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INSIGHTS

WALKING IN THE WILDERNESS – THE EXPERIENCES OF A FRENCH TAX LAWYER PRACTICING IN THE U.S.

IMPLEMENTING THE BORDER ADJUSTMENT TAX: WINNERS & LOSERS

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

AND MORE

Insights Special Edition

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EDITORS' NOTE

This is a special edition of *Insights*, the monthly tax journal of Ruchelman P.L.L.C., addressed to (i) the **visiting students** of *l'Université de Rennes I*, (ii) their professors, **Yolande Sérandour**, *Professeur à l'Université de Rennes I*, and **Emmanuel Raingeard de la Blétière**, *Maître de Conference à l'Université de Rennes I*, and (iii) their hosts at New York Law School, **Ann F. Thomas**, Otto L. Walter Distinguished Professor of Tax Law and Director, Graduate Tax Program, and **Alan I. Appel**, Director, International Taxation Program.

- **Walking In the Wilderness – The Experiences of a French Tax Lawyer Practicing in the U.S.** Attorney at law and avocat à la cour Fanny Karaman describes her experiences practicing law in the U.S. and France. Quite different expectations are placed on tax lawyers in the two countries.
- **Implementing the Border Adjustment Tax: Winners & Losers.** Last June, the House Ways and Means Committee released its tax reform plan, which repeals the current corporate income tax and replaces it with a new regime, commonly referred to as the border adjustment tax. The border adjustment tax will harm certain companies and aid others. To be expected, exporters like the proposal and importers hate it. Strangely, each side argues that employment will be increased if its position is adopted, an example of how voodoo economics support a politicized tax proposal. Philip R. Hirschfeld and Kenneth Lobo look at the industries that will be impacted if the tax is adopted.
- ***Usufruct*, Bare Ownership, and U.S. Estate Tax: An Unlucky Trio.** Splitting ownership into *usufruct* and bare ownership is a common estate planning technique in several civil law countries. However, it may have adverse tax consequences when the holder of the bare legal title resides in the U.S. Fanny Karaman and Stanley C. Ruchelman explain the benefits and the pitfalls.
- **Basis Planning in the *Usufruct* and Bare Ownership Context.** Concepts of *usufruct* and bare legal ownership are widely used by parents resident in civil law jurisdictions in Europe. However, when the next generation is resident in a common law jurisdiction, such as the U.S., the results are not always pretty. Fanny Karaman, Beate Erwin, and Stanley C. Ruchelman examine the tax consequences for the U.S. children and the steps available to the European parents that may limit adverse tax consequences in the U.S.
- **A Concise Guide to Acquisition Vehicles for the Purchase of U.S. Real Estate by Foreign Individuals.** Purchases of U.S. real estate for personal use, investment, or development continue to boom. For foreign individuals, the choice of investment vehicle is critical. How many ways are there to structure an investment in U.S. real property by a foreign person? Many. Nina Krauthamer describes the five you must know.

We hope you enjoy this issue.

– The Editors

WALKING IN THE WILDERNESS – THE EXPERIENCES OF A FRENCH TAX LAWYER PRACTICING IN THE U.S.[1]

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Tags
France
Foreign Lawyer
Legal Procedure
Tax Law
United States

While a French-U.S. perspective is reflected in this article, most foreign tax lawyers practicing in the U.S. may find part of their own experience mirrored here.

Sharing the incredible experience of practicing tax law in the United States evidently encompasses mentioning some main and obvious differences. Among them stand the differences between the practice of tax law in a civil law system as opposed to a common law one, the differences between the practice in a state that has one national lawgiver and the practice in a state that has 52 lawgivers, the differences between the binding force of legislation drafted at the level of the European Union and legislation drafted at the U.S. Federal level.

But more than the aforementioned main legal differences, the cultural ones appear to be at the very heart of the most striking differences between the French practice of tax law and the American one. The example that best stands for the cultural differences between the two countries lays in the communication with the Tax Authorities. It also constitutes by far the most surprising one when arriving from France. In France, a taxpayer's representation in front of the French Administration Fiscale does not come without its share of hostilities. Written communications that occur prior to the taxpayer's representation by counsel between the French Tax Administration and the taxpayer can often result in very heated exchanges. Once represented by counsel, both sides strictly apply procedural rules, the bulk of the exchanges are in written form and oral communications do not entail any substantial information that could be relied upon by the taxpayer in the resolution of the matter at issue.

