

Supreme Court holds IRS must audit within three years

By Robert W. Wood

Everyone wants to avoid a tax audit. If you can legitimately point to the statute of limitations to head off tax trouble and expense, you should. After all, if it is simply too late for the IRS to make a claim, you won't have to prove you were entitled to a deduction or need to find and produce receipts.

The IRS primarily monitors the normal three-year statute of limitations. However, the IRS does come after people outside this period, especially during audits of years *within* those three years. The IRS may seek to open a few ostensibly closed years.

Given the importance of the statute — both for heading off audit trouble and for knowing when you may be able to throw some of those receipts away — these issues have been controversial. The rules for corporations, partnerships, nonprofit organizations, and individuals are consistent. The overarching federal tax statute of limitations runs 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, the statute runs three years following your actual (late) filing date.

However, here's where it can get messy. The IRS gets 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. However, the IRS has argued in court and in regulations that overstating your basis — having the *effect* of a 25 percent understatement of gross income — gives it an extra three years.

Advising about this timing minefield has been tough. Trying to get an IRS regulation thrown out is extraordinarily difficult. The circuit courts split on this issue. The IRS won so that the six-year statute of limitations applied in the 7th Circuit: *Beard v. Comm'r*, 633 F.3d 616 (7th Cir. 2011); Federal Circuit: *Grapevine Imps., Ltd. v. U.S.*, 636 F.3d 1368 (Fed. Cir. 2011); 10th Circuit: *Salman Ranch, Ltd. v. Comm'r*, 647 F.3d 929 (10th Cir. 2011); and D.C. Circuit: *Intermountain Ins. Serv. of Vail v. Comm'r*, 650 F.3d 691 (D.C. Cir. 2011).

However, taxpayers beat the IRS so the three-year limit applied in the 4th Circuit: *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. N.C. 2011); 5th Circuit: *Burks v. United States*, 633 F.3d 347 (5th Cir. Tex. 2011) and *Equip. Holding Co. v. Comm'r*, 439 Fed. Appx. 368 (5th Cir. 2011); and 9th Circuit: *Bakersfield Energy Partners, LP v. Comm'r*, 568 F.3d 767 (9th Cir. 2009).

Final answer?

The Supreme Court hears few tax cases, but given this messy split of authority it had good reason to finalize the matter and agreed to decide if the IRS can go back six years or only three. *United States v. Home Concrete & Supply, LLC*, 132 S. Ct. 71 (U.S. 2011); See *Home Concrete & Supply, LLC v. United States*, 634 F.3d 249 (4th Cir. N.C. 2011). To the surprise of many, the Court dramatically cut back on IRS reaches into six year territory. *United States v. Home Concrete & Supply, LLC*, 2012 U.S. LEXIS 3274 (U.S. Apr. 25, 2012).

Example: 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. The IRS position has been that the six-year statute applies here, not three. The Supreme Court ruled that the IRS only gets three.

Significantly, the *Home Concrete & Supply* case was a tax shelter case involving wealthy investors doing sophisticated transactions in attempts to create arguably paper losses. Sometimes the usual tax rules are effectively bent in such cases to try to undo a tax result that seems too good to be true. For that reason, some observers thought the Supreme Court might find a way to allow the IRS to audit six years in a tax shelter case, even though the home sale basis example above might be limited to three years.

However, the High Court stuck to three years and did not try to split the decision with the wisdom of Solomon. At the same time, this was only a 5-4 decision, with four justices viewing the IRS actions in year five or six as justified. Given how aggressive the IRS has been on this issue, some taxpayers should keep worrying even though the Supreme Court has resolved the case.

Nevertheless, the taxpayer win in *Home Concrete & Supply* will have a *huge* trickle down effect, not just impacting these cases. Many taxpayers with audits that would be closed under the three-year period can be expected to reap significant tax savings. Some reports say the case calls into question up to a billion dollars in tax revenues. The IRS was hoping to collect enormous sums in about 30 related cases involving "Son of Boss" tax shelters.

Watch out for special rules.

Even with the Supreme Court case, some IRS statute of limitations rules are confusing. 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. If you make tax payments (by withholding or estimated tax payments) but haven't filed tax returns for three or four years, when you file those long-past-due returns, overpayments in one year may not offset underpayments in another.

The situation with extensions of the IRS statute of limitations also deserves mention. The IRS must normally examine a return within three years. However, the IRS may contact you asking you to *extend* the statute of limitation. Some taxpayers just say no, but that usually leads to the IRS sending a notice assessing extra taxes. They may not have the time to thoroughly review your explanation of why you don't owe more. In most cases, tax lawyers advise that you agree to the requested extension. It is sometimes possible, however, to limit the scope of the extension to certain tax issues, or limit the additional time granted (i.e., to an extra year). It is wise to seek professional tax help if you receive such an inquiry.

For taxpayers everywhere, the *Home Concrete & Supply* case will mean a little more security. Apart from the holding of the case that a basis overstatement is not an omission of income, the case may have a chilling effect on the IRS. Many taxpayers are likely to be happy about that.

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



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