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Exam

To Extend or Not to Extend, That Is the Question—Rules and Considerations Regarding Statutes of Limitations in IRS Examinations

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Countless taxpayers, from individuals to large corporations, have found themselves on the receiving end of a statute extension request from an Internal Revenue Service (IRS) auditor. Deciding how to proceed on that request is complicated. Taxpayers are often frustrated by the length of time an audit has already consumed, and almost all are reluctant to give Exam more time to rummage around in their return. Nevertheless, taxpayers generally do not want to seem uncooperative with Exam and failure to extend the statute will mean they are one step closer to potentially costly litigation. Deciding whether to agree to a statute extension is an important, under-the-radar decision that can have a significant impact on the resolution of a case and the time and expense it takes to reach that resolution. Taxpayers facing this decision should inform themselves of the rules governing statutes of limitations and extensions thereof, in addition to a few other key considerations that often arise in these circumstances.

I. Statutory Framework

For taxpayers considering whether to grant a statute extension, it is critical that they inform themselves of the rules governing such extensions and statutes of limitations generally in the tax controversy space.

A. Statutes of Limitations for Government Assessment

Absent an exception or statute extension, the IRS must make assessments of tax within three years from the date a return is filed.¹ If a taxpayer were to file before its original filing deadline, this three-year statute would not begin to run until the original filing deadline.² However, where a taxpayer files under an extension, the three-year statute does not begin to run until the date the return is actually filed.³ The filing of an amended return (typically *via* Form 1040-X or 1120-X) does not restart the three-year clock, and such an amendment only extends the statute at all if it is filed within 60 days before the expiration of the

original statute and shows an increase in the amount of tax owed.⁴ Even in those instances, however, the statute of limitations can only be automatically extended by a maximum of 60 days.⁵

The Internal Revenue Code does provide various exceptions that can extend or otherwise alter the default three-year statute of limitations.⁶ Where a taxpayer makes a substantial omission from its gross income, the default statute of limitations is doubled, giving the IRS six years from the date of filing to assess tax.⁷ A substantial omission is considered an amount exceeding 25% of reported gross income.⁸ Such an omission or understatement includes an overstatement of basis in computing gain.⁹ Should a taxpayer fail to file a return at all, the statute of limitations does not begin to run, and the IRS can assess tax or initiate proceedings at any time.¹⁰ Less commonly asserted exceptions arise with regard to fraudulent returns and willful attempts to evade tax, among other circumstances.¹¹

B. Statutes of Limitations for Refund Claims

Refund claims have two separate statutes of limitations. The first involves the timing for filing an administrative claim with the IRS, and the second involves the timing for filing suit in court. Taxpayers who wish to file administrative claims for credit or refund with the IRS must do so by the later of: (i) three years after the return is filed, or (ii) two years after the tax is paid, whichever of those two deadlines expires later.¹² Just as with the assessment statute, the credit and refund statute cannot begin to run before the original due date, and if the taxpayer files under an extension, the statute does not begin to run until the actual date of filing.¹³ If the IRS does not act on the refund claim, the taxpayer can file a refund suit in court after six months.¹⁴ Furthermore, refund suits must be filed no later than two years after the IRS issues a formal disallowance.¹⁵

The refund posture in particular features a trap for unwary taxpayers. If the taxpayer receives a notice that reflects that the claim is being disallowed, it is critical that taxpayers determine whether the disallowance is a formal, final disallowance or a proposed disallowance. A proposed disallowance should include language like “propose” and will usually offer the taxpayer an opportunity to request an Appeals conference. A formal disallowance, on the other hand, will include language such as “legal notice” and will instead offer the taxpayer information on how to bring suit. The latter is what initiates the two-year statute of limitations for bringing a refund suit.¹⁶ Both final

disallowances and proposed disallowances can be considered by Appeals. It can often be the case that the Appeals process takes significant time. In that case, taxpayers with a final disallowance must keep an eye on the two-year clock to file in court. Notwithstanding Appeals giving meaningful consideration to taxpayer arguments that the claim was wrongfully denied, there could come a day when Appeals rejects the claim entirely because the two-year clock to file in court has lapsed. If a taxpayer is mindful that the end of the two-year clock is on the horizon, taxpayers can request Appeals to extend the two-year statute to file in court *via* a Form 907. If the Appeals Officer refuses, taxpayers can terminate the Appeals proceeding and file suit in court.

Deciding whether to agree to a statute extension is an important, under-the-radar decision that can have a significant impact on the resolution of a case and the time and expense it takes to reach that resolution.

