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In this article, the last 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 explain further difficulties arising from the addition of rules on controlled foreign corporations, passive foreign investment companies, and the U.S. exit tax.

The last installment of our three-part series explains U.S. tax considerations of a divided interest strategy for the bare owner who is a U.S. person.[1] In most situations involving global families, it is the bare owner, rather than the holder of the usufruct, who is a U.S. person. The usufruct holder is often a nonresident alien who puts in place the property division for foreign estate planning purposes. In many instances, one or more members of the younger generation move to the United States. In some cases, the reservation of the usufruct and gift of the bare ownership precede the acquisition of U.S. tax residency by the bare owner; in other cases, the usufruct/bare ownership arrangement is put into place when the child has already acquired U.S. tax residency. As discussed in the first two installments, this is an unsettled area of U.S. tax law that creates substantial uncertainty for the U.S. bare owner.

Key complexities arise when the usufruct holder is a non-U.S. person, putting the divided interest partly inside and partly outside U.S. taxing jurisdiction. This article focuses primarily on this scenario unless otherwise noted. In our experience, the key U.S. federal income tax issues that arise for the bare owner who is a U.S. person are:

- income tax reporting with respect to income generated by the property subject to the usufruct;
- computation of gain on the sale of the property, including whether the bare owner is eligible for a basis step-up upon the death of the usufruct holder;
- the application of various U.S. antideferral regimes to such an individual;
- foreign information reporting related to the bare ownership interest; and
- application of the exit tax regime.

[1] *See* 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; and Longman and Muller, "Grin and Bare It, Part II: Tax Issues for the Usufruct Owner in the United States," *Tax Notes Int'l*, June 19, 2023, p. 1605.

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Tax Treatment

Tax Treatment — Income

As discussed in Part I, in plain-vanilla divided interest cases, the bare owner has no current right to the fruits of the property, hence no current income. For example, in the simplest case, the bare owner would not be entitled to rental income, interest, or dividends generated by the directly-held property subject to the reservation of a usufruct.

The situation is more complex in the case of an indirect interest via a controlled entity, the shares of which are the object of the usufruct and bare ownership interests. Often, the usufruct holder will have gifted the bare ownership of shares to one or more family members while retaining control of the entity. The voting rights may be split between the usufruct and bare owner with the usufruct holder usually having the right to decide, for example, on the distribution of current-year or accumulated profits by the entity and the bare owner generally having the right to decide on the liquidation of the entity or changes in its corporate form.

Distributions of ordinary dividends and annual income under French law inure to the benefit of the usufruct holder, in contrast to accumulated reserves, which affect the company's value and are generally considered to benefit the bare owner. Hence, a usufruct holder's decision to not distribute the current-year profits of the entity may be considered the economic equivalent of an additional gift to the bare owner, but the actual transfer of the accumulated profits will later take the form under French law of a corporate distribution, either as a dividend or as liquidation proceeds. Whether the corporate form excludes the distribution from the scope of any French transfer tax is still highly debated by French courts. In one case, the highest French commercial court treated the distribution as effectively received by the usufruct holder with a debt of a corresponding amount being registered in the usufruct holder's estate at the time of his death.[2] However, the highest French civil court has ruled that the bare owner, and not the usufruct holder, has the right to receive a distribution of the accumulated reserves.[3]

The situation results in uncertainty for the U.S. bare owner about whether the appropriate way to report the accumulated earnings is as a gift from a foreign person or in accordance with its corporate form (dividend income or capital gain from liquidation proceeds). This uncertainty is further compounded when the status of the entity as a controlled foreign corporation or a passive foreign investment company is also uncertain.

Tax Treatment — Gain

The sale or other taxable disposition of property that is or was subject to a usufruct raises several questions for the U.S. bare owner. If the usufruct holder is still alive, certain transactions may entitle the bare owner to some amount of proceeds or income — such as an extraordinary dividend or a sale of the property. Whether the transaction occurs during the life of the usufruct holder or after death, a fundamental question for purposes of determining the amount of gain for the U.S. bare owner (or former bare owner, in a case in which the bare owner's interest has ripened into a full interest) is the U.S. tax basis.

