BASIS PLANNING IN THE USUFRUCT AND BARE OWNERSHIP CONTEXT

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As explained in an earlier article,[1] a common civil law estate planning technique involves an older generation making a gift of bare ownership in an income generating asset – generally real property – to members of a younger generation. The person making the gift retains the *usufruct* interest, meaning the income from, and the use of, the property. This planning technique is beneficial for tax purposes in civil law countries. However, it can have adverse effects when a bare owner is or becomes a U.S. citizen or resident. This article addresses planning opportunities with the potential to resolve some or all those adverse tax consequences in the U.S.

BACKGROUND

In civil law jurisdictions, attributes of ownership can be divided into two separate categories:

- *Usufruct* – This attribute gives the holder the right to the enjoyment of the underlying asset and the right to the income generated by the underlying asset, typically for the balance of the holder's lifetime.
- Bare ownership – This attribute gives the holder the right to transfer the underlying asset during the period of the *usufruct* interest.

Generally, a *usufruct* right lasts for the lifetime of the holder. It can be compared to a life estate found in common law systems.[2] It can also last for a shorter period in certain countries. Upon the death of the holder of the *usufruct* interest, or at the end of its term, 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 will transfer the bare ownership to their children while retaining the *usufruct*. This provides the *usufruct* holder with the

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1. Fanny Karaman and Stanley C. Ruchelman, "Usufruct, Bare Ownership, and U.S. Estate Tax: An Unlucky Trio," *Insights* 8 (2016).
2. Rev. Rul. 66-86. See also P.L.R. 9121035, in which the usufruct interest was determined to constitute a trust. In this private letter ruling, the decedent named her son as heir in the entirety, and the son maintained the option to renounce his heirship. The decedent's will provided that, in the event her son renounced his heirship, he would be entitled to the usufruct right in all the decedent's properties, including operating businesses, with the bare ownership passing to the son's children. The decedent's will further provided that her son would be the administrator of her estate. The private letter ruling concluded that, under the terms of the will, a trust arrangement was created and the holder of the usufruct interest was a trustee. Note that a private letter ruling is a binding authority only for the taxpayer to whom it is issued; it may not be cited as an authority by others.

right to the income and the enjoyment of the property until 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. Upon the parents' death, the *usufruct* is automatically carried over to the children, free of inheritance tax under foreign tax law, thereby granting full ownership in the property to the children.

ADVERSE U.S. TAX CONSEQUENCES: CARRY-OVER BASIS AND CAPITAL GAINS TAXATION

For tax law purposes in civil law countries, a beneficiary may receive a stepped-up basis as a result of (i) an *inter vivos* gift of bare ownership or (ii) a transfer at death of the *usufruct*.[3] In addition, the capital gain realized upon the sale of the property interest may be exempt from tax if the beneficiary holds the interest during a specific holding period. The holding period of the property generally starts on the earlier of the receipt of the bare ownership or the termination of the *usufruct* interest.[4] This allows for an efficient transfer for both foreign income tax purposes and foreign gift and succession tax purposes.

In comparison, U.S. tax law does not allow a step-up in basis upon a gift of bare ownership or the receipt of the *usufruct* interest upon death of its holder. This becomes a problem when the holder of the unified interests attempts to sell the property. U.S. income tax treaties contain a saving clause allowing the U.S. to tax its citizens and residents – as determined under the treaty – as if the treaty were not in effect. This provision generally allows the U.S. to tax capital gains realized on the sale of foreign assets by a U.S. person, whether the assets consist of real property or personal property.[5] The taxable gain constitutes the difference between the amount realized upon the sale and the property's adjusted basis in the hands of the donee.[6]

Generally, the treaty provides for a U.S. foreign tax credit for the amount of the foreign taxes paid by a U.S. citizen or resident.[7] However, under certain treaties, the foreign tax credit may be subject to a foreign tax credit limitation under U.S. domestic law. Further, if the foreign country does not impose tax because of the step-up in basis in the property for purposes of its tax law, the benefit of the foreign tax credit is ephemeral. The U.S. rules do not allow a step-up in basis, gain will exist, and the U.S. will impose tax on that gain. The imposition of U.S. tax renders the tax planning done under foreign law meaningless. It simply shifts tax revenue from the foreign country to the U.S.

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3 See, for instance, for rights in real property situated in France: BOI-RFPI-PVI-20-10-20-10, no. 350, September 12, 2012.

