Forbes

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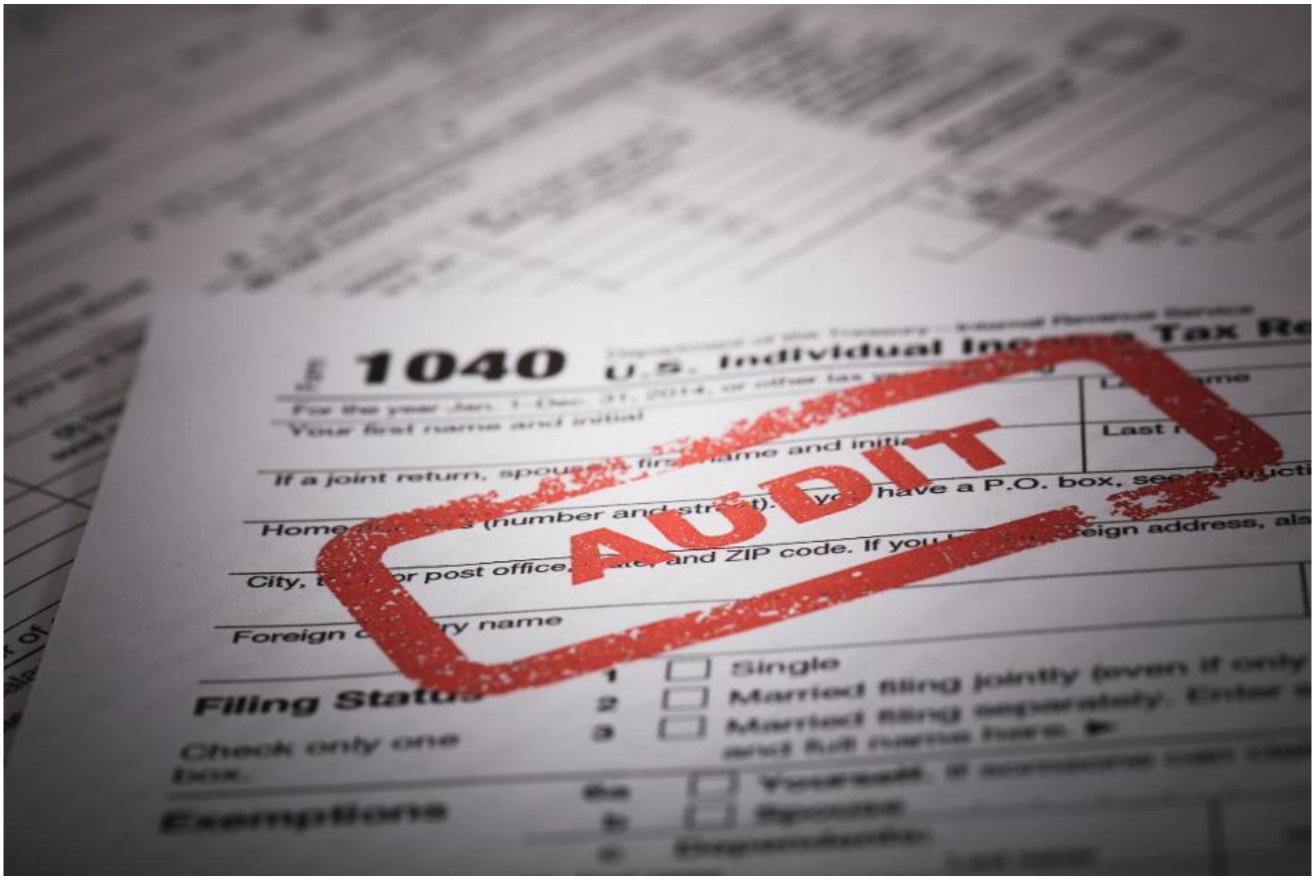
THE TAX LAWYER

TAXES 10/08/19

IRS Audit Period Is 3 Years, 6 Years Or Forever: How To Cut Your Risk

It is only natural to worry about an IRS audit, and the duration of audit periods can be downright frightening. Tax lawyers and accountants are used to monitoring the duration of their clients' audit exposure, and so should you. Watch the calendar until you are clear of audit. In most cases, that will be either three years or six years after you file your return. But in some cases, even though you filed and thought everything was in order, the statute of limitations on the IRS ability to audit you *never* runs. The basic rule is that the IRS can audit for three years after you file, but there are many exceptions that give the IRS six years or longer. For example, the three years is doubled to six if you omitted more than 25% of your income. This 25% rule can apply to tax basis too.

Say you sell a piece of property for $3M, claiming you bought it for $1.5M. In fact, you paid only $500,000. The effect of this basis *overstatement* is 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*, the Supreme Court held that overstating your basis is *not* the same as *omitting* income. The Supreme Court said 3 years was plenty for the IRS to audit. However, Congress *overruled* the Supreme Court, giving the IRS six years in such a case.



The IRS also gets six years to audit if you omitted more than $5,000 of foreign income (say, interest on an overseas account). Six years is a long time, and the IRS has *no time limit* if you never file a return or file fraudulently. Another scary rule is that the IRS can audit forever if you omit certain tax forms. They include Form 5471 if you own part of a foreign corporation, Form 3520 for gifts or inheritance from foreign nationals, and Form 8938 for overseas assets. There is a ten year statute too. Once a tax assessment is made, the IRS *collection* statute is typically ten years.

Figuring out the applicable statute of limitations that applies to you and then waiting it out can be nerve-wracking. An audit can involve targeted questions, or audits can ask for proof of virtually every item. 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. Most tax advisers tell clients to agree to the extension. However, it's best to get some professional advice about your own situation. You may be able to limit the time or scope of the extension.

To help limit your exposure, here are some tips. If you file early, do you shorten the audit period? Normally no, the IRS audit clock starts running on the *later* of your actual filing or the due date. If you file in January and your return is due April 15th, the audit clock starts to tick on April 15th. Keep good records, and keep copies of all your past tax returns forever. Report all your income, and disclose your tax positions on your return, even if you are claiming the money isn't taxable, is taxable as capital gain, etc.

Consider having your return professionally prepared. Report offshore accounts on tax returns and FBARs, and make sure you file any other forms that could extend your statute to six years or forever. Steer clear of tax shelters and things the IRS counts as 'listed transactions' that can bring trouble. If you have big tax issues about a particular issue—say a lawsuit recovery, casualty loss, etc., consider getting targeted tax advice from a tax lawyer or CPA.

If the IRS contacts you, consider getting professional advice. Don't ignore the IRS, but be careful what you do and what you say. Sometimes issues can be addressed easily if you do it carefully and timely. Consider your audit exposure before you file. If you don’t sign your return, the IRS does not consider it a valid tax return. That means the three years never starts to run. Don’t alter the penalties of perjury language at the bottom before you sign. If you do so, it also can mean the tax return does not count.

In any audit situation, gathering receipts is no fun, nor is explaining what you claimed and why. If your returns are unusual or aggressive, it can be worse. So try to plan ahead, be prepared, and consider having professionals handle it.

This is not legal advice. For tax alerts or tax advice, email me at Wood@WoodLLP.com.