# Facts About IRS Audits To Keep You Out of Trouble

By Robert W. Wood

It would be very satisfying to say, "Sorry, IRS, you are too late to audit me!" It can save you stress and expense, and avoid having to prove that you were entitled to a deduction or find receipts. The IRS statute of limitations is important for heading off audit trouble, whether you are an individual, corporation, partnership, nonprofit organizations and individuals are consistent. Here's what you need to know.

## Myth #1: The IRS Has Three Years, and Then You're Home Free

Not really. It is true that the main federal tax statute of limitations runs three years after you file your tax return. But there are many exceptions that give the IRS six years or longer. Timing can be critical. If your tax return is due April 15, but you file early, the normal statute runs three years after the *due* date. Filing early does not start the three years to run. If you get an extension and file on October 15, your three years runs from then. If you file late and *do not* have an extension, the statute runs three years following your actual (late) filing date.

The statute is six years if your return includes a "substantial understatement of income." Generally, this means you have left off more than 25% of your gross income. Suppose that you earned $200,000 but only reported $140,000? You omitted more than 25%, so that means you can be audited for six years.

The circumstances can matter too. Maybe this was unintentional or reporting in reliance on a good argument that the extra $60,000 wasn't your income. That means 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, as we will see. What about not an omission of income, but overstated deductions? The six-year statute of limitations does not apply if the underpayment of tax was due to the overstatement of deductions or credits.

## Myth #2: Only Omitting 25% of Your Income Triggers Six Years

Actually, the 25% is a practical one. For years, there was litigation 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.

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

In *U.S. v. Home Concrete & Supply, LLC*,[1] the Supreme Court slapped down the IRS, holding that overstating your basis is *not* the same as *omitting* income. The Supreme Court said three years was plenty for the IRS to audit. But Congress *overruled* the Supreme Court and gave the IRS six years in such a case, so that is the current law. Six years can be a long time.

## Myth #3: No Return or Fraudulent Return

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? 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 altering 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 tax protester statement. However, some well-meaning taxpayers forget to sign, or may unwittingly change the penalties of perjury wording. Some other taxpayers just miss a form to end up in audit purgatory.

## Myth #4: Foreign Income, Foreign Gifts and Assets Are the Same

Nope, this kind foreign income and assets are different to the IRS, and they trigger tougher rules. 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 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 FATCA, the Foreign Account Tax Compliance Act. 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 U.S. persons residing abroad. But the forms are nothing to ignore. If you are required to file Form 8938 and skip it, the IRS clock never even starts to run.

## Myth #5: U.S. and Foreign Companies Are Treated the Same

Not hardly. If you own part of a foreign corporation, it can trigger extra reporting, including filing an IRS Form 5471. It is an understatement to say 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, incomplete or inaccurate. 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 harsher.

If you fail to file a required Form 5471, your entire tax return remains open for audit indefinitely. This override of the normal 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. In addition, the IRS 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 the form, it is almost as if you didn't file a return. Forms 5471 are not only required of U.S. shareholders in controlled foreign corporations. They are also required when a U.S. shareholder acquires stock resulting in 10% ownership in any foreign company. The harsh statute of limitation rule for Form 5471 was enacted in 2010, part of the same law that brought us FATCA, the Foreign Account Tax Compliance Act.

## Myth #6: Limits for Amended Tax Returns

If you want to amend your 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 only has 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.

## Myth #7: Time Limits on Tax Refunds

Getting money back from the IRS is hard. 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. This is painful, resulting in lost tax money, and it catches many taxpayers unaware.

## Myth #8: It's a Mistake To Give the IRS More Time

On the contrary, usually if the IRS wants more time to audit you, you should generally agree. The IRS must normally examine a tax return within three years, unless one of the exceptions discussed here applies. The IRS tracks the three-year statute, but the IRS may need more time to audit.

The IRS may contact you asking you to sign a form extending the statute. It can be tempting to say no, but saying no is often a mistake.

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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 very 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).

## Myth #9: Counting the Years Is Easy

Counting three years is easy, but it can be tough to apply the statute and to count those three years in some cases. For example, sayan IRS notice is sent to a partnership, but not to its individual partners. The partnership tax rules may give the IRS extra time. In other cases, 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. 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. If you flee the country for years and return, you may find that your tax problems can spring back to life.

## Myth #10: You Don't Need To Worry About the States

Actually, state tax filings matter a lot. The IRS may audit first and the state later, or the reverse. They are usually connected. Some states have the same three- and six-year statutes as the IRS. Some have their own, like California, where the basic tax statute of limitations is four years, not three. In California if the IRS adjusts your federal return, you are *required* to file an amended return to match up what the feds did. If you don't, the California statute will *never* run out.

In most states, if you never file a return, the state statute never starts to run. That means thinking about your exposure. In California, for example, if you move out, filing non-resident returns just to report California source income to start California's statute can be wise. There can be many tricky interactions between state and federal statutes of limitations.

## Myth #11: Proof of Filing Isn't Important

Actually, being able to prove exactly when you filed and exactly what forms were included 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 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 backup data after six or seven years. However, 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 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.

## Conclusions

An audit can involve targeted questions and requests on 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 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 in the clear.

## Endnote

1. *U.S. v. Home Concrete & Supply, LLC*,132 S. Ct. 1836 (2012).