Tax Basis for U.S. Purposes

In general, a U.S. bare owner should be eligible for a step- up in basis under section 1014 upon the death of a U.S. usufruct holder because the value of the divided interest property will be included in the usufruct holder's U.S. taxable estate by virtue of section 2036. Further, the IRS has ruled that a step-up in basis applies to property inherited from a non-U.S. decedent under section 1014(b)(1), irrespective of the fact that the property is not included in a U.S. taxable estate.[4]

However, we have located no direct authority that addresses whether a bare owner is entitled to a stepped-up basis under section 1014 upon the death of a *non-U.S.* usufruct holder. We have therefore approached the analysis based on

[2] Cour de cassation, Chambre commerciale, No. 14-16.246 (May 27, 2015).

[3] Cour de cassation, Première chambre civile, No. 15-19.471 (June 22, 2016).

[4] Rev. Rul. 84-139, 1984-2 C.B. 168.

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general principles relevant to both section 1015 and section 1014. In general, property acquired by gift has a carry-over basis with reference to the donor's basis, and property acquired from a decedent is eligible for a stepped-up basis under section 1014. The situation of the bare owner is a bit of a hybrid — in many cases the bare owner status would provide certain rights before the death of the usufruct holder, but the bare owner would have no possession of the property or the ability to dispose of it, realize its income, and so forth until the decedent passes away, arguably suggesting that the property would be "acquired from a decedent" within the meaning of section 1014.

If the gift of the bare ownership constitutes a completed gift for U.S. transfer tax purposes, and the bare ownership is likened to a remainder interest in property, then the carry-over basis rules of section 1015 should apply. In many cases, gifts of bare ownership interests are likely to be completed gifts[5] — but certain powers reserved by the usufruct holder could make the analysis grayer, and possibly result in an incomplete gift. Further, it is likely that most quasi-usufruct arrangements would result in the finding of an incomplete gift.

Section 1015 and the Uniform Basis Rules

Section 1015 provides that for the purposes of computing gain from property acquired by gift, the basis is the same as it would be in the hands of the donor or the last preceding owner by whom the property was not acquired by gift (special rules apply for purposes of determining loss). Reg. section 1.1015-1(b) further provides that property acquired by gift has a single or uniform basis although more than one person may acquire an interest in the property — such as in the case of a life tenant and remainderman. The rules note that the "uniform basis" of the property remains fixed subject to proper adjustment for items under sections 1016 and 1017 (such as depreciation or capital improvements). In a situation in which a completed gift of a bare ownership interest is analogized to a remainder interest, these uniform basis rules may apply to determine the amount of gain reportable by the U.S. bare owner if the underlying property is sold during the life of the usufruct holder.

The section 1015 regulations provide that the date that the donee acquires an interest in property by gift is the date on which the donor relinquishes dominion over the property and not necessarily when title to the property is acquired by the donee. Therefore:

> the date that the donee acquires an interest in property by gift where he is a successor in interest, such as in the case of a remainderman of a life estate or a beneficiary of the distribution of the corpus of a trust, is the date such interests are created by the donor and not the date the property is actually acquired.[6]

Rev. Rul. 68-268, addressing application of the uniform basis rules to the bequest of a remainder interest for purposes of sections 1014 and 1015, finds that no step-up in basis applies to take into account the increase in property value following an intervening life estate for which no value is included in the remainderman's estate.[7] It is possible therefore that the regulation cited above would apply to the ripening of a bare interest into a full interest but we have not located any authority directly on point.

1014 Basis Step-Up at Death of Usufruct Holder

Although we have not located any direct authority in the case of either a complete or incomplete gift of a bare ownership interest, we believe the likelihood of eligibility for a 1014 basis step-up would be greater in the case of an incomplete gift of a bare ownership that has ripened into a full interest upon the death of the non-U.S. usufruct holder. That said, it remains unclear whether a U.S. person whose interest in property derives from the ripening of a bare ownership interest is entitled to a section 1014 basis step-up.

The analysis of whether a gift of a bare ownership is complete or incomplete may itself be inconclusive — or at least complicated, as noted in

[5] *See, e.g.*, LTR 201825003.

