BUSINESS LAW TODAY

IRS Can Audit for Three Years, Six, or Forever: Here's How to Tell

By Robert W. Wood

Fans of NBC's *Law & Order* may have a negative reaction when a suspect gets away because of the statute of limitations, and cheer when the DA *still* finds a way to prosecute someone that viewers know is guilty. Statutes of limitations exist for a reason, however, and when it comes to your own taxes, you should sigh in relief if the IRS tries to audit you too late.

If you can point to the statute of limitations to head off the trouble and expense of a tax audit, you should. It is not pleasant to have to prove you were entitled to a deduction or to find and produce receipts. If it is too late for the IRS to audit you, the IRS is out of luck.

Given the importance of the statute—both to heading off audit trouble and to knowing when you can safely discard some of those receipts—it pays to be statute savvy. In this area of the tax law, the rules for corporations, partnerships, nonprofit organizations, and individuals are consistent. Here's what you need to know.

1. The IRS Typically Has Three Years. The overarching federal tax statute of limitations runs three years after you file your tax return. If your tax return is due April 15, but you file early, the statute runs exactly three years after the *due* date, not the filing date. If you get an extension to October 15, your three years runs from then. On the other hand, if you file late and do *not* have an extension, the statute runs three years following your actual (late) filing date. There are many exceptions discussed below that give the IRS six years or longer, however.

2. Six Years for Large Understatements of Income. The statute of limitations is six years if your return includes a "substantial understatement of income." Generally, this means that you have left off more than 25 percent of your gross income. Suppose that you earned $200,000 but only reported $140,000. Given that you omitted more than 25 percent, you can be audited for up to six years. Maybe this understatement was unintentional or you reported in reliance on a good argument that the extra $60,000 was not your income. The six-year statute applies, but be aware that the IRS *could* argue that your $60,000 omission was fraudulent. If so, the IRS gets an unlimited number of years to audit. What about not an omission of income, but overstated deductions on your return? The six-year statute of limitations does not apply if the underpayment of tax was due to the overstatement of deductions or credits.

3. Six Years for Basis Overstatements. The IRS has argued in court that other items on your tax return that have the *effect* of more than a 25-percent understatement of gross income give it an extra three years. There was litigation for years over what it means to *omit* income from your return. Taxpayers and some courts said "omit" means to leave off, as in do not report, but the IRS said it was much broader.

> **Example:** You sell a piece of property for $3M, claiming that your basis (what you invested in the property) was $1.5M. In fact, your basis was only $500,000. The effect of your basis overstatement was that you paid tax on $1.5M of gain when you should have paid tax on $2.5M.

In *U.S. v. Home Concrete & Supply, LLC,* 132 S. Ct. 1836 (2012), the Supreme Court slapped down the IRS, holding that overstating your basis is *not* the same as *omitting* income. The Supreme Court held that three years was plenty of time for the IRS to audit, but Congress overruled the Supreme Court and gave the IRS six years in such a case, which is the current law. Six years can be a long time.

4. Foreign Income, Foreign Gifts, and Assets. Another hot-button issue these days involves offshore accounts. The IRS is still going after offshore income and assets in a big way, which dovetails with another IRS audit rule: the three years is doubled if you omitted more than $5,000 of foreign income (say, interest on an overseas account). This rule applies even if you disclosed the existence of the account on your tax return, and even if you filed an FBAR reporting the existence of the account. This six years matches the audit period for FBARs. FBARs are offshore bank account reports that can carry civil and even criminal penalties far worse than those for tax evasion.

Certain other forms related to foreign assets and foreign gifts or inheritances are also important. If you miss one of these forms, the statute is extended. In fact, the statute never runs. If you receive a gift or inheritance of over $100,000 from a non-U.S. person, you must file Form 3520. If you fail to file it, your statute of limitations never starts to run.

