The IRS Challenges Gifts to and from Foreign Persons: Analyzing Two Recent Victories for Taxpayers

By Hale E. Sheppard*

I. Introduction

Gifting can be rewarding, but it can also generate problems with the Internal Revenue Service ("IRS"). The applicable tax and information-reporting rules are generally complicated, of course, and they can become downright tricky when foreign persons are involved. The IRS has attempted to capitalize on this reality in two recent cases, asserting large penalties against a U.S. individual *receiving* a gift from a foreign relative, and seeking significant gift taxes and penalties from another U.S. individual *making* a gift to a foreign relative. Although the IRS lost in both instances, these types of challenges should serve as a warning to taxpayers to better understand international tax compliance matters, as well as the potential downsides associated with attempting to resolve inadvertent violations with the IRS through one of its disclosure programs.

II. Receiving Gifts from Foreign Persons

U.S. individuals with international interactions have various tax and information-reporting obligations with the IRS. One such duty is triggered by receiving a foreign gift. A recent case, *Wrzesinski v. United States*, highlights this obscure issue.[1] Readers first need some background to understand that case and its significance.

A. Duties and Penalties

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 (*Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts*) with the IRS providing data about the event.[2] The receipt of the foreign gift does *not* trigger U.S. income

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taxes for the recipient, 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 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 where U.S. individuals receive foreign gifts.[3]

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

B. Possible Mitigation

As explained above, a showing of reasonable cause can help taxpayers avoid penalties. In ascertaining 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.[7] Doing so unveils the following critical 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 and/or pay taxes.[8] 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 complexity of the issue.[9]

Second, a taxpayer's reasonable reliance on an independent, informed, qualified tax professional often constitutes reasonable cause.[10] For purposes of this so-called "reasonable reliance defense," the concept of "advice" broadly covers "any communication" from an advisor and it "does not have to be in any particular form."[11] The Supreme Court mandates that the IRS liberally construe this defense in favor of taxpayers.[12] The Tax Court, for its part, has held that reasonable reliance only exists where three elements are present: the advisor was a competent professional with sufficient expertise, the taxpayer provided the advisor necessary and accurate information in a timely manner, and the taxpayer relied in good faith on the advisor's advice.[13]

Lastly, the IRS has admitted that most taxpayers are oblivious to the need to file Form 3520 when they receive a foreign gift, particularly because such an event does not trigger taxes for U.S. purposes. The IRS stated the following in a recent training guide for personnel addressing information return issues in the context of voluntary disclosures.

In general, gifts and inheritances are not taxable to the recipient. Many taxpayers and representatives know that basic tenant of tax law but are not aware of the requirement to report large foreign gifts and inheritances.[14]

C. Case of First Impression

With this underlying information in hand, it is time to move to the first federal case dealing with Form 3520 penalties related to foreign gifts, *Wrzesinski v. United States*.

The taxpayer in the case was born, raised, and educated in Poland. He immigrated to the United States when he was 19 years old. 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 advisor from Poland in 2010 to inquire about any U.S. duties triggered by his receipt of the gift. The tax advisor, who was an Enrolled Agent, 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* several 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 preparation of his Form 1040 for 2010, the taxpayer again asked his tax advisor if he needed to file anything with the IRS in connection with the gifts from his mother. The tax advisor, as before, incorrectly told the taxpayer that nothing was due.

The taxpayer did not receive any additional gifts, and the IRS never audited him. Things changed in 2018. The taxpayer wanted to do some re-gifting, sending a portion of the money that he previously received from his mother years ago 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. Therefore, he did some searches about "foreign gifts" on the Internet. 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 regarding international 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 voluntary disclose program known as the Delinquent International Information Return Submission Procedure ("DIIRSP").[15] The taxpayer, with the assistance of the attorney, filed Forms 3520 for 2010 and 2011 pursuant to 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 advisor before filing his Forms 1040, gave the tax advisor details about the foreign gifts, received erroneous advice from the tax advisor, and relied on such advice.

After nearly a year, the IRS sent the taxpayer two notices in May 2019, indicating that he owed total penalties of $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 of $207,500 by filing a Protest Letter in June 2019. To strengthen his position, the taxpayer later submitted a Supplemental Protest Letter, attaching a letter from the tax advisor in which he corroborated the taxpayer's reasonable-reliance defense. The tax advisor 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 his decision. The Appeals Officer agreed to abate $166,000 of the penalty. That left $41,500, or five 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 for Refund did not establish reasonable cause and were "frivolous." The taxpayer then initiated a Suit for Refund in District Court in September 2022.

