the IRS released Notice 2022-36, 2022-36 IRB 188, in August. It indicated, among other things, that some Forms 3520 for 2019 and 2020 would not be penalized. The IRS said that depending on the status of a given case, the penalties would be "automatically abated, refunded or credited, as appropriate, without any need for taxpayers to request this relief."[35]

While this relief will surely benefit many taxpayers facing unfair Form 3520 penalties, the taxpayer in *Wrzesinski* likely will not be among the lucky ones. Why? He filed his Forms 3520 as part of the DIIRSP in August 2018, received penalty notices in May 2019, submitted a protest letter in June 2019, lodged the supplemental protest letter in July 2019, and dealt with the Appeals Office in December 2020. Some of these actions occurred in the thick of the pandemic and the corresponding problems for the IRS, which would seem to make Notice 2022-36 applicable, at least in spirit. However, the Forms 3520 that the taxpayer in *Wrzesinski* filed were for 2010 and 2011, not 2019 and 2020. Thus, absent an expansion of the relief envisioned in Notice 2022-36, the IRS likely will argue that it is inapplicable to him.

Pending Case

Wrzesinski, which centers solely on Form 3520 penalties linked to the receipt of foreign cash gifts, is important for two main reasons. For starters, it appears to be the first case addressing this particular issue. It also touches on other interesting, tangential issues that might prove relevant to taxpayers confronting similar situations.

The taxpayer filed his refund suit in September, so the dispute is just getting underway. He was born, raised, and educated in Poland, and emigrated to the United States when he was 19 years old. He has been 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 (an enrolled agent with the IRS) to inquire about any U.S. duties triggered by receipt of the gift. The tax adviser expressly told him that the gift did not cause U.S. income tax liabilities or trigger any other duties. The taxpayer's mother made the gift via four separate transfers from Poland to the United States, spanning 2010 (a total of $350,000) and 2011 (a total of $480,000). Thus, the taxpayer received over $100,000 in cash gifts from a foreign person in each of those years. 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 gift from his mother. The tax adviser, as before, incorrectly told the taxpayer that nothing was due. The complaint filed with the district court does not go into detail, but one assumes that the taxpayer did not revisit the issue with the tax adviser when preparing his Form 1040 for 2011 because they addressed it the prior year.

Nothing happened for a long time; the taxpayer did not receive additional gifts, and the IRS never audited him. Things changed in 2018. The taxpayer wanted to engage in some re-gifting and send a portion of the money that he previously received from his mother to his godson in Poland. The taxpayer thought that he, as a U.S. person, might have tax-related duties when sending a gift abroad, so he did some internet research about foreign gifts, which led him to articles about the duties of U.S. persons who receive money from foreign persons. Shocked by this information, the taxpayer contacted a local attorney with experience in international tax matters.

[33] *See, e.g.*, AICPA letter calling for more transparency from the IRS on backlog (July 11, 2022).

[34] Notice 2022-36, section 2.

[35] Notice 2022-36, section 3(A).

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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 that there might be a way for the taxpayer to rectify matters with the IRS on a penalty-free basis through the DIIRSP. The taxpayer, with the assistance of the attorney, filed Forms 3520 for 2010 and 2011 in accordance with the DIIRSP, along with statements explaining the reasonable cause behind his failure to file earlier. This occurred in August 2018. The statements contained several contentions, the most important of which were that the taxpayer consulted with his tax adviser before filing his Form 1040 for 2010, gave the tax adviser details about the foreign gifts, received erroneous advice from the tax adviser, and relied on that advice.

In May 2019 the IRS sent the taxpayer two notices saying that he owed penalties totaling $207,500 for the late Forms 3520. That figure represented the highest possible penalty amount, which was 25 percent of the gifts received. In essentially rejecting the DIIRSP application and accompanying statements, the IRS concluded that ordinary business care and prudence require taxpayers to make themselves aware of their duties and that ignorance of tax laws could not serve as a basis for reasonable cause.

The taxpayer disputed the IRS notices and penalties by filing a protest letter in June 2019. To strengthen his position, he later filed a supplemental protest letter, attaching a letter from his tax adviser that acknowledged the veracity of the facts set forth in the complaint. In other words, the tax adviser corroborated the taxpayer's reasonable reliance defense.

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

The taxpayer, clearly indignant, paid the remaining $41,500 and filed claims for refund in March 2022, which the IRS swiftly denied. The IRS took the position that the refund claims did not establish reasonable cause and were frivolous. The taxpayer then filed a suit for refund in the district court in September.

Conclusion

Wrzesinski is positioned to be of great importance to the tax world. First, the case will educate the public about the obscure duty to file Form 3520 upon receipt of some foreign gifts by U.S. persons. Second, the IRS will be forced to clarify its stance regarding what, exactly, constitutes reasonable cause in the context of complex international information returns. Third, the IRS will need to explain the functioning, or perhaps malfunctioning, of the DIIRSP and its enticement to taxpayers of penalty-free resolution. Fourth, the IRS will have to address whether its long-standing prohibition against nuisance settlements still exists. Fifth, the district court must decide the amount of deference to grant the IRS's penalty decision — in particular its conclusion that the taxpayer's reasonable reliance defense did not establish reasonable cause and was frivolous. Sixth, the IRS likely will be obligated to justify what might be characterized as an inconsistent application of penalty relief under Notice 2022-36. For this and other reasons, taxpayers facing Form 3520 penalties, now and in the future, should be paying attention to this pending case. ■

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