In the United States on the other hand, communicating with the Internal Revenue Service is inherently different. The communication between the I.R.S. and the taxpayer or the taxpayer's representative is meant for all parties to work together towards the most efficient resolution of the matter for both sides. Picking up the phone and calling the Internal Revenue Service to request an additional day or week to send in the taxpayer's answer to an Information Document Request for instance is not surprising. Nor is it surprising that the oral answer from the agent is trusted in and relied upon, without any written confirmation of the granted extension. Several factors could explain this difference, among which the fact that the French Tax Authorities' publications are binding on the French Administration Fiscale, whereas I.R.S. publications are not. While this undeniably constitutes a protection for the French taxpayer, it also is a reflection of the overall pressure the Administration Fiscale is under, leading it to permanently be cautious in all its communications with the taxpayer or the taxpayer's representative.

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[1] This article originally appeared in *GGi Insider* 67 (2013).

But above all, the driving force behind the cultural differences seems to be American society's core dedication to the business world. In the field of tax law and the taxpayer's representation, this dedication is not only reflected by the Internal Revenue Service's way of communicating with the taxpayer but also by the Internal Revenue Code itself, the detailed Treasury Regulations accompanying it, and the judges' constant effort to explain the thought process they followed in reaching their conclusion, leaving little place to interpretation, hence to uncertainties. In France, the procedure is pedagogical: winning for the correct reason is everything; winning for any other reason leaves an empty feeling.

IMPLEMENTING THE BORDER ADJUSTMENT TAX: WINNERS & LOSERS

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Border Adjustment Tax
International Tax
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OVERVIEW

The House plan to tax imports and exempt exports (the "border adjustment tax" or "B.A.T.")[1] is part of a tax reform package that is expected to raise more than $1 trillion to offset lower income tax rates and improve U.S. competitiveness against global rivals. It is designed to encourage U.S. companies to move manufacturing operations back to the U.S. or use U.S.-based, rather than foreign-based, manufacturers.

Sixteen major U.S. companies, including Boeing Co., General Electric Co., and Caterpillar Inc., recently urged Congress to adopt the B.A.T. with an eye toward establishing more competitive pricing for U.S. manufactured goods.[2]

However, the B.A.T. also raises concerns for certain manufacturers – retooling to a U.S. supply line is costly and can take many years to setup. Of course, the severity of the retooling problem may be looked at as a driving reason for adopting a policy of encouraging manufacturing in the U.S. Ultimately, the B.A.T. will not be a winning proposition for all American businesses, as it benefits corporations that are net exporters to other countries, rather than companies who import goods to sell to the U.S. market.

On the international stage, the potential losers and others have already raised a loud outcry against adoption of the B.A.T. The proposal likely will be challenged in the World Trade Organization ("W.T.O.") by member nations that will be harmed by the tax.

Set forth below is a description of those industries that are expected to be helped and harmed by this proposal and an examination of the potential impact on U.S. currency. Also, set forth below are likely arguments that will support a challenge in the W.T.O. and a discussion of the impact on the American consumer – who may be the biggest loser if the plan is adopted. Note that most of the arguments addressed to consumers are championed by retailers that source inventory abroad.

EFFECT ON THE VALUE OF THE U.S. DOLLAR

There is some divergence as to whether the B.A.T. will result in an increase in the

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1 The tax on imports is actually an indirect tax since the proposal will deny a deduction for the cost of imported goods, which will increase the taxable gain when those products are later resold. By contrast, the proposal will exempt gain from the sale of exports from tax.

2 Ginger Gibson, "CEOs of 16 U.S. Companies Urge Congress to Pass Border Tax," Reuters, February 21, 2017.

value of the U.S. dollar. Since the border tax will materially alter the terms of trade between the U.S. and the rest of the world, the border tax could be expected to lead to a sharp increase in the value of the dollar.[3]

Per economic theory, there will be a reduction in U.S. demand for imported products, and as such, U.S. consumers will transfer fewer U.S. dollars to foreign sellers, thereby reducing the global supply and raising the value of the dollar. Consequently, it would be more expensive for foreign buyers to purchase U.S. goods and cheaper for U.S. importers to purchase goods from overseas. Yet, other analysts believe that the sale of goods will have very little effect on the dollar, as the U.S. has already transitioned from an economy principally based on goods to one based on knowledge and technology.[4]

"Technical economic observations that there will be no negative impact to American industry and the consumer have not been embraced by other commentators and have been silenced the critics of the tax."

The dollar could rally 25% – to levels not seen since the 1980's – according to economists, including Harvard University's Martin Feldstein, who was chairman of the Council of Economic Advisors under President Ronald Reagan.[5] U.S. holders of foreign assets would see the value of those foreign assets drop. This also suggests that the dollar denominated purchase price of foreign produced products will drop. Because many foreigners borrow in U.S. dollars, some commentators have speculated that a global debt crisis may follow for those that do not hedge foreign currency exposure in their home country.[6]

Martin Feldstein, however, believes that the critics of the border tax have not taken into account that the rise in value of the U.S. dollar will serve to offset any possible price adjustments that may result from the tax. Feldstein illustrates this by looking at the impact on an imported product that now costs $100. The purchase price of this imported product will rise to $125 so that the net effect of the 20% border tax will be a price of $100. Feldstein computes this as follows: the new $125 import price is reduced by a 20% tax on that amount (or $25) so the net price equals the present $100. Feldstein then asserts that "a 25% rise in the dollar would reduce the import cost to $80 – that is, $100 divided by 1.25. The border tax would then raise the domestic selling price to the original $100, so the importer could pay 20% of that and have $80 left to cover the cost of the import."[7] Feldstein's technical economic observations that there will be no negative impact to American industry and the consumer have not been embraced by other commentators and have been silenced the critics of the tax.