[6] Reg. section 1.1015-1(c).

[7] Rev. Rul. 68-268, 1968-1 C.B. 349.

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the previous installment. Even if the facts support a finding of an incomplete gift, the consequences of that determination on the eligibility for a basis step-up under section 1014 are not well-established in the case law or other authorities. Although section 1014(a) refers generally to "acquiring the property from a decedent," to be eligible for the basis step-up, the property transfer must fit within one of the subparagraphs of section 1014(b). In the case of an incomplete gift of the bare ownership, the bare owner's full interest in the property upon the death of the usufruct holder could arguably be said to have been "acquired by bequest, devise, or inheritance" within the meaning of section 1014(b)(1).

In our view, it seems reasonable that if property was the subject of a gift that only became complete upon an individual's death, then it would be properly categorized as "inherited." In other words, the purported "gift" of the bare ownership was incomplete for U.S. transfer tax purposes — and therefore the property would only be deemed acquired upon death.

However, the IRS generally considers property that would fall under section 1014(b)(1) to be comprised of a decedent's probate estate.[8] Reg. section 1.1014-2(a)(1) provides that "property acquired by bequest, devise or inheritance, or by the decedent's estate from the decedent, whether the property was acquired under the decedent's will or under the law governing the descent and distribution of the property of decedents" is considered to have been acquired from a decedent. Significantly, there is no equivalent to probate or section 2036 under French law and therefore neither the usufruct interest (which terminates by operation of French law), nor the bare ownership interest, causes the property to be included in the French estate.

Accordingly, the French notary who is charged with administering the estate under French law will not include the property in the estate tax return. However, the property may be taken into account for purposes of determining the forced heirship rules under French law, or in other ways that make it in the nature of a testamentary transfer rather than an *inter vivos* gift. Because there may be no foreign law equivalent to probate or even the notion of an estate as a legal person, we believe the meaning in section 1014(b)(1) of "property received by bequest, devise or inheritance, or by the decedent's estate from the decedent" should be analyzed in the context of the applicable foreign rules.

Section 1014(b)(2) and (b)(3) each allow a basis step-up for certain trust transfers involving powers retained by the decedent until death. Those sections describe arrangements that are also incomplete gifts for U.S. transfer tax purposes, thereby implying that section 1014(b)(1) does not operate to provide a basis step-up to all arrangements that become completed transfers upon a decedent's death. But because those sections deal exclusively with trusts, they do not shed light on the full extent to which non-trust arrangements that become completed transfers at death might fall within section 1014(b)(1).

If the property cannot be said to fall within the category of property described in section 1014(b)(1), and the usufruct and bare ownership arrangement does not qualify as a trust within the meaning of section 1014(b)(2) or (b)(3),[9] there is a risk that the IRS could argue that the best fit within section 1014(b) would be section 1014(b)(9), which is a catchall provision that requires inclusion in the decedent's U.S. gross estate to be eligible for a basis step-up. In the typical situation in which this question arises, the usufruct holder and decedent is a nonresident alien, and the property at issue is not U.S.-situs. Therefore, the requirement of inclusion in a U.S. gross estate would not be satisfied, in which case the property would *not* be eligible for a basis step-up if a section 1014(b)(9) analysis applies.[10]

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[8] *See, e.g.*, *Collins v. U.S.*, 318 F. Supp. 382 (C.D. Cal. 1970) (contract rights were not part of the decedent's probate estate and hence were not eligible for a basis step-up under section 1014(b)(1)). *See also Wasserman v. Commissioner*, 24 T.C. 1141 (1955) (partnership interest was held to have passed by the terms of the partnership agreement rather than the laws of intestacy, and hence the transfer was by contract and not testamentary. As a result, the property did not fall within the predecessor to section 1014(b)(1)). *See also* reg. section 1.1014-2(a)(1).

[9] Qualification as a trust would seem to be the exception to the rule, based on the authorities cited above.

[10] *See also* reg. section 1.1014-2(b), noting that property included in the catchall "does *not* include property not includible in the decedent's gross estate *such as property not situated in the United States acquired from a nonresident who is not a citizen of the United States*." (Emphasis added.)