The IRS quickly came under scrutiny for its handling of the Form 3520 penalties in *Wrzesinski v. United States*, with commentators warning that an unfavorable decision for the IRS could open the proverbial can of worms.[16] The tax attorneys at the Department of Justice ("DOJ"), who handle refund litigation, 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 lodged by the taxpayer.[17] In other words, the DOJ fully surrendered before it submitted any pleadings with the District Court, engaged in any discovery procedures, filed any legal briefs, or otherwise attempted to defend the IRS' earlier position that the taxpayer should be stuck with penalties.

Prevailing against the IRS and DOJ must have been satisfying to the taxpayer in *Wrzesinski v. United States*. Indeed, he held his ground, obtained judicial vindication in a case of first impression, and eventually managed to rid himself of all penalties. The taxpayer's victory is bittersweet for others facing international information-return penalties, though. They yearned for a victory for the taxpayer, of course, but only *after* a trial and the issuance of full-blown written opinion by the District Court. These events might have yielded some items helpful to *all* taxpayers with inadvertent international non-compliance. For example, the IRS would have been forced to clarify its stance regarding what constitutes "reasonable cause" when it comes to obscure international information returns, like Form 3520. The IRS, moreover, would have found itself obligated to explain the standards and procedures applicable to the DIIRSP. Additionally, the District Court likely would have analyzed 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.[18] Because the DOJ conceded the case 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 Form 3520.

III. Making Gifts to Foreign Persons

A more recent Tax Court case, *Schlapfer v. Commissioner*, addresses the other side of the coin. Specifically, it examines U.S. tax and information-reporting duties associated with making a gift to any person, including a foreign one.[19] Readers first need some foundational knowledge to grasp the importance of this new case.

A. Worldwide Scope

U.S. persons generally must pay federal income tax on *all* income derived, regardless of where the income originates.[20] In other words, U.S. persons face a system of worldwide taxation, requiring them to declare to the IRS on Form 1040 or the appropriate tax return all income, whether it was earned, obtained, received, or accrued in the United States or a foreign country. This expansive duty creates numerous compliance traps for U.S. persons who have lived, worked, and/or invested abroad at any point.

B. Information Reporting

Individual taxpayers with foreign involvement ordinarily must do several things with the IRS, including, but not limited to, the following. They must electronically file a FinCEN Form 114 ("FBAR") supplying details about foreign accounts. In situations where taxpayers own or have certain other links to foreign entities, they need to file specialized information returns, too. One example is Form 5471 (*Information Return of U.S. Persons with Respect to Certain Foreign Corporations*).[21]

Violations of these duties can trigger significant penalties. First, taxpayers omitting foreign income often confront U.S. tax liabilities, as well as sizable penalties related directly to the taxes. Examples include negligence penalties equal to 20 percent of the tax debt, penalties rising to 40 percent of the tax debt in situations involving undisclosed foreign financial assets, and penalties reaching 75 percent of the tax debt if the IRS can prove civil fraud.[22]

Second, large sanctions for unfiled, late, inaccurate, or incomplete FBARs can overwhelm taxpayers. Congress was concerned about widespread FBAR non-compliance for many years; therefore, it enacted stringent penalties in 2004.[23] In the case of non-willful violations, the maximum penalty is $10,000 per year.[24] Higher penalties apply where willfulness exists. When a taxpayer willfully fails to file an FBAR, the IRS may assert a penalty equal to $100,000 or 50 percent of the balance in the undisclosed account at the time of the violation, whichever amount is larger.[25]

Third, various penalties arise when taxpayers do not disclose their relationships with foreign entities. For instance, U.S. persons who are officers, directors, and/or shareholders of certain foreign corporations ordinarily must file Form 5471 with the IRS.[26] If they neglect to do so, the IRS may assert a penalty of $10,000 per violation, per year.[27]

The penalties described above can be significant, even when considered separately. They can become untenable, though, when the IRS decides to "stack" penalties, asserting several of them in connection with the same foreign item. A District Court recently held the "stacking" of certain penalties by the IRS is not prohibited by law or the Constitution.[28]

C. Involuntary Extensions of Assessment Periods

The IRS generally has three years from the date on which a taxpayer files a return to assess additional taxes and penalties related to that return.[29] The IRS can extend the three-year period in various situations, two of which are described below.