C. Statute Extensions

Statutes of limitations in IRS examinations can be extended “by agreement” and “in writing.”¹⁷ Both parties must consent to such an extension, and that consent can be limited to specific items.¹⁸ This consent is typically made *via* one of the following Forms¹⁹:

- Form 872 (*Consent to Extend the Time to Assess Tax*), either blanket or restricted²⁰ or
- Form 872-P (*Consent to Extend the Time to Assess Tax Attributable to Partnership Items*).

II. Key Considerations

When determining whether to consent to a statute extension, taxpayers must keep several considerations in mind with regard to their chances of a positive resolution at Exam, Appeals (docketed or otherwise), or in litigation. If a taxpayer declines to consent to the statute extension, Exam will almost certainly issue the statutory notice of deficiency. The taxpayer’s options at that point are (1) agree to whatever adjustments the Exam team determines, (2) file a petition in Tax Court, and (3) pay the asserted tax and pursue a refund claim. Publicity and cash flow often

dominate the considerations of whether to consent to the extension to avoid being forced into court. Filing suit in court will have the impact of airing the taxpayer's dirty laundry in public. In addition, pursuing a refund claim requires full payment up front, which is often difficult for taxpayers from a cash-flow perspective. The increasing length of audits as well as the difficulty of reaching acceptable resolutions has caused many taxpayers to think harder about agreeing to a statute extension. We address below the dynamics of issue resolution if taxpayers consent to extend the statute of limitations compared to what would unfold if they do not consent.

A. Opportunity to Resolve Issue with Exam

When deciding whether to agree to a statute extension, taxpayers ought to consider the pace and momentum of the audit. Where a Revenue Agent is dragging his or her feet, it may be in the taxpayer's best interest to deny the statute extension and force the Revenue Agent to "put up or shut up." However, in other instances, some taxpayers will be perfectly content with letting the audit go on as long as Exam will allow to delay having to pay the disputed tax. Of course, with every day that passes comes another day of interest accrual, so this course of action can become a costly one relatively quickly.

There could also be fact-specific reasons to grant an extension. In cases where a taxpayer has made progress convincing Exam of its position, extended time for negotiation could provide time for further movement on Exam's part. In cases where there are several terabytes of relevant data and documents, extended time for review could have a major positive impact on fact development. On the flip side, if the taxpayer and Revenue Agent have hit a wall in their discussions, it could be most beneficial for the taxpayer to move on to Appeals and/or the courthouse.

Taxpayers who move on from Exam also move on from the opportunity to seek Fast Track Settlement, a process that may be available if the remaining unagreed issues are somewhat limited in number and scope. Once the IRS accepts an application for Fast Track Settlement, it attempts to resolve the case completely in 60 days for small business/self-employed (SBSE) and tax-exempt and government entities (TEGE) cases and 120 days for large business and international (LB&I) cases.²¹ Taxpayers with remaining unagreed issues that are not highly complex or numerous should consider the possibility of Fast Track

Settlement before refusing to grant a statute extension and resigning themselves to litigation. The Exam team must agree to any resolution in Fast Track, so assessing the prospect of the Exam team accepting a resolution that would be amenable to the taxpayer is critical.

Each of these considerations is also relevant when deciding how long the statute extension should be. Often but not always, the taxpayer and Exam will have conflicting interests about the length of the extension, and the above considerations are critical to keep in mind during these negotiations.

Further, not all statute extensions are made equally, as it is possible for a taxpayer and the IRS to negotiate a restricted consent to extend the statute of limitations.²² When a taxpayer and the IRS enter into a restricted consent agreement to extend the statute, the agreement limits the items that can be considered at Exam and/or Appeals beyond the expiration of the statute to an enumerated subset of the items at issue. The IRS maintains that "[i]t is the Service's position that the taxpayer has a right to request a restricted consent" if several specific criteria are satisfied.²³ However, even in instances seemingly apt for a restricted consent agreement, such agreements are rarely granted in practice.

B. Prospect of Settling at Appeals

To wind up in Appeals, the taxpayer must first typically consent to a statute extension. This is because, for most cases, Appeals will not accept a case with fewer than 365 days remaining on the statute of limitations.²⁴ Therefore, if a taxpayer is less than a year away from statute expiration and wishes to be considered for Appeals, it must extend the statute beyond that 365-day threshold. Another necessity for meaningful Appeals review is that the taxpayer must fully develop the factual record during the exam because Appeals will not consider new items after the examination record is closed. This is another reason why it is often in the taxpayer's interest to grant a statute extension, rather than proceed to Appeals with an incomplete factual record, only to be kicked right back to Exam down the road for further factual development.

