POISONED GIFTS
The Case for Reform of Section 6039F

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Section 6039F[2] is the classic example of a solution in search of a non-existent problem. It should be repealed. And if it is not repealed, its scope should be radically cut back and the Internal Revenue Service's use of the section should be reined in. What is happening now cannot be what Congress intended (if it actually thought about it, which itself is a matter of doubt). As matters stand, it is doubtful whether the Service has ever on a single occasion made use of the section for what we might divine was its purpose; instead, it has become a cash cow which results in uninformed citizens and residents being forced to pay tens of millions of dollars of penalties every year for failing to report transactions to the government that substantively are completely taxfree.

Moreover, the way section 6039F is administered by the Service is heavy-handed to an abusive extreme, a shameful imposition of government power on taxpayers who are not evading any tax. The government lured many such taxpayers into believing that if they became aware of their failure to comply with the statute, they could make things right by filing late and providing a reasonable explanation for the failure (and reasonable explanations are easy to find, as we shall see). Any sucker who falls for this will be promptly and immediately imposed the maximum penalty and then forced to deal with an impenetrable bureaucracy from which he or she may be able to escape, if at all, only at enormous cost in professional fees. In my long professional career of advising on international tax matters, I have always, without exception, advised clients to correct their mistakes, even at the risk of incurring interest and penalties; but in the case of section 6039F, the government's misconduct is so consistently egregious and oppressive that I feel, in many cases, that the right advice is to do nothing.

And the government's abuse of section 6039F and Form 3520 goes beyond punishing the non-compliant. It extends further, to the automatic imposition of penalties beyond the maximum permitted by statute and to imposing penalties on taxpayers just for filing the form at all, even when that filing is timely. If only these incompetent mistakes could be fixed with a simple phone call, except that it is impossible to reach the Service, or by a protest letter, except that the Service personnel who impose the penalties refuse to read the letters. It cannot be that my firm alone has suffered multiple examples of this treatment, where one cannot get a penalty reversed even after proving that the form was filed on time and where a 25% penalty is imposed on a form that is less than a month late (the statutory rule is 5% per month, with a maximum of five months). Often, the only solution is to contest the penalty when the Service attempts to collect it, but IRS collections will not abate or reverse a penalty that is over $1 million. Wholly unreasonable amounts of legal expenses must then be incurred to fix the problem, in an area replete with procedural minefields.

So what is this provision that has triggered these hostile feelings in someone whose friends and professional colleagues would in any other situation describe as the calmest and straightest of

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[2] Section 6039F of the Internal Revenue Code of 1986, as amended (the "Code"). All unprefixed references to sections are to sections of the Code.

straight arrows? Section 6039F was enacted into the Code by the Small Business and Job Protection Act of 1996.[3] It provides that if the value of the aggregate foreign gifts received by a U.S. person, other than a tax-exempt organization, during any year exceeds $10,000, the U.S. person must file a report with the Service as prescribed. A foreign gift is defined as "any amount received from a person other a U.S. person which the recipient treats as a gift or bequest." There are two exceptions described below.

The $10,000 amount is required to be inflation adjusted.[4] However, in 1997, the Service waived reporting for gifts of $100,000 or less, but only for gifts and bequests from foreign individuals or estates.[5] The $100,000 amount has never been inflation-adjusted nor is it required to be. Once the threshold has been met, only gifts of $5,000 or more are required to be separately identified and the identity of the donor is not required to be disclosed. On the other hand, purported gifts from foreign corporations and foreign partnerships are required to be reported if they meet the inflation-adjusted statutory threshold.[6] While we will refer where necessary to the rules relating to such corporate and partnership gifts, unless otherwise stated, references in this article to foreign gifts are to gifts and bequests from individuals and estates (not trusts).

The Service requires that reportable foreign gifts and bequests be reported on Form 3520 (Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts). Form 3520 is a multi-purpose form that is also used to report certain transactions in relation to foreign trusts. The only parts of the form that the recipient of a foreign gift or bequest must complete are the first page (general information) and Part IV. The only information required is the date of gift or bequest, a description of the property received, and the fair market value of the property received. The donor does not have to be named, nor does the form inquire about the relationship of the donor to the donee, although surely this would better allow the Service to identify purported gifts that were in fact something else.

Given that a gift or bequest from any person, foreign or U.S., is not subject to tax in the hands of the recipient,[7] what purpose is served by asking for this information? The legislative history of section 6039F gives no explanation! For example, the Joint Committee on Taxation's General Explanation of the 1996 Act states that there was no there was no requirement to report gifts or bequests from foreign sources under prior law; it also explains the new provision. But it gives no reason for the change. The Conference Report is the same.[8] In other words, Congress never stated why this addition to the law was needed.

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[3] Pub. L. 104-188, section 1905(a). The law does not identify the job that was, in fact, protected.

[4] Section 6039F(d). In 2022, this amount is $17,339 – see Rev. Proc. 2021-45 sec. 3.47.

[5] Notice 97-34, 1997-1 CB 422, Section VI-B.1.

