Rethinking the Penalty for the Failure to File Gift Tax Returns

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In this article, the authors argue that Congress must reform the penalty structure associated with the failure to file gift tax returns if it wants to maintain the integrity of the transfer tax system.

Introduction

The Internal Revenue Code mandates that when taxpayers make taxable gifts,[1] they must file gift tax returns. Some taxpayers comply with that mandate; others do not. Regarding the latter, the penalty structure is toothless and rarely applies. Noncompliant taxpayers are essentially at liberty to make undisclosed taxable gifts with impunity. If Congress truly wants to maintain the integrity of the transfer tax system, it must reform the penalty structure associated with the failure to file gift tax returns.

It is not merely an academic issue. There is compelling evidence that the gift tax return compliance rate is abysmal. The IRS Estate and Gift Tax Examinations team recently conducted a nationwide audit of intrafamily real property transfers involving little or no consideration.[2] The noncompliance rate was stunning: An estimated 60 to 90 percent of taxpayers making transfers failed to file gift tax returns.[3]

Existing Penalty Regime and Its Shortcomings

The code imposes three taxes on the gratuitous transfer of wealth: gift, estate, and generation-skipping transfer taxes.[4] Those three transfer tax systems function interdependently. Consider that the gift and estate taxes have the same so-called applicable exclusion amount ($5.25 million).[5] To the extent not used during life, the balance shields testamentary transfers from tax.[6] Because the gift and estate taxes use the same applicable exclusion amount, for computational purposes, a taxpayer's adjusted taxable gifts are added back into a taxpayer's adjusted gross estate to determine the taxpayer's overall transfers subject to tax.[7] Potentially applicable to both *inter vivos* and testamentary transfers, the GSTT is similar in structure to the gift and estate taxes, but it applies only to transfers to so-called skip persons — essentially, heirs who are two or more generations younger than the transferor.[8] The code provides for a GSTT exemption ($5.25 million) that parallels the applicable exclusion amount[9]; more specifically, taxpayers may apply their GSTT exemption to lifetime gifts[10] and, to the extent not exhausted, to testamentary bequests[11] in order to shield the transfers from the GSTT.

Taxpayers who make taxable gifts are required to file gift tax returns (that is, Form 709, "U.S. Gift (and Generation-Skipping Transfer) Tax Return").[12] A taxpayer who fails to file a gift tax return must pay a penalty equal to the amount of tax due plus 5

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[1]Gratuitous transfers are taxable gifts if they exceed the annual exclusion ($14,000), are not gifts of a "present interest," and do not qualify for any other gift tax exclusion (*e.g.*, the payment of educational and medical expenses on another taxpayer's behalf). Section 2503.

[2]William P. Barrett, "IRS Targets Family Real Estate Transfers," *Forbes* (Mar. 24, 2011); Scott D. Michel and Beth Shapiro Kaufman, "Unreported Gifts of Real Property: Time for Voluntary Disclosure," *Tax Notes*, Aug. 1, 2011, p. 513; Jasper G. Taylor III, "IRS Estate and Gift Tax Compliance Initiative Targets Real Property Transfers Between Related Parties"; Josh Ungerman, "The New Gift Tax Audits: IRS Identifies Non-Filers Using State Property Records," *Forbes* (Oct. 19, 2011).

(Footnote continued in next column.)

[3]Taylor, *supra* note 2.

[4]*See generally* John R. Luckey, "A History of the Federal Gift, Estate, and Generation-Skipping Transfer Taxes," Congressional Research Service (2003).

[5]Section 2505. The amount is adjusted annually for inflation. Section 2010(c)(3).

[6]Section 2010.

[7]Section 2001(b)(1)(B).

[8]Section 2613(a).

[9]Section 2631(a). This amount is adjusted annually for inflation. Section 2631(c).

[10]Section 2632.

[11]*Id.*

[12]Section 6019(a).

percent per month for each month's delinquency, up to a 25 percent maximum.[13] In addition to the failure-to-file penalty, there is a failure-to-pay penalty equal to the amount of tax due and owing times 0.5 percent per month for each month's delinquency, up to a 25 percent maximum.[14] The failure-to-file and pay penalties overlap (that is, the application of one causes a corresponding reduction of the other).[15] Taxpayers who willfully fail to file a gift tax return may also be subject to criminal sanctions,[16] but those are rarely imposed.[17] Practitioners involved in situations in which taxpayers do not file gift tax returns risk criminal charges or referral to the IRS Office of Professional Responsibility for violating Circular 230.[18]