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The requirement under the catchall that the property be includable in a U.S. gross estate to be eligible for a basis step-up appears inconsistent with the holding of Rev. Rul. 84-139. In that ruling, a U.S. individual inherited real property located in a foreign country from a nonresident alien decedent who was a resident in that country under its laws. The ruling held that the U.S. heir was entitled to a basis step-up, notwithstanding the language of section 1014(b)(9), because the individual inherited the property within the meaning of section 1014(b)(1), which, when applied, operates to provide the basis step-up instead of section 1014(b)(9).[11] Because the property fell within section 1014(b)(1), it was immaterial that it was not includable in the decedent's U.S. gross estate.

The general counsel memorandum associated with the 1984 revenue ruling noted above explains that estate inclusion was not meant to be a universal requirement and goes through some of the history behind the section 1014 basis step-up. It also points out how these rules are arguably problematic in the case of foreign situs property acquired from a nonresident alien, because the qualification for a basis step-up depends on the form of acquisition. It notes:

> For example, such property would qualify [for the step-up] if inherited, but would not if it were acquired by survivorship rights through a joint tenancy.

To the extent an incomplete gift of a bare ownership's ripening into a full interest upon the death of the usufruct holder is analogized by the IRS to a joint tenant survivorship scenario or an acquisition by contract, as in the *Wasserman* case noted above, there is a risk that section 1014(b)(9) would apply. In the French context, the lack of a need for involvement by a notary in the context of a usufruct arrangement might be said to be analogous to a nonprobate transfer such as joint survivorship rights, but it is not entirely clear how the 1014(b) rules would apply.

Rev. Rul. 2023-2 sheds some light on the government's view of these section 1014 rules.[12] In it, the IRS states that, in the case of an irrevocable trust settled by a decedent over which the decedent had retained a power to be treated as its tax owner under the grantor trust rules, but where the transfer of assets to the trust was a completed gift for gift tax purposes and not includable in the decedent's gross estate, the basis of the assets would not be stepped up under section 1014(a), because the asset was not acquired from the decedent within the meaning of 1014(b).

The ruling summarized the section 1014 regulations as well as Rev. Rul. 84-139, noted above. For the property at issue to be eligible for a basis step-up, the facts must fall within one of the section 1014(b) subparagraphs. It analyzed whether any of the subparagraphs applied, dedicating most of the analysis to section 1014(b)(1).

The government expounded on the meaning of the words bequeathed, devised, and inherited. The ruling notes:

- a "bequest" is the act of giving property (usually personal property or money) by will, citing *Black's Law Dictionary* and Supreme Court precedent;[13]
- a "devise" is the act of giving property, especially real property, by will; and
- an "inheritance" is property received from an ancestor by bequest or devise under the laws of intestacy or property.[14]

In the case of property transferred in trust, the IRS found that it was not the decedent's death that transferred the assets — so section 1014(b)(1) did not apply. The IRS also cited *Collins*, noted above, connecting property falling under section 1014(b) to the concept of a probate estate. To the extent a U.S. bare owner has not received a "full interest" in the property upon the death of the usufruct owner by any bequest or devise given the absence of any mention of the transfer in the usufruct holder's will, the acquisition is left with the laws of intestacy. Based on what we view as a relatively narrow parsing of section 1014(b)(1), there is a risk that the government might not view the ripening of a bare ownership interest — even in a case in which, by virtue of the gift being

[11] *See* section 1014(b)(9)(C).

[12] Rev. Rul. 2023-2, 2023-16 IRB 658.

[13] *U.S. v. Merriam*, 263 U.S. 179, 184 (1923).

[14] Again, citing *Black's Law Dictionary*.

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incomplete, the bare owner had nothing from a U.S. transfer tax perspective before death — as falling within section 1014(b)(1).

Despite this recent authority, in our view, the fundamental question for the U.S. bare owner remains unresolved, and merits a detailed review of the facts relevant to the particular situation.

Application of Antideferral Regimes

CFC Rules

As noted in the previous installment, antideferral regimes, such as the CFC rules and the PFIC rules, may apply when a U.S. person has an interest in a non-U.S. corporation.

