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You Don't Pay Income Tax on 'Gifts', But Be Careful!

By Robert W. Wood

What is really a gift anyhow? Your definition and the IRS's definition might be different. Of course, the facts and the background are going to matter. Just suppose that you do a major favor for your employer, and he gives you a gift of $20,000. Is that really a gift? You might try to document it that way if you are aggressive, but it's not likely the IRS would agree. Plainly, the IRS would say it is a bonus, even if it is not run through usual payroll.

In fact, both you and your employer could have tax exposure over this. How so? You could be in trouble for not reporting the payment as income on your tax return. Your employer could be in trouble for not withholding taxes and paying them over to the IRS and the state. Those potential liabilities can be big. And you as the recipient of the 'gift' may have exposure for not putting it on your tax return. And the statute of limitations on audit may be affected too.

After all, the main IRS audit statute is three years after you file your return. But the IRS gets six years to audit if you fail to report 25% of your income. So if the 'gift' is big enough to do that, your exposure may go longer. So what is a gift? True gifts are not income the IRS can tax, but the line between what is income and what is a gift is sometimes disputed.

What about more usual family gifts, where your uncle or grandmother sends you money? That is clearly safer than your employer, and family gifts are probably made with what the IRS calls "detached and disinterested generosity." Even so, it's worth considering the optics, how you might look if this kind of thing comes up in an audit. Ideally you don't just want money to show up in your bank account, since the IRS could someday call it income if you cannot explain that it is not.

Having a contemporaneous instrument of gift, or at least a letter from your relative saying that it is a gift is a good idea. But assuming that it's a gift, any gift tax or gift tax return is the problem of the person who gave it to you, right? Not so fast. It's true that in the U.S., gift tax falls on the giver not the recipient. But these days, with a $12.06 million lifetime exemption from gift and estate taxes, most people don't have to pay gift tax (though they still may need to file gift tax returns reporting the gift).

But as a recipient, beware of *foreign* gifts. With the sharp eyes of the IRS abroad and looming under the Foreign Account tax Compliance Act (FATCA) filings, foreign bank accounts are vastly less secret than they used to be. Income from abroad is taxable and you must report your foreign bank accounts. It's harder to claim ignorance of these rules than in the past. But what about foreign gifts and inheritances?

These rules aren't as well-publicized, but the stakes can be huge. If you receive a gift or inheritance, it isn't income so you might think there's nothing to report. Besides, if there is a gift or estate tax, under U.S. tax rules, the person *giving* you the money or property pays it, not the recipient. However, that's not the end of the reporting story. The gift money from your foreign uncle can hit your account and not be taxed as income to you.

Yet if you are concerned about *proving* that something was a gift or inheritance instead of income, you'd better file IRS Form 3520. Ditto if you are concerned about avoiding penalties. The IRS instructions say you should file a Form 3520 if you receive:

1. More than $100,000 from a nonresident alien individual or a foreign estate (including foreign persons related to that nonresident alien individual or foreign estate) that you treated as gifts or bequests; or

2. More than $14,375 from foreign corporations or foreign partnerships (including foreign persons related to such foreign corporations or foreign partnerships) that you treated as gifts.

You are required to report bequests on Form 3520 when you actually or constructively receive them. Thus, report a gift in the year you actually receive it, or in the year you *could have* acquired it, whichever is first. What if you forget, or just don't know about these rules? That can be costly. The penalty for reporting a gift late is 5 percent of its value for each month the gift is not reported (capped at 25 percent).

However, no penalty applies if the IRS is convinced the failure to report was due to reasonable cause and not willful neglect. In my experience, on these forms in particular, the IRS is tough, and is inclined not to waive penalties without a big effort. Another nettlesome form is the Form 3520-A, Information Return of Foreign Trust With a U.S. Owner. Taxpayers must report ownership interests in foreign trusts. The penalty for failing to file or filing inaccurately is the *greater* of $10,000 or 5% of the gross value of trust assets determined to be owned by the U.S. person. Ouch.

As with foreign accounts and foreign assets, these rules are being looked at more closely by the IRS. And in recent years, the IRS has gone on a real penalty notice spree regarding these forms. Not filing can mean a penalty. Plus, if you file late, the IRS may penalize you, making you wonder if late filing is a good move or a bad one. Like so much else in the tax world, it can depend. Be careful out there.

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