Consider the following example. Suppose a taxpayer who had previously not made taxable gifts transfers title to a farm, valued at $6,264,000, to her daughter in 2013. After accounting for the annual exclusion and applicable exclusion amount, the amount of the taxable gift is $1 million (that is, $6,264,000 less the annual exclusion of $14,000 and the applicable exclusion amount of $5.25 million). Suppose further that the taxpayer, without seeking an extension, fails to file Form 709 until July 2, 2014, and then pays the $400,000 gift tax due.[19] Under that fact pattern, the applicable penalties for the three-month delinquency would be as follows: (i) failure-to-file penalty of $54,000[20] and (ii) failure-to-pay penalty of $6,000.[21] The combined penalty of $60,000 ($54,000 plus $6,000) presumably would be substantial enough to encourage compliance with the requirement that a return be filed.

But in most cases, the existing penalty regime proves hollow because, as noted, despite the gift tax return submission requirement, there is often no concomitant tax payment requirement. Taxpayers generally either lack the financial wherewithal to part with millions of dollars during their lifetimes or are loath to make taxable gifts in which they would encounter an immediate tax burden. Further, that the gift tax is tax exclusive (that is, the applicable rate is applied to the net gift, exclusive of gift taxes) and the estate tax is tax inclusive (that is, the applicable rate is applied to the gross estate before taxes are deducted) does not appear to sway taxpayers to accelerate the depletion of their ultimate estates through gift giving.

Given taxpayers' reluctance to make gifts that would generate a tax liability, even financially well-to-do taxpayers[22] rarely make gifts that in aggregate exceed the threshold of the applicable exclusion amount.[23] While taxable gifts of less than the applicable exclusion amount must be reported on a gift tax return,[24] taxpayers who fail to file may nevertheless not face a penalty. Why? The code applies failure-to-file penalties only when tax is actually due.[25] Note that when the IRS recently conducted nationwide gift tax audits and discovered widespread noncompliance, it "had determined that ninety-seven taxpayers had violated gift tax reporting requirements by failing to file, and just twelve cases resulted in assessment of tax and penalties."[26]

Treating the failure-to-file gift tax returns with impunity creates immense practical concerns. Suppose in 2014 Taxpayer J purchases the title to a house for $1,014,000 and immediately gives that title to her daughter but does not file a gift tax return despite having made a $1 million gift (that is,

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[13]Section 6651(a)(1).

[14]Section 6651(a)(2).

[15]Section 6651(c)(1).

[16]Section 7203.

[17]*See* Michel and Kaufman, *supra* note 2, at 514 (stating that although criminal charges for the failure to file gift tax returns are rare, the IRS will pursue criminal charges in egregious cases).

[18]*Id.* at 514-515.

[19]The $1 million taxable gift multiplied by the 40 percent gift tax rate. Section 2502(a).

[20]In determining the failure-to-file penalty, the $400,000 of tax due should be multiplied by 15 percent (5 percent x 3 (the number of months the taxpayer was delinquent)) less 1.5 percent (*i.e.*, the failure-to-pay penalty), or 13.5 percent.

[21]In determining the failure-to-pay penalty amount, the $400,000 of tax due should be multiplied by 1.5 percent (0.5 percent x 3 (the number of months the taxpayer was delinquent)).

[22]For example, Sam Walton reportedly began giving away shares of Wal-Mart stock to his children in 1953 through a family limited partnership and paid a relatively modest amount of gift tax that resulted in billions of dollars escaping estate tax at his death in 1992. *See* Zachary R. Mider, "How Wal-Mart's Waltons Maintain Their Billionaire Fortune," Bloomberg (Sept. 11, 2013), *available at* http://www.bloomberg.com/news/2013-09-12/how-wal-mart-s-waltons-maintain-their-billionaire-fortune-taxes.html.

[23]*See* IRS Statistics of Income website, *available at* http://www.irs.gov/uac/SOI-Tax-Stats—Total-Gifts-of-Donor,-Total-Gifts,-Deductions,-Credits,-and-Net-Gift-Tax (indicating that of the 219,544 gift tax returns that were filed in 2011 (the last year for which data are available), approximately 3,000 of the returns involved gifts of $1 million or more (the applicable exclusion amount for 2011), and only approximately 11,000 tax returns resulted in the payment of tax).

[24]*See supra* notes 1 and 12.

[25]By way of contrast, in the income tax sphere, there is usually a third party (*e.g.*, an employer or financial institution) providing payments and submitting tax information returns, which makes the failure to file a tax return associated with the income tax difficult. Section 6041(a). When it comes to giving and receiving gifts, there is no third-party reporting because the only candidate for such reporting — the recipient of the gift — has no reporting obligation that would enable the IRS to determine that a taxable gift was made.

