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Why your IRS audit period might be longer than you think

By Robert W. Wood

Do you fear an IRS audit? Most people do, at least on some level. An audit can involve targeted questions and requests on particular items only. Alternatively, audits can cover the waterfront, asking for proof of virtually every line item. Even if you do your best when filing, 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 gone even a few years later, so the stakes can be high. Tax lawyers and accountants are used to monitoring the duration of their clients' audit exposure, and so should you. It pays to know how far back you can be asked to prove your income, expenses, bank deposits, and more. It may sound paranoid, but it is helpful to know when you are likely to be in the clear.

Tax returns are annual and getting them filed also means starting the clock ticking for how long the IRS has to audit you.

In most cases, your audit exposure will be either three years or six years. But in some cases, even though you filed and believed that everything was in order, the statute of limitations never runs. Let's start with the basic three-year rule.

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 you file early, do you shorten the audit period? Normally no, the IRS audit clock starts running on the later of your actual filing or the due date. If you file in January and your return is due April 15, the audit clock starts to tick on April 15. If you get an extension and file on October 15, however, your three years starts to run from then.

If you file late and do not have an extension, the statute runs three years following your actual (late) filing date. The IRS tracks the three years religiously, so if you are going to be audited, it nearly always will start during that three-year window. Of course, the start of an audit may involve the IRS asking you to extend the statute of limitations, a topic addressed below.

However, in some cases, the IRS can audit six tax years, not three. For example, the usual three years is doubled to six if you omitted more than 25% of your income. If you overstate your cost basis on something you sell, that counts too. The three years is also doubled if you omitted more than $5,000 of foreign income (say, interest on an overseas account), even if you disclosed the account. There are just some of 13 key IRS statute of limitation rules.

Even worse, don't omit Form 3520 for gifts or inheritance from foreign nationals, or Form 8938 for overseas assets. If you skip one of these forms, the IRS clock never even starts to run. The IRS also has no time limit if you never file a return. For unfiled tax returns, criminal violations or fraud, the IRS can take its time. In most criminal or civil tax cases, though, the practical limit is six years.

What other tax forms allow the IRS to audit forever? If you own part of a foreign corporation, it can trigger reporting, including filing an IRS Form 5471. 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 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 IRS statute of limitations is sweeping. The IRS not only has an indefinite period to examine and assess taxes on items relating to the missing Form 5471, but it can also make any adjustments to the entire tax return with no expiration until the required Form 5471 is filed.

Think of a Form 5471 like the signature on your return. Without it, it really isn't a return. Forms 5471 are not only required of U.S. shareholders in controlled foreign corporations, hey are also required when a U.S. shareholder acquires stock resulting in 10% 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, the Foreign Account Tax Compliance Act.

The possibility that the IRS can audit forever is chilling, though you can reduce your exposure by considering your audit exposure before you file. If you don't sign your return, the IRS does not consider it a valid tax return. That means the three years can never start to run. Another big no-no is if you alter the penalties of perjury language at the bottom of the return before you sign. If you do that, it also can mean the tax return does not count.

Finally, what happens if the IRS asks for more time to audit you? Yes, the IRS may ask you for an extension. The IRS may say they need more time to audit you. You may relish the thought of telling the IRS absolutely not! Even a routine tax audit can be expensive and nerve-wracking. But you have to assume that if the IRS is asking you to extend the statute, the IRS is already monitoring you.

For the most part, people usually do voluntarily give the IRS more time to audit. Why would anyone do that? It works like this. The IRS contacts you (perhaps 21/2 years after you file), asking you to extend the statute. Most tax advisers say that you should usually agree. If you say "no" or ignore the request, the IRS will assess extra taxes, usually based on an incomplete and quite unfavorable picture.

You might think that you could fail to answer at all, and that the IRS might forget about you. But this is something the IRS is very careful about. The IRS rarely misses issuing a Notice of Deficiency, and you usually will be worse off than if you agreed to the extension. There are exceptions to this rule, but relatively few. You may, however, be able to limit the scope of the extension to certain tax issues, or to limit the time. Get a professional to help you weigh your facts.

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