Once the statute lapses and Exam issues a statutory notice of deficiency, the taxpayer has 90 days to file a Petition in U.S. Tax Court.²⁵ While there can be an opportunity at docketed Appeals, initiation of a Tax Court case gives rise to publicity concerns, which can be especially troubling and meaningful for publicly traded companies or individuals in the public eye.

C. Other Considerations

One thing a taxpayer must decide early on in the tax controversy process (and continue to re-evaluate throughout) is what a “win” looks like to them. Beginning with this end in mind will be informative to the taxpayer in deciding where to fight its battles along the way. Cases resolved at Appeals often result in an outcome somewhere between the taxpayer’s and IRS’ respective positions. Court is typically the only arena in which a taxpayer will earn a complete victory. If ending up at a middle ground while avoiding the costs and hazards of litigation is a win for a taxpayer, that taxpayer should likely grant a statute extension to give Appeals time to accept and consider the case. If the questions at issue are existential to the taxpayer, the sort of practice the taxpayer intends to carry on with going forward, or legal in such a way as to necessitate a precedential opinion, that taxpayer will likely be less incentivized to grant a statute extension as it would only delay the issuance of its ticket to court.

Another scenario in which it is less practical to extend the statute for a shot at Appeals resolution is where there is a coordinated effort from the IRS on an issue. For example, where the IRS has issued a generic legal advice memorandum (GLAM) on the taxpayer’s issue or the taxpayer participated in a listed transaction, the probability of any sort of positive result (or perhaps even resolution at all) at Appeals is near zero. At that point, it is often not worth extending the statute for an opportunity to be

heard at Appeals, and taxpayers are better off taking their chances in court.

As with most decisions in a tax controversy, the taxpayer will also have to consider costs when deciding whether to extend the statute. One key distinction between Tax Court cases and refund cases is that a taxpayer need not pay the alleged tax liability in order to have standing in Tax Court because the Tax Court is a deficiency jurisdiction.²⁶ Therefore, deciding not to grant a statute extension and instead proceeding to Tax Court can often accelerate resolution without accelerating collection. And going to Tax Court does not bar the door to Appeals because a taxpayer can be referred to docketed Appeals, although that taxpayer would have to consider the cost impacts of pursuing both an Appeals and litigation strategy.

Finally, it is also worth considering the fact that deposits made with the IRS to stop the running of interest on potential underpayments accrue interest of their own to be paid to the taxpayer in the event the deposit is returned.²⁷

III. Conclusion

Many a taxpayer has grappled with the IRS over whether to agree to a statute extension, but without a proper understanding of the rules and key considerations, it is not a fair fight. Taxpayers should consider the rules and scenarios described above and make an informed decision on how to proceed with respect to statute extensions.

ENDNOTES

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¹ Code Sec. 6501(a).

² Code Sec. 6501(b)(1).

³ Code Sec. 6501(a).

⁴ Code Sec. 6501(c)(7).

⁵ *Id.*

⁶ A special rule also exists under Code Sec. 6501(e)(2) for estate and gift tax returns, which this column does not address.

⁷ Code Sec. 6501(e)(1).

⁸ *Id.*

⁹ Code Sec. 6501(e)(1)(B)(ii).

¹⁰ Code Sec. 6501(c)(3).

¹¹ See Code Sec. 6501(c). Certain of these further exceptions also extend the statute of limitations indefinitely, while others extend the statute based on when the Service is furnished certain information (such as notice of participation in a listed transaction).

¹² Code Sec. 6511(a).

¹³ Code Secs. 6501(a) and (b)(1).

¹⁴ Code Sec. 6532(a).

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ Code Sec. 6501(c)(4)(A).

¹⁸ See IRM 25.6.1.10.3.3.3 (Jul. 5, 2024).

¹⁹ Other less common extension forms include but are not limited to terminable extension forms

like Forms 872-A and 872-T, and excise tax exam extensions under Form 872-B.

²⁰ www.irs.gov/pub/irs-utl/f872ovdi.pdf.

²¹ See IRS Pub. 4539 (2012) (LB&I); IRS Pub. 5022 (2021) (SBSE); IRS Pub. 5092 (2017) (TEGE).

²² See IRS Pub. 1035 (2017).

²³ *Id.*

²⁴ See IRM 25.6.23.71(1) (Feb. 17, 2021).

²⁵ Code Sec. 6213(a). This deadline is extended to 150 days if the notice is addressed to a person outside the United States.

²⁶ Code Sec. 6213(a).

²⁷ Code Sec. 6603(d).

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