[6] Ibid., section VI-B.2, which notes that such gifts are subject to recharacterization under section 672(f)(4).

[7] Section 102(a). The only exception is a gift from a covered expatriate, but the vast majority of foreign gifts are not from covered expatriates. Section 2801, enacted by Public Law 110-245 section 301, effective for gifts made by covered expatriates whose expatriation date was on or after June 17, 2008. Section 2801 is a provision with its only problems, to the point where 14 years after its enactment no tax has been collected. I continue to be amazed at how Congress thought it was good idea to enact a provision that encourages foreign persons to avoid making gifts to U.S. relatives and to make them to foreign relatives instead.

[8] Conference Report on H.R. 3448, Small Business Job Protection Act Of 1996; Congressional Record Vol. 142, No. 116 (available at https://www.congress.gov/congressional-record/1996/08/01/house-section/article/H9568-3 at H9655 - viewed April 16, 2022).

When I asked a friend who was at Treasury during the 1990s and helped craft the recommendations for the various foreign trust rules that ended up in the 1996 legislation, he referred to "the games that have always been played with 'gifts' from foreign sources." Congress at least did not bother to give even this much of an explanation. And what games are those, I wonder, if the gifts actually came from family members? No evidence has been presented that these "games" were any more widespread than voter fraud.

We can discard at least one reason: It's quite clear that a trust distribution is not reportable under section 6039F, even if the distribution is treated as a gift in the hands of the recipient.[9] Instead, it must be reported (on Form 3520) under section 6048(c). We do not need section 6039F to deal with trust distributions.

We therefore have to guess at the reason. The most reasonable inference, given that the provision accompanied a group of income tax provisions relating to foreign trusts, was that it was intended to provide information that would enable the detection of income tax avoidance. Essentially, by receiving these reports, the Service would be able to examine whether the transfer of property received by the U.S. taxpayer really was a gift, in which case it was indeed not subject to income tax, or was income disguised as a gift. This inference is supported by the cross-reference to section 672(f)(4), providing for income tax to be imposed on certain "purported" gifts by foreign corporations and partnerships. Section 672(f)(4) was also enacted by the 1996 Act.[10]

Failure to comply with section 6039F carries with it heavy penalties. If the gift is not timely reported, the IRS has the right to determine the tax consequences of the gift and the U.S. person must pay a penalty equal to 5% of the amount of the gift for each month for which the failure continues, not to exceed 25%. These penalties do not apply to any failure to report if the recipient shows that the failure is due to reasonable cause and not to willful neglect.

It's not hard to see how all this might go wrong. Section 6039F was never well known to tax preparers. A typical income tax preparer charged with computing a taxpayer's income might well not think to ask about the receipt of a gift, which is not taxable. The Service never bothered to publicize the requirement. It has never included a question about foreign gifts in Part III of Schedule B of Form 1040, where it asks about foreign trusts as well as foreign bank accounts, which are also subject to reporting requirements with heavy penalties for compliance failures. The 114 pages of general instructions to Form 1040 for 2021 do not mention the requirement. Income tax preparation software typically doesn't ask a question about foreign gifts. How, we have to wonder, were taxpayers supposed to know about this obscure requirement?

Further, the information gathered by the form has no value to the Service.[11] The author has asked the Service if it has ever audited a gift from an individual reported on Form 3520 and determined

[9] Section 6039F(b).

[10] We might note that there is no presumption in section 6039F that an amount treated by the taxpayer as a gift is income if adequate records concerning the gift are not provided to the Service. There is such a presumption in the case of trust distributions – see section 6048(c)(2) – presumably because a trust distribution can be income if made out of distributed net income or undistributed net income of a foreign trust but is not income if made out of trust capital or is treated as a gift, either under the grantor trust rules or section 663(a)(1) (certain fixed distributions provided for by the trust instrument).

[11] There is, I believe, a disturbing trend in the United States for the government to ask for a huge amount of information from its citizens that it does not have the ability to process and which instead is used as a vehicle for

that the gift was actually not a gift. There has been no reply to date, many months after submission of a FOIA request. I suspect, in fact, that the Service has never even audited such a gift for purposes of making such a determination. Rather, the Service's entire focus has been on penalizing taxpayers for compliance failures, when not a single penny of tax was being avoided. And perhaps I am speculating here, but I would guess that the vast majority of those penalties has been imposed on taxpayers who came forward voluntarily to report late.

What should we do? First, I would argue that section 6039F should be repealed. The reports themselves do not raise revenue; only the failure to report and the attendant penalties raise revenue. It is dishonorable for our government to create useless reporting requirements that it does not need and the only use for which seems to be to enable the government to levy penalties on those who do not comply. If, notwithstanding, Congress perceives some use for these reports that it has not previously thought fit to mention to us, it should at least make an exception for gifts from family members and it should in any case eliminate reporting of inheritances.

Further, the Service needs to back off. It should have a policy of automatically or at least generously abating the penalties in any case where the gift is from a family member – in fact, it could simply not require Form 3520 reporting for gifts from and bequests from family members. It should have a liberal policy of first-time abatement that does not require thousands of dollars of professional fees to extract.