Under prior law, a bare owner's economic interest would not have been enough to classify a foreign corporation as a CFC, absent facts that established some amount of vote for the bare owner. The determination of the entity's status would therefore have required a detailed facts and circumstances analysis of whether the voting rights, which may have been split between the usufruct holder and bare owner, resulted in effective control of the foreign entity for purposes of section 957(a)(1). While there is extensive case law in this area, we are not aware of any authority that directly addresses the split of voting rights between a non-U.S. usufruct holder and a bare owner.[15]

Based on changes to the CFC rules under the Tax Cuts and Jobs Act, effective beginning in 2018, it is possible that the attribution of enough value to a bare owner of a non-U.S. company might tip the scale toward classifying that entity as a CFC, notwithstanding the fact that voting control remains with the non-U.S. usufruct holder or other shareholders.[16]

For example, suppose an 80-year-old nonresident alien owns 90 percent of the shares of a French company in full ownership. The 10 percent remaining shares are held by a U.S. person in full ownership. On these facts, the French company would not be a CFC.

However, if that nonresident alien makes a gift of the bare ownership of her shares to her U.S. daughter, the U.S. daughter would be attributed 70 percent of her mother's 90 percent of the value of the company for French transfer tax purposes.[17] However, the mother would retain the right to control 100 percent of the income of the French company, because of her ability to cause the company to either distribute the income as current-year dividends or to accumulate the income and attribute it to the bare owner.

On these facts, the bare owner could be considered to have a greater-than 50 percent economic interest in the foreign company, which, under the current rules of sections 951(b) and 957, would appear to classify the company as a CFC. However, based on LTR 8748043, we believe that an important factor in the analysis as to whether the bare owner would be required to include any subpart F income (or global intangible low-taxed income) would be the extent of the bare owner's entitlement to dividend distributions. The IRS's reasoning in LTR 8748043 was based on reg. section 1.958-1(c)(2), noting that the determination of a person's proportionate interest in a foreign corporation is made on the basis of all facts and circumstances, and that a person's proportionate interest in a foreign corporation will generally be determined with reference to the person's interest in the income of the corporation.

Although as a mere bare owner, the U.S. daughter in this example may not have any income inclusions under section 958(a),[18] if the foreign corporation were nonetheless classified as a CFC, the classification could have ricochet effects for the other U.S. owner(s). For example, the 10 percent minority U.S shareholder may need to include subpart F income or GILTI if the French company is a CFC. If instead of there being a single 10 percent U.S. owner, there were two unrelated 5 percent U.S. owners, other complications could arise. If the company is treated as a CFC based on the valuation rule described above, under the rules for valuing assets for purposes of the PFIC rules under section 1297(e), the company may wind up being

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[15] *See, e.g.*, *Framatome Connectors USA Inc. v. Commissioner*, 118 T.C. 32 (2002).

[16] *See* section 951(b).

[17] We note that for U.S. tax purposes, the actuarial interests would usually differ from the French law determination. One might look to reg. section 1.958-2(c)(1)(ii) in applying the general all facts and circumstances analysis for purposes of the constructive ownership rules.

[18] *See* LTR 8748043, discussed above.

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classified as a PFIC because of the inability to use fair market value for purposes of the asset test, which could be hugely detrimental to the minority U.S. shareholders.

PFIC Rules

Even if the ownership structure of the foreign company is outside of the CFC rules, questions of PFIC status for the bare owner may arise. The PFIC rules are notoriously complex, and difficult enough to apply in the case of typical full ownership of PFIC stock. An attempt to apply the rules in the context of a usufruct/bare ownership split is subject to yet another level of complexity.

While we have not identified any authorities directly on point, arguably, the analysis of LTR 8748043 should apply in the PFIC context as well; that is, the antideferral rules should not apply to a bare owner when it is the non-U.S. usufruct holder that is entitled to dividends or other distributions. This approach would be consistent with reg. section 1.1291-9(j)(1), which provides that in the context of a deemed dividend election, a corporation will not be treated as a PFIC in relation to a shareholder for those days included in the shareholder's holding period when the shareholder, or a person whose holding period of stock is included in the shareholder's holding period, was not a U.S. person within the meaning of section 7701(a)(30). How the holding period rules apply upon the ripening of a bare ownership interest and eligibility for certain PFIC-related elections, such as a qualified electing fund election, is also unclear.

