

Usufructuary Taxation - Avoiding the Zero Basis

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defense to the alleged illegality;¹⁴¹ it thus may be necessary to be able to put forward several concurrent defenses in order to deny the tie.¹⁴²

Jerald L. Perlman

USUFRUCTUARY TAXATION— AVOIDING THE ZERO BASIS

The usufruct is a commonly occurring Louisiana property right, primarily due to the effect of article 916 of the Louisiana Civil Code,¹ which establishes, in the case of an intestate decedent, a usufruct in favor of the surviving spouse on the decedent's share of the community property. Because the usufruct is created frequently and since recent amendments to the Internal Revenue Code of 1954 have increased the possibility that the usufructuary will be exposed to income tax liability, it is important that such amendments and their effect be reviewed. Section 1001(e)² of the Internal Revenue Code of 1954,³ which was enacted by section 516(a) of the Tax Reform Act of 1969,⁴ provides in part that the basis for determining gain or loss on a term

141. Austin, *The Tying Arrangement: A Critique and Some New Thoughts*, 1967 Wis. L. Rev. 88, 122-23.

142. United States v. Jerrold Electronics Corp., 187 F. Supp. 545 (E.D. Pa. 1960), *aff'd mem.*, 365 U.S. 567 (1961). The leading case on tie-in defenses, required three: goodwill, single product, and new product.

1. LA. CIV. CODE art. 916: "In all cases, when the predeceased husband or wife shall have left issue of the marriage with the survivor, and shall not have disposed by last will and testament, of his or her share in the community property, the survivor shall hold a [in] usufruct, during his or her natural life, so much of the share of the deceased in such community property as may be inherited by such issue. This usufruct shall cease, however, whenever the survivor shall enter into a second marriage."

2. "Sec. 1001(e) CERTAIN TERM INTERESTS.—

"(1) IN GENERAL.—In 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 or 1015 (to the extent that such adjusted basis is a portion of the entire adjusted basis of the property) shall be disregarded.

"(2) TERM INTEREST IN PROPERTY DEFINED.—For purposes of paragraph (1), the term 'term interest in property' means—

(A) a life interest in property,
(B) an interest in property for a term of years, or
(C) an income interest in a trust.

"(3) EXCEPTION.—Paragraph (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." INT. REV. CODE OF 1954, § 1001(e), enacted by H.R. 13270, 91st Cong., 1st Sess. § 516(a) (1969).

3. All references to section numbers are to the Internal Revenue Code of 1954 unless otherwise specified.

4. H.R. 13270, 91st Cong., 1st Sess. (1969).

interest in property,⁵ acquired by gift or inheritance, shall be zero where the term interest is sold or otherwise disposed of. The purpose of this Comment is to examine in detail how this new subsection affects income, gift and estate tax planning.

Prior Law

An examination of the rules for computing the basis of the usufruct which had developed prior to the enactment of the Tax Reform Act of 1969 is required for a proper understanding of the new section 1001(e). When a usufruct is acquired by inheritance, the fair market value of the property subject to the usufruct on the date of death (or alternate valuation date⁶ if used) is the foundation for the computation of the basis of the usufruct.⁷ In the case of a gift of a usufruct, the basis of the property subject to the usufruct in the hands of the donor is the foundation.⁸ The applicable value⁹ (fair market value for inheritance or donor's basis for gift), referred to as the "uniform basis," is then apportioned between the usufructuary and

5. A term interest in property is defined by section 1001(e)(2) as a life interest in property, an interest in property for a term of years, or an income interest in a trust. Although this comment is primarily concerned with the usufructuary's interest (a life interest in property), most of the material discussed would be equally applicable to the other type of term interests in property. It is beyond the scope of this comment to attempt to distinguish between the civil law usufruct and its common law counterpart, the life estate. For present purposes, the two are treated as equivalents.

6. The alternate date for the valuation of the gross estate is established by section 2032 of the Internal Revenue Code of 1954. The alternate date for the valuation of the estate was recently changed from one year after the decedent's death to six months after decedent's death. *See* H.R. 13270, 91st Cong., 1st Sess. § 101(a) (1969).

7. "[T]he basis of property in the hands of a person acquiring the property from a decedent or to whom the property passed from a decedent shall, if not sold, exchanged, or otherwise disposed of before the decedent's death by such person, be the fair market value of the property at the date of the decedent's death . . ." INT. REV. CODE of 1954, § 1014(a).

