Common Errors With the IRS Statute of Limitations

by Robert W. Wood

Robert W. Wood

Robert W. Wood practices law with Wood LLP (www.WoodLLP.com) and is the author of *Taxation of Damage Awards and Settlement Payments* and other books available at www.TaxInstitute.com.

In this article, Wood examines 11 myths about the IRS statute of limitations that taxpayers sometimes erroneously rely on.

It would be very satisfying to say, "Sorry, IRS — you're too late to audit me!" It could save you stress and expense and from having to find receipts or prove that you were entitled to a deduction. The IRS statute of limitations is important for heading off audit trouble whether you are an individual, corporation, partnership, or nonprofit organization. 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 run from then. If you file late and do not have an extension, the statute runs three years from your actual (late) filing date.

The statute of limitations is six years if your return is found to include a "substantial understatement of income." Generally, this means that you have left off more than 25 percent of your gross income. Suppose that 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 the understatement was unintentional or reported in reliance on a good argument that the extra $60,000 wasn't your income. That still 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 you, as we will see. What about no omission of income but overstated deductions? The six-year statute of limitations does not apply if the underpayment of tax was caused by the overstatement of deductions or credits.

Myth 2: Only omitting 25 percent of your income triggers six years.

Actually, the 25 percent figure 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" meant 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 *Home Concrete*,[1] the Supreme Court rebuffed the IRS, holding that overstating your basis is not

[1] *United States v. Home Concrete & Supply LLC*, 566 U.S. 478 (2012).

the same as omitting income. The Court said three years was plenty of time 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 to audit 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 never start 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 as filed. Such a move might sound like a tax protester statement, but some well-meaning taxpayers forget to sign or might 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. 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 standard three-year limitation period 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 foreign account on your tax return, and even if you fulfilled your reporting duties by filing a Financial Crimes Enforcement Network Form 114, "Report of Foreign Bank and Financial Accounts (FBAR)." This six-year limitation period matches the audit period for FBARs. FBAR reporting violations can carry civil and even criminal penalties that are far worse than those for tax evasion.

Some other forms concerning foreign assets and foreign gifts or inheritances are also important. If you miss one of these forms, the statute of limitations is extended — or, in fact, it never runs. If you receive a gift or inheritance of more than $100,000 from a non-U.S. person, you must file IRS Form 3520, "Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts." If you fail to file it, your statute of limitations never starts to run.

Form 8938, "Statement of Specified Foreign Financial Assets," was added to the tax law by the Foreign Account Tax Compliance Act. Form 8938 requires U.S. filers to disclose the details of foreign financial accounts and assets that are valued over specific 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 the filing of Form 5471, "Information Return of U.S. Persons With Respect to Certain Foreign Corporations." 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 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 for the missing Form 5471 but it can also make adjustments to the entire tax return, with no time limit.

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.

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 doesn't. However, when your amended tax return shows an increase in tax owed and you submit it within 60 days before the three-year statute runs, the IRS 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 owed does not trigger an extension of the statute of limitations.

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 might find that overpayments in one year do not offset underpayments in another. This is painful, resulting in lost tax money, and it catches many taxpayers unawares.

Myth 8: It's a mistake to give the IRS more time.

On the contrary, 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 of limitations, but it may need more time to audit. So the IRS might 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.

Saying no 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 might make unfavorable assumptions. Thus, most tax advisers tell their clients to agree to the requested extension. You may, however, be able to limit the scope of the extension to specific tax issues or to limit the time (say, to 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 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 might be tolled (held in abeyance) by an IRS John Doe summons, even if you have no notice of it.

A John Doe summons is issued not to taxpayers but to banks and other third parties that have relationships with taxpayers. You might 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 might issue the promoter a summons asking for all the names of his clients and customers. While he fights to keep from 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 when the taxpayer is outside the United States. If you flee the country for years and then return, you might find that your tax problems spring back to life.

Myth 10: You don't need to worry about the states.

Actually, state tax filings matter a lot. The IRS might 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 state return to match up with 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 of limitations never starts to run. That means thinking about your exposure. In California, for example, if you move out, filing nonresident 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 might 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 of limitations 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 the basis in an asset.

For example, receipts for home remodeling that occurred 15 years ago are still relevant as long as you own the house. You might 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.

Conclusion

An audit can involve targeted questions and requests for only particular items. Alternatively, audits can cover the waterfront, asking for proof of virtually every line item. Even if you do your best, 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 even gone 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 be. 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. ■