Also, the Service should include a line item in Form 1040, or at the very least in the instructions, notifying taxpayers of the need to file these returns. The Service also needs to do a much better job of letting tax preparers know about section 6039F. Tax preparers concern themselves with income; since a gift is not income to the recipient, it will not necessarily occur to a preparer to ask the recipient about it.

The rules relating to gifts from partnerships and foreign corporations have their own problems. Let's start with the obvious point that the statutory foundation for the rules is found in section 672(f)(4), that is in Subchapter J which, as its title indicates, deals with estates, trusts, beneficiaries and decedents, as well as trust grantors. But a gift from a foreign corporation or a partnership has nothing whatsoever to do with trusts. No one who did not already know about the rules would think to look there.

But beyond this, there are other difficulties. The statute itself simply gives the IRS power to recharacterize a transfer from a corporation or a partnership which the transferee treats as a gift or bequest, if the IRS determines that recharacterization is appropriate to prevent the avoidance of

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punishing the non-compliant. Examples are easy to find: Consider the overlapping requirements of IRS Form 8938 and the FBAR; the requirement for U.S. persons to report signature authority over foreign accounts in which they have no financial interest; the requirement in the Corporate Transparency Act that will require an estimated 30 million businesses to report their ultimate beneficial owners not once but every time there is a change; the requirement to file Form 8621 in relation to passive foreign investment companies even if the taxpayer has no reportable income; the apparent belief of the Service that individuals resident in another country under the provision of an income tax treaty must nevertheless file many international information forms as if they were residents. I am open to some government official credibly telling us what, if anything, the government is doing, or in the case of the CTA, plans to do with all this data. Perhaps I am too cynical, but I think that much more effort will be put into penalizing the noncompliant than making use of the data for enforcement of our tax laws.

the purposes of subsection 672(f). The regulations impose onerous requirements which seem to ignore the real world.

In the case of partnerships, any "purported gift or bequest" from a (domestic or foreign) partnership must be included in the U.S. donee's gross income as ordinary income, with certain exceptions. In the case of purported gifts or bequests from a foreign corporation, the gift or bequest must be included in the donee's income as if it were a distribution, presumably to be dealt with under section 301(c). Section 301(c) only treats the portion of the distribution that is treated as a dividend as includible in gross income and also provides that the portion of the distribution which is not a dividend is to be applied against adjusted basis, with any excess being treated as gain from the sale of property. However, the regulations provide that the donee's basis in the stock will be treated as zero. There is no statutory basis for this provision.

The exceptions in the regulations that apply to individuals are the following:

First, the U.S. donee may demonstrate that either a U.S. citizen or resident who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for U.S. tax purposes as a distribution to such individual and a subsequent gift or bequest to the U.S. donee; or a nonresident alien who directly or indirectly holds an interest in the partnership or foreign corporation treated and reported the purported gift or bequest for purposes of the tax laws of the alien's country of residence as a distribution to such individual and a subsequent gift or bequest to the U.S. donee, and the U.S. donee timely complied with the reporting requirements of section 6039F, if applicable.

The regulations do not explain what the U.S. donee can do if there were no relevant tax laws in the foreign country – many countries do not impose income taxes or provide applicable exemptions (for example, by exempting foreign income); many others do not impose gift or inheritance taxes (our neighbor Canada, for example); and some impose neither. And what if the foreign country treated the payment as employment or services income rather than as a distribution?

Second, the rule does not apply to a purported gift or bequest from a domestic partnership if the U.S. donee can demonstrate that all beneficial owners of the partnership are United States citizens or residents or domestic corporations. Presumably, this means at the time of the gift. There seems to be no principled reason for this exception.

We cannot conclude this rant without also suggesting that the IRS should also reconsider the penalties it imposes for failure of a U.S. beneficiary (who is not a grantor) to report distributions from a foreign grantor trust. Such a distribution is treated as a gift for income purposes.[12] I understand that where a foreign trust is involved, the IRS may well want to examine whether the trust is a grantor trust or not. But if that is really what it wants, then it should not impose huge penalties where the trust turns out to be a grantor trust. The failure to file the form in such circumstances is a foot fault, and no income tax has been avoided by the beneficiary. At the very least, penalties should not be imposed when the grantor of the grantor trust is a family member of the beneficiary (or the beneficiary's spouse) or, if the Service cannot bring itself to eliminate the

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[12] See Rev. Rul 60-70.

penalties, non-wilful failures should be put on a similar level to the penalties for non-wilful failing to file Form 5471.

I am not the only person who thinks that the IRS has lost its way. The AICPA, the Florida Bar, and the Texas Bar, even a former senior IRS official, Daniel Price, have all weighed in.[13] I belatedly add my name to that list. It is high time that the IRS completely rethink its approach to Form 3520 and I also urge Congress to repeal section 6039F or radically reform it so that it actually meets some useful government objective.

[13] See "Commentators Line Up to Critique Foreign Trust Penalty Operation", Tax Notes, March 6, 2023