IRS Form 8938 was added to the tax law by the Foreign Account Tax Compliance Act (FATCA). Form 8938 requires U.S. filers to disclose the details of foreign financial accounts and assets over certain thresholds. This form is separate from FBARs and is normally filed with your tax return. The thresholds for disclosure can be as low as $50,000, so it pays to check out the filing requirements for your situation. Higher thresholds apply to married taxpayers filing jointly and to U.S. persons residing abroad. The form is nothing to ignore. If you are required to file Form 8938 and skip it, the IRS clock *never* even begins to run.

5. IRS Form 5471. Ownership of part of a foreign corporation can trigger extra reporting, including filing an IRS Form 5471. It is an understatement to say that this form is important. Failing to file it means penalties, generally $10,000 per form. A separate penalty can apply to each Form 5471 filed late, incompletely, or inaccurately. This penalty can apply even if no tax is due on the whole tax return. That is harsh, but the rule about the statute of limitations is even more harsh: If you fail to file a required Form 5471, *your entire tax return remains open for audit indefinitely*.

This override of the standard three-year or six-year IRS statute of limitations is sweeping. The IRS not only has an indefinite period to examine and assess taxes on items relating to the missing Form 5471, but also can make any adjustments to the *entire* tax return, with no expiration until the required Form 5471 is filed.

You can think of a Form 5471 a bit like the signature on your tax return. Without it, it is almost as if you didn't file a return. Form 5471 is not only required of U.S. shareholders in controlled foreign corporations, but also when a U.S. shareholder acquires stock resulting in 10-percent ownership in any foreign company. The harsh statute-of-limitations rule for Form 5471 was enacted in 2010 as part of the same law that brought us FATCA.

6. No Return or Fraudulent Return. What if you never file a return or file a fraudulent one? The IRS has no time limit if you never file a return or if it can prove civil or criminal fraud. If you file a return, can the IRS ever claim that your return didn't count so that the statute of limitations never starts to run? The answer is "yes." If you don't sign your return, the IRS does not consider it a valid tax return. That means the three years can never start to run.

Another big "no-no" is if you alter the "penalties of perjury" language at the bottom of the return where you sign. If you alter that language, it also can mean that the tax return does not count. Such a move may sound like a tax protester statement; however, some well-meaning taxpayers forget to sign or may unwittingly change the penalties-of-perjury wording. Other taxpayers just miss a form to end up in audit purgatory.

7. Amending Tax Returns. Taxpayers must abide by time limits, too. If you want to amend a tax return, you must do it within three years of the original filing date. You might think that amending a tax return would restart the IRS's three-year audit statute, but it doesn't.

However, where your amended tax return shows an *increase* in tax, and when you submit the amended return within 60 days before the three-year statute runs, the IRS has only 60 days after it receives the amended return to make an assessment. This narrow window can present planning opportunities. In contrast, an amended return that does *not* report a net increase in tax does not trigger an extension of the statute.

8. Claiming a Refund. The adage that possession is nine-tenths of the law can apply to taxes in some cases. Getting money back from the IRS is difficult. If you pay estimated taxes, or have tax withholding on your paycheck but fail to file a return, you generally have only two years (not three) to try to get it back.

Suppose you make tax payments (by withholding or estimated tax payments), but you have not filed tax returns for five years. When you file those long-past-due returns, you may find that overpayments in one year may not offset underpayments in another. The resulting lost tax money is painful, and it catches many taxpayers unaware.

9. Extending the Statute. The IRS typically must examine a tax return within three years, unless one of the many exceptions discussed here applies, but the IRS does track the three-year statute as its main limitation. Frequently, the IRS says that it needs more time to audit.

The IRS may contact you about two-and-a-half years after you file, asking you to sign a form to extend the statute of limitations. It can be tempting to relish your power and refuse, as some taxpayers do; however, doing so in this context is often a mistake. It usually prompts the IRS to send a notice assessing extra taxes, without taking the time to thoroughly review your explanation of why you do not owe more. The IRS may make unfavorable assumptions. Thus, most tax advisers tell clients to agree to the requested extension.

You may, however, be able to limit the scope of the extension to certain tax issues, or to limit the time (say, an extra year). You should seek professional tax help if you receive such an inquiry. Get some advice about your particular facts.