8. This assumes that the adjusted basis of the property is less than the fair market value of the property, but it does represent the basic rule. The complete rule states that "[i]n the case of property acquired by gift . . . the basis of the property for the purpose of determining gain is the same as it would be in the hands of the donor [i.e., the donor's basis]. . . . The same rule applies in determining loss unless the basis . . . is greater than the fair market value of the property at the time of the gift. In such case the basis for determining loss is the fair market value at the time of the gift." Treas. Reg. § 1.1015-1(a), T.D. 6265, 1957-2 CUM. BULL. 490.

9. This value is referred to as the uniform basis of the property. Any adjustment to the basis of the property either by the usufructuary or the naked owner is made to this uniform basis. The apportionment is only made at the time when it becomes necessary to ascertain the basis of the usufructuary's or naked owner's interest therein. *See* Treas. Reg. §§ 1.1014-4, 1.1014-5, and 1.1015-1(b), T.D. 6500, 1963-2 CUM. BULL. 327.

the naked owner in accordance with the annuity table provided in the Estate Tax Regulations at section 20.2031-11.¹⁰ This apportionment is based on the life expectancy of the usufructuary and is essentially a method for assigning to the usufructuary a portion of the total basis in the property that fairly represents his ownership interest therein.¹¹

Section 273¹² states that the basis of a usufruct acquired by gift, bequest, or inheritance shall not be amortizable.¹³ However, this section does not apply when the usufruct is sold. When a usufruct is sold its new basis,¹⁴ the purchase price, is amortizable over the life of the usufruct and is deductible under section 167.¹⁵ This interpretation of section 273 was recently affirmed by implication in the Ninth Circuit's decision in *Gist v. United States*.¹⁶ There the amortization was allowed as a deduction, but only for the cost of the life estate acquired by purchase and not for that portion acquired by inheritance.

The income tax consequences of the sale of a usufructuary's

10. The valuation factors for all forms of life estates, remaindermen and annuities were recently revised. For deaths or gifts prior to December 31, 1970, the tables presented at Treas. Reg. § 20.2031-7(f) which are based on a 3½% interest rate may be used. For deaths or gifts after December 31, 1970, the tables at Treas. Reg. § 20.2031-11 must be used. These new tables reflect a revision in the mortality tables (reflecting separately the mortality rates of males and females) and an increase to a 6% interest rate. *See generally* Treas. Reg. §§ 20.2031-7, 20.2031-11 (1970).

11. For example, if the uniform basis of the whole property is \$100,000 and the usufructuary is 60 years of age, then if the usufructuary is female the usufruct would have a basis of \$63,226 and the naked ownership would have a basis of \$36,774. If the usufructuary is male, then the basis of the usufruct would be \$55,052 and the basis of the naked ownership would be \$44,948. Under the prior regulation (Treas. Reg. § 20.2031-7(f)), the basis of the usufruct would have been \$39,879 and the basis of the naked ownership would have been \$60,321 regardless of whether the usufructuary were male or female.

12. "Amounts paid under the laws of a State, a Territory, the District of Columbia, a possession of the United States, or a foreign country as income to the holder of a life or terminable interest acquired by gift, bequest, or inheritance shall not be reduced or diminished by any deduction for shrinkage (by whatever name called) in the value of such interest due to the lapse of time." INT. REV. CODE of 1954, § 273.

13. The amortization referred to here is the allocable portion which, if deductible, would be deductible under the provisions of section 167.

14. This new basis is referred to as a purchased basis. It should be distinguished from the basis of a usufruct acquired through gift or inheritance.

15. *Commissioner v. Fry*, 283 F.2d 869 (6th Cir. 1960), and *Bell v. Harrison*, 212 F.2d 253 (7th Cir. 1954), hold that the purchaser of a life estate may amortize the cost of the life estate ratably over the life expectancy of the beneficiary. These cases dealt with the purchaser of the interest of a life beneficiary of a trust. After the Commissioner's contentions were rejected in the *Fry* case, he acquiesced to the holding in those cases. *See* Rev. Rul. 132, 1962-2 CUM. BULL. 73.

16. 423 F.2d 1118 (9th Cir. 1970).

interest can best be illustrated by example. Assume that *W* inherits a perfect¹⁷ usufruct on certain property with the value of the usufruct computed to be \$10,000. This \$10,000 is thus the basis for *W*'s usufructuary interest. Assume further that *W*'s life expectancy is five years, that the property subject to the usufruct will generate \$2,000 of income annually, and that on the same date which *W* inherits this usufruct she sells it to *X* for \$10,000 (her portion of the uniform basis). The purchaser of the usufruct, *X*, has a basis of \$10,000 therein. Since this is a purchased basis, it is amortizable by *X* over the life expectancy of *W* in accordance with Revenue Ruling 62-132,¹⁸ and this amortization is deductible under section 167 from the income generated by the property. The tax consequences to *X* have not been altered by the enactment of section 1001 (e); however, the consequences to *W* have been changed. Prior to its enactment, *W* would have had no taxable gain or loss on the sale because her basis of \$10,000 exactly offsets the sales price.¹⁹

