Expert View

Even The IRS Has Time Limits

Robert W. Wood 10.08.09, 12:00 PM ET

If you are a fan of *Law & Order* as I am, you may have a negative reaction when a suspect claims the law can't touch him because of the statute of limitations. By relying on a technicality that hinges on the mere passage of time, it's almost as if the suspect is admitting he did it.

In any tax dispute, you'll want to make good substantive arguments. Still, don't discount the importance of the statute of limitations.

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 yellowed receipts) if it is simply too late for the IRS to make a claim?

Given the importance of the statute--both to heading off audit trouble and to knowing when you may be able to throw some of those receipts away--it is surprising how few taxpayers are statute savvy.

Fortunately, 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.

Normally, the IRS Has Three Years

The overarching federal tax statute of limitations runs for three years after you file a tax return. If your tax return is due April 15, but you file early, the statute runs exactly three years after the due date. If you file late and do not have an extension, the statute runs three years following your actual (late) filing date.

Sometimes, the IRS Gets Six Years

The statute is six years if your return includes a "substantial understatement of income." Generally this means you've left off 25% or more of your gross income, but exactly what that means is currently the subject of litigation. The IRS is now arguing in court that anything on your tax return that has the *effect* of a 25% understatement of gross income gives it an extra three years. Still, most court decisions conclude that overstating deductions is *not* the same as omitting income.

The IRS has asserted it has six years to go after basis over-statements. Here's what that means: Suppose you sell a piece of property for $3 million, claiming your basis (what you've invested in the property) was $1.5 million, when your basis was really only $500,000? You pay tax on $1.5 million of gain, when you *should* have paid tax on $2.5 million. Your basis over-statement probably means a six-year statute applies.

However, the IRS recently lost tax cases on this point in both the Ninth and Federal Circuits. *Bakersfield Energy Partners v. Comm'r*, 568 F.3d 767 (9th Cir. 2009), and *Salman Ranch Ltd. v. U.S.*, 573 F.3d 1362 (Fed. Cir. 2009). That made lots of taxpayers happy. In an attempted end-run around the courts, though, the IRS has just issued temporary regulations confirming its own view. (See IRS Temporary Regs., T.D. 9466, Sept. 25, 2009.) That was a controversial move, and we can expect more skirmishes.

Nevertheless, as a practical matter, resort to the six-year statute is rare. Usually, the IRS invokes it when an audit of one year (open under the three-year statute) extends to connected issues in earlier years. Still, the IRS has ramped up focus on the six-year statute.

Sometimes, the IRS Has Forever

What if you never file a return or file a fraudulent one? *Law &* Order fans will understand what I mean when I say this is the

tax equivalent of murder--the statute of limitations never runs out. The IRS has no time limit if you never file a return or if it can prove civil or criminal fraud.

Amending Tax Returns

Taxpayers must abide by a time limit 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 return restarts the three-year statute, but it doesn't. However, where your amended return shows an increase in tax, and you submit the amended return 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. 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 about possession being 9/10ths of the law applies to taxes too--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 haven't filed tax returns (shame on you!) for three or four years? When you file those long-past-due returns, overpayments in one year may not offset underpayments in another.

Beware of 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 even more time to assess extra taxes. In California, for example, the basic tax statute of limitations is four years. However, if the IRS adjusts your federal return, you are *obligated* to file an amended return in California. If you don't, the California statute will *never* run out.

Extending the Statute

The IRS must normally examine a return within three years. However, the IRS may contact you about two and a half years after filing, asking you to *extend* the statute of limitation. Some taxpayers just say no, but that usually leads the IRS to send a notice assessing extra taxes, without taking the time to thoroughly review your explanation of why you don't owe more. So in most cases, you should agree to the requested extension. You may, however, be able to limit the scope of the extension to certain tax issues, or limit the time (say, an extra year). You should seek professional tax help if you receive such an inquiry.

Statute Traps

Statute of limitation issues come up frequently, and the facts can become confused. As but one example, consider what happens when a tax 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.

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! This comes up, for example, if an accountant or other promoter has sold you on a tax strategy. The IRS may issue the accountant a summons asking for all the names of his client/customers. While he fights turning those names over, the statute of limitations clock for his clients is stopped.

My Kingdom for a Horse!

Keep scrupulous records, including proof of when you mailed your returns. The difference between winning and losing, or getting a good or mediocre settlement (the vast majority of IRS disputes are settled) often depends on 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. (Incidentally, I do not advise clients to file electronically until the tax law mandates it.) As for record retention, you can destroy receipts and back-up data after six years. Never destroy old tax returns. Also, as you're destroying old receipts, if they relate to basis in an asset, keep them. For example, receipts for home remodeling 10 years ago are still relevant as long as you own the house. You may need to prove your basis when you later sell it.

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