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REFUNDS AUTHORIZED FOR FAILURE TO MEET QUALIFIED USE TEST

— by Neil E. Harl*

One of the more contentious issues in tax law in recent years has been the qualified use test for purposes of special use valuation of land for federal estate tax purposes.¹ The Economic Growth and Tax Relief Reconciliation Act of 2001, H.R. 1836, has added another chapter to the saga by allowing refunds for some failures to meet the test, retroactive to January 1, 1977.² That is very good news for affected taxpayers.

History of the qualified use test

Although the special use valuation statute was initially interpreted as not including a qualified use or “trade or business” test, IRS in 1980 took the position that the decedent must have had an “equity interest” in the farm operation (for special use valuation to be available to the estate) - (1) at the time of death and (2) for five or more of the last eight years prior to death.³ In addition, except for the two-year grace period,⁴ each qualified heir must have met the same test during the recapture period after death.⁵ As a practical matter, the IRS position meant that cash rent leases were not permissible, either in the pre-death period or in the recapture period after death.

Under pressure from Congress, IRS in a Senate Finance Committee hearing on April 27, 1981, announced a change of interpretation in the pre-death period.⁶ IRS indicated that the test could be met, in the pre-death period, by the decedent or a member of the decedent’s family.⁷ That meant that the qualified use test could be met with a cash rent lease to a family member as tenant. Later, in 1981, Congress amended the statute to reflect the IRS position.⁸ However, neither the IRS announcement nor the Congressional action addressed the post-death requirement.

Cash rent leases in the post-death period (other than during the two-year grace period immediately following death) violated the requirement that each qualified heir had to be “at risk” in the operation.

Under an amendment enacted in 1988, retroactive to 1977, a surviving spouse who inherits qualified real property under a special use valuation election is permitted to lease the land on a “net cash basis” to a member of the spouse’s family without causing recapture.⁹ The Technical and Miscellaneous Revenue Act of 1988¹⁰ waived the statute of limitations on refunds for one year to enable taxpayers to utilize this relief provision. However, the 1988 amendment did not permit an estate that had

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never filed a special use valuation election to make a retroactive election and claim a refund for overpayment of federal estate tax.11

Legislation enacted in 1997, and retroactive for leases entered into after December 31, 1976, specified that rental of land on a "net cash basis" by a surviving spouse or a lineal descendant of the decedent to a member of the family of such spouse or descendant did not cause recapture of special use valuation benefits during the recapture period after death.12 However, the 1997 amendment did not authorize refunds for years closed by the statute of limitations.13 A refund claim could be filed for interest for the open years.14

The 2001 Amendment

The 2001 amendment allows refunds, retroactive to 1976, for estates eligible under the 1997 amendment if a refund or credit is barred by the statute of limitations.15 Under the 2001 amendment, if a claim for refund or credit is filed within one year from the date of enactment (June 7, 2001), a refund or credit is to be allowed if based on the application of the net cash leasing provisions for spouses and lineal descendants16 even though barred by the statute of limitations.17

Conclusion

Taxpayers eligible for a refund or credit under the 2001 amendment should act promptly. It is rare for Congress to allow refunds or credits for periods barred by the statute of limitations. Further relief in this area seems unlikely.

FOOTNOTES
4 I.R.C. § 2032A(c)(7)(A).
5 Id.
7 I.R. 147, April 27, 1981.
9 I.R.C. § 2032A(b)(5)(A).
10 TAMRA, § 6151(b)(2).
11 Ltr. Rul. 9122004, Feb. 21, 1991 (surviving spouse's cash rent lease of property to cousins would have triggered recapture tax otherwise).
12 I.R.C. § 2032A(c)(7)(E).
14 Id.
16 I.R.C. § 2032A(c)(7)(E).