WINNERS AND LOSERS

Potential winners with regard to the B.A.T. will likely be (i) companies that are U.S. exporters and (ii) companies with significant input costs produced in the U.S.

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3 Holman Jenkins, "What's Behind the Border Tax Kabuki?," *Wall Street Journal*, February 17, 2017.

4 Julian Emanuel, "The Winners and Losers of a Border Adjustment Tax," interview, Bloomberg, February 14, 2017. Stefan Kreuzkamp, "The Border Tax and Other U.S. Tax Issues," Deutsche Asset Management, February 24, 2017.

5 Martin Feldstein, "The Illusory Flaws of 'Border Adjustment,'" *Wall Street Journal*, February 26, 2017.

6 Chelsey Dulaney, "Border-Tax Plan Draws Few Bettors," *Wall Street Journal*, February 14, 2017, B10.

7 Feldstein, "The Illusory Flaws of "Border Adjustment."

As previously mentioned, the C.E.O.'s of 16 major U.S. companies recently signed a letter to Congress endorsing the B.A.T. (the "Letter"). The signatories represent:

Boeing	Caterpillar	Celanese Corp.
Celgene Corp.	CoorsTek	Dow Chemical Co.
General Electric	Eli Lilly and Co.	McIlhenny Company
Merck & Co Inc.	Raytheon Co.	S&P Global Inc.
Oracle Corp.	United Technologies Corp.	Pfizer Inc.
	Varian Medical Systems Inc.	

While these businesses have clearly determined that they fit into one or both of the foregoing categories, the following discussion outlines the industries and sectors that are thought to be helped or harmed by the B.A.T.

Aircraft Manufacturers

Companies that produce American-made aircraft for commercial or private use are expected to benefit from the B.A.T. An example is Boeing, which argues that its primary competitor, Airbus, similarly benefits from V.A.T. refunds for non-E.U. sales while Boeing aircraft are subject to V.A.T. in the E.U. However, if Boeing or other aircraft manufacturers import parts or subassemblies as part of their supply chains, they will be adversely effected by the border tax. This may affect the makeup of supply chains for U.S. manufacturers.[8] However, the elimination of tax on exports of aircraft should far outweigh the cost of the B.A.T. on subassemblies.

American Consumers

A common theme echoed by many industries is that the B.A.T. will result in higher prices for the American consumer.[9]

The Americans for Affordable Products Coalition ("A.A.P.C."), a group of 150 businesses and trade coalitions, was formed to protest the B.A.T.[10] The A.A.P.C. estimates that the tax will raise the cost of everyday products like food, gas and medicine by up to 20% and threaten millions of jobs. It also indicated that this could have a harmful effect on middle-income American families and result in potentially evaporating 27% of their savings with the increased cost caused by the tax. Some notable members of A.A.P.C. are retailers like Target Corp. and Macy's, Inc., and import-focused trade associations like the National Association of Beverage Importers and the National Grocers Association.[11]

Americans for Prosperity ("A.F.P.") is a conservative political advocacy group in the U.S., which is funded by the businessmen and philanthropist brothers David H. Koch and Charles Koch. A.F.P. opposes the concept of funding lower corporate

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8 Kirk Johnson, "Trump Talk Rattles Aerospace Industry, Up and Down Supply Chain," *New York Times*, February 23, 2017.

9 Patti Domm, "A Plan to Tax Us Imports Has Better Odds of Becoming Law than Many People Think," CNBC, December 21, 2016.

10 Chavie Lieber, "100+ Retailers Are Joining Forces to Combat the GOP Border Adjusted Tax," Racked, February 1, 2017.

11 A full list of AAPC members who stand opposed to the border adjustment tax is set forth here.

rates by increasing consumer prices. It criticized the border adjustment plan as a tax on consumers.[12]

Automotive Industry

No matter where assembled, automobiles sold in the U.S. contain a large number of components produced abroad. One consulting firm recently prepared a report projecting the anticipated price increase that would result from the B.A.T. Ford Motor Co. would raise prices by an average of $282 per vehicle while GM would raise prices a $995 price hike. For other manufacturers, the projected increases are $1,312 for American Honda, $1,672 for Fiat Chrysler Automobiles, $2,298 for Nissan North America, and $2,651 for Toyota. Mazda Motors imports its full lineup and its projected increase is $5,156 per vehicle. The American International Automobile Dealers Association argues that impact of the B.A.T. will be to lower new car sales.[13]

Clothing and Apparel Industry

The U.S. clothing and apparel market comprises about 28% percent of the global total. Americans buy nearly 20 billion garments a year – close to 70 pieces of clothing per person. Roughly 2% of that is made in the U.S.[14] Thus, B.A.T. is likely to adversely affect this industry severely.

