PARTNERS BEYOND BOUNDARIES

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Have you filed your tax returns or do you owe money to the IRS? Are you anxious about the assessments and collections?

This thought leadership paper dwells on the statute of limitations for IRS audit, collections and refunds.

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Statutes of limitations are enactments in a common law legal system that sets the maximum time after an event that legal proceedings based on that event may be initiated

The conceptual basis of statutes of limitations has been explained by the US Supreme Court in Chase Sec. Corp. v. Donaldson, 325 U.S. 304, 314 (1945) as follows:
Statutes of limitations find their justification in necessity and convenience rather than logic. They represent expedients, rather than principles. They are practical and pragmatic devices to spare the courts from litigation of stale claims, and the citizen from being put to his defence after memories have faded, witnesses have died or disappeared, and evidence has been lost. They are by definition arbitrary, and their operation does not discriminate between the just and the unjust claim, or the voidable and unavoidable delay. They have come into the law not through the judicial process but through legislation. They represent a public policy about the privilege to litigate. Their shelter has never been regarded as what is called a "fundamental" right or what used to be called a "natural" right of the individual. He or she may, of course, have the protection of the policy while it exists, but the history of pleas of limitation shows them to be good only by legislative grace and to be subject to a relatively large degree of legislative control.

Statute of limitations puts time limits on various tax-related actions that taxpayer and the Internal Revenue Service can take. It applies to tax refunds, auditing tax returns and collection of taxes. A brief analysis of the applicability of statute of limitations as they are applied by the IRS is discussed below: is as follows-

Tax credits and refund

General Rule

Filing a timely claim is the essential first step in obtaining a credit or refund of an overpayment. If the IRS determines that the claim has merit, it will allow the credit or refund; if not, the taxpayer can institute a suit for refund in a federal district court or the Court of Federal Claims.

As per IRC § 6511, where the tax is one for which a return is required, the claim must be filed by taxpayers with the IRS until the later of

- 3 years from the date of the original deadline of the tax return or;
- 2 years from the date, the tax was actually paid.

Taxpayers can claim any additional refunds by sending in corrections with an amended return, which must be filed with the IRS before the statute of the limitations expires. The statute of limitations for refund claims in § 6511 also applies if the taxpayer filed a return and paid tax in error when no return or tax was due. Filing an extension extends the period for claiming refunds to three years from the extended deadline of filing tax return.

Exceptions to general rule

- Refund resulting from deductions for bad debt or worthless securities can be claimed up to seven years.

The three year statute of limitations does not apply in the situation where taxpayers are unable to manage their financial affairs due to physical or mental impairments.

Auditing tax return

General Rule

As per IRC § 6501, the IRS has three years, from the date taxpayer actually filed tax return, to audit taxpayer's tax return or to assess any additional tax liabilities. § 6501(a) also provides that the government cannot begin any court proceeding for the collection of the tax after the three-year assessment period, if a timely assessment was not made. The IRS rarely institutes a collection suit before making an assessment.
A return can start the running the § 6501(a) three-year period even if it is defective or incomplete in certain respects. A return is sufficient "if it purports to be a return, is sworn to as such ... and evinces an honest and genuine endeavour to satisfy the

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law." The Tax Court followed in Beard v. Commissioner, 82 T.C. 766, 777 (1984) a four-part test to determine the sufficiency of a purported return: there must be sufficient data to calculate tax liability; the document must purport to be a return; there must be an honest and reasonable attempt to satisfy the requirements of the tax law; and the taxpayer must execute the return under penalties of perjury.

Exceptions to general rule

Six years

- The IRS has 6 years in a case where the taxpayer has omitted income that amounts to more than 25% of income that was reported on the tax return. Omitting income also includes overstatement of basis or other fraudulent acts as held in U.S. v. Home Concrete & Supply, LLC. The Supreme Court slapped down the IRS, holding that overstating your basis is not the same as omitting income. The Court said 3 years was plenty for the IRS to audit. But Congress recently overruled the Supreme Court and gave the IRS six years in such a case.
- The IRS also has six years to audit a tax return and assess additional tax on income related to undisclosed foreign financial assets if the omitted foreign income is more than$5,000.

Indefinite period

- Audit period remains open indefinitely if the taxpayer files a false or fraudulent tax return or even if a taxpayer never files a return.
- Audit period also remains open indefinitely if the taxpayer omits certain tax forms.

Collection of outstanding tax liabilities

Once a timely assessment has been made, IRC § 6502 restricts the time for collection by levy or by a judicial proceeding. As per IRC § 6502, the IRS has 10 years, from the day a tax liability has been finalized, to collect outstanding tax liabilities, plus any penalties and interest.

The ways in which tax liability can be finalised are:
- It is the amount of tax reported on a tax return that is filed by the taxpayer.
- Assessment of additional tax from an audit, or a proposed assessment that has become final.

The IRS can obtain an extension of the period for collection in two situations:

- On obtaining an instalment agreement, the IRS may seek an extension of the statute and if one is obtained, the IRS has until a date 90 days after the expiration of the period in the extension agreement to collect by levy or a proceeding in court; and
- In connection with a release of levy after the 10-year period and an agreed extension of the time for collection entered into prior to the release, the IRS can collect by levy or a proceeding in court prior to the expiration of the period agreed upon in the extension.

Suspension of running of perio d of limitations (IRC § 6503)

Regardless of whether the running of the statutes of limitations is suspended or extended, the result is the same: additional time is available for assessment and/or collection of tax. Where there is a suspension, however, it generally governs assessment of tax attributable to any item or items for the taxable year in question. When there is a valid suspension, the time remaining in the limitations period is tacked on to the end of the suspension period. The running of the limitations periods for assessment (§ 6501) and for collection (§ 6502) is suspended when the IRS issues a notice of deficiency.

- Limitation on assessment and collection of tax shall be suspended for the period during which the Secretary is prohibited from making the assessment or from collecting by levy or a proceeding in court, and for 60 days thereafter.
- The collection statute is suspended during any period that the taxpayer's assets are in the custody of a court and for an additional six months.
- Limitation on collection of tax shall be suspended for periods when the taxpayer resides outside the United States for at least six months.
- Limitation on collection of tax shall be suspended for a period equal to the period from the date property (including money) of a third party is wrongfully seized or lien is made to the date the property is returned or the date on which a judgment with respect to such property becomes final, and for 30 days thereafter.
- IRS is reviewing an offer in compromise, instalment agreement, innocent spouse relief, collection due processing hearing,
- A taxpayer is under the automatic stay of bankruptcy protection plus an additional six months(for collection) and plus additional 60 days(for assessment),
- Limitation on collection of tax shall be suspended for a period when extension of time for payment of estate tax, undistributed PFIC earnings tax liability, tax attributable to

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Statute of limitations for IRS audit, collection and refunds (contd..)

recoveries of foreign expropriation losses was granted to the taxpayer.

- Upon the application for a Taxpayer Assistance Order pursuant to I.R.C. § 7811(b), the collection statute is suspended from the date of the taxpayer's application until the decision of the Taxpayer Advocate.

The focus of this newsletter is statute of limitations under the Internal Revenue Code, and hence state tax provisions on this subject have not been covered. However, most states' laws provide for a limitations period both for sales/use tax and for income/franchise tax assessments. The statute of limitations may vary from state to state depending upon various factors including but not limited to the type of taxes, tax payer status, quantum of misstated amounts on the returns, filed v/s unfiled returns, etc.

Knowing these and other statute of limitations is of paramount importance for taxpayers especially the ones who are under IRS scrutiny.

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