WHAT'S A USUFRUCT? THE SOMEWHAT CONVULUTED VIEW FROM THE UNITED STATES OF A COMMON FRENCH PLANNING TOOL

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U.S. TAX TREATMENT OF USUFRUCTS

LE DÉMEMBREMENT DE PROPRIÉTÉ EST UN OUTIL TRADITIONNEL DE TRANSMISSION PATRIMONIALE EN DROIT FRANÇAIS. QUELLES EN SONT LES IMPLICATIONS NOTAMMENT FISCALES À L'ÉTRANGER ? LE PRÉSENT ARTICLE EXPOSE LES CONSÉQUENCES FISCALES AUX ETATS-UNIS D'UN DÉMEMBREMENT DE PROPRIÉTÉ RÉALISÉ EN FRANCE.

While usufructs are a common succession-planning tool in civil law jurisdictions like France, there is little U.S. law addressing the taxation of usufructs. Only the state of Louisiana, which follows civil law, recognizes a usufruct. No other U.S. state recognizes usufructs. So how does the United States treat such usufruct arrangements? This article will examine the usufruct, how the United States taxes it, and how the rules apply in practice.

- What are the rights of the usufructuary? The usufructuary has the right to use the property and is entitled to income from the property. The usufructuary's interest is generally similar to a life estate under common law.

- How and when is it taxed? The tax treatment of a usufruct arrangement depends on the facts and circumstances of each arrangement. A usufructuary typically is taxed on the income earned by the property. When a usufruct arrangement is created, a gift of the bare property interest generally is treated as made. This gift may be subject to U.S. gift tax, but the value of the gift may be limited to the value of the bare property interest.

- What is the nature of the right of the bare owner? The "naked" or "bare" owner (equivalent to a remainderman in a common law jurisdiction) is the legal owner of the property. Upon the usufructuary's death, the usufructuary's interest is automatically transferred to the bare property owner who then owns the property in full.

- How and when is it taxed? If the usufructuary is a U.S. person, then the value of property subject to a usufruct arrangement generally is included in the usufructuary's estate for U.S. estate tax purposes if the usufructuary was the one who created the usufruct and gave the bare ownership. In that case, the bare property owner generally receives a tax basis in the property equal to the value of the property at the time of the usufructuary's death. If someone other than the usufructuary created the usufruct, then the bare property owner receives a carry-over basis because there is no inclusion in the estate of the usufructuary.

APPLICABLE U.S. TAX TREATMENT OF USUFRUCTS

A usufruct may be treated as a life estate (or form of co-ownership), because there is no separate fiduciary or title owner, or under the U.S. treasury regulations, an ordinary trust. An ordinary trust is defined as "an arrangement created either by will or by an inter vivos declaration whereby trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts."[1] Nevertheless, the Internal Revenue Service (the "IRS") has issued private letter rulings (PLRs) in which it characterized a usufruct as a trust for income tax purposes. For example, in PLR 9121035, the IRS concluded that a usufruct was classified as a trust for U.S. tax purposes. In the ruling, the usufructuary, in addition to his usufruct rights, had administrative powers over the assets subject to the usufruct (similar to the role of a trustee). It is possible that the IRS would not treat a usufruct as a trust for income tax purposes if the usufructuary did not have administrative powers similar to those in the letter ruling.

Regardless of whether a usufruct is treated as a form of co-ownership (e.g., a life estate) or a trust for U.S. tax purposes, if the usufructuary owns interests in non-U.S. entities, the individuals holding bare interests in the usufruct arrangement may not be subject to U.S. income tax or U.S. income tax reporting obligations. Generally, individuals holding a bare interest in an entity have no interest in the income, and therefore, depending on the circumstances, such individuals may not be subject to U.S. income tax or reporting obligations with respect to such entity.

For example, in PLR 8748043, the IRS concluded that a usufructuary of a Netherlands usufruct was considered the owner of the underlying stock until the usufruct period ended. Under Dutch law, the usufructuary was entitled to the use and enjoyment of assets subject to the usufruct during the usufructuary's lifetime, but the usufructuary was obligated to preserve intact the underlying property. Upon the usufructuary's death, the usufruct terminated and all rights with respect to the property were thereafter enjoyed by the remaindermen. In addition, in the case of this usufruct imposed on stock, any dividends paid during the term of the usufruct by the corporation with respect to its stock must have been paid to the usufructuary and no dividends could be paid to the remaindermen.

