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In this article, the second of three in a series on U.S. tax issues that arise when property is divided into a usufruct and a bare ownership interest, Longman and Newton Muller explore the U.S. federal income tax consequences for U.S. usufruct holders, U.S. transfer tax issues, and exit tax issues.

As discussed in Part I of this three-part article series,[1] the treatment of divided interests in property in the form of usufruct and bare ownership interests is an unsettled area in U.S. tax law. In this installment, we first discuss the consequences to a usufruct holder who is a U.S. person for U.S. federal income tax purposes. We then discuss the transfer tax consequences, including whether the division of the property is treated as a completed gift for U.S. gift tax purposes, which is not always clear. Finally, we discuss the exit tax consequences to a U.S. usufruct holder, a hybrid of income and transfer tax issues.

Income Tax Issues

Substantive Tax Treatment

In many ways, the substantive tax treatment of a U.S. usufruct holder is very similar to that of a full owner.

In general, it follows the economic rights set forth under the foreign law treatment, generally subjecting the usufruct holder to tax on the rents, dividends, or other income generated by the property subject to the usufruct. These economic rights should be equally subject to tax in the foreign jurisdiction, generating a foreign tax credit to reduce the U.S. tax burden on the usufruct holder (unless the amount received by the usufruct holder is considered exempt under foreign rules or is not considered taxable income).[2] Hence, like a full ownership interest, while the tax benefits in the foreign jurisdiction may be offset or canceled by the U.S. tax consequences, the divided interest strategy should not, itself, create double income taxation.

Often, a U.S. person who retains a usufruct on shares of a foreign corporation will be subject to

[1] Jenny L. Longman and Nora Newton Muller, "Grin and Bare It: Usufruct and Naked Ownership Structures in the United States," *Tax Notes Int'l*, Jan. 30, 2023, p. 579.

[2] This may occur in France, for example, when a U.S. usufruct holder sells his principal residence and the gain is exempt under local tax law, whereas the U.S. rules would tax the gain in excess of $250,000. We also assume that typically, the income generated would be foreign-source for U.S. federal income tax purposes.

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U.S. anti-deferral rules, like the subpart F regime or rules concerning passive foreign investment companies. In that case, there may be taxation timing issues between the foreign jurisdiction and the United States, as often occurs when a U.S. person has full ownership in foreign company shares.

However, it may be difficult to determine whether the usufruct holder or bare owner (or both) should be treated as the shareholder for applying the U.S. anti-deferral rules, including the determination of whether a foreign corporation is classified as a controlled foreign corporation as defined in section 957. For example, if an 80-year-old usufruct holder of 51 percent of the foreign corporation is a U.S. person, but the bare owner is not, the present value of the usufruct interest (if discounted based on section 7520 rates) may not be greater than 50 percent of the total value of the CFC.

Under section 958, the shareholder's proportionate interest is determined based on all the facts and circumstances, with reference to their interest in the corporation's income.[3] Indeed, the IRS confirmed in a private letter ruling that a usufruct holder with exclusive rights to any dividend paid by the corporation during the usufruct term is considered the owner of the shares for determining subpart F inclusions under section 951(a) during that term.[4]

While this rule is clear in the facts described in the letter ruling, often the usufruct holder may not have an exclusive right to all the income of the foreign corporation. The bare owner may have a right to distributions that would be treated as stock redemptions in the foreign jurisdiction but as a dividend in the United States under section 302. Moreover, the bare owner may have the right to accumulated earnings, while the usufruct owner has only the right to the current-year earnings. As a result, a decision by the corporation not to pay a dividend from the current earnings could convert those earnings into the bare owner's property, whether upon liquidation of the corporation or payment of a dividend out of accumulated earnings.

Adding further complexity to economic rights, the share's voting rights are often divided between the usufruct holder and bare owner, with each having the primary voting rights depending on the type of decision being made by the corporation. In France, as described in Part I, the usufruct holder, at a minimum, will generally be eligible to exercise voting rights related to the attribution and distribution of profits. The bare owner may be required to vote on any decision regarding the existence of the legal entity, including a change in legal form, merger, or liquidation. Therefore, the determination of a shareholder's percentage of both vote and value for the test in section 957, applying the rules of section 958, may not be straightforward.