Companies with Locally Sourced I.P.

For politicians concerned about U.S. base erosion from royalty payments for the use of intangible property ("I.P.") owned outside the U.S., the B.A.T. may incentivize corporations to forego transfers of I.P. to foreign affiliates based in low-tax jurisdictions. Additionally, if the corporate tax rate falls to 20% or 15%, there may be little incentive left for U.S. corporations to move I.P. offshore.

Energy Sector: Oil Drillers and Refiners

The energy sector in America comprises both drillers and refiners. Domestic drillers stand to benefit from the B.A.T. and support the proposal. However, there is a split among refiners.[15]

The U.S. is the largest producer of shale oil in the world, and while the U.S. produces about 8.6 million barrels of crude oil per day, it imports about 8 million barrels of crude oil on the same basis. Under the B.A.T., the cost of imports would no longer be deductible. Most imports come from Canada, but others come from Mexico, Colombia, Venezuela, and Saudi Arabia. Saudi crude oil is shipped to the Saudi Aramco owned plant in Texas.[16] Refiners on the east or west coasts, such as Tesoro

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12 "Americans for Prosperity Holding Republicans Accountable," Americans for Prosperity, February 17, 2015.

13 Nick Bunkley, "Tax Threat Heightens Concern About Affordability," Automotive News, February 13, 2017.

14 Stephanie Vatz, "Why America Stopped Making Its Own Clothes," KQED News, May 23, 2013.

15 Christopher Mathews and Amy Harder, "Border Tax Divides Energy Sector," *Wall Street Journal*, February 24, 2017.

16 Domm, "A Plan to Tax Us Imports Has Better Odds of Becoming Law than Many People Think."

Corp. and PBF Energy, rely heavily on this imported crude and are opposed to the tax. Refiners with a better mix of domestic crude and the ability to export fuel products are more neutral to the idea.[17]

"Over the last decade, there has been a growing U.S. trade deficit in fresh and processed fruits and vegetables."

There is concern that gas prices may increase by up to 20% for consumers due to the increased tax on imported crude oil. Goldman Sachs Group Inc. projects that U.S. oil prices could surge to $65 a barrel from a recent $54, reflecting a sharp tightening in the supply-demand balance in the U.S. market.[18] Internal reports of the American Petroleum Institute have concluded that the proposal will raise gasoline prices by $0.20 per gallon or more in the short term.

This is somewhat less than a recent tax increase per gallon on gasoline sold in the State of New Jersey. Anecdotally, the price increase did not result in less congestion within the state.

Supporters of the proposal have argued that the B.A.T. will strengthen the U.S dollar, which will offset any short-term surge in gas prices. The American Fuel and Petrochemical Manufacturers ("A.F.P.M.") have also concluded that gas prices will surge. A.F.P.M. tends to represent refiners and cautions that the B.A.T. could have considerable impact on refiners, consumers, and the economy."[19]

Food and Agriculture Sector

California farmers supply much of the produce that is on the shelves of American supermarkets,[20] and most domestic producers – particularly U.S. corn exporters – stand to benefit from the tax. Nonetheless, foreign growers supply a substantial portion, too, especially in the winter months.

Over the last decade, there has been a growing U.S. trade deficit in fresh and processed fruits and vegetables. Although U.S. fruit and vegetable exports totaled $6.3 billion in 2015, U.S. imports of fruits and vegetables were $17.6 billion, resulting in a gap between imports and exports of $11.4 billion (excludes nuts and processed nut products). This trade deficit has generally widened over time as growth in imports has outpaced export growth. As a result, the U.S. has gone from being a net exporter of fresh and processed fruits and vegetables in the early 1970's to being a net importer of fruits and vegetables today.[21] This of course may change if consumers shy away from imported products from jams to fruits.

Mexico sold $10.4 billion of fruits and vegetables to the U.S, in 2015 making it the biggest supplier of produce from abroad. Products include tomatoes, avocados, peppers, grapes, cucumbers, melons, berries, and onions. Canada is the second biggest supplier with sales of $2.9 billion in 2015. Bananas are from tropical regions. Most of the bananas you buy are grown within 20 degrees on either side of the equator.[22]

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17 Mathews and Harder, "Border Tax Divides Energy Sector."

