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Is Your Tax Audit Risk 3 Years, 6 Years, Or Even More?

By Robert W. Wood

Just about everyone hopes that their tax audit exposure is low. It can even be worth specifically asking your tax professionals if they see anything on your draft tax return that might raise eyebrows. If they point something out, it does not mean that you should forgo claiming something that is legitimate.

But considering the issue, its magnitude, presentation, and the overall mix on your return can be good business. Of course, it is common to worry that you might not be able to substantiate every deduction. And there may be particular issues — sometimes big issues — that impact whether income goes on this year's return or next, or regardless of substantiation, whether an expense is sufficient business related that you can deduct it.

As you worry about these things post-filing, are you at risk for three years, six years, or more? Taxes are horribly complex, and even innocent activities can be misinterpreted. That's one of many reasons it pays to know how far back you can be audited. Start with the old rule that the IRS *usually* has three years after you file to audit you.

But there are many exceptions that give the IRS six years or longer. Several of those exceptions are so prevalent today that the six year statute of limitations is becoming more common. The three years is doubled to six if you omitted more than 25 percent of your income. For years, there was a debate over what it *means* to *omit* income from your return. Taxpayers and some courts said "omit" means leave off, as in don't report. But the IRS said it was much broader, including reporting that has the *effect* of an omission of income.

Say 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 only $1.5 million of gain, when you *should* have paid tax on $2.5 million. In *U.S. v. Home Concrete & Supply, LLC*, 132 S. Ct. 1836 (2012), the 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 for the IRS to audit.

Then, Congress *overruled* the Supreme Court, and gave the IRS six years in such a case. Six years is a long time. Filing your tax return early won't help either. The time periods can be even longer in some cases. The IRS has *no time limit* if you never file a return or file fraudulently. Even so, the practical limit for the IRS to go back is usually six years. Another scary rule is that the IRS can audit forever if you omit certain tax forms.

Plus, once a tax assessment is made, the IRS *collection* statute is typically 10 years. And, in some cases that ten years can essentially be renewed. That's one reason the IRS can sometimes go back an astounding 30 years! In *Beeler v. Commissioner*, T.C. Memo 2013-130, the Tax Court held Beeler responsible for 30-year-old payroll tax penalties.

Figuring out the applicable statute of limitations that applies to your situation — and then waiting it out — can be nerve-wracking. An audit can involve targeted questions and requests of proof of particular items only. Alternatively, audits can also cover the waterfront, asking for proof of virtually every line item.

For all these reasons, it pays to know how far back you can be asked to prove your income, expenses, bank deposits and more. 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.

For this and other reasons, most tax advisers generally tell clients to agree to the extension. It can be hard for clients to agree, especially if they had been eagerly counting off the months on their calendar. 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.

Another hot button that impacts the statute of limitations involves offshore accounts. The IRS goes after offshore income and assets in a big way, and that dovetails with another IRS audit rule. The IRS also gets six years to audit if you omitted more than $5,000 of foreign income (say, interest on an overseas account). That matches the audit period for FBARs, annual offshore bank account reports that can carry civil and even criminal penalties far worse than those for tax evasion.

For all these reasons, be careful and keep good records. You should keep copies of your old tax returns forever. But after a time–many people say seven years–you *should* be able to throw out records and receipts. Yet there are many things that remain relevant almost forever.

Some records, such as purchase records for property, and the cost of improvements to property that go into your basis, are examples. If you remodel your kitchen and sell your house 20 years later, the receipts for your remodeling job are still relevant to your tax return in 20 years.

The statutes of limitation applicable to your tax returns are important. Always check them carefully, including all exceptions. Being able to tell the IRS it is too late to audit can be, well, priceless. California usually gets four years, but sometimes more, and that's another story.

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