Internal Revenue Service Doubles Three-Year Statute of Limitations

By Robert W. Wood

Yes, that's six long years of tax worry, a result from the latest tax case about the three-year versus six-year Internal Revenue Service statute of limitations. In any tax dispute, you'll want to make good substantive arguments. Still, don't discount the importance of the statute of limitations.

In fact, many tax cases are won on it. If you face a tax audit and can legitimately point to the statute of limitations to head off trouble and expense, you should. Why do you have to prove you were entitled to a deduction or have to find a receipt if the IRS comes along too late?

The statute of limitations is important for heading off audit trouble and for knowing when you may be able to throw some of those receipts away. As such, it is surprising how few taxpayers are statute savvy. Unfortunately, the tax statutes are changing.

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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.

However, the IRS statute of limitations is six years if your return includes a "substantial understatement of income." Generally this means you've left off 25 percent 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 percent understatement of gross income gives it an extra three years.

In particular, the IRS has asserted that it has six years to go after basis over-statements. Here's what that means: You sell a piece of property for $3 million, claiming that your basis (what you have 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. Your basis over-statement probably means a six-year statute applies.

The latest skirmish in this epic battle over how long the IRS can audit is *Salman Ranch LTD*, No. 09-9015 (10th Cir. May 31, 2011), where the 10th U.S. Circuit Court of Appeals held the IRS could go back six years, not just three. There are numerous other cases now too.

Here in the 9th U.S. Circuit Court of Appeals, the rule is still three years. See *Bakersfield Energy Partners LP v. Comm'r*, 568 F.3d 767 (9th Cir. June 17, 2009). Yet there is significant concern now that the 9th Circuit may reverse itself in the next case it receives. Moreover, it is becoming increasingly likely that the U.S. Supreme Court will address this debate.

Many observers have the opinion that the Supreme Court has already tipped its hand on this issue. In *Mayo Foundation for Medical Education and Research*, 178 L. Ed. 2d 588, the Supreme Court suggested that IRS regulations were entitled to significant deference. That's important, since the three-year versus six-year statute debate isn't only about case law.

The IRS has actually tried to regulate its litigating position, issuing regulations that say it gets six years. That makes the *Mayo Foundation* decision particularly ominous.

Some have characterized the IRS action as an attempt to bootstrap its way to victory. If regulations purport to "clarify" the statute, they give the IRS its needed six years.

Beware of California though. When you talk of taxes and the statute of limitations, California marches to its own drummer. In California, 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.

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.

Thus, 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.

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 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.

Despite all the scary news, the good news is that most of the time the IRS only gets three years. It pays to monitor when the statute expires so you know when a particular year is in the clear.

This discussion is not intended as legal advice, and cannot be relied upon for any purpose without the services of a qualified professional.