18 Dulaney, "Border-Tax Plan Draws Few Bettors."

19 *Supra*, note 17.

20 Brian Palmer, "The C-Free Diet: If We Didn't Have California, What Would We Eat?," July 10, 2013.

21 Renee Johnson, *The U.S. Trade Situation for Fruit and Vegetable Products*, Congressional Research Service report (December 1, 2016).

22 "Map of Banana Farms," Chiquita Bananas.

Machinery Manufacturers

The American company Caterpillar is one of 16 signatories to the Letter supporting the B.A.T. It is expected that Caterpillar and its American competitor, John Deere, as net exporters, would stand to benefit from the B.A.T. In comparison, foreign competitors such as Komatsu and Mahindra will likely be damaged by the B.A.T. when they import machinery to the U.S. The comparison of U.S. manufacturers and their foreign competitors in this category illustrates a potential weakness of the B.A.T., as the B.A.T. may be construed as a subsidy that provides a financial benefit to U.S. residents. For example, while Caterpillar and John Deere can deduct the cost of goods sold in computing taxable income under the B.A.T., Komatsu and Mahindra are subject to a gross sales tax.

Military Contractors

Since the U.S. is the world's leading arms exporter,[23] companies manufacturing military arms and equipment are enthusiastic proponents of the B.A.T. Note that because U.S. law prevents U.S. military technology from being produced outside the U.S., most of the inputs are sourced in U.S. Raytheon and United Technologies are signatories to the letter endorsing the B.A.T.

"Ninety-five percent of shoes and clothing sold in the U.S. is made elsewhere."

Retail Industry

The retail industry is the nation's largest private-sector employer, providing and supporting more than 42 million American jobs, and many existing retailers are undergoing significant changes brought about by the rise of online competition. With the implementation of the B.A.T., major retailers such as Walmart and Target will be hit with increased costs, as most merchandise they sell is sourced abroad – from apparel to electronics. In fact, 95% of shoes and clothing sold in the U.S. is made elsewhere.[24]

There is a view that the value of the U.S. dollar will increase as a result of the B.A.T. and that increase will soften price increases. However, officers of major brand clothing have argued it is disingenuous to state that currency changes would even-out the impact of the B.A.T. The comment is reflective of the current almost universal view of U.S. retailers.[25]

These companies face a choice of absorbing some or all the cost of the tax or passing some or all of the cost to their customers. Neither result is favorable for retailers, and several major retail C.E.O.'s recently met with President Donald Trump and House Ways and Means Committee Chairman Kevin Brady (R-T.X.) at the White House to express concerns that the tax would hurt their industry.[26] Walmart's announced position is that the added cost is likely to be passed on to the consumers in the form of higher prices when shopping at a brick-and-mortar store or on the internet.

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23 Thom Shanker, "U.S. Sold $40 Billion in Weapons in 2015, Topping Global Market," *New York Times*, December 26, 2016.

24 Alex Parker, "Border Adjustment a 'Hidden Tax' on Consumers: Wal-Mart VP," *Daily Tax Reports* 32 (2017).

25 *Id.*

26 Ben Popken, "Trump Meets with Retail CEOs to Discuss Taxes, Jobs, and Economy," NBC News, February 15, 2017.

Although retail is generally presumed to be on the losing side of the B.A.T., there are some retailers that could benefit from the tax. Stores that operate primarily in the U.S. and sell to customers who are less price sensitive are within this category. Examples are Neiman Marcus and Saks Fifth Avenue.

Pharmaceutical Industry

While U.S. drug manufacturers and net exporters Eli Lilly, Merck, Celgene, and Pfizer were signatories the Letter, the pharmaceutical industry, which imported over $86 billion in products in 2015, will be largely harmed by the border tax.

This industry is comprised of companies engaged in researching, developing, manufacturing, and distributing drugs for human or veterinary purposes. The U.S. is the world's largest pharmaceutical market with $333 billion in sales in 2015 – about triple the size of the second largest market, China. Generic drugs are less expensive for the American consumer and are favored by insurance companies for reasons of cost. India contributes around 30% of the overall volume of pharma products consumed in the U.S.

Directly and indirectly, the industry supports over 3.4 million jobs across the U.S. and added an estimated $790 billion to the economy in 2014.[27] No estimate is given by trade associations of the number of jobs that will be lost as a result of the B.A.T. or the reduction in sales that is projected.

Tourism and Higher Education

Tourism is a major industry in America. A stronger U.S. dollar means that, at the margins, fewer foreign persons may visit the U.S. as tourists.[28] A stronger dollar also means that Americans planning a vacation may find traveling abroad much less expensive. Thus, vacations outside the U.S. may increase, which would also be harmful to the U.S. tourism industry.

