USUFRUCT, BARE OWNERSHIP, AND U.S. ESTATE TAX: AN UNLUCKY TRIO

Authors
Fanny Karaman
Stanley C. Ruchelman

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INTRODUCTION

Splitting ownership into *usufruct* and bare ownership is a common estate planning technique in several civil law countries. However, when imported to the U.S., this planning technique may have adverse tax consequences under the general inclusion rules of Code §2033 or the retained power rules of Code §2036. This article discusses the U.S. estate tax issues that may arise when the *usufruct* holder is a U.S. resident at the conclusion of his or her lifetime.

SUMMARY OF *USUFRUCT* V. BARE OWNERSHIP

In civil law countries, ownership attributes can be divided into two separate rights:

- *Usufruct*, which gives its holder the right to the enjoyment of the underlying asset and the right to the income generated by the underlying asset
- Bare ownership, which essentially gives its holder the right to transfer the underlying asset

Generally, a *usufruct* right lasts for the lifetime of its holder. It can be compared to the life estate found in common law systems.[1] It can also be set up for a shorter period of time in certain countries. Upon the death of the holder of the *usufruct* interest, or at the end of its term if shorter, the *usufruct* right is automatically transferred to the bare owner, thereby providing the bare owner with full title to the underlying property.

As a general estate planning tool, parents transfer the bare ownership to their children while retaining the *usufruct* for their lifetime. This provides them with the right to the income and the enjoyment of the property until their death. As the transfer of the bare ownership is less than the transfer of the full ownership, the gift tax base is reduced, thereby resulting in a lower tax at the time the plan is initiated.

As an example, in France the French Tax Code provides for the following arbitrary valuation of the bare ownership and the *usufruct*, based on the age of the *usufruct*

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1 Rev. Rul. 66-86. However, see also P.L.R. 9121035, in which the *usufruct* interest was determined as constituting a trust. In that ruling, the decedent named her son as heir in the entirety. However, he had the option to renounce his heirship. The decedent's will provided that, in that event, her son would be entitled to the *usufruct* right in all her properties, including operating businesses, with the bare ownership passing to her son's children. Her will further provided that her son would be the administrator of her estate. The terms of her will thus created a trust instrument.

holder at the time of the transfer.[2] The expressed percentages must be applied to the value of the full legal title.

Age of the *Usufruct* Holder	*Usufruct* Value	Bare Ownership Value
Less than:		
21 completed years	90%	10%
31 completed years	80%	20%
41 completed years	70%	30%
51 completed years	60%	40%
61 completed years	50%	50%
71 completed years	40%	60%
81 completed years	30%	70%
91 completed years	20%	80%
More than:		
91 completed years	10%	80%

Upon the parents' death, the *usufruct* is automatically carried over to the children, free of inheritance tax, thereby granting full ownership in the property to the children.

U.S. ESTATE TAX CONSEQUENCES

While under applicable foreign laws the death of the *usufruct* holder and the ensuing transfer of the decedent's *usufruct* interest to the bare owner is not a taxable event for inheritance tax purposes, the U.S. estate tax analysis may differ.

Several scenarios exist. One possible scenario is that the decedent's death creates a *usufruct* interest. Another possible scenario is that the *usufruct* interest was received by the decedent during his or her lifetime. Yet another scenario is that the decedent retained the *usufruct* interest during his or her lifetime while transferring the bare ownership. These scenarios carry different estate tax consequences.

Code §2033 – Estate Inclusion

Code §2033 provides that "the value of the gross estate shall include the value of all property to the extent of the interest therein of the decedent at the time of his death."

[2] Article 669, I of the French Tax Code.

The entire transferred property includes all property, whether real or personal, tangible or intangible, and wherever situated, beneficially-owned by the decedent at the time of death.[3]

In the context of the death of a U.S. *usufruct* holder, the question posed is whether the value of the *usufruct* interest plus the value of bare legal title computed as of the date of death are included in the decedent's estate. Such inclusion would essentially cancel out the benefits of the foreign estate planning.

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No Decrease in Value of the Taxable Estate for a Usufruct *Interest Created Upon Death in Property Owned by the Decedent*

In *Estate of Jeanne Lepoutre v. Commr.*,[4] a husband and wife were French citizens and residents at the time of their marriage. Their *ante nuptial* agreement provided that the applicable marital regime was a community property regime under which each spouse had an undivided 50% interest in the property. In addition, upon the death of the first spouse, the surviving spouse was entitled to the *usufruct* interest of the deceased spouse for the remainder his or her life or until the surviving spouse remarried.