10. Other Statute Traps. Statute-of-limitation issues come up frequently, and the facts can become confusing. As but one example, consider what happens when an IRS notice is sent to a partnership, but not to its individual partners. The audit or tax dispute may be ongoing, but you may have no *personal* notice of it. You might think that your statute has run and that you are in the clear; however, the partnership tax rules may give the IRS extra time.

Also watch for cases where the statute may be "tolled" (held in abeyance) by an IRS John Doe summons, even though you have no notice of it. A John Doe summons is issued not to taxpayers, but to banks and other third parties who have relationships with taxpayers. You may have no actual notice that the summons was issued. Even so, there is an automatic extension of the statute of limitations in some cases. For example, suppose a promoter has sold you on a tax strategy. The IRS may issue the promoter a summons, asking for all the names of his or her client/customers. While he or she fights turning those names over, the statute-of-limitations clock for all of those clients (which might include you) is stopped.

Another situation in which the IRS statute is tolled is where the taxpayer is outside the United States. If you flee the country for years and return, you may find that your tax problems can spring back to life. You might also be living and working outside the United States and have no knowledge that the IRS has a claim against you. Even then, your statute of limitations is extended.

11. State Tax Statutes. Some states have the same three- and six-year statutes as the IRS, but set their own time clocks, giving themselves more time to assess extra taxes. In California, for example, the basic tax statute of limitations is four years, not three. However, if the IRS adjusts your federal return, you are obligated to file an amended return in California to match up to what the feds did. If you don't, the California statute will *never* run out. In addition, as in most states, if you never file a California return, California's statute never starts to run. Some advisers suggest filing nonresident returns just to report California source income to begin California's statute. There can be many tricky interactions between state and federal statutes of limitations.

12. Keeping Good Records. The statute of limitations is sometimes about good record-keeping. Proving exactly when you filed your return, or exactly what forms or figures were included in your return, can be critical. For that reason, keep scrupulous records, including proof of when you mailed your returns. The difference between winning and losing may depend on your records. The vast majority of IRS disputes are settled, and getting a good, or mediocre, settlement can hinge on your records as well.

If you file electronically, keep all the electronic data, plus a hard copy of your return. As for record retention, many people feel safe about destroying receipts and back-up data after six or seven years; but never destroy old tax returns. In addition, do not destroy old receipts if they relate to basis in an asset. For example, receipts for home remodeling 15 years ago are still relevant, as long as you own the house. You may need to prove your basis when you later sell it, and you will want to claim a basis increase for the remodeling 15 years back. For all these reasons, be careful and keep good records.

13. Ten Years to Collect. Once a tax assessment is made, the IRS *collection* statute is typically 10 years. This is the basic collection statute, but in some cases that 10 years can essentially be renewed, and there are some cases where the IRS seems to have a memory like an elephant. For example, in *Beeler v. Commissioner*, T.C. Memo. 2013-130, the Tax Court held Mr. Beeler responsible for 30-year-old payroll tax liabilities.

Conclusions. An audit can involve targeted questions and requests of proof of particular items only. Alternatively, audits can cover the waterfront, asking for proof of virtually every line item. Even if you do your best with your taxes, taxes are horribly complex. Innocent mistakes can sometimes be interpreted as suspect, and digging into the past is rarely pleasant. Records that were at your fingertips when you filed might be buried or gone even a few years later, so the stakes with these kinds of issues can be large.

Tax lawyers and accountants are used to monitoring the duration of their clients' audit exposure, and so should you. It pays to know how far back you can be asked to prove your income, expenses, bank deposits, and more. Watch the calendar until you are clear of audit. In most cases, that will be either three years or six years after you file.

Robert W. Wood practices law with Wood LLP (www.WoodLLP.com) and is the author of Taxation of Damage Awards and Settlement Payments, Qualified Settlement Funds and Section 468B, and Legal Guide to Independent Contractor Status, all available at www.TaxInstitute.com. This discussion is not intended as legal advice.