4 See, for instance, for rights in real property located in France: BOI-RFPI-PVI-20-20, no. 40, April 10, 2015.

5 See, for example, the France-U.S. Income Tax Treaty (the "France Treaty") currently in effect. Paragraph 2 of Article 29 (Miscellaneous Provisions) allows the U.S. to impose tax on income and gains from real property located in France when realized by a U.S. citizen or resident, notwithstanding paragraph 1 of Article 6 (Income from Real Property) and paragraph 1 of Article 13 (Capital Gains).

6 Code §1001(a).

7 See, for example, paragraph 2(a) of Article 24 (Relief from Double Taxation) of the France Treaty.

Absence of U.S. Gift Tax

Contrary to the principles followed in civil law countries, U.S. gift tax is imposed on the donor and not on the beneficiary.[8]

Gifts made by a non-citizen, nonresident individual to a U.S. person are not subject to U.S. gift tax if the gifted property has its situs located outside the U.S.[9] However, when the aggregate gifts received from a non-U.S. donor during the same year have a value in excess of $100,000, the U.S. beneficiary must report the gifts on Form 3520, *Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts*.[10] Failure to report the gift on Form 3520 can result in a penalty of 5% per month, based on the amount of the gift, capped at 25%.[11]

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Although no U.S. gift tax exposure exists at the time of the gift, income tax will be assessed on the U.S. donee on gain realized at the time of a subsequent sale.[12]

Basis in Bare Ownership Received as a Gift

For property received as a gift, the donee retains the donor's basis in the property (the donor's "carryover basis").[13] When the recipient sells the asset, tax is imposed on total gain, which includes the unrealized gain accrued by the donor prior to the date of the gift. An exception applies only to the extent of U.S. gift tax paid by the donor on the gift. As a result, if the donor previously received the property by gift, the donor's basis in the property carries over from the first person in the chain of donors.

To illustrate, if a grandmother gave property to a father and the father gives property to his daughter, the daughter's basis in the property is determined by reference to the grandmother's basis. Not only was that basis determined many years ago, there likely are no records of the grandmother's basis in the property and the currency that was used to acquire the basis is likely no longer in existence. Note that if the basis carries over from the donor, the donor's holding period carries over, too.[14]

No Stepped-Up Basis in Usufruct Interest of Certain Foreign Property

Generally, the basis of property acquired from or passed from a decedent at the time of death is the property's fair market value.[15] 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.[16] Thus, for example, a life interest generally is considered to be property acquired from a decedent if the property is required to be included in determining the value of the decedent's gross

8 Code §2501(a)(1).

9 Code §2511(a); Code §2511(b).

10 Code §6039F and Notice 97-34.

11 Code §6039F(c).

12 Code §1001.

13 Code §1015(a). Special rules exist for loss property.

14 Code §1223(2).

15 Code §1014(a)(1).

16 Code §1014(b)(9).

estate. However, an exception applies to a *usufruct* interest that is received by the bare owner of the property where the property is not included in a gross estate.[17] In this case, the property itself has a uniform basis, consisting of the basis in the life interest and the basis in the remainder interest. When the *usufruct* interest terminates, the bare legal owner takes the uniform basis in the property.

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

U.S. BASIS PLANNING

Once the gift of the bare legal title is made, there typically is little that can be done by the holder to increase basis. However, prior to the gift, the parents may take steps to undergo a transaction that is tax free in the country of residence but would be taxable according to U.S. tax concepts. The goal of the transaction is to obtain an immediate step-up in basis to fair market value as of the date of the transaction and, in this way, minimize the problem that will be encountered when the *usufruct* terminates.

However, when a U.S. person owns an interest in a corporation that invests principally in passive assets, such as publicly traded shares, bonds, certificates of deposit, or certain real estate, additional planning must be undertaken after the step-up is achieved.

One possible method of accomplishing a step-up is for the non-U.S. parents to contribute the property to a foreign entity with limited liability for all its members. Thus, the entity is treated as a corporation for U.S. tax purposes. For reasons explained below, the foreign entity should not be a *per se* corporation.[18]

The capital structure of the entity should provide for a class of common shares and a class of nonqualified preferred stock, as defined for U.S. tax purposes.[19] Under Code §351(g), the use of nonqualified preferred shares will trigger recognition of gain under U.S. concepts and a step-up in basis of the shares.

For shares to be considered a class of preferred stock, they must be limited and preferred as to dividends.[20] This means that the shares do not participate in corporate growth to any significant extent.[21] Stock that can be converted into common stock does not constitute nonqualified preferred stock.[22]

For the class of preferred shares to be nonqualified, one of the following attributes must be applied to the class of preferred shares in the organizational documents of the entity:[23]

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17 Treas. Reg. §1.1014-2(b)(2).