The husband and wife were domiciled in Connecticut at the time of the wife's death. Upon her death, an estate tax return was filed by the estate, and no part of the community property was included in her taxable estate on the return. In part, the position of the decedent's estate was that the decedent was not the owner of any portion of the community property under the matrimonial regime created by the *ante nuptial* agreement. Instead, the decedent possessed a mere expectancy of ownership with regard to her portion of the community property. That expectancy terminated upon her death because she was survived by her husband. In the alternative, the position of the estate was that the value of the surviving spouse's *usufruct* should be excluded from her estate.

Upon examination, the I.R.S. increased the taxable estate by the wife's 50% interest in the community property. The estate petitioned the Tax Court for a redetermination of tax.

The questions presented to the court were (i) whether 50% of the community property of the decedent and her husband was includible in her taxable estate under Code §2033, and (ii) if so, whether the value of the *usufruct* reduced the value of the wife's interest in the community property subject to estate tax.

The court found that, based on the couple's French marital regime, 50% of the community property had to be included in the decedent's gross estate under Code §2033. The reasoning of the court is an interesting read,[5] but it is beyond the scope of this article.

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3 Treas. Reg. §20.2033-1(a).

4 *Estate of Jeanne Lepoutre v. Commr.*, 62 T.C. 84, (1974).

5 Relying on *Estate of Paul M. Vandenhoeck v. Commr.*, 4 T.C. 125 (1944), the court determined that, under French marital property law, the interest of a wife in the community property is a present interest that is equal to that of a husband. It did not matter that the husband exercised management and control over the community property.

Concerning the *usufruct* interest enjoyed by her husband, the court disallowed any reduction in value. The court reasoned as follows:

> [T]he *ante nuptial* agreement provided for rights in the surviving spouse only upon the death of the other spouse and therefore under the Federal estate tax law was in the nature of a testamentary disposition and a transfer of an interest in property at the death of the first to die.

Inclusion of Usufruct *Right Received from Pre-Deceased Husband in a Decedent's Estate*

When the underlying asset of the *usufruct* right is a consumable asset, such as money, the bare title holder generally has a claim to the value of the asset transferred to the *usufruct* holder.

In P.L.R. 9223006, a surviving spouse received a *usufruct* right to a note that her deceased husband held at the time of his death. The husband's estate elected to have the property treated as qualified terminable interest property. The value of the husband's estate was reduced by the amount that passed to his wife.[6] To offset the loss of estate tax revenue, the property will be included in the wife's estate at the conclusion of her lifetime.[7]

The origin of this note was a sale by the deceased husband of his business. He elected to report the gain on the sale under the installment method. The wife, in her capacity as *usufruct* holder after his death, had the right to use the funds received under the note and paid taxes on these funds accordingly. The gain represented income in respect of a decedent for the widow.[8]

Louisiana law was the applicable law. It provided that, in the case of a *usufruct* right to a consumable asset such as a promissory note, the *usufruct*uary is required to pay the bare owner either the value of the property at the beginning of the *usufruct* or to deliver the bare owner things of the same quality and quantity. As a result, the bare legal owner had a claim against her estate for the value of the *usufruct* interest less any capital gains tax paid. The appreciation in value of the widow's assets attributable to further investment of the note proceeds is not subject to any claim of the bare legal holder. The note in excess of its value at the time the *usufruct* interest was granted to the wife remained in her estate upon her death and was includable in her taxable estate.

If the underlying asset had been income producing real estate, the bare owner would not have had a claim against the decedent's estate. The full value of the accumulations of income under the *usufruct* right constitutes property included in the decedent's estate in the above scenario.

Code §2036 – Retention of Powers if Decedent Transferred Bare Ownership During Life but Retained *Usufruct*

In the previously mentioned private letter ruling, the *usufruct* holder was never the full owner of the underlying property. Rather, the holder received the *usufruct* from

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[6] Code §2056(a).

[7] Code §2056(b)(7).

[8] Code §691(a).

the owner at the time of the owner's death. The estate planning technique described earlier, in which parents own full title to a given asset and transfer the bare ownership to children while retaining the *usufruct*, is not covered by the private letter ruling. This can lead to unattractive estate tax results for parents who move to the U.S. after the *usufruct* arrangement has been entered.

Code §2036 provides for the inclusion in an individual's taxable estate of property transferred during his or her lifetime, by trust or otherwise, when the transferor retained certain rights in the underlying property. This applies to transfers under which the transferor has retained certain rights for any of the following periods:

- The transferor's life
- Any period not ascertainable without reference to the transferor's death
- Any period that does not in fact end before the transferor's death

The rights so retained must be either

- the possession or enjoyment of, or the right to the income from, the property; or
- the right, either alone or in conjunction with any person, to designate the persons who shall possess or enjoy the property or the income therefrom.