[26]*See* Ungerman, *supra* note 2.

$1,014,000 less the $14,000 annual exclusion). Suppose 20 years later, Taxpayer J dies with a taxable estate of $9 million. Assuming the executor of Taxpayer J's estate is not her daughter, it is likely that the executor will not be aware of the decedent's gift made two decades earlier; therefore, the transfer will not likely be treated as an adjusted taxable gift and added to Taxpayer J's gross estate. Instead, the decedent's executor will probably report a taxable estate of only $9 million, rather than $10 million had the taxable gift been added back into the adjusted estate as required under the code.[27] That oversight will produce an ill-gotten benefit to Taxpayer J's estate heirs of $400,000, namely, the estate tax savings associated with Taxpayer J's failure to report the earlier $1 million gift (that is, $1 million x 40 percent estate tax rate).[28]

Transactions similar to the foregoing example are probably repeated hundreds, if not thousands, of times annually with nonfiling taxpayers bearing no consequences. The absence of penalty imposition signifies that the penalties for failure to file gift tax returns are wholly inadequate. In drafting the penalty, Congress likely sought to parallel the failure-to-file penalty applicable to delinquent income tax return filings,[29] but that replication overlooks a central distinction between the income and gift taxes: The former generally results in a tax being imposed, and the latter does not. Further, the gift tax is unlike the income tax in another crucial respect — namely, the amount of the gift in the current year has a potentially significant impact on the tax on gratuitous transfers in subsequent years, making the need for proper return filing pivotal to its integrity. Using the same platform for both the income and gift penalties is thus nonsensical and should be abandoned.

Reforming the Gift Tax Penalty Structure

The research regarding tax compliance indicates that there are several possible factors that contribute to taxpayers being compliant.[30] Those factors include compliance norms[31] and deterrence under an economic cost benefit analysis.[32] Although the research regarding tax compliance is inconclusive,[33] there is a general consensus among politicians, academics, and the general public that the existence of tax penalties is an important contributory factor to tax compliance.[34]

Given the important role tax penalties play in fostering tax compliance, choosing the right penalty structure — that is, the one that yields the highest rate of taxpayer compliance for the least possible administrative cost — is of pivotal importance. That is another way of saying that not all penalties function with the same level of efficacy. As drafted, the failure-to-file penalty for gift tax return submissions is underinclusive and has proven ineffectual.

Yet broadening the application of the penalty to apply in every instance when a taxpayer fails to file a gift tax return raises important political concerns. Consider that the code contains several penalties for failure to file tax returns even when no tax is owed. For example, if a U.S. shareholder owns an interest in a controlled foreign company and fails to file Form 5471, a $10,000 annual penalty applies.[35] Likewise, in those instances when a taxpayer receives a foreign gift that exceeds $10,000 and fails to file Form 3520, a failure-to-file penalty applies at a rate equal to 5 percent of the amount of the foreign gift for each month the failure continues (not to exceed 25 percent).[36] In the sphere of tax information returns, fixed-dollar-amount penalties abound for those taxpayers who do not submit required tax information returns on a timely basis.[37]

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[27]*See supra* note 7.

[28]Because the limitations period does not expire in those cases when no return is filed, noncompliant taxpayers always risk a future audit. Section 6501(c)(3). Although this is apt to be a rare occurrence, this may periodically occur. *See, e.g.*, Bridget J. Crawford and Theresa Fortin, "Sumner Redstone's 40-Year-Old Gift," *Tax Notes*, Aug. 19, 2013, p. 833 (in a settlement in which Redstone transferred shares to a family-owned business into a trust for his children and never reported such transfer, the IRS is at liberty to audit such transfer).

[29]Section 6651(a)(1).

[30]James Alm, Gary H. McClelland, and William D. Schulze, "Why Do People Pay Taxes?" 48 *J. of Public Economics* 21 (1992) (explaining the diverse reasons taxpayers comply).

[31]Leandra Lederman, "The Interplay Between Norms and Enforcement in Tax Compliance," 64 *Ohio St. L.J.* 1453 (2003); Susan C. Morse, "Tax Compliance and Norm Formation Under High-Penalty Regimes," 44 *Conn. L. Rev.* 675 (2012); Eric A. Posner, "Law and Social Norms: The Case of Tax Compliance," 86 *Va. L. Rev.* 1781 (2000).

[32]*See generally* American Bar Association Commission on Taxpayer Compliance, "Report and Recommendations on Taxpayer Compliance," 41 *Tax Law.* 329, 348-349 (1987).