1. Unfiled, Late, or Incomplete Information Returns

Code Sec. 6501(c)(8), which is an exception to the general three-year rule for assessment, applies to cases where a taxpayer fails to file certain international information returns.[30] This provision states that, if a taxpayer does not submit a required return, such as a Form 8938 or Form 5471, then the assessment-period *never* starts to run. The IRS, therefore, has an endless opportunity to audit not only the unfiled information returns, but also the tax returns to which they should have been attached in the first place. This essentially prevents taxpayers with international non-compliance from running out the clock on the IRS.[31]

The IRS has issued various types of internal guidance featuring an expansive interpretation of its powers. Specifically, the IRS issued a memorandum to staff concluding that the extended assessment period "applies to the entire return and not only to the tax deficiency attributable to the information which was not reported, unless the failure to provide the required information is due to reasonable cause and not willful neglect."[32] The IRS also released an International Practice Unit, which underscores that the assessment period remains open indefinitely when a taxpayer either fails to file a Form 5471 or files one that is not "substantially complete."[33]

2. Substantial Omissions of Income

The preceding segment addressed the IRS' ability to expand assessment periods indefinitely where taxpayers have missing, late, or incomplete international information returns. The IRS has similar powers in cases of unreported income, particularly foreign income.

The relevant provision states that if (i) a taxpayer omits income from a tax return, *and either* (ii) such omitted income exceeds 25 percent of the gross income that the taxpayer actually reported on the tax return, *or* (iii) such omitted income is more than $5,000 *and* is attributable to one or more foreign financial assets, then the IRS can assess income taxes within six years of the date on which the taxpayer files the relevant tax return.[34] Stated differently, in the circumstances described here, the period during which the IRS can identify a taxpayer, conduct an audit, and impose additional taxes and penalties expands from three to six years. The primary consequence of this provision is that minor amounts of omitted foreign income can keep the assessment period open for a full six years, and it takes little to reach the threshold of $5,000 in today's economy.[35]

D. Delays Galore

The Taxpayer Advocate Service ("TAS") noted in its report to Congress for 2012 several concerns about international tax administration. It pointed out, for instance, that the average processing time was 550 days (*i.e.*, nearly a year and a half) for those opting out of the Offshore Voluntary Disclosure Program ("OVDP").[36]

The TAS repeated its earlier thoughts in 2013.[37] It cited even longer processing times than in the previous years for cases in the voluntary disclosure programs.[38]

In 2014, TAS reiterated its apprehensions to Congress about the voluntary disclosure programs, particularly the OVDP, and the effects on taxpayer rights.[39] The TAS emphasized that "IRS delays may have prompted some benign actors to accept disproportionate offshore penalties," and "OVDP cases generally remain unresolved for long periods."[40]

The Treasury Inspector General for Tax Administration ("TIGTA") released a report in 2016 pointing out that it took the IRS nearly two years to complete approximately 20,000 initial case certifications, with nearly 250 taking more than four years. [41] TIGTA explained that the reason for these excessive delays was "internal control weaknesses" and "poor communication between functions."[42]

E. Making Gifts to Foreign Persons

U.S. citizens and residents who make certain gifts generally are hit with gift taxes.[43] Such taxes apply regardless of whether the gift is made directly or indirectly, the property is real or personal, or the property is tangible or intangible.[44] The amount of tax is based on the value of the property transferred at the time the transfer is completed.[45] Individuals who transfer property gratuitously ordinarily must report this event to the IRS on a timely Form 709 (*U.S. Gift and Generation-Skipping Transfer Tax Return*).[46]

Gift taxes do not apply in various situations. Of particular relevance to this article, the term U.S. resident in the gift tax content only covers individuals who have a "domicile" in the United States at the time that they make a gift.[47] The regulations indicate that an individual "acquires a domicile in a place by living there, for even a brief period of time, with no definite present intention of moving therefrom [and] residence without the requisite intention to remain indefinitely will not constitute domicile ...."[48]

F. Recent Case

With that essential information understood, readers are ready to turn to the recent Tax Court case involving foreign gift issues, *Schlapfer v. Commissioner*.

1. Initial Facts and Assets

The taxpayer was born, raised, and educated in Switzerland. He began working there, too. In 1979, when he was about 30 years old, he was transferred to the United States by his employer. He first had a non-immigrant visa, he later obtained a Green Card, and he eventually became a U.S. citizen in 2008. He started several businesses while living in the United States, one of which was European Marketing Group, Inc. ("EMG"). It was a company established in Panama that managed investments. The taxpayer was the sole owner of EMG.

