

# How the Statute of Limitations Impacts Your Taxes

**W**ith April 15 looming, everyone worries about tax filings. Even though you can obtain an automatic extension, these merely extend the time for *filing* your tax returns, not for *paying* your taxes. So taxes should be on everyone's mind.

However, I'd suggest you also consider your old tax returns, and what tax years will soon be beyond the statute of limitations. All lawyers should be used to thinking about statutes of limitation. Serendipitously, one tax filing can often also signal the lapse of a prior year's taxes, making it beyond audit. That should make you smile.

You'll want to make good substantive arguments in any tax dispute. Still, if you face a tax audit and can legitimately point to the statute of limitations to obviate trouble and expense, you should. The statute of limitations is important in heading off audit trouble. It's also good to know when you can throw away some of those receipts.

The primary federal tax statute of limitations is three years. If your tax return is due April 15, but you file early, the statute runs three years after the due date. If you file late and do not have an extension, the statute runs three years following your actual (late) filing.

Significantly though, the statute is six years if your return includes a "substantial understatement of income." Generally this means you've omitted 25 percent or more of your gross income. However, the Internal Revenue Service is now arguing in court that anything on your tax return having the effect of a 25 percent understatement of gross income gives it an extra three years. Still, most court decisions conclude that overstating deductions is *not* the same as omitting income.

The IRS has also asserted in temporary regulations that it has six years to go after basis overstatements where you underpay your tax on a sale by overstating how much you originally paid. There will be further litigation on this issue. Fortunately for all of us, though, IRS resort to the six-year statute is rare.

The IRS usually invokes the six-year statute when an audit of one year (open under the three-year statute) extends to connected issues in earlier years. In contrast, the IRS monitors the three-year statute closely. That means for most people, you're home free in three years. Bear in mind, though, that the IRS has no time limit if you never file a return or if it can prove civil or criminal fraud.

As in most things, California marches to a different drummer, and its tax statutes of limitation are predictably different. Notably, California's basic tax statute of limitations is four years, not three. California likes that extra year, often coming in on the heels of a federal audit.

Plus, California tax law is full of traps. For example, if the IRS adjusts your federal income tax return, you are required to file an amended tax

return in California to conform to those changes. If you don't, California will have an unlimited period of time to come after you.

The statute of limitations on tax returns impacts your ability to file amended tax returns too, as well as the IRS and the Franchise Tax Board's ability to audit them. If you want to amend a tax return, you must do so within three years of the original filing date. You might think that amending a tax return would restart the three-year statute, but it doesn't.

In fact, where your amended return shows an increase in tax, and you submit the amended return within 60 days before the three-year statute runs, the IRS has 60 days after it receives the amended return to make an assessment. This narrow window can present planning opportunities. Some people will amend a return right before the statute expires. An amended return that does not report a net increase in tax does not trigger an extension of the statute of limitations.

Does the normal three-year rule apply to tax refunds? Not hardly. Suppose you pay estimated taxes or have tax withholding on your paycheck but fail to file a tax return. In that case, you generally have only two years (not three) to try to get it back.

Also, the IRS or FTB may contact you (usually a few years after filing), and ask you to *extend* the statute of limitations. If you just say "no" it usually prompts the IRS or FTB to send a notice assessing extra taxes.

Up against a fading statute of limitations, the IRS or FTB may assess extra taxes without taking the time to thoroughly review your explanation of why you don't owe more. For that reason most tax advisers will tell you to agree to the requested extension when the IRS or FTB asks.

However, you may be able to limit the scope of the extension to certain tax issues. Alternatively,

you may be able to limit the time (say, to an extra year). In any event, you should seek professional tax help if you receive such an inquiry.

The difference between winning and losing a tax case, or getting a good versus mediocre settlement with the IRS (the vast majority of IRS disputes are settled) often depends on records. For that reason, there is no better tax advice than this simple mantra: Keep scrupulous records! That includes proof of when you mailed your returns.

After all, the statute of limitations usually begins to run when a return is *filed*, so keep certified mail or courier confirmation. If you file electronically, keep all the electronic data, plus a hard copy of your return. As for record retention, you could destroy receipts and back-up data after six years. Nevertheless, never destroy old tax returns. Even, if you choose to destroy old receipts, retain any that relate to basis in an asset. For example, receipts for home remodeling ten years ago are still relevant as long as you own the house. You may need to prove your basis when you later sell it.

*This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.*



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