An examination of this transaction reveals that when the usufruct was sold to *X*, *W* collected in one lump sum all of the profits expected to be generated by the property subject to the

17. The perfect usufruct is the only type of usufruct to which section 1001(e) could apply. If the usufruct were imperfect, under Louisiana Civil Code article 536, the usufructuary would become the perfect owner of the property subject to the usufruct. Since section 1001(e) only applies to a *term* interest in property, and since the term interest is extinguished in the case of an imperfect usufruct, that section is inapplicable.

18. Rev. Rul. 132, 1962-2 CUM BULL. 73.

19.

Under prior law:	Year 1	Year 2	Year 3	Year 4	Year 5	Total
If usufructuary retained the usufruct then:						
W's taxable income	<u>\$2,000</u>	<u>\$2,000</u>	<u>\$2,000</u>	<u>\$2,000</u>	<u>\$2,000</u>	<u>\$10,000</u>
If usufructuary sells the usufruct then:						
	\$10,000 Sales price (10,000) Basis					
W's taxable income	<u>\$ -0-</u>	Gain on sale				\$ -0-
X's taxable income						
Income of usufruct	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000	
Basis amortization	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)	
Taxable income	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>
Total taxable income of <i>W</i> & <i>X</i>						<u>\$ -0-</u>

Thus, under the prior law, \$10,000 escapes taxation when the usufruct is sold.

no loss on the sale can be recognized. This zero basis has the effect of treating the amount received on the sale of the usufruct almost as if it were the future income inuring to the benefit of the usufructuary.²³ The purchaser, X, will have taxable income only to the extent that the income produced by the usufruct exceeds his purchased amortizable basis.

This unique solution, reducing the basis for gain or loss to zero, has the effect of creating taxable income in the person who was able to avoid income taxes prior to the amendment. The only inequity apparently remaining in this solution is that the total sales price is taxed as a lump sum in one year, whereas if the usufructuary retains the usufruct, the income is taxed over the life of the usufruct. However, since the usufruct usually qualifies as a capital asset,²⁴ the benefits conferred on such assets as well as those benefits contained in the installment sale provisions of the Internal Revenue Code²⁵ should provide adequate relief. If the draftsmen actually intended to equalize the tax consequences in the situation where the usufruct is sold with those where it is not sold, they should have excluded the usufruct from the capital asset classification and provided for a ratable inclusion of the sales price in the selling usufructuary's gross income over the life of the usufruct. This, however, presupposes that the usufructuary will live as long as his expected life; otherwise some income would go untaxed. One important

If usufructuary sells the usufruct then:

	\$10,000 Sales price						
	(-0-) Basis						
W's taxable income	<u>\$10,000</u> Gain						\$10,000
X's taxable income							
Income of usufruct	\$2,000	\$2,000	\$2,000	\$2,000	\$2,000		
Basis amortization	(2,000)	(2,000)	(2,000)	(2,000)	(2,000)		
Income	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	<u>-0-</u>	
Total taxable income of W & X							<u>\$10,000</u>

Thus, the amendment to section 1001 does in effect tax W on the same total amount as if the usufruct had not been sold.

23. This is to say that whatever the usufructuary receives on the sale of the usufruct is considered as a fair price for the estimated future returns from the usufruct. The zero basis treats the proceeds of this sale just as the yearly earnings would have been treated, except that the sale of the usufruct could generate capital gains rather than ordinary income.

24. The scope of this paper does not lend itself to a discussion of which usufructs are capital assets and which ones are not. Suffice it to say that generally the usufruct will qualify as a capital asset under section 1221.

25. See INT. REV. CODE of 1954, § 453(b).

exception to the application of the zero basis is provided by section 1001(e) (3),²⁶ which will be discussed *infra*.

Type of Transactions Covered

Section 1001(e) applies to sales and other dispositions of a term interest in property. To determine what transactions are covered by the term "other dispositions," it is necessary to evaluate various transactions in light of the legislative intent behind the enactment of that section. Since the term "sale or other disposition" is used not only in paragraph *e* of section 1001, but also in paragraphs *a* and *b*, consideration must be given to the rulings under these latter paragraphs.

A gift may be classified in some situations as an "other disposition." Where one taxpayer donates his usufruct to another, the zero basis is totally inapplicable. Since there is no gain or loss recognized by the donor on the transaction, there is no reason to use any basis, much less the zero basis. Furthermore, since the basis of property acquired by gift is not