For a non-U.S. corporation that clearly carries on an active business, the uncertainty regarding classification as a CFC may be relatively contained and not spill into the potential classification of the corporation as a PFIC. However, the foreign corporation for which a usufruct is reserved is often a holding company with an investment portfolio or minority investments in other companies.[5] In a situation like this, that corporation is likely classified as a PFIC under section 1297, and a U.S. owner might rely on the CFC/PFIC overlap rule of section 1297(d). When the CFC status of the foreign corporation is uncertain, there may be potential PFIC exposure to the U.S. usufruct owner.

Foreign Information Return Reporting

The foreign information return reporting for a usufruct holder of an interest in a foreign entity or account would likely look very similar to the reporting for a full owner on forms 5471, 8865, 8621, and 8938, and Financial Crimes Enforcement Network Form 114 (or the foreign bank account report). A taxpayer might consider including a footnote on the relevant form to explain the nature of the interest.

To determine the maximum value of the interest on Form 8938, it is not entirely clear

[3] Reg. section 1.958-1(c)(2).

[4] LTR 8748043, following Rev. Rul. 64-249, 1964-2 C.B. 332, and analyzing a usufruct created under Dutch law for a surviving spouse, with the couple's children as remaindermen.

[5] Further, a company that appears to be "active" may risk being classified as a PFIC if it has significant passive assets.

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whether, for a usufruct holder, the value disclosed should be the value of the term interest or the value of the full interest in the property. To value an interest in a foreign trust, the Treasury regulations under section 6038D look to the value of amounts received over the course of the reporting year as well as the value of the term interest, taking into account the valuation tables under section 7520.[6] However, we note that, according to the authorities described in Part I, a usufruct/bare ownership property division may *not* result in treatment as a trust for U.S. income tax purposes. Section 6038D does not address *non-trust* term interests in property. If the interest is likened to a jointly owned interest, the instructions require that each of the usufruct and bare owners reports the entire value of the interest in the joint owner's specified foreign financial assets. Similarly, the FBAR requires that each joint owner of an account report the full value. This valuation is generally a disclosure matter only, with no financial impact for the taxpayer, and therefore the higher value may be used on a conservative basis. However, for a voluntary disclosure filing, including under the Streamlined Domestic Offshore Program, the valuation used may affect the penalty amount for the taxpayer.

Transfer Tax Issues

Bare Ownership Interest as a Completed Gift

When a U.S. person[7] makes a gift of a bare ownership interest and retains a usufruct, there is an initial threshold question of whether the gift is complete for U.S. transfer tax purposes.

Depending on the nature of rights retained by the usufruct holder and other factors, the gift of the bare ownership may not amount to a completed gift for U.S. transfer tax purposes — notwithstanding that the transfer may constitute a gift for French tax purposes. Reg. section 25.2511-2(b) provides:

> As to any property, or part thereof or interest therein, of which the donor has so parted with dominion and control as to leave in him no power to change its disposition, whether for his own benefit or for the benefit of another, the gift is complete. *But if upon a transfer of property (whether in trust or otherwise) the donor reserves any power over its disposition, the gift may be wholly incomplete, or may be partially complete and partially incomplete, depending upon all the facts in the particular case. Accordingly, in every case of a transfer of property subject to a reserved power, the terms of the power must be examined and its scope determined.* [Emphasis added.]

Although it may be uncommon, sometimes the usufruct holder may reserve additional powers that could cause the transfer of the bare ownership to be incomplete. This analysis is based on all facts and circumstances and would need to be evaluated based on the deed creating the usufruct as well as foreign law. For example, in connection with a usufruct reservation on company stock where the usufruct holder has the power to declare an extraordinary dividend that would benefit him but not the bare owner, essentially "chipping away" at the bare owner's entitlement, the gift may be incomplete.[8]

Sometimes, practitioners look to the reversion rights commonly included in French deeds providing for the transfer of a bare ownership described in Part I. Articles 951 and 952 of the French Civil Code allow for a reversion right for a donor that must be exercised and confirmed in the notarial deed, in case the bare owner predeceases the donor without issue. Indeed, under the Treasury regulations, a gift is incomplete in any case in which the donor reserves the power to revest title in him or herself.[9]

However, this right alone might not be sufficient to render the gift incomplete based on a recent private letter ruling in which the IRS analyzed whether a donation of bare ownership in certain artworks to a museum was a completed gift. In LTR 201825003, the taxpayer reserved a usufruct of artworks in which the remainder interest passed to a museum subject to a number of conditions: The museum must comply with

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[6] Reg. section 1.6038D-5(f)(2).

