Is Your Tax Audit Risk 3 Years, 6 Years, Or Even More?

By Robert W. Wood

Just about everyone hopes that their tax audit exposure is low. It can even be worth specifically asking your tax professionals if they see anything on your draft tax return that might raise eyebrows. If they point something out, it does not mean that you should forgo claiming something that is legitimate.

But considering the issue, its magnitude, presentation, and the overall mix on your return can be good business. Of course, it is common to worry that you might not be able to substantiate every deduction. And there may be particular issues — sometimes big issues — that impact whether income goes on this year’s return or next, or regardless of substantiation, whether an expense is sufficient business related that you can deduct it.

As you worry about these things post-filing, are you at risk for three years, six years, or more? Taxes are horribly complex, and even innocent activities can be misinterpreted. That’s one of many reasons it pays to know how far back you can be audited. Start with the old rule that the IRS usually has three years after you file to audit you.

But there are many exceptions that give the IRS six years or longer. Several of those exceptions are so prevalent today that the six year statute of limitations is becoming more common. The three years is doubled to six if you omitted more than 25 percent of your income. For years, there was a debate over what it means to omit income from your return. Taxpayers and some courts said "omit" means leave off, as in don’t report. But the IRS said it was much broader, including reporting that has the effect of an omission of income.

Say you sell a piece of property for $3 million, claiming that your basis (what you invested in the property) was $500,000. The effect of your basis was only $1.5 million. In Home Concrete & Supply, LLC v. U.S., 132 S. Ct. 1836 (2012), the Supreme Court slapped down the IRS, holding that overstating your basis is a tax lawyer with www.WoodLLP.com, and the author of “Taxation of Damage Awards & Settlement Payments” (www.TaxInstitute.com). This is not legal advice.

For all these reasons, it pays to know how far back you can be asked to prove your income, expenses, bank deposits and more. Frequently, the IRS says it needs more time to audit. The IRS will ask you to sign a form extending the statute of limitations, usually for a year. If you don’t sign, the IRS will send you a tax bill, usually based on unfavorable assumptions.

Another hot button that impacts the statute of limitations involves offshore accounts. The IRS goes after offshore income and assets in a big way, and that dovetails with another IRS audit rule. The IRS also gets six years to audit if you omitted more than $5,000 of foreign income (say, interest on an overseas account). That matches the audit period for FBARs, annual offshore bank account reports that can carry civil and even criminal penalties far worse than those for tax evasion.

For all these reasons, be careful and keep good records. You should keep copies of your old tax returns forever. But after a time—many people say seven years—you should be able to throw out records and receipts. Yet there are many things that remain relevant almost forever.

Some records, such as purchase records for property, and the cost of improvements to property that go into your basis, are examples. If you remodel your kitchen and sell your house 20 years later, the receipts for your remodeling job are still relevant to your tax return in 20 years.

The statutes of limitation applicable to your tax returns are important. Always check them carefully, including all exceptions. Being able to tell the IRS it is too late to audit can be, well, priceless. California usually gets four years, but sometimes more, and that’s another story.