18 Treas. Reg. §301.7701-3(a).

19 In France, for instance, a *société par actions simplifiée* ("S.A.S.") could be used.

20 Code §351(g)(3).

21 *Id.*

22 P.L.R. 200311002; P.L.R. 200411025.

23 Code §351(g)(2)(A).

- The holder of such stock is given the right to require the issuer or a related person to redeem or purchase the stock.[24]

- The issuer or a related person is required to redeem or purchase such stock.[25]

- The issuer or a related person is given the right to redeem or purchase the stock and, as of the issue date, it is more likely than not that such right will be exercised.[26]

- The dividend rate on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices.[27]

In applying the foregoing tests, the term "related person" has the standard meaning that appears in Code §267(b) or §707(b). Thus, the term includes, *inter alia*, brothers, sisters, spouses, ancestors, lineal descendants, an individual, and a corporation for which more than 50% in value of the outstanding stock is owned, directly or indirectly, by or for such an individual.[28] It also includes a corporation that is a member of a 50%-controlled group owned by an individual and a corporation that is otherwise under common control with another corporation. If the corporation owns a 50% interest in the capital or profits of a partnership, the partnership will be a related person.[29]

In light of the foregoing rules, once a foreign entity with the appropriate capital structure is formed, the plan would include the following steps:

1. The parents obtain a supportable valuation of the property. Two classes of shares are formed. One is a class of nonqualified preferred shares with capital equal to the maximum allowed under foreign law. The shares would (i) give the holder a preferential right to a fixed dividend that would be below the dividend amount distributed to shareholders of the common stock, so as to not significantly share in the growth of the company, and (ii) be based on Euribor.[30]

2. The parents contribute property to the corporation in return for the two classes of shares. Under U.S. tax concepts, but not foreign tax concepts, gain must be recognized with regard to property transferred in return for the nonqualified preferred shares.[31] For U.S. tax purposes, the parents receive a basis in the nonqualified preferred shares equal to the percentage of the contributed property's fair market value as attributed to the nonqualified preferred stock.[32] The common shares have a carryover basis.

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24 Code §351(g)(2)(A)(i).

25 Code §351(g)(2)(A)(ii).

26 Code §351(g)(2)(A)(iii).

27 Code §351(g)(2)(A)(iv).

28 Code §§351(g)(3)(B), 267(b)(1).

29 Code §707(b).

30 Under French law, for instance, such a fixed amount would be honored up to the French equivalent of earnings and profits out of which dividend distributions are made.

31 Code §351(g).

32 Code §358(a)(2).

3. The parents gift bare ownership of the shares of nonqualified preferred stock and common stock to their children, including the U.S. child. For U.S. tax purposes, the basis in the bare ownership of the common shares and the basis in the bare ownership of the nonqualified preferred shares are determined pursuant to actuarial tables set forth under Treas. Reg. §20.2031-7.[33] The balance of the basis is allocated to the *usufruct* interest.

At the completion of step 3, the opportunity to obtain a further tax-free step-up in basis for the U.S. child is unlikely.

"If a non-U.S. corporation is a P.F.I.C., a U.S. shareholder will be subject to special tax treatment for excess distributions received from the P.F.I.C."

P.F.I.C. ISSUES AFTER BASIS STEP-UP

Foreign Entity as a P.F.I.C.

Once the basis has been stepped up by reason of the asset transfer and the gift of bare ownership, the U.S. focus must be redirected to the character of the newly formed entity. If the assets of the entity are investment assets and the sole U.S. child's bare legal title (or that of all the U.S. children in the aggregate) does not amount to more than 50%, by vote or value, of the entity, the entity may be a passive foreign investment company ("P.F.I.C."). In broad terms, a P.F.I.C. is a foreign corporation if one of the following tests is satisfied:

- 75% or more of the non-U.S. corporation's gross income for the taxable year is passive income
- 50% or more of the value of the non-U.S. corporation's assets are of a kind that generate passive income[34]

Passive income is defined as income that would be considered foreign personal holding company income ("F.P.H.C.I.") under Code §954(c). Cash and assets that can be readily converted into cash, including the working capital of an active business, are considered passive assets.

Excess Distribution Regime

If a non-U.S. corporation is a P.F.I.C., a U.S. shareholder will be subject to special tax treatment for excess distributions received from the P.F.I.C. A distribution is an excess distribution if it exceeds 125% of the average of the distributions received in the three preceding taxable years. All gains recognized from the direct or indirect disposition of P.F.I.C. stock are treated as excess distributions.[35]

The "excess distribution" is taxed as follows:

- The excess distribution is allocated to each day in the holding period of the shares.
- To the extent that the excess distribution is allocated to a prior year when the non-U.S. corporation was a P.F.I.C., the distribution is taxed at the highest ordinary income tax rate in effect for that year.