[7] In the context of the application of U.S. transfer tax, a "U.S. person" refers to a U.S. citizen or domiciliary.

[8] *See* reg. section 25.2511-2(c).

[9] *Id.*

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various requirements for exhibition, the museum must not become privately owned, and there must not be certain changes in law, like a change that would cause the transfer to be taxable. The deed was also subject to a condition precedent that a favorable ruling on the absence of a completed *inter vivos* gift for U.S. gift tax purposes be obtained. If any of the conditions were not satisfied, the usufruct holder would have a right to revoke the transfer. If the condition precedent was unsatisfied, the deed would not come into force at all.

The letter ruling concluded that the gifts were complete, notwithstanding the condition precedent because the conditions that could cause a revocation were independent of any act of the taxpayer. Focusing on the dominion and control of the donor, the IRS reasoned that a transfer is a completed gift notwithstanding a reversionary right that is not within the control of the donor. By extension, reversion rights upon the death of the bare owner without issue, or other terms that could result in additional benefits to the donor but not within their control, may be insufficient to support an incomplete gift analysis.[10]

An incomplete gift may also be found if the usufruct holder's creditors have access to the entire property.[11] As discussed in Part I, under French law, the quasi-usufruct interest holder is authorized to manage the portfolio as a legal title holder, including for purposes of satisfying creditor claims of the quasi-usufruct holder. This fact would therefore support a position that in these quasi-usufruct arrangements, the property division would be treated as an incomplete gift under U.S. transfer tax.

Value of the Bare Ownership Gift

When a U.S. person[12] makes a completed gift of a bare ownership interest and retains a usufruct, there is an additional question of how to value the gift for U.S. gift tax purposes. Although U.S. gift tax regulations provide standardized methods for valuing remainder interests in property after a life or term interest,[13] special valuation rules may apply in a typical family estate planning setting under section 2702. Section 2702 applies to "transfers in trust" to certain classes of family members in which the transferor (or a family member) retains an interest in the trust. Notwithstanding the use of the term "trust," the rules are actually broader and may apply to transfers of term interests in property as well (including a life interest in property).[14] When there is a completed gift of a remainder interest and section 2702 applies, the partial interest retained by the transferor may be valued at zero — resulting in a taxable gift equal to the full value of the property and not just the value of the remainder interest.[15] In U.S. planning, specific trusts like grantor-retained annuity trusts are used to enable the donor to make a gift to family members with a gift tax base of less than the full value of the property — this retained interest in the case of a grantor-retained annuity trust is a fixed amount and is permitted as a "qualified interest" for which section 7520 valuation principles may be used to value the gift.[16]

Section 2036 may cause gifted property with a retained life interest to be included in the gross estate of the donor upon death as a transfer of property with a retained income interest. Worse still, the value to be included at death would ordinarily be the *full value* of the property, without a reduction for the value of the bare ownership gifted.[17] To the extent there was a completed gift of the bare ownership, the estate tax inclusion usually would not result in *double* tax.[18] The previously gifted property should be excluded from "adjusted taxable gifts," and thus from the amount on which the estate tax is calculated, under section 2001(b)(1)(B) because it is included in the gross estate under section 2001(b)(1)(A).[19] Although there is no *double* U.S. transfer tax for a

[10] This conclusion would be similar to the operation of section 673(b), which limits grantor trust treatment based on a reversionary interest upon the death of a minor lineal descendant beneficiary.

[11] *See Alice Spaulding Paolozzi v. Commissioner*, 23 T.C. 182 (1954). *See also* Rev. Rul. 76-103, 1976-1 C.B. 293.

[12] Again, in this gift tax context, a "U.S. person" refers to a U.S. citizen or domiciliary.

[13] Reg. section 25.2512-5(a).

[14] Reg. section 25.2702-4(a).

[15] *See* reg. section 25.2702-2(b).

[16] *See* reg. section 25.2702-3(b).

[17] *See* reg. section 20.2036-1(c)(1)(i).