International students comprise a growing share of student population, especially in hard topics such as science and math.[29] For those who are not on U.S. dollar denominated scholarships, a stronger dollar increases the cost for a foreign students.

WORLD TRADE ORGANIZATION OPPOSITION

The W.T.O. was formed in 1995 and is composed of 164 member nations as of July 29, 2016. The W.T.O. provides a framework for negotiating trade agreements and a forum for resolving trade disputes among members.[30]

Many commentators have suggested that the B.A.T. would violate W.T.O. rules and precipitate a challenge in the W.T.O. by countries that export to the U.S. U.S. Congressman Kevin Brady is the Chairman of the House Ways and Means Committee

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27 U.S. Dept. of Commerce, International Trade Administration, *2016 Top Markets Report Pharmaceuticals.*

28 Jed Graham, "GOP Border-Tax Plan Would Sock U.S. Tourism – Including Trump Hotels," *Investor Business Daily*, February 15, 2017.

29 Stuart Anderson, "International Students Are Vital To U.S. Higher Education," *International Educator* Jan.-Feb. (2017).

30 See "World Trade Organization – Home page."

and the principal advocate for the B.A.T. He is convinced the B.A.T. is compliant with W.T.O. rules. Others believe that it may violate W.T.O. rules because of the inability to include the cost of imports as part of cost of goods sold at the same time that the cost of locally made products can be included in such costs. This may be a form of subsidy that may violate the Agreement on Subsidies and Countervailing Measures.[31]

The definition of a subsidy is composed of three basic elements: (i) a financial contribution (ii) by a government or any public body within the territory of a W.T.O. member state (iii) that confers a benefit.[32] All three of these elements must be satisfied in order for a subsidy to exist. A financial contribution requires a charge on government funds. The term includes the relinquishment of government revenue or the failure to collect revenue (as would be the case with a credit or an exemption from tax generally due on domestic sales).[33]

In February, the German ambassador to the U.S. expressed concern that the B.A.T. may not be consistent with W.T.O. rules, but declined to say whether Germany might file a complaint with the W.T.O.[34]

THE TRUMP ADMINISTRATION'S POSITION

President Trump has not yet reached a final decision on whether to support or oppose the border tax proposal.[35] However, President Trump has expressed concern about the plan calling it "too complicated" in an interview with the Wall Street Journal.[36]

CONCLUSION

Like many controversial issues, belief in the potential adverse effects of the B.A.T. seems to depend on a company's status as a net exporter or net importer of inventory. To importers, adoption of the B.A.T. will harm major sectors of the American economy in a significant manner. They believe that the effect will be widespread and will embroil the U.S. in a controversy with its trading partners that will lead to a trade dispute that for resolution in the W.T.O. These companies argue that the ultimate consumers of their product may be the biggest losers through higher prices. Interestingly, industrial labor unions whose members are consumers seem to be quiet on the issue of the B.A.T.

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31 Martin Kohr, "The Planned US Border Tax Would Most Likely Violate WTO Rules – Part 2," Inter Press Service, February 17, 2017.

32 See Fanny Karaman, Stanley C. Ruchelman, and Astrid Champion, "European State Aid and W.T.O. Subsidies," *Insights* 9 (2016), pp. 9, 14.

33 Article 1 of the Agreement on Subsidies and Countervailing Measures and Article 16 of G.A.T.T. 1994.

34 Nick Wadhams & Margaret Talev, "German Ambassador Warns Import Tax May Violate WTO Rules," *Daily Tax Report* 36 (2017).

35 Kaustuv Basu & Aaron Lorenzo, "Confusion Continues on Trump's Take on Border Adjustment," *Daily Tax Report* 37 (2017).

36 Dulaney, "Border-Tax Plan Draws Few Bettors."

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

Authors
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Tags
Bare Ownership
Estate Tax
France
Usufruct

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."

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[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.

“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.”

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

[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.

<u>Sale of Gratuitously Received *Usufruct* Interest</u>

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.

"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."

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.

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12 Code §1014(a)(1).

13 Code §1014(b)(9).

14 Treas. Reg. §1.1014-2(b)(2).

BASIS PLANNING IN THE *USUFRUCT* AND BARE OWNERSHIP CONTEXT

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Tags
Bare Ownership
Estate Planning
Pre-Immigration Planning
Real Property
Usufruct

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]

"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."

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

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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.

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

"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."

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).

A CONCISE GUIDE TO ACQUISITION VEHICLES FOR THE PURCHASE OF U.S. REAL ESTATE BY FOREIGN INDIVIDUALS[1]

Author
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Tags
Estate and Gift Tax
Foreign Corporation
Foreign Investment
Foreign Trusts
Real Estate
Partnership

Purchases by foreign individuals of U.S. real estate for personal use, investment, or development continue to boom. Those individuals will face particular U.S. income, estate, and gift tax issues. Choice of a proper investment vehicle is critical.

