



failing to report gifts from overseas can result in large penalties

MSK Client Alert

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Background. The law is well settled that the recipient of a gift or bequest is not required to pay income taxes when he or she receives the gift or bequest. For example, if John receives a gift of \$200,000 from his good friend Jane, John will not owe any income taxes as a result of this gift. Depending on the source of the gift, however, John may be required to notify the IRS that he received it. Specifically, if Jane is not a U.S. citizen or resident, John will be required to report the receipt of this gift to the IRS (even though he will not owe any taxes). If John fails to timely report this gift, he may be liable for a penalty of up to 25% of the value of the gift.

The Law. In 1996, the Small Business Job Protection Act added Section 6039F to the Internal Revenue Code. Section 6039F requires recipients of certain gifts from "non-U.S. persons" to report these gifts to the IRS (even though the gifts are not taxable to the recipient). Section 6039F also imposes an onerous penalty on persons who fail to comply with its requirements.

Despite the fact that this provision became law 17 years ago, many people (including many tax practitioners) are not aware of its reporting requirements. Because the consequences of failing to comply with the reporting requirements can be severe, we thought that it would be helpful to review these requirements to help ensure that they are not ignored.

Determining Which Gifts Must Be Reported. Certain gifts and bequests from "non-U.S. persons" that exceed a threshold amount are potentially subject to the Section 6039F reporting requirements.

A non-U.S. person is any person other than a citizen or resident of the U.S. or a U.S. partnership or corporation. A non-U.S. person also includes a foreign estate.

For purposes of determining whether the receipt of a gift from a non-U.S. person is reportable, different reporting thresholds apply to gifts received from nonresident alien individuals and foreign estates and to gifts received from

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foreign partnerships and foreign corporations.

The IRS requires a U.S. person to report a gift from a nonresident alien or foreign estate if the total amount of gifts from these sources is more than \$100,000 during the tax year. Once the \$100,000 threshold has been met, the recipient must separately identify each gift that is more than \$5,000, but is not required to identify the donor. For example, if a U.S. citizen receives a \$1 million bequest from the estate of a deceased relative who was not a U.S. citizen or U.S. resident, even though the bequest will not result in an income tax liability to the beneficiary (who is a U.S. citizen), the beneficiary will be obligated to report the receipt of the bequest to the IRS.

A U.S. person must report the receipt of gifts from foreign corporations and foreign partnerships if the total amount of the gifts from all such entities during the year is more than \$10,000, subject to cost-of-living adjustments. The cost-of-living adjustments make the reporting threshold \$14,723 for 2012 and \$15,102 for 2013. Once the threshold has been met, the gift recipient is required to separately identify all gifts from a foreign corporation or foreign partnership and provide the name of the donor.

Satisfying the Reporting Requirements. A recipient subject to the reporting requirements must file IRS Form 3520 (Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts). The Form 3520 is due on the same day that the recipient's income tax return for that year is due (including any extensions obtained with respect to that return). The Form 3520 is not filed with the recipient's income tax return. Instead, it must be separately filed with the IRS at the address shown on the instructions to the Form 3520 (at present, the Form 3520 must be filed with the IRS Service Center in Ogden, UT).

Exceptions to the Reporting Requirements. Certain gifts are exempt from these reporting rules. Specifically, qualified tuition payments that are made directly to an educational institution for the education or training of the gift recipient are exempt. Similarly, qualified medical payments that are made directly to a person who provides medical care to the gift recipient are exempt. In addition, certain gifts that are adequately disclosed on a tax return are exempt from the reporting requirements.

Penalty for Failing to Comply With the Reporting Requirements. The penalty for not timely reporting a foreign gift on a Form 3520 can be severe. The penalty is measured by the value of the gift and is equal to 5% of its value for each month that the failure to report continues, up to a maximum of 25%. This means, for example, that if a U.S. person receives a gift from overseas with a value of \$1 million and fails to file the Form 3520 for five months or more, he or she will be required to forfeit \$250,000 of this gift (plus interest).

The IRS is authorized to abate the penalty if the recipient can show that the failure to report the gift is due to reasonable cause and not due to willful neglect.

Planning Opportunities. With some planning, it may be possible to avoid having to report the receipt of a gift in certain instances. For example, assume that a U.S. person expects to receive a gift of \$150,000 from a nonresident alien individual or from a foreign estate. If practical, the recipient can try to arrange to have the gift paid over two tax years such that the amount paid does not exceed \$100,000 in either year. Alternatively, it may be possible to have some or all of the gift paid in the form of qualified tuition or medical payments. If this can be done and if the remainder of the gift is less than the threshold amount for reporting, it may be possible to avoid



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having to file the Form 3520.