The retention of the right to directly or indirectly vote shares of stock in a controlled corporation constitutes a retention of the enjoyment of the transferred property for this purpose.

Thus, Code §2036 applies to a retention of property by a transferor during his or her lifetime, with the following retentions in said property:

- The right to the possession of the property
- The right to the enjoyment of the property
- The right to the income of the property

The amount to be included in the decedent's gross estate is not the value of the transferred interest. Rather, it is the value of the entire transferred property, valued at the time of death.[9] This essentially cancels out the benefits of the foreign estate planning technique.

INCOME TAX MATTERS

The remaining question relates to the computation of gain realized on a taxable disposition of a *usufruct* interest or the sale of a combined interest after the death of the *usufruct* holder. In broad terms, gain is the excess of sales price over basis.

Sale of Gratuitously Received *Usufruct* Interest

Code §1001 deals with the determination of the amount of, and the recognition of, gain or loss upon the disposition of property. Code §1001(e)(1) provides that:

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9 Treas. Reg. §20.2036-1(c)(1)(i).

> [i]n determining gain or loss from the sale or other disposition of a term interest in property, that portion of the adjusted basis of such interest which is determined pursuant to section 1014, 1015, or 1041 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.[10]

As a result of this provision, a holder of a *usufruct* interest has a zero basis in that interest for purposes of determining the amount realized from its sale when the *usufruct* interest was originally received in a gratuitous transfer.

Sale of Gratuitously Received Combined Interest

A different result is achieved if the *usufruct* interest and the bare legal title are sold in a single transaction. There, a portion of the basis in the property is allocated to the income interest.

Code §1001(e)(3) provides for an exception by stating that

> [Code §1001(e)(1)] shall not apply to a sale or other disposition which is a part of a transaction in which the entire interest in property is transferred to any person or persons.

In P.L.R. 7101070280A, a decedent left the *usufruct* of his assets to his sister, with the bare ownership going to other individuals. The sister and the bare owners then wished to sell their respective interests in a given property to an unrelated party, thereby providing the unrelated party with the full ownership in the underlying asset.

The private letter ruling states that in this scenario, where both the *usufruct* interest and the bare ownership are sold to an unrelated party, Code §1014 can be relied on for purposes of determining the basis the *usufruct* holder received in her interest. Thus, her basis in the *usufruct* interest was the fair market value of her interest at the time the split interests were created upon the death of her brother. In the facts contained in the P.L.R., the valuation was made based on the *usufruct* holder's age at the time her brother passed away by applying the actuarial valuation tables of Treas. Reg. §20.2031-7.

Carry-Over Basis for Certain Foreign-Situs *Usufruct* Interests Received at Death

In the case of U.S. children and non-U.S. parents, if the *usufruct* interest relates to property outside the U.S. and that interest passes to the children during a parent's lifetime, there may be no step-up in the basis of the property even though the property would be of a kind that would be included in a U.S. taxable estate if it were located in the U.S.[11]

Generally, the basis of property acquired from or passed from a decedent at the time

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10 Code §1014 provides as a general rule that the basis in property received from a decedent is its fair market value at the date of the decedent's death. Code §1015 provides as a general rule that the donee receives a carryover basis in the *usufruct* interest.

11 If the property were in the U.S., all the conditions of Code §2036 would be met by reason of the parent's retention of the *usufruct* interest, which is a retained interest.

of death is the property's fair market value.[12] The terms "property acquired from" or "property passed from" a decedent include property acquired by reason of death, form of ownership, or other condition, if the property is required to be included in determining the value of the decedent's gross estate.[13] Thus, for example, a life interest generally is considered property acquired from a decedent if the property is required to be included in determining the value of the decedent's gross estate. However, an exception applies for property not includible in the decedent's gross estate, such as property not situated in the U.S. acquired from a nonresident who is not a citizen of the U.S.[14]

If no step-up is allowed in the basis of the entire property, increased capital gains tax will be incurred by the children in the U.S. when the property is eventually sold.

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CONCLUSION

A *usufruct* interest can have different consequences depending on the rights that it carries under applicable law and the facts and circumstances surrounding its transfer. While constituting an interesting estate planning technique for foreign law purposes, additional planning is required when the *usufruct* holder moves to the U.S.

[12] Code §1014(a)(1).

[13] Code §1014(b)(9).

[14] Treas. Reg. §1.1014-2(b)(2).