On July 6, 2006, the taxpayer applied for a Universal Life Policy ("Insurance Policy") offered by Swisspartners Insurance Company. The alleged purpose of the Insurance Policy was to create and fund an instrument that his mother, aunt, and uncle could use to benefit his nephew. None of those family members was a U.S. person. The application identified (i) the taxpayer as the policyholder, (ii) the mother, aunt, and uncle as the insured lives, (iii) the taxpayer and his spouse as primary beneficiaries, and (iv) the taxpayer's children and stepchild as secondary beneficiaries. The application also indicated that AIG Private Bank in Switzerland would serve as custodian, meaning that the assets of the Insurance Policy would be located there. Swisspartners issued the Insurance Policy in September 2006.

The taxpayer used two sources to fund the Insurance Policy: $50,000 in cash and 100 shares of EMG. These assets were held in the account at AIG Private Bank, and

EMG issued a stock certificate showing the account as the owner. These actions occurred in late 2006.

The taxpayer then made some changes the following year. Importantly, during the first half of 2007, he removed himself as a policyholder and substituted his mother, aunt, and uncle as joint policyholders.

2. Stop, Disclosure Time

The taxpayer entered into the OVDP in 2012, submitting the requisite packet of materials to the IRS in late 2013. Why did he do this? Well, based solely on the items he filed with the IRS, it appears that the taxpayer had (i) not filed annual Forms 5471 to report his ownership of EMG, (ii) not filed annual FBARs to disclose foreign accounts, (iii) omitted substantial amounts of income from foreign sources, including EMG, and (iv) not filed a Form 709 to report the gift to his foreign relatives. As explained above, these types of violations would normally trigger substantial taxes, penalties, and extensions of assessment periods. Among the likely benefits of resolving matters through the OVDP for the taxpayer were avoiding potential criminal charges, limiting the number of years scrutinized by the IRS, and reducing penalties.

The Forms 5471 provided by the taxpayer regarding EMG notified the IRS of the total amount and type of shares outstanding, the number held by the taxpayer, and the key financial data for the company in the form of income statements, balance sheets, and earnings and profits calculations. The so-called "Offshore Entity Statement" submitted by the taxpayer offered the IRS further data about the ownership of EMG and the transfer of certain shares. It explicitly said that the taxpayer formed EMG in 2003, owned it outright until July 6, 2006, and then gifted it to his mother. Finally, the taxpayer supplied yet more details to the IRS on the Statement he attached to his "protective" Form 709 for 2006. It explained that the taxpayer had gifted the EMG stock valued at about $6.1 million on July 6, 2006, which was the date on which he applied for the Insurance Policy. The taxpayer further explained in the Statement that he was not subject to gift taxes because he did not have a "domicile" in the United States when he made the gift. The taxpayer claimed that he did not intend to permanently reside in the United States until later, in 2008, when he obtained his U.S. citizenship.

The taxpayer reported on Form 709 a gift of the EMG stock, instead of the Insurance Policy, because the instructions for the OVDP told taxpayers to disregard certain entities that hold underlying assets, and he believed that the Insurance Policy fell into that category.

3. IRS Scrutiny Begins

In 2014, a Revenue Agent sent the taxpayer an Information Document Request ("IDR") centered on Form 709. It asked for materials regarding the gift of the EMG stock in 2006 and his alleged intent not to remain in the United States until he later received his citizenship in 2008. The taxpayer quickly responded to the IDR, sending the Revenue Agent a copy of the EMG stock certificate showing the AIG Private Bank account as the owner, bank statements verifying payment of premiums and valuation, the letter to Swisspartners changing the policyholder to his mother in early 2007, and the updated term sheet of the Insurance Policy signed by his mother. In addition, the taxpayer explained that Swisspartners made a "scrivener's error" when it initially designated him as the policyholder in 2006, as all parties had intended his mother to fill that role all along. The taxpayer also submitted affidavits from family members and business partners regarding his plan not to remain in the United States in 2006.

The taxpayer essentially heard nothing further from the IRS during the ensuing two years. Then, in January 2016, the IRS notified the taxpayer that it was auditing the "protective" Form 709 for 2006 that he filed as part of the OVDP. The taxpayer agreed to a meeting with the IRS, during which he answered questions on various topics, including the nature of the gift and its value. Moreover, the taxpayer voluntarily signed Form 872 (*Consent to Extend the Time to Assess Tax*), thereby giving the IRS until November 20, 2017 to resolve the Form 709 matter.