Foreign Information Reporting

In the case of a completed gift of a bare ownership interest, we believe the bare owner would be required to report the asset on the relevant foreign information return (for example, Form 5471, Form 8865, Form 3520, Form 8938, and so forth) and on the foreign bank account report, perhaps with a footnote to explain the nature of the interest. Indeed, LTR 201032021 held that a completed gift of a bare ownership interest is subject to reporting under section 6039F (which corresponds to Part IV of Form 3520).

In the case of an incomplete gift of a bare ownership interest, the bare owner might consider reporting on a protective basis. Consideration should also be given as to whether Form 3520 should be filed upon the death of the usufruct holder.

Exit Tax Consequences

As noted in the previous installment, the exit tax rules raise a number of questions, in large part because of their reliance on transfer tax concepts that are difficult to apply to a usufruct/bare ownership situation.

If a bare owner expatriates from the United States, it would first be necessary to determine whether the bare owner should be treated as owning the future interest for purposes of both the net worth test and the mark-to-market tax under 877A by undertaking a U.S. transfer tax analysis. In the case of an incomplete gift of a bare ownership interest, we believe the value should not factor into the net worth of the individual, and the assets subject to the usufruct should not be subject to the mark-to-market tax.

If the bare owner has received the remainder interest in a transfer from the usufruct owner and donor that is better classified as a completed gift for U.S. transfer tax purposes, we believe that the value of the remainder interest may be included in the net worth test. Notice 97-19[19] provides that for purposes of the net worth test, an individual is considered to own any interest in property that would be taxable as a gift under chapter 12 of subtitle B of the code if the individual were a citizen or resident of the United States who transferred the interest immediately before expatriation. The notice provides specific rules for valuing interests in trusts and provides an example in which a trust beneficiary's life interest must be valued. Thus, although a bare owner may not be capable of gifting an interest to another, the rules applicable to trusts suggest that the value of that partial interest in the property does count for purposes of the $2 million net worth threshold.

If the value of the bare owner's net assets is high enough, then the question of how to apply the mark-to-market tax in relation to the bare ownership interest will arise. For purposes of determining the mark-to-market gain, a covered expatriate is considered to own any interest in

[19] Notice 97-19, 1997-1 C.B. 394.

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property that would be taxable as part of the gross estate for federal estate tax purposes as if the expatriate had died on the day before the date of departure as a citizen or resident of the United States, and an individual is deemed to own the beneficial interests in each trust or portion of a trust — even if that trust would not constitute part of the gross estate.[20] We believe the uniform basis rules may apply for determining this mark-to-market tax — although we have found no authority on point.[21] We note that in the exit tax context, the expatriate (if a non-U.S. citizen) should be eligible for a basis step-up upon first acquiring U.S. resident status. It is not clear how this basis step-up upon residency acquisition would apply if the uniform basis rules also apply — it would seem the step-up would be of the entire uniform basis, as opposed to the bare owner's portion.

In short, the intersection of the unsettled U.S. tax treatment of usufruct and bare ownership property divisions with another very much undeveloped area of the law, the exit tax rules, leaves many questions unanswered.

[20] Notice 2009-85, 2009-45 IRB 598.

[21] *See* reg. section 1.1014-5.

Conclusion

While the discussion in this article does not clear the minefield of uncertainties that are presented by the divided interest strategy when the bare owner is a U.S. person, we hope it will help an adviser plan for the consequences of the divided interest strategy at the various stages of ownership. Too often, the client will contact the adviser either after the gift of the bare ownership has been made or with the simple question of whether the gift is taxable in the United States. While it is usually easy to assure the client that the gift is not taxable to the bare owner for U.S. purposes, the more challenging questions are discussed in this Part III. It is critical for the U.S. tax adviser to work closely with the foreign tax counsel to determine whether the future taxable events and U.S. antideferral regimes that may apply to the bare owner could nullify, in whole or in part, the foreign estate tax planning that is the motivation for the nonresident alien owner gifting the bare ownership. ■

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