TAX MYTHS ABOUT IRS STATUTE OF LIMITATIONS

Written by Robert W. Wood

It would be extremely satisfying to say, “Sorry, IRS, you are too late to audit me!” It would save you stress and expense, and would 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, or nonprofit organization. Here is what you need to know.

Myth #1. The IRS Has Three Years, and then You are 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, therefore, can be critical. If your tax return is due on April 15, but you file early, the normal statute runs three years after the *due* date. As a result, filing early does not start the three years statute to run. If you get an extension and file on October 15, your three years runs from that later date. 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, however, that you earned $200,000, but only reported $140,000 of income. In this situation, 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 sound argument that the extra $60,000 was not your income. This means the six-year statute applies. But taxpayers must be aware that the IRS certainly *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 a situation where it is not an omission of income, but a return with 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 and significant number. For years, there was litigation over what it *meant* to *omit* income from your return. Taxpayers and some courts said “omit” meant leave off, as in, do not report. But the IRS said that an act of omission was much broader than merely failing to report income.

Example: You sell a piece of property for $3,000,000, claiming that your basis (what you invested in the property) was $1,500,000. In fact, your basis was only $500,000. The effect of your basis overstatement was that you paid tax on $1,500,000 of gain, when you should have paid tax on $2,500,000.

In *United States v. Home Concrete & Supply, LLC*,[01] the United States 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 of time for the IRS to perform an audit. But Congress *overruled* the Supreme Court and gave the IRS six years in such a case, so that remains the current law. Six years, as can be expected, 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. One question often asked is, if you file a return, can the IRS ever claim that your return did not count, so that the statute of limitations never starts to run? The answer to this question is yes. In other words, if you fail to sign your return, the IRS does not consider it a valid tax return. This means the three years never starts to run.

Another big no-no is 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 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 to end up in audit purgatory.

Myth #4: Foreign Income, Foreign Gifts, and Foreign Assets Are the Same. Nope, these types of income, gifts, and assets are viewed differently by the IRS, and they trigger tougher rules. The IRS is still going after offshore income and assets in a substantial 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 (for instance, 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. For example, 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 this form, 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. residents 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 true. 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 that is filed late or is either incomplete or inaccurate. This penalty can apply even if no tax is due on the whole tax return. This is a harsh rule, 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, but the IRS also 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 never filed a return. Form 5471's are not only required of U.S. shareholders in controlled foreign corporations, but they are also required when a U.S. shareholder acquires stock resulting in ten 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.

Myth #6: Limits for Amended Tax Returns. If you want to amend your tax return, you must do so 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 does not. However, where your amended tax return shows an *increase* in tax, and when you submit the amended return within sixty days before the three-year statute runs, the IRS only has sixty 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 difficult. 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 the excess returned. Suppose you make tax payments (by withholding or estimating 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 often is a painful lesson, resulting in lost tax money, and it catches many taxpayers completely 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 initiate and conduct an 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.

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 money. The IRS may make very unfavorable assumptions in these situations. 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, say an 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 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 and will instantly spring back to life.

Myth #10: You Don't Need to Worry About the States. Actually, state tax filings matter a great deal. 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. Moreover, in California, if the IRS adjusts your federal return, you are *required* to file an amended return to match up what the IRS did. If you do not, 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 of state, 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 tax returns. The difference between winning and losing an audit 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. 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 the calculation of the basis in an asset.

For example, receipts for home remodeling fifteen years ago are still relevant, as long as you own the house. You may need to prove your basis when you later sell the property, and you will want to claim a basis increase for the remodeling fifteen 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, tax returns 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.

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01 *U.S. v. Home Concrete & Supply, LLC*, 566 U.S. 478, 132 S. Ct. 1836, 182 L. Ed. 2d 746 (2012).