The IRS ultimately issued an Examination Report concerning Form 709. It featured two main contentions. First, the IRS argued that the taxpayer gifted the Insurance Policy, not the EMG stock. Second, the IRS maintained that the taxpayer did not make a gift in 2006 because the transfer was not complete until 2007, when he changed (or corrected) the documents to show his mother, instead of himself, as a policyholder of the Insurance Policy. The taxpayer refused to accept these conclusions within the OVDP. The IRS, therefore, gave him two options. These consisted of voluntarily "opting out" to resolve matters through the normal procedures or being involuntarily "removed" by the IRS. The taxpayer elected the former.

4. Drawing Lines in the Sand

Based on its theory that the taxpayer made a gift in 2007, not 2006, the IRS prepared a "substitute" Form 709 for that year showing a tax liability of about $4.4 million, along with penalties of around $4.3 million. The IRS issued a Notice of Deficiency for these amounts in October 2019, which the taxpayer disputed by filing a Petition with the Tax Court.

At some point before trial, the IRS filed a Motion for Summary Judgment, asking the Tax Court to determine that the taxpayer gifted the Insurance Policy (and not the EMG stock) in 2007 (instead of 2006), as a result of which he owes the gift tax liability and penalties.

The taxpayer, rising to the occasion, filed his own Cross-Motion for Summary Judgment. He urged the Tax Court to rule that the assessment period for imposing gift taxes (for 2006 or 2007) expired before the IRS issued its Notice of Deficiency because he "adequately disclosed" the gift to the IRS.

5. Tax Court Analysis

The Tax Court began by summarizing the rules regarding assessment periods for gift taxes. It explained that the IRS generally has three years after the filing of the relevant Form 709 to make adjustments. An exception exists, however. Code Sec. 6501(c)(9) dictates that the IRS can assess gift taxes *at any time* if a taxpayer fails to file a Form 709 showing the value of the gift. That provision cautions, though, that the IRS cannot rely on the exception with respect to "any item which is disclosed [on Form 709], or in a statement attached to [Form 709], in a manner adequate to apprise the [IRS] of the nature of such item."[49] Similarly, the applicable regulations explain that a "transfer will be adequately disclosed on the return only if it is reported in a manner adequate to apprise the IRS of the nature of the gift and the basis for the value so reported."[50] The Tax Court underscored that the adequate disclosure rule applies to both completed and incomplete gifts. It cited the pertinent regulation as follows:

> Adequate disclosure of a transfer that is reported as a completed gift on the gift tax return will commence the running of the period of limitations for assessment of gift tax on the transfer, *even if the transfer is ultimately determined to be an incomplete gift* ... For example, if an incomplete gift is reported as a completed gift on the gift tax return and is adequately disclosed, the period for assessment of the gift tax will begin to run when the return is filed ...[51]

Based on the preceding, the Tax Court declared that, in order to determine the start of the assessment period, "the focus is on when the transfer was reported, not when the transfer was completed."[52] Therefore, the Tax Court indicated that it would center its analysis on whether the taxpayer in *Schlapfer v. Commissioner* "adequately disclosed" the gift on his Form 709 for 2006, because that would suffice *even if* the IRS were correct in its allegation that the gift was not completed until 2007.

The Tax Court next turned to the concept of "adequately disclosed" under the special rules for gift taxes. It referenced a recent case holding that a disclosure is adequate if it is "sufficiently detailed to alert the [IRS] to the nature of the transaction so that the decision as to whether to select the return for audit may be a reasonably informed one."[53] The Tax Court then signaled the regulation describing what constitutes adequate disclosure. It mentions several factors, including the following ones of relevance: (i) A description of the property transferred and any consideration received by the transferor; (ii) The identity of and relationship between the transferor and each transferee; and (iii) A detailed description of the method used to determine the fair market value of the property transferred, including any financial data utilized in determining the value of the interest, any restrictions on the transferred property that were considered in determining the fair market value, and a description of any discounts claimed in valuing the property.[54]

The taxpayer alluded to four documents to support his contention that he adequately disclosed the gift when he made his OVDP submission on November 20, 2013. These consisted of Form 709 for 2006, the Statement attached to Form 709, Form 5471 enclosed with his Form 1040 for 2006, and the Offshore Entity Statement.