Direct ownership by the foreign individual is generally discouraged, as it may create the need for an ancillary probate proceeding in the state where the property is located as a condition of a transfer in the event of the death of the individual. Ownership of the real estate at death or ownership through a disregarded entity, such as a single-member L.L.C., could result in onerous U.S. estate taxes of roughly 40%, plus possible state estate taxes, as well. In this regard, it is imperative to analyze (i) the income, estate, and gift taxes of the individual's country of residency (with the help of local counsel) and (ii) the possible application of an estate tax treaty between the U.S. and the individual's country of residence. U.S. estate tax treaties may change the situs rules for the imposition of the estate tax (althought not ordinarily in the case of real property), may offer an enhanced exemption from tax or a marital deduction, and, of equal importance, may require that the home country permit a credit against the estate tax imposed by the other taxing jurisdiction. Extensive U.S. tax planning may not prove to be necessary if the home country's estate tax is comparable to the U.S. estate tax and a credit for U.S. tax is available in the home country.

It is important to consider whether the individual will be using his or her own funds to make the acquisition, or whether the acquisition will be financed by borrowing. If the individual can procure nonrecourse financing to purchase the property (ordinarily difficult in a personal context), the amount subject to U.S. estate taxes would be limited to the fair market value of the property net of the amount of the nonrecourse financing.

Several structures are potentially available to hold a U.S. real estate investment. They include the following.

TWO-TIER STRUCTURE

In the case of development property, where it is likely that the income to be realized is ordinary income, a two-tier corporate structure is quite popular. Typically, the foreign individual (or a foreign trust) owns a foreign holding corporation (sometimes referred to as a "foreign blocker"), which in turn owns a U.S. real estate corporation. (Use of a U.S. L.L.C. is not desirable, as a single-member L.L.C. would be disregarded, and therefore, the foreign corporation would be treated as owning the property for U.S. tax purposes.) Stock of a foreign corporation is treated as a

[1] This article was originally published in the November 2015 edition of the ABA Section of Real Property, Trust and Estate Law's *RPTE eReport* and has been altered for this publication.

non-U.S. situs asset and therefore not subject to U.S. estate tax. The corporate formalities imposed under the laws of the jurisdiction of the foreign corporation (and consistent with U.S. tax principles) associated with ownership by a corporation must be carefully observed.

This two-tier corporate structure may be used for other types of acquisitions if estate tax certainty is an important goal. If the U.S. real estate is personal use property, some practitioners recommend that the property be rented for fair market value, supported by a broker's market analysis, and that the rent be used to pay all operating costs and carrying charges. Other practitioners believe that for personal use property, rent could be limited to the operating costs and carrying charges; some practitioners believe that rent need not be charged at all.

"Foreign trusts are often desirable in the case of personal use property or long-term passive real estate investments where it is desirable to capture the lower capital gains rates applicable to individuals (and trusts)."

Gain on the sale of the property would be subject to tax at the corporate rates of tax (35% Federal and, *e.g.*, approximately 12% N.Y.S. and N.Y.C. after consideration of the Federal deduction), which are higher than the rates applicable to sales of U.S. property by nonresident, non-citizen individuals, and foreign trusts (20%, or 25% on depreciation recapture, Federal and, *e.g.*, approximately 9% N.Y.S.). After a sale, cash can be distributed without further tax if the U.S. real estate corporation is liquidated; cash distributions in a non-liquidation context could be taxed as dividends, subject to U.S. withholding tax. This structure provides for a high level of U.S. estate tax certainty but at a cost of higher income tax rates in certain circumstances.

ONE-TIER STRUCTURE: FOREIGN CORPORATION

For personal use property, some practitioners recommend a one-tier foreign corporate structure whereby a foreign corporation purchases personal use property directly (or through a single-member L.L.C.) for use by shareholders of the corporation, with rental at less than full fair market rent. Those practitioners believe that, at worst, the foregone rent would be treated as a disguised dividend to the shareholder – generally with no adverse U.S. tax consequences, as a dividend by a foreign corporation is not subject to U.S. withholding tax. Other practitioners believe that there could be a risk that under these circumstances the I.R.S. may impose both a corporate tax and an additional branch profits tax on imputed rental income. A sale of the property would give rise to tax on gain at the corporate rates above, although the additional branch profits would not apply if the corporation terminates its U.S. business (and certain other conditions are met).