The PLR analyzed whether the usufructuary or the remaindermen was treated as the owner of stock subject to the usufruct arrangement for applying the United States controlled foreign corporation ("CFC") rules. These rules generally provide that the determination of a person's proportionate interest in a non-U.S. corporation be made based on all the facts and circumstances in each case. A person's proportionate interest in a non-U.S. corporation generally will be determined with reference to such person's interest in the income of the corporation, but any arrangement that artificially decreases a U.S. person's proportionate interest will not be recognized. The IRS reasoned that because the usufructuary had a 100 percent interest in the corporation's income during the usufruct's term, the usufructuary was treated as the owner of the corporate stock during such time for purposes of the CFC rules. It is possible, however, that the IRS would take a contrary position. In addition, although not free from doubt, bare ownership likely is reportable on IRS Form 8938 *(Statement of Specified Foreign Assets)* – especially where the bare property interest holder is entitled to liquidation rights[2].

Under the U.S. estate tax rules, if a person retains certain interests in property transferred to a trust, the property transferred by to the trust is treated as retained and the value of such property is included in the donor's estate at death. If a person establishes a usufruct interest for himself and makes a gift of the remainder interests to others, this rule may apply to include the value of the property transferred to the usufruct arrangement in the transferor's estate for U.S. tax purposes. In general, the beneficiary of such property receives an income tax basis in the property equal to the fair market value of the property on the date of the decedent's death. With proper planning, any built-in gain in the property may be eliminated and therefore the remainderman will be subject to income tax only on the post-death appreciation of the property.

APPLICATION OF RULES IN PRACTICE

A typical French succession plan often involves the client retaining a usufruit or usufruct interest and giving the *nue propriété* or bare ownership to the next generation. The benefits from a French perspective are typically that the value of the gift on which French gift tax will be paid is reduced based on the age of the donor. At the donor's subsequent death, the usufruct interest evaporates and "poof" nothing is included in the usufructuary's estate to be taxed at death. Thus, the appreciated

[1] Treas. Reg. § 301.7701-4.
[2] This is because an interest in a "specified foreign financial asset" is reportable on a Form 8938 if any income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the asset are or would be required to be reported, included, or otherwise reflected on the taxpayer's income tax return. Treas. Reg. § 1.6038D-2(b)(1).

value all passes entirely to the bare property owner at the usufructuary's death, typically the usufructuary's child.

Firstly, the concept of a usufruct is little known in the U.S. law. Thus, the arrangement is likened to other more familiar U.S. concepts namely, either a trust or a life estate/remainder interest depending on the characteristics of the arrangement. Typically, French usufructs are treated as life estates and bare property interests as remainder interests. A transfer by the donor (usually a parent) of the bare property ownership interest to the donee (often a child) could give rise to U.S. income, gift and estate tax reporting requirements depending on the asset in question (shares in a company or real property) and who is making the transfer (such as a U.S. citizen/domiciliary or a non-U.S. citizen, non U.S. domiciliary (NCND). If the donor is a U.S. citizen residing in France (or a U.S. resident transferring a bare ownership interest in French property), the donor will be subject to U.S. estate tax at the time of death. This is because the United States views the donor as not relinquishing the entire property but retaining a string, which is the usufruct interest. As such, the United States does not treat the gift as a completed gift but as a gift with a retained interest resulting in the full fair market value of the asset at death being includible in the U.S. person's estate and subject to U.S. estate tax. Furthermore, there is no credit for the gift tax paid to France in the earlier year of transfer unless the individual also paid U.S. gift tax, which would only occur if the lifetime transfers exceeded the exemption amount (currently $11,400,000). Let us look at some examples.

Example 1. U.S. person creates and retains usufruct; gift of bare property to U.S. person.

Mother, a U.S. citizen residing in France, owns her home in France worth 5 million Euros. Mother gives the *nue propriété* interest to her daughter also a U.S. citizen and retains the *usufruit*. Based on Mother's age, she gets a 30% discount on the value of the *nue propriété* interest and pays French gift tax on 3.5 million Euros. Mother will need to report the gift in the United States, but assuming she has her full $11,400,000 exemption amount, she will not pay any U.S. gift tax. As a result, the French gift tax paid will not be credited in the United States. Assume Mother dies 10 years later and the property is worth 8 million Euros. There will be no further French inheritance tax as the *usufruit* interest vanishes at Mother's death. However, the full 8 million Euros comes back into her U.S. taxable estate and together with other assets is subject to U.S. estate tax at a rate of 40%. She will not get a credit for the French gift tax paid 10 years earlier. This generally is an unfavorable result. It solves the French inheritance tax problem at a reduced rate, but it does not solve the U.S. estate tax inclusion issue with no crediting of the gift tax previously paid.