The IRS urged the Tax Court to ignore the Offshore Entity Statement because it was not part of Form 709. The Tax Court declined. It concluded that it could consider not only Form 709, but also any documents attached to it, and any informational documents referenced in it, when deciding whether adequate disclosure occurred.[55] Expanding on this logic, the Tax Court noted that the taxpayer submitted the Offshore Entity Statement as part of his OVDP packet that included Form 709. It went on to observe that the Statement attached to Form 709 referenced the EMG stock, which alerted the IRS to review the Offshore Entity Statement. Accordingly, the Tax Court said that it would consider all four documents identified by the taxpayer (*i.e.*, Form 709, the Statement attached to Form 709, Form 5471, and the Offshore Entity Statement) in making its decision.[56]

Down but not out, the IRS argued that the taxpayer did not "adequately disclose," as this concept is described in Code Sec. 6501(c)(9) and the corresponding regulation, because he did not "strictly comply" with all the requirements. The taxpayer countered that he at least "substantially complied" with them. The Tax Court began by addressing the fundamental question of whether substantial compliance is enough in this context. It explained that courts have developed the "substantial compliance" doctrine, which dictates that a tax position will be allowed if the taxpayer shows that he substantially, though not fully, complied with the applicable requirements. The critical question is whether the requirements at issue relate "to the essence of the statute."[57] If so, then strict compliance is mandatory. On the other hand, if the requirements are merely procedural or directory, then a taxpayer can fulfill them *via* substantial compliance.[58] The Tax Court in *Schlapfer v. Commissioner* looked to Code Sec. 6501(c)(9) and described its essence as providing the IRS with a viable way to identify Forms 709 that should be audited using minimal resources. It then noted that the IRS itself had previously acknowledged in its own regulations that "substantial compliance" can satisfy the "adequate disclosure standard."[59]

This article demonstrates that the obligations for U.S. individuals receiving or making foreign gifts can be thorny, resolving non-compliance through one of the disclosure programs might not produce the expected results, and the IRS can be remarkably aggressive in its efforts to assess penalties and taxes in the international realm.

The next issue for the Tax Court was whether the taxpayer "substantially complied" with the regulations under Code Sec. 6501(c)(9). Given the nature of the gift (*i.e.*, either EMG stock or the Insurance Policy), the Tax Court reasoned that only the following three criteria were relevant: (i) A description of the property transferred and any consideration received by the transferor; (ii) The identity of, and the relationship between, the transferor and each transferee; and (iii) A detailed description of the method used to determine the fair market value of the property transferred. Grounded in its review of the four key documents that the taxpayer provided the IRS as part of his OVDP packet, the Tax Court ruled that the taxpayer at least substantially complied with the regulation describing adequate disclosure.[60]

In summary, the Tax Court held that the taxpayer strictly complied or substantially complied with the applicable regulations under Code Sec. 6501(c)(9) thanks to his filing of Form 709 for 2006, the Statement attached to Form 709, Form 5471, and the Offshore Entity Statement. Consequently, he "adequately disclosed" the gift to the IRS when he filed the OVDP packet on November 20, 2013. The general assessment period of three years would have expired on November 20, 2016, but the taxpayer voluntarily extended it to November 30, 2017, by granting the IRS Form 872. Either way, the assessment period expired years before the IRS issued its Notice of Deficiency in October 2019. The IRS, in other words, was too late. The Tax Court granted the taxpayer's Cross-Motion for Summary Judgment, thereby defeating the IRS before the trial even began.

The strategies of the IRS in *Schlapfer v. Commissioner* might leave readers scratching their heads. Why did the IRS not just concede that the gift occurred in 2006 and focus its challenge on the taxpayer's assertion that he did not have a "domicile" in the United States at that time? Logic dictates that the IRS was slow in processing the taxpayer's opt-out from the OVDP (as it was with so many others), it mistakenly allowed the assessment period for 2006 to lapse despite the fact that it obtained a yearlong extension from the taxpayer, and it was forced to scramble. This likely led to the theory that the taxpayer made a gift in 2007, a year for which he did not file a Form 709, such that the IRS counted on an indefinite assessment period.

IV. Conclusion

This article demonstrates that the obligations for U.S. individuals receiving or making foreign gifts can be thorny, resolving non-compliance through one of the disclosure programs might not produce the expected results, and the IRS can be remarkably aggressive in its efforts to assess penalties and taxes in the international realm.

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1 *Wrzesinski*, Case No. 2:22-cv-03568, Eastern Dist. of Penn, Complaint, Sep. 1, 2022; Andrew Veldarde, *Son of Polish Lottery Winner Challenges Foreign Gift Penalty*, 2022 Tax Notes Today Federal 174-26 (Sep. 7, 2022); Hale E. Sheppard, *Foreign Gifts, Forms 3520, Big Penalties, and Pending Case*, 177, 1 Tax Notes Federal 57 (2022).

