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How Long Can the IRS Audit?

It Depends

Fans of *Law & Order* may have a negative reaction when a suspect gets away because of the statute of limitations. Some fans might even cheer when the DA *still* finds a way to prosecute someone whom viewers know is guilty. But statutes are there for a reason. And when it comes to your own taxes, you should feel a big sigh of relief if the IRS tries to audit you too late.

If you face a tax audit and can legitimately point to the statute of limitations to head off trouble and expense, you should. Why should you have to prove you were entitled to a deduction—or have to find and produce receipts—if it is *too late* for the IRS to make a claim? Rules are rules, and the IRS must follow them, too.



In short, when it comes to taxes, do not discount the importance of the statute of limitations. It can be pretty satisfying to say to the IRS, “Sorry, you’re too late.” 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 part of the tax law, the rules for corporations, partnerships, nonprofit organizations and individuals are consistent. Here’s what you need to know.

1

Normally, the IRS has three years

The overarching 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, as we shall see. But, starting with the normal three years, how is that counted?

If your tax return is due April 15, but you file early, the statute runs exactly three years after the *due* date. So, filing early does not start the three years to run. If you get an extension to October 15, and file then, 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.

2

Six years for large understatements of income

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. Suppose you earned \$200,000 but only reported \$140,000? You omitted more than 25 percent, 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.

3

Six years for basis overstatements

Still, you must add to the six-year category certain other items. 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 *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 than that.

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.

4

Foreign income, foreign gifts and assets

Another hot button these days involves offshore accounts. 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 a foreign bank account report (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.



IRS Form 5471

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*.

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.

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 percent 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.



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? 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. Some other taxpayers just miss a form, only to end up in audit purgatory.



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 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.



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 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.



Extending the statute

The IRS must normally 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.



How Long Can the IRS Audit?

The IRS may contact you about two and a half years after you file, asking you to extend the statute of limitations. The IRS will ask you to sign a form extending the statute. It can be tempting to relish your power and just say no, as some taxpayers do. However, saying no to the IRS 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 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). 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. 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 turn-

ing 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.

11 State tax statutes

Some states have the same three- and six-year statutes as the IRS. But some 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 with what the feds did. If you don't, the California statute will *never* run out. Plus, as in most states, if you never file a California return, California's statute never starts to run.

Some advisers suggest filing non-resident returns just to report California source income to start 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. 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 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, 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.

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*,² the Tax Court held Mr. Beeler responsible for 30-year-old payroll tax liabilities.

Conclusion

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. 

endnotes

1. 132 S. Ct. 1836 (2012).
2. T.C. Memo. 2013-130.