FOREIGN IRREVOCABLE DISCRETIONARY TRUST

Foreign trusts are often desirable in the case of personal use property or long-term passive real estate investments where it is desirable to capture the lower capital gains rates applicable to individuals (and trusts). Generally, a purchase of U.S. real property by a trust with cash contributed to the foreign trust by a foreign individual would not trigger adverse U.S. estate or gift tax consequences where the individual retains no rights to the income or assets of the trust. A foreign trust is defined by the U.S. tax laws to mean any trust that is not a "domestic" trust. A trust will be considered domestic if (i) a U.S. court can exercise primary supervision over trust administration (the "Court Test") and (ii) U.S. persons control all substantial trust decisions (the "Control Test").

It is ordinarily not necessary to rent personal use property at full fair market rental, unless the intended user is a U.S. person. In that case, a failure to charge rent would be treated as a distribution to the U.S. person in the amount of the fair market value of the use of such property.

It is possible for the settlor (grantor) of the trust to be a potential beneficiary of the trust without causing a U.S. estate tax inclusion upon the death of the settlor (grantor). This generally requires an institutional trustee and no "understanding" as to the settlor's entitlement to discretionary distributions of income or capital. The settlor cannot be a trustee or trust protector. Essentially, the grantor loses control over the property and proceeds from its sale. Any use of the property by the settlor would require the payment of rent at full fair market value.

Tax on the sale of the property is calculated using the rates applicable to individuals (the 3.8% "net investment income tax" does not apply to foreign individuals and foreign trusts). Withholding under the Foreign Investment in Real Property Tax Act of 1980, or "F.I.R.P.T.A.," (generally under recent law changes a 15% withholding tax upon the sale of U.S. real estate by a foreign person) would be applicable in the event of a sale or distribution of the U.S. property. Generally, the cost of establishing and maintaining a foreign trust may prove to be higher than the cost of establishing and maintaining a foreign corporation.

A U.S. trust may also be a suitable vehicle, although in that case, capital gain income would attract the additional "net investment income tax" unless distributed to a foreign individual. F.I.R.P.T.A. withholding would not apply.

FOREIGN GRANTOR TRUST

A foreign individual will be treated as the owner of U.S. real property, subject to the favorable income tax rates applicable to individuals, if the property is owned by a grantor trust. In the case of a foreign individual grantor, a trust will be so treated if either the grantor reserves the right to revoke the trust solely or with the consent of a related or subordinate party (and revest title to the assets to himself), or the amounts distributable during the life of the grantor are distributable only to the grantor and/or the spouse of the grantor. The individual is treated as the owner of the property for U.S. income tax purposes and there is no need to rent the property.

This structure does not afford protection against U.S. estate tax. It is recommended for those individuals who can procure life insurance (generally term insurance) at a reasonable cost to provide for estate taxes upon the death of the individual. While the U.S. real estate is subject to U.S. estate tax, life insurance proceeds with respect to nonresident, non-citizen individuals are not subject to U.S. estate tax.

If a residuary beneficiary of the trust is a U.S. person, it is important that the grantor retain the right to direct the income of the trust to achieve a step-up in basis upon the death of the grantor, reducing the tax on a future actual sale of the property.

PARTNERSHIPS AND MULTI-MEMBER L.L.C.'S

A partnership, or a multi-member L.L.C. taxed as a partnership, is a flow-through entity for U.S. tax purposes. Investment in U.S. real estate through such a vehicle would afford the individual member or partner the lower capital gains rates applicable to individuals if the real estate is a capital asset. However, ownership of U.S. real property through a U.S. or foreign partnership is generally discouraged because of the uncertainties concerning the situs of a partnership interest for U.S. estate tax purposes, as well as a potential withholding tax applicable to foreign partners. Some practitioners believe that a case can be made for the non-U.S. situs of an interest in a foreign partnership. If the underlying assets of the partnership are situated in the U.S., while there is no specific statutory authority, an interest in a foreign partnership may be subject to U.S. estate tax if the death of a partner causes dissolution of the partnership under local law, or even if it does not, if the partnership carries out business in the U.S. Certain estate tax treaties with the U.S. may offer relief from taxation.

Investment in U.S. real property by a foreign individual requires a careful examination of an appropriate acquisition vehicle. It is often challenging to structure an acquisition that can minimize exposure to both income and estate taxes. However, a failure to consider U.S. taxes could result in an onerous tax burden for the foreign investor.

"Ownership of U.S. real property through a U.S. or foreign partnership is generally discouraged because of the uncertainties concerning the situs of a partnership interest for U.S. estate tax purposes."

About Us

We provide a wide range of tax planning and legal services for foreign companies operating in the U.S., foreign financial institutions operating in the U.S. through branches, and U.S. companies and financial institutions operating abroad. The core practice of the firm includes tax planning for cross-border transactions. This involves corporate tax advice under Subchapter C of the Internal Revenue Code, advice on transfer pricing matters, and representation before the I.R.S.

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Our law firm has offices in New York City and Toronto, Canada. More information can be found at www.ruchelaw.com.

Disclaimer

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