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[33] See, for instance, P.L.R. 7101070280A.

[34] Code §1297.

[35] Code §§1291(a)(2), 1291(b)

- The tax for such earlier P.F.I.C. years is deemed to be paid late and late payment interest is imposed.
- An excess distribution that is allocated to a pre-P.F.I.C. year is taxed at ordinary income rates, not the favorable rates for qualified dividends or capital gains.

A U.S. investor must report the tax on Form 8621, *Information Return by a Shareholder of a Passive Non-U.S. Investment Company or Qualified Electing Fund*. The form must be filed even if no excess distribution is received. This alerts the I.R.S. that the taxpayer is a direct or indirect shareholder of a P.F.I.C.

Qualified Electing Fund Regime

Instead of the excess distribution regime, a U.S. investor in a P.F.I.C. may make a qualified electing fund ("Q.E.F.") election for the P.F.I.C. shares. If this election is made, the U.S. investor includes a *pro rata* share of the P.F.I.C.'s ordinary income and net capital gain in gross income each year.[36] In addition, the shares of a Q.E.F. may be sold and favorable long-term capital gain treatment is allowed so long as the Q.E.F. election was in effect from the first year in which it was a P.F.I.C. A Q.E.F. election can be made only if the P.F.I.C. agrees to timely provide sufficient information to the U.S. owner to compute its tax under the flow-through regime applicable to a Q.E.F. Without the company's cooperation, the election is not valid.

A U.S. investor may elect to defer the U.S. tax that is imposed under the Q.E.F. regime.[37] Interest accrues on the deferred liability.[38] The investor is treated as if an amount equal to the deferred tax were borrowed to pay the tax. Seen in this light, the interest charge under the Q.E.F. regime more accurately tracks the benefit of deferral than the excess distribution regime. This is especially the case for investments in low dividend, high gain P.F.I.C. shares. The excess distribution regime allocates that gain to every day in the holding period, which has the effect of de-linking the interest charge from the actual deferral of tax.

"Consideration should be given to making a Q.E.F. election to avoid the penalty taxes of the excess distribution regime that accompany P.F.I.C. status."

If a Q.E.F. election is made after the first year of ownership or immediately after a purging election, the election will not prevent the excess distribution rules from applying to a gain from the disposition of shares of the Q.E.F.

Path Forward for U.S. Bare Owners of P.F.I.C.'s

Consideration should be given to making a Q.E.F. election to avoid the penalty taxes of the excess distribution regime that accompany P.F.I.C. status. Because the Q.E.F. election will allow the income to pass through to shareholders, and a reasonable argument can be made that investment income passes through to the parents who own the *usufruct* interest, investment income of the entity should not be a problem for the U.S. child. However, because gains pass through to the holders of the bare legal title, the U.S. child may be taxed on the *pro rata* share of capital gains that are allocated to that child. At that point, income tax will be due and basis will be increased in the Q.E.F., or an election can be made by the U.S. child to defer the tax owed with regard to his share of the gain. Interest accrues on the deferred tax.

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36 Code §1293(a).

37 Code §1294(a)(1).

38 Code §1294(g).

Entities that Avoid P.F.I.C. Status

If the assets owned by the parents consist principally of shares of an operating company and those shares represent an interest of at least 25% in the operating company, the P.F.I.C. issue should not be applicable. In applying the passive ownership and income tests, a look-thru rule is applied. If a non-U.S. corporation owns 25% or more of a lower-tier corporation, the shares in that corporation are ignored. The non-U.S. corporation is deemed to own its *pro rata* share of the assets of the lower-tier corporation, and the non-U.S. corporation is deemed to receive its *pro rata* share of that corporation's income for purposes of categorizing the non-U.S. corporation.[39] In this manner, the subsidiary's income and assets are "blended" with those of the non-U.S. corporation to determine whether the latter is a P.F.I.C.

CONCLUSION

The separation of property rights between bare legal title and *usufruct* interests makes enormous sense for a family that has no children residing in the U.S. Inheritance tax can be reduced substantially based on the age of the older generation at the time of the gift of bare legal title. However, difficult issues are faced in the U.S. when the property is a highly-appreciated asset. More importantly, where the separation of property rights has been followed through several generations, the appreciation may be measured as the growth in value from the original acquisition cost by the family member who first acquired the asset several generations earlier.

This article has proposed a method to bring the cost basis of assets up to the fair market value at the time that the property is owned by foreign parents. While this may effectively address all prior appreciation across the ages, it comes at a cost. P.F.I.C. rules may apply to the U.S. child in the next generation. For this individual, the Q.E.F. regime may be the best available answer.

39 Code §1297(c).