Everyone Should Know How Long the American IRS Can Audit

BY ROBERT WOOD

IRS Headquarters in Washington, D.C.
© Shutterstock

The American IRS is known throughout the world, and FATCA, the US global reporting law, has extended its reach. Everyone should know how long the IRS has to audit or collect taxes under several different statutes of limitation.

Around the world, the IRS has a surprisingly long reach. To begin with US citizens and green card holders must report their world-wide income to the IRS. On top of that, companies and investors that have any US source income must report their income to the IRS too. And then there are the non-tax payment forms, such as FATCA compliance and financial account reporting.

When you consider the power of the IRS, it can be daunting for most anyone. Just look at how the IRS and US Justice Department radically reshaped the previously secretive and powerful world of Swiss banking. The IRS collected over $10 billion, and has now moved on to vast numbers of other offshore jurisdictions.

So, knowing how long you could be in the IRS crosshairs can be good business. The overarching federal tax statute of limitations runs three years after you file your tax return. But don't stop with that simple rule. There are many exceptions that give the IRS six years or longer, in some cases forever.

The overarching federal tax statute of limitations runs three years after you file your tax return. But don't stop with that simple rule.

The statute is six years if your return includes a "substantial understatement of income". Generally, this means you have left off more than 25 percent of your gross income. 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. For years, there was litigation over what it *means* to *omit* income from your return.

In *US v. Home Concrete & Supply, LLC,* 132 S. Ct. 1836 (2012), the US Supreme Court slapped down the IRS, holding that overstating your tax basis in assets you sell is *not* the same as *omitting* income. But Congress *overruled* the Supreme Court and gave the IRS six years by statute, so that is the current law.

The IRS is still going after offshore income and assets in a big way, and that dovetails with another IRS audit rule. The three years is *also* doubled to six 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.

Certain other forms related to foreign assets and foreign gifts or inheritances are also important. If you miss one of these forms, the statute never runs. If you receive a gift or inheritance of over $100,000 from a non-US 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 FATCA, the Foreign Account Tax Compliance Act.

Form 8938 requires US filers to disclose the details of foreign financial accounts and assets over certain thresholds. If you are required to file Form 8938 and skip it, the IRS clock *never even starts* to run.

If you own part of a foreign corporation, it can trigger extra reporting, including filing an IRS Form 5471. Failing to file it means penalties, generally $10,000 per form. A separate penalty can apply to each Form 5471 filed late, incomplete or inaccurate.

This penalty can apply even if no tax is due on the whole tax return. Even worse, if you fail to file a required Form 5471, *your entire tax return remains open for audit indefinitely*. Forms 5471 are not only required of US shareholders in controlled foreign corporations. They are also required when a US shareholder acquires stock resulting in 10 percent ownership in any foreign company.

What if you never file a tax 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. Statute of limitation issues come up frequently, and the facts can become confusing.

Consider what happens if 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, but partnership tax rules may give the IRS extra time.

Also watch for cases where the statute may be "tolled" (held in abeyance) by an tsummons, 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. Yet it can extend *your* statute of limitations.

This can occur if a promoter has sold you on a tax strategy. The IRS may issue the promoter a summons asking for all the names of his client/customers. While he fights turning those names over, the statute of limitations clock for all of those clients is stopped.

Another situation in which the IRS statute is tolled is where the taxpayer is outside the United States. Even after many years, when you return, you may find that your tax problems can spring back to life.

The statute of limitations is sometimes about good record-keeping. Even being able to prove 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.

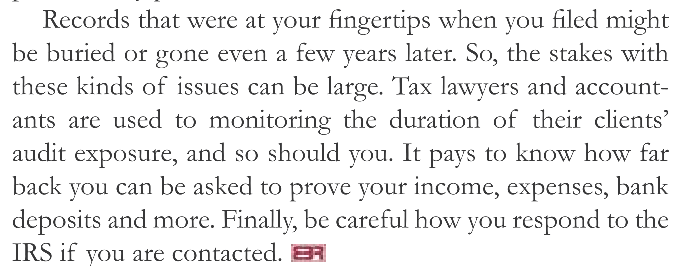
The difference between winning and losing a tax case may depend on your records. The vast majority of IRS disputes are settled, and getting a good or mediocre settlement can hinge on your records too. The statute usually begins to run when a return is filed, so keep certified mail or courier confirmation.

If you file electronically, keep all the electronic data, plus a hard copy of your return. As for record retention, many people feel safe about destroying receipts and back-up data after six or seven years. However, you should never destroy old tax returns. Keep copies forever. Also, do not destroy old receipts if they relate to basis in an asset.

For example, receipts for home remodelling 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 remodelling 15 years back. For all these reasons, be careful and keep good records.

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 ten 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.

Conclusion. An IRS audit or investigation can involve targetted questions and requests of proof of particular items only. Alternatively, it might cover the waterfront, asking for proof of virtually every 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. Finally, be careful how you respond to the IRS if you are contacted.

Robert W. Wood is a tax lawyer representing clients worldwide from offices at Wood LLP, in San Francisco (www.WoodLLP.com). He is the author of numerous tax books, and writes frequently about taxes for *Forbes, Tax Notes,* and other publications. This discussion is not intended as legal advice.