[33]James Alm, Isabel Sanchez, and Ana de Juan, "Economic and Noneconomic Factors in Tax Compliance," 48 *Kyklos* 3 (1995). As Joel Slemrod notes, "there is still much dispute about the proper conceptual model to use in addressing" tax compliance. Joel Slemrod, *Introduction to Why People Pay Taxes: Tax Compliance and Enforcement* 1, 2 (Joel Slemrod ed., 1992).

[34]*See generally* Joshua D. Blank, "Collateral Compliance," 162 *U. Pa. L. Rev.* ___ (2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2032788; Michael Doran, "Tax Penalties and Tax Compliance," 46 *Harv. J. on Legis.* 111 (2009); Alex Raskolnikov, "Crime and Punishment in Taxation: Deceit, Deterrence, and the Self-Adjusting Penalty," 106 *Colum. L. Rev.* 569 (2006).

[35]Section 6038(b)(1).

[36]Section 6039F(c).

[37]*E.g.*, sections 6721(a) and 6722(a).

But simply broadening the penalty for failure to file a gift tax return would likely be politically unpopular. While Congress *could* institute a failure-to-file penalty equal to the greater of either $10,000 or 5 percent per month upon the tax due and owing, and *could* even apply that penalty in those instances when the taxpayer innocently made taxable gifts, not realizing that a tax return filing obligation exists, it would probably not want to do so. The gift tax is poorly understood by many taxpayers, so burdensome penalties for inadvertent violations would strike both Congress and the public as being unduly harsh. Congress would not, for example, want to impose the penalty on a taxpayer who has a $400,000 net worth and benevolently assists his adult child in purchasing her first home by making a cash gift of $20,000 but mistakenly does not file a gift tax return. That taxpayer's delinquency was simply not motivated by transfer tax avoidance and does not deserve stringent penalty.

We propose a modest alternative that would avoid the fate associated with a broad-based penalty while still making the failure-to-file penalty more efficacious. A penalty for failure to file a gift tax return that is equal to a set dollar amount (say, $10,000) should apply only in those instances when a taxpayer fails to file a gift tax return and, at the time of transfer, the net worth of the taxpayer exceeds a set dollar threshold level (say, $1 million and, in the case of married taxpayers, $2 million).[38] To simplify the administration of that proposal, aside from marketable securities, a taxpayer's net worth could be measured using the adjusted tax basis dollar amounts of his assets. Reliance on historical tax basis figures would obviate the need to secure fair market value property appraisals for items such as real estate, closely held business interests, and artwork. (Admittedly, to avoid penalty application, taxpayers might intentionally seek to diminish or camouflage his net worth. However, the penalty itself is too small to warrant those types of maneuvers; and, in any event, taxpayers who go through extreme avoidance exercises risk criminal sanctions.) The existing penalty structure would remain applicable in those instances when a gift tax was due and owing (that is, a failure-to-file penalty of 5 percent per month for every month there is a delinquency, up to a 25 percent maximum, and the failure-to-pay penalty of 0.5 percent per month for every month there is a delinquency, up to a 25 percent maximum).[39]

By establishing a minimum penalty limited to those instances when taxpayers have a net worth beyond a designated threshold, the failure-to-file penalty would not apply to most transfers. However, the failure-to-file penalty would apply in those instances when the gift tax is likely to be fulfilling its primary historic role as a protector of the estate tax base.[40] Some commentators might advocate a higher net worth application threshold equal to the applicable exclusion amount at the time the gift is made. At a lower net worth threshold amount, their concern might be that the penalty would be too inclusive. We, however, assume that those taxpayers whose net worths exceed a set threshold (as proposed, $1 million) are on the economic path to having a taxable estate and, accordingly, should be subject to heightened scrutiny. Ultimately, the precise dollar threshold is a political decision to be made by Congress.

Application of the Proposal

Were Congress to enact the proposed legislative reform, no longer would financially well-to-do taxpayers — those to whom transfer tax is most likely to apply — be able to scoff at their gift tax return filing obligations without the fear and risk of being penalized.

Reconsider the earlier fact pattern in which a taxpayer wished to financially assist her daughter's purchase of a home, but assume the taxpayer's net worth is $4 million rather than $400,000 and the amount of the gift is $200,000 rather than $20,000. Under current law, if the taxpayer makes the $200,000 gift and fails to file a gift tax return, there are no consequences associated with her dereliction; under our proposal, the same dereliction would result in the imposition of a $10,000 penalty (assuming the IRS conducted an audit that uncovered this failure). Given the severity of that penalty, most risk-adverse taxpayers would take the necessary steps to ensure filing compliance.[41]

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[38]The doubling of the proposed exemption amount reflects the doubling of the applicable exclusion amount through the new portability rules. Section 2010(c)(4).