2 Code Sec. 6039F(a); IRS Notice 97-34, Section VI.

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

4 Code Sec. 6039F(c)(1)(B); IRS Notice 97-34, Section VI, IRB 1997-25, 22.

5 Code Sec. 6039F(c)(2); IRS Notice 97-34, Section VII, IRB 1997-25, 22; I.R.M. §20.1.9.10.5 (Jan. 29, 2021); I.R.M. §8.11.5.6.3 (Dec. 18, 2015).

6 Small Business Job Protection Act of 1996, U.S. House of Representatives, 104th Congress, 2nd Session, Report 104-737, Aug. 1, 1996, pg. 337 (stating that 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 Because the IRS has not issued regulations explaining the meaning of "reasonable cause" for purposes of Forms 3520, the courts have been receptive to arguments based on reasonable cause standards found elsewhere in the Internal Revenue Code and Internal Revenue Manual. *See, e.g.,* Chief Counsel Advice 200645023 (Jun. 20, 2006); *James*, 100 AFTR 2d 2012-5587 (2012); *Moore*, 115 AFTR 2d 2015-1375 (2015); *In re Wyly, et al.*, BC-DC-TX, 2016-1 USTC ¶50,282, 552 BR 338, 117 AFTR 2d 2016-2058 (2016).

8 I.R.M. §20.1.1.3.2.2.6 (Nov. 25, 2011).

9 *Id.*

10 Reg. §1.6664-4(c)(1).

11 Reg. §1.6664-4(c)(2).

12 *R.W. Boyle*, SCt, 85-1 USTC ¶13,602, 469 US 241, 251, 105 SCt 687 (1985).

13 *Neonatology Associates, P.A.*, 115 TC 43, Dec. 53,970 (2000), *aff'd*, CA-3, 2002-2 USTC ¶50,550, 299 F3d 221 (2002).

14 *Voluntary Disclosure Practice Examiner Guide Paper*, 2022 Tax Notes Today Federal 138-24 (Sep, 7, 2022), pg. 44; *See also* IRS Chief Counsel, INFO 2013-0015 (Mar. 29, 2013).

15 *See* 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 four remaining international disclosure programs, as well as the now defunct Offshore Voluntary Disclosure Program).

16 Hale E. Sheppard, *Foreign Gifts, Forms 3520, Big Penalties, and Pending Case*," 177 Tax Notes Federal 57 (Oct. 3, 2022).

17 *Wrzesinski*, District Court for the Eastern District of Pennsylvania, Status Report in Lieu of Answer, Case No. 2:22-cv-03568 (Mar. 7, 2023); *Foreign Gift Penalties to be Refunded and Case Dismissed*, 2022 Tax Notes Today 49-13 (Mar. 7, 2023); Andrew Velarde, *DOJ Concedes in Polish Lotto Foreign Gift Penalty Case*, 2023 Tax Notes Today 49-5 (Mar. 14, 2023).

18 IRS Policy Statement 8-47, I.R.M. §1.2.1.9.6 (Apr. 6, 1987); Reg. §601.106(f)(2); I.R.M. §35.5.2.4 (Dec. 31, 2012); I.R.M. §34.8.2.5.1(10) (Aug. 5, 2014); *A. Fajardo*, 78 TCM 453, Dec. 53,547(M), TC Memo. 1999-308 (indicating that the IRS attorney ignored policy and offered the *pro se* taxpayer a "nuisance settlement" in an effort to dispense with his substantiation case).

19 *R. Schlapfer*, Dec. 62,218(M), TC Memo. 2023-65.

20 Code Sec. 7701(a)(30)(A); Reg. §301.7701(b)-1; Code Sec. 61(a) and Reg. §1.61-1(a) both provide that "gross income" generally means "all income from whatever source derived."

21 For a detailed discussion of common international filing requirements, *see* Hale E. Sheppard, *Extended Assessment Periods and International Tax Enforcement: Rafizadeh v. Commissioner, Unreported Foreign Assets, and Use of FATCA Weapons*, 44, 5 J. Int'l Tax'n 25 (2018); Hale E. Sheppard, *Lessons from an International Tax Dispute: Three Interrelated Cases, in Three Different Proceedings, Generating Three Separate Liabilities*, 46, 5 Int'l Tax J. 43 (2020).