[18] *See* section 2001(b); *see also* Richard Stephens et al., *Federal Estate and Gift Taxation*, at 19.03[4][c][2] (2023).

[19] Section 2001(b) (flush language).

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completed gift of a bare ownership interest by a U.S. transfer tax resident, there is no U.S. federal transfer tax *benefit* to a U.S. person in the reservation of a usufruct, in stark contrast to France and many other civil law jurisdictions. Following from the estate tax inclusion of the asset would be a basis step-up in the property under section 1014.

As lousy as the U.S. transfer tax consequences are for a U.S. donor with substantial assets, this planning tool may still be worthwhile for a U.S. person subject to French inheritance tax with assets unlikely to exceed the U.S. combined estate and gift tax exemption amount. For example, if a U.S. person's worldwide assets are about $5 million (an amount well under the exemption), and that individual owns valuable real estate in France (for example, an apartment worth €2.5 million), that individual may still benefit from significant tax savings related to French inheritance tax that would otherwise be due upon death because the decedent owned the French real estate in full ownership. Even if the full value of the French real estate would be includable in the decedent's U.S. gross estate, that individual should not have a taxable estate for purposes of the U.S. estate tax if the value of the property and the value of any other prior taxable gifts remains below the exemption level applicable at death. Further, the usufruct holder's heirs (if U.S. persons themselves) would benefit from a step-up in the basis of the property for U.S. federal income tax purposes.

U.S. Exit Tax

Reservation of a usufruct would further complicate the case of a U.S. person who is a covered expatriate and subject to the U.S. exit tax under section 877A. Generally, U.S. gift and estate tax principles apply to determine what a covered expatriate owns under the rules of section 877A, which governs applicability of the exit tax regime.[20] For the "net worth" test, an individual is considered to own any interest in property that would be taxable as a gift under IRC chapter 12 of subtitle B if they are a citizen or resident of the United States who transferred the interest immediately before expatriation. For a prior incomplete gift of the bare ownership interest, the usufruct holder would likely be considered to own a full interest in the property because that person remains the owner of the entire property for U.S. gift tax purposes. When the usufruct owner had been previously taxed on a completed gift of a bare ownership interest, it's unclear how the net worth test would apply to the retained life interest — these rules do not specifically address how to value a retained interest that may have previously been included in the gift tax base under section 2702.[21] The expatriation rules also deal with the valuation of interests in trusts, but it is unclear if those rules would necessarily apply, given that in most cases, the property division is more likely to be treated as a life estate/remainder interest rather than a trust.

To compute the tax liability under the mark-to-market regime, a covered expatriate is considered to own any interest in property that would be taxable as part of his or her gross estate for federal estate tax purposes under IRC chapter 11 of subtitle B as if he or she had died on the day before the expatriation date as a citizen or resident of the United States. Therefore, even in the case of a completed gift of a bare ownership interest, the expatriating usufruct holder may be subject to exit tax as if he or she owned a full interest in the property because of the likely inclusion of the property under section 2036. It's unclear to us whether this is the intended result — but in our experience, we encounter questions concerning exit tax more often regarding an expatriating bare owner.

While section 877A(h)(2) provides a step-up in basis to the fair market value of property as of the first date of residence for nonresident aliens who become U.S. residents and are later subject to the exit tax, it is not entirely clear how these rules apply to a usufruct holder. We will address basis issues in more detail in the next installment of this three-part series.

In short, the exit tax rules under section 877A are a minefield that combines the pitfalls of income tax and transfer tax regimes for a U.S. person who is a usufruct holder.

[20] *See* Notice 2009-85, 2009-45 IRB 598; Notice 97-19, 1997-10 IRB 1.

[21] *See* reg. section 25.2702-6(a)(1).

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Conclusion

Although the income tax consequences for a U.S. citizen or resident usufruct holder are relatively straightforward and should generally follow the economic rights of the property interest, except for the application of anti-deferral regimes, uncertainties abound in relation to the treatment of foreign law divided ownership strategies in the context of U.S. information reporting, transfer tax, and exit tax rules.

In the next and final installment of the series, we will discuss the reverse side of the coin, when a bare ownership interest is held by a U.S. person (which, in our practices, we see more commonly than property divisions involving a U.S. usufruct holder). ■

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