How Long Does The IRS Have To Audit Your Return?

By George W. Connelly

People are always asking how long the IRS can wait from the time you file your return to conduct an audit of your income and expenses. The simple, most definitive answer is "it all depends," so let's take a look at the rules.

The time in which the IRS must conduct its audit is governed by what's known as a "statute of limitations." That statute doesn't begin to run until you actually file a return. Once you file a return, the IRS has three years from the time the return was filed (or, April 15th of the year in which you file, if it is filed early) to conduct and complete an audit. That means that the IRS has to select your return for examination, conduct whatever level of audit it is going to perform, and either get an agreement from you to an additional amount of tax or a refund, secure an extension of limitations period from you, or issue you a document known as a "Notice of Deficiency" (indicating what it has determined your correct tax liability to be and giving you ninety days to go the United States Tax Court). If it fails to complete one of these actions within three years, in most situations the proverbial “ballgame” is over and it will be too late for the IRS to assert an additional tax liability for that year. The filing of an amended return does not extend the period in which an audit must take place. As you might expect, however, there are exceptions.

The first exception involves a situation where a taxpayer, or a husband and wife on a joint return, fail to report 25% of their correct gross income. If the IRS can prove that such an amount of income was omitted, then a six year period – running from the time the return was filed – applies. Fortunately, merely overstating deductions, or being unable to prove up the expenses that are deducted, does not in most instances constitute an "omission" from income. If you're in a business, and if you overstate or claim too many or too large an amount of cost of goods sold, that could constitute an omission of gross income. Likewise, in tax shelter cases, the IRS is presently taking the position that overstating a basis of an asset which is sold, so that either the amount of gain is reduced or an excessive amount of loss is produced, can also constitute an “omission of income.” Keep in mind that the IRS must "prove" the omission, and that one's good faith has nothing to do with whether this exception applies.

The other major exception relates to the presence of fraud – a knowing and willful attempt to evade tax. In order to rely on this exception, the IRS must prove such fraud by clear and convincing evidence with respect to every tax year for which it seeks to extend the limitations period. When fraud is proven, the statue of limitations is indefinite. Moreover, in a recent case of *Foxworthy, Inc. v. Commissioner*, T.C. Memo 2009-203, the United States Tax Court ruled to the effect that in the case of a joint return, fraud by one spouse is sufficient to extend the limitations period for that return for both spouses (actually, it followed a series of prior opinions). Thus, if your spouse is not properly reporting income and expenses, it's worth being vigilant, because the limitations period could be open for **both** of you if the Internal Revenue Service ever looks into the facts and conducts an examination, even if you were not part of the fraud.

There is one other exception, and it relates only to people involved in what's called a "TEFRA partnership." Since 1982, certain partnerships are subject to the unified audit and litigation procedures that were made a part of the Tax Equity and Fiscal Responsibility Act of 1982, and they provide that in the case of an audit of such an entity, a separate period of limitations may apply to the examination of that entity, and such a period would also extend the limitations period for the IRS to make an adjustment to the member's returns, but only with respect to adjustments relating to that entity.

Does this mean that after three years or six years or whenever, one should throw out all her records? Absolutely not! There are going to be situations where one has to establish the basis of an asset (for which depreciation or a capital loss is claimed), or the existence of a loss carryforward from well before the normal, three year limitations period. Thus, before you take your old tax records to the incinerator or the shredder, it's important to go through them and make sure that any documentary material that relates to a transaction that is or will be the subject of a later years' return be saved, just in case. In most audits, the burden of proving a deduction is on the taxpayer, and that includes proving the basis of an asset for which even capital gain is reported.

The foregoing is of course not intended as legal advice, but just as a summary of the pertinent periods after which the IRS may no longer examine your returns. If you are notified of an examination, you should discuss these rules with your personal tax advisor. ♦

~ George Connelly, a Silver Fox Advisor

Silver Fox Advisors™