22 Code Sec. 6662; Code Sec. 6663.

23 Pub. L. No. 108-357 (Oct. 22, 2004).

24 31 USC §5321(a)(5)(B)(i). This penalty is inapplicable if the taxpayer was "non-willful" and there was "reasonable cause" for the violation. *See* 31 USC §5321(a)(5)(B)(ii).

25 31 USC §5321(a)(5)(C)(i).

26 Code Sec. 6038; Reg. §1.6038-2; Code Sec. 6046; Reg. §1.6046-1; Code Sec. 6679; Reg. §301.6679-1; Instructions to Form 5471.

27 Code Sec. 6038(b)(1); Reg. §1.6038-2(k)(1)(i); Code Sec. 6046(f); Reg. §§1.6046-1(k).

28 Hale E. Sheppard, *What Garrity Teaches about FBARs, Foreign Trusts, "Stacking" of International Penalties, and Simultaneously Fighting the U.S. Government on Multiple Fronts*, 20, 6 J. Tax Pract. Proc. 27 (2019).

29 Code Sec. 6501(a).

30 Code Sec. 6501(c)(8).

31 Public Law 111-147 (Mar. 18, 2010), Title V, Subtitle A, Parts I through V, Section 511(b) (emphasis added).

32 IRSIG SBSE-25-0312-022 (Mar. 9, 2012) (emphasis added).

33 "Failure to File the Form 5471—Category 4 and 5 Filers—Monetary Penalty," International Practice Unit (updated as of Oct. 7, 2015); *See also* IRS Program Manager Technical Advice 2014-018 (2015) (explaining the coverage of Code Sec. 6501(c)(8) in the context of unfiled Forms 8938 by an executor).

34 Code Sec. 6501(e)(1)(A); U.S. Joint Committee on Taxation. Technical Explanation of the Revenue Provisions Contained in Senate Amendment 3310, The "Hiring Incentives to Restore Employment Act," under Construction by the Senate. JCX-4-10 (Feb. 23, 2010), pgs. 64–66; Public Law 111-147, Hiring Incentives to Restore Employment Act, Code Sec. 513(d), Mar. 18, 2010.

35 IRSIG SBSE-25-0312-022 (Mar. 9, 2012).

36 Taxpayer Advocate Service 2012 Annual Report to Congress, Vol. I, pg. 135 (Dec. 31, 2012).

37 Taxpayer Advocate Service 2013 Annual Report to Congress, Vol. I, pg. 228 (Dec. 31, 2013).

38 Taxpayer Advocate Service 2013 Annual Report to Congress, Vol. I, pg. 232 (Dec. 31, 2013).

39 Taxpayer Advocate Service 2014 Annual Report to Congress, Vol. I (Dec. 31, 2014).

40 Taxpayer Advocate Service 2014 Annual Report to Congress, Vol. I, pg. 88 (Dec. 31, 2014).

41 TIGTA Report 2016-30-030, pg. 12 (Jun. 2, 2016).

42 *Id.*

43 Code Sec. 2501(a)(1); Reg. §25.2501-1(a)(1); Code Sec. 2512(b).

44 Code Sec. 2511(a).

45 Code Sec. 2512(a); Reg. §25.2511-2(a).

46 Code Sec. 6109; Reg. §25.2501-1(a)(1).

47 Reg. §25.2501-1(b).

48 *Id.*

49 Code Sec. 6501(c)(9).

50 Reg. §301.6501(c)-1(f)(2).

51 Reg. §301.6501(c)-1(f)(5) (emphasis added).

52 *R. Schlapfer*, Dec. 62,218(M), TC Memo. 2023-65, pg. 11.

53 *Id.* (citing *Thiessen*, 146 TC 100, 114, 146 TC No. 7, Dec. 60,564 (2016).

54 Reg. §301.6501(c)-1(f)(3).

55 *R. Schlapfer*, Dec. 62,218(M), TC Memo. 2023-65, pg. 13.

56 *R. Schlapfer*, Dec. 62,218(M), TC Memo. 2023-65, pg. 14.

57 *Id.; See also D. Bond*, 100 TC 32, 40–41, Dec. 48,822 (1993).

58 *R. Schlapfer*, Dec. 62,218(M), TC Memo. 2023-65, pg. 14; *See also L.R. Dunavant*, 63 TC 316, Dec. 32,871 (1974); *Columbia Iron & Metal Co.*, 61 TC 5, Dec. 32,159 (1973).

59 *R. Schlapfer*, Dec. 62,218(M), TC Memo. 2023-65, pg. 15.

60 *R. Schlapfer*, Dec. 62,218(M), TC Memo. 2023-65, pgs. 16 and 19.