[39]*See supra* notes 13 and 14.

[40]H. Comm. on Ways and Means, Report on Revenue Act of 1932, H.R. Rep. No. 72-708, at 8 (1932) (indicating that gift tax was needed "to assist in the collection of the income and estate taxes, and prevent their avoidance through the splitting up of estates during the lifetime of a taxpayer"); S. Comm. on Finance, Report on Revenue Bill of 1932, S. Rep. No. 72-665, at 11 (1932) ("As a protection to both estate and income taxes, a gift tax is imposed"). Ways and Means Chair Charles R. Crisp reiterated this stated purpose in floor debates. 75th *Cong. Rec.* 5691 (1932) (statement of Crisp) ("The estate tax, without a mother [gift] tax to protect it, might easily be evaded").

[41]In such instances, tax return preparers would likely strongly advocate the submission of a gift tax return for fear that if they failed to make such a recommendation, they could be sued for malpractice based on their failure to advise their clients of the risks associated with not filing. *See generally* Jacob L.

(Footnote continued on next page.)

The effects of enhanced gift tax compliance would be felt in all three transfer tax arenas. First, enhanced gift tax return compliance should result in more robust gift tax revenue collections because taxpayers, through filings, would be forced to acknowledge the exhaustion of their applicable exclusion amounts. Second, because taxpayers would be more apt to account for the reduction of their applicable exclusion amounts, they would have correspondingly less available upon their demise, resulting in more robust estate tax revenue collections. Finally, some or all of a taxpayer's lifetime gifts may absorb a taxpayer's available GSTT exemption; that absorption should ultimately yield greater GSTT collections or, alternatively, estate tax revenue collections as taxpayers strategically avoid transfers to skip persons.

Some taxpayers and tax practitioners may nevertheless object to the proposal. Taxpayers who make small taxable gifts (for example, a $1,000 gift of a future interest) and who accidentally fail to file a gift tax return may vociferously complain that a flat minimum penalty is too harsh. If Congress shares that concern, it can refine the penalty to make it equal to the greater of the following: (i) the lesser of (a) $10,000 or (b) half of the amount transferred or (ii) 5 percent per month times the tax due and owing.[42] Tax practitioners, too, may oppose reform, asserting that some of their clients may be reluctant to disclose their net worth and thereby negate their ability to ascertain penalty applicability. As long as tax practitioners point out the need to submit a gift tax return to their clients' attention, however, the clients themselves should decide whether a gift tax return submission is warranted.

Notwithstanding the potential downsides, adoption of our legislative proposal makes a lot of sense. One of the fundamental virtues associated with enhanced taxpayer compliance measures is that they are able to produce more revenue without increasing taxes or necessitating a broadening of the tax base. And, if those measures can be instituted without raising taxpayers' administrative burdens, they can prove to be a real boon to the code's integrity. The legislative compliance measure that we propose meets the following condition: It would increase revenue with virtually no additional administrative burdens to taxpayers. Congress should therefore pass it with little controversy or opposition.

Todres, "Tax Practice: Areas in Which It Occurs and the Measure of Damages — an Update," 78 *St. John's L. Rev.* 1011 (2004).

[42]In the case of the gift of $1,000 future interest, the resulting failure-to-file penalty would equal $500.

Conclusion

For the past several decades, penalties for failure to file a gift tax return have rarely been applied. That is in dramatic contrast to the number of times taxpayers have endured the failure-to-file penalty in the income tax sphere.[43] Those dichotomous outcomes are attributable to one source — the applicable exclusion amount, which shields most taxable gifts from gift tax exposure and simultaneously from the failure-to-file penalty. As currently constructed, the penalty for failure to file a gift tax return is thus ill-designed and demands congressional reformation.

Our proposal to establish a minimum penalty threshold coupled with a net worth requirement would spark filing compliance among economically well-to-do taxpayers (that is, the population of taxpayers most likely to be subject to transfer tax). Implementation of this proposed reform would not only bode well for gift tax compliance, but due to the close kinship between the gift tax and estate and GSTTs, it would enhance the compliance rates associated with both of these taxes as well.

We acknowledge that our proposed reform measure would not constitute a panacea for transfer tax revitalization. Instead, our reform initiative is much more modest in nature, simply seeking to ensure that taxpayers fulfill their tax return filing obligations. The importance of tax return filing obligations, however, should never be minimized; to emphasize this point, Congress should immediately enact the proposed legislative compliance measure.

[43]For a delineation of penalty application, see generally IRS Data Book 2011, at 42, Table 17.