That said, there is a positive aspect. When Mother dies, because the full value of the property is includible in her estate, the property will enjoy a full step up in basis to the date of death value (8 million Euros), and therefore the daughter will have a new 8 million Euros basis. If Daughter sells the property shortly after her mother's death for 8 million Euros, she will pay no U.S. capital gains tax. However, given that it is French real property her basis under French law will be the 5 million euros value at the time of transfer and she will pay French capital gains tax unless she qualifies for some other exemption (e.g., she and her mother held it for more than 30 years). Daughter will be exposed to french capital gain tax on the difference between the sale price realized by Daughter of 8 million Euros less the 5 million value at transfer or 3 million Euros. This gain will be exempt from U.S. capital gains tax.

Example 2. Non- U.S. person creates and retains usufruct; gift of bare property to U.S. person.

Same facts is in example 1 except Mother is a non-U.S. person (she is not a U.S. citizen and she is not U.S. tax resident). No U.S. gift or estate tax issues would apply because both Mother and asset are non-U.S. However, the step up in basis analysis may differ. When the creator of the usufruct is a non-U.S. citizen and non-U.S. domiciliary (NCND) and the property transferred is non-U.S. situs, the Internal Revenue Service may argue that the property does not benefit from a step up in basis under IRC 1014. However, there is IRS guidance to support the argument for a basis step-up because possession/ownership of the property passes to the daughter via operation of local French law (via a combination of property and inheritance laws). If no step-up were allowed, Daughter as a U.S. person would have to pay increased U.S. capital gains tax at the disposition. The IRS may argue no step-up in basis, however the taxpayer would argue possession/ownership of property passes to adult child by operation of French law in which case the child should arguably get an IRC 1014(b)(1) step up pursuant to analysis similar to Rev. Rul. 84-139 and GCM 39320.

Example 3. Third party creates the usufruct.

If instead of Mother creating the arrangement, retaining the usufruct interest and giving the bare property interest to Daughter, Father creates the arrangement, gives the usufruct to Mother and the bare property interest to Daughter. In this instance, under U.S. tax law, when Father dies, there is no inclusion in his estate because he did not retain the usufruct interest. When Mother dies, there is no inclusion in her estate because she did not create the usufruct. However, there would be no step-up in basis at the death of either Father or Mother because there is no inclusion in either of their estates. Thus, Daughter will take a carry-over basis from Father and be exposed to U.S. capital gains tax.

Example 4. Couple married under community property regime create usufruct at death of first spouse to die.

A married couple who are French citizens and residents at the time of their marriage have a community property marital regime. Each spouse has a divided 50% interest in the property in question and at the death of the first spouse, the surviving spouse is entitled to a usufruct interest in the decedent's half until the surviving spouse's death or until remarriage. At the time of the first spouse's death, they are both U.S. residents and domiciliaries. Should the decedent's one-half value of the community property be included in the decedent's gross estate? Yes. The decedent's share is includable in the decedent's estate and is not reduced by the creation of the usufruct upon death. In *Estate of Lepoutre (62 T.C. 84 (U.S.T.C. 1974)*, a 1974 tax court decision, the court applied French law and held that the value of the usufruct does not reduce the interest in the community property and is includable in the gross estate.

Reporting Requirements.

The U.S. bare property owner may have additional U.S. reporting obligations. These include, but are not limited to, the following:

- Form 3520 *(Annual Return to Report Transactions with Foreign Trusts and Receipt of Certain Foreign Gifts)* – This reporting is required if the value of the gifted bare property ownership interest from a non-U.S. person exceeds the filing threshold ($100,000 if from an individual).

- Form 8938 *(Statement of Specified Foreign Financial Assets)* – This reporting could be required annually if the bare property interest is in a "specified foreign financial asset" and would require reporting the value of the U.S. person's bare property interest on an annual basis with her U.S. tax return.

- Form 8865 *(Return of U.S. Persons With Respect to Certain Foreign Partnerships)* – This form may be required to be filed if the bare property interest is in a foreign holding company classified as a foreign partnership for U.S. tax purposes. An example of such an entity is an SCI – which generally is treated as a foreign partnership for U.S. tax purposes without electing other treatment[3].

- Form 5471 *(Return of U.S. Persons With Respect to Certain Foreign Corporations)* - This form may be required to be filed if the bare property interest is in a foreign holding company classified as a foreign corporation for U.S. tax purposes. An example of such an entity is an SA – which is treated as a "per se" foreign corporation for U.S. tax purposes[4].

As one can gather from the analysis above, usufructs are a valuable succession-planning tool in France, but they can pose major planning problems when dealing with U.S. persons. While this is not always the case, advisors should be cautious when recommending usufruct/bare property planning to any clients with U.S. connections.

[3] See Treas. Reg. §§ 301.7701-3, -5.
[4] See Treas. Reg. §§ 301.7701-2(b)(8)(i), -5.