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a closer look

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GLOBAL TAX WEEKLY a closer look

Global Tax Weekly – A Closer Look

Combining expert industry thought leadership and the unrivalled worldwide multi-lingual research capabilities of leading law and tax publisher Wolters Kluwer, CCH publishes Global Tax Weekly — A Closer Look (GTW) as an indispensable up-to-the minute guide to today's shifting tax landscape for all tax practitioners and international finance executives.

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Topicality, thoroughness and relevance are our watchwords: CCH's network of expert local researchers covers 130 countries and provides input to a US/UK

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Alongside the news analyses are a wealth of feature articles each week covering key current topics in depth, written by a team of senior international tax and legal experts and supplemented by commentative topical news analyses. Supporting features include a round-up of tax treaty developments, a report on important new judgments, a calendar of upcoming tax conferences, and "The Jester's Column," a lighthearted but merciless commentary on the week's tax events.

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Practitioners Beware: Usufruct May Provide Pitfalls In The US

by Simone Alting,
Schwartz International



Introduction

In European civil law countries, a common estate tax planning tool is for parents, during their lifetime, to transfer the "bare ownership" of property to their children while retaining the usufruct rights which gives them the right to the income and the enjoyment of the property until their death. A usufruct is comparable to the life estate and the bare ownership is comparable to the remainder interest in Common Law jurisdictions.

Collins Dictionary of Law [© W.J. Stewart, 2006] defines "usufruct" as: *The right of enjoying a thing, the property of which is vested in another, and to draw from the same all the profit, utility and advantage which it may produce, provided it be without altering the substance of the thing.*

This planning tool is popular for reasons that the transfer of the bare ownership is valued at less than the transfer of the full ownership, reducing the gift tax base and thus the resulting gift tax liability at the time of the transfer.¹ In addition, some countries, such as Germany, allow for a full amount of gift tax exemption for transfers every ten years, in which case parents can transfer property valued at EUR400,000 (USD465,477) every ten years to each child.²

To understand this concept, it has to be noted that the European gift and inheritance tax laws are structurally different from those in the US. While the US taxes the "estate" of a decedent and the "estate tax" is paid by the estate before any assets are distributed to heirs, under many European jurisdictions' inheritance tax law the heir is taxed on his or her share of the inherited property at rates that vary depending on the relationship to the decedent (1st degree, 2nd degree, *etc.*).

Usufruct From A US perspective – Internal Revenue Code §2036

While for European estate planning purposes the "usufruct" may be a perfect planning tool because, upon death of the usufructuary, the transfer of the decedent' *usufruct* interest to the

bare owner is not a taxable event for inheritance tax purposes, the US estate tax laws take a different approach.

A transfer of a property by an owner during his or her lifetime (*inter vivos*) who retains a beneficial interest in the property will constitute an incomplete transfer for gift and estate tax purposes. §2036(a)(1) requires inclusion in the gross estate the value of property transferred during life if the decedent retained the "*possession or enjoyment of, or the right to income from, the property ...*".

§2036(a)(1) will apply if: (1) the decedent/transferor made a transfer of the property during lifetime; (2) the decedent/transferor retained the possession or enjoyment of, or right to the income from, the transferred property; (3) the interest was retained for life or for any period not ascertainable without reference to the transferor's death or for any period which does not in fact end before his or her death; and (4) the transfer was made after June 6, 1932.³

The statute is as far reaching as to include a mere "right to income," even if the transferor does not expressly reserve that right.⁴ Equally, transfers subject to an understanding, express or implied, that the transferor would receive income or corpus or both when requested, would subject the transferred property to §2036(a)(1).⁵

Thus, according to the Internal Revenue Code, the common European practice of transferring the underlying property to a child during lifetime while retaining the use or benefits of the property will lead to an incomplete transfer such that the property will be included in the decedent's gross estate for US tax purposes.

Conclusion

Often US tax practitioners are confronted with a client who is an owner of a usufruct right and who has since moved to the US. As discussed above, due to the differing concepts in Civil and Common law jurisdictions, a usufruct interest may result in different consequences depending on the facts and circumstances surrounding its transfer. While constituting a valuable estate planning technique for European tax purposes, it may have far-reaching consequences if practitioners are not aware of the US tax and reporting rules.

ENDNOTES

¹ For example, under Article 669, I of the French General Tax Code, valuing is done by applying a scale that takes the life expectancy of the usufructuary into account because usufruct only exists during the

lifetime of the person who holds it. For Germany, see *Bundesfinanzministerium, Anlage zu § 14 Absatz 1 BewG* (German Valuation Tax Code).

² § 14 and 16 ErbStG (German Gift and Inheritance Tax Code).

³ Special rules apply to transfers after March 3, 1931 and before June 7, 1932.

⁴ See *Estate of McNicol v. Commissioner*, 265 F.2d 667 (3d Cir 1959).

⁵ "... an interest or right is treated as having been retained or reserved if at the time of the transfer there was an understanding, express or implied, that the interest or right would later be conferred." *Estate of Paxton v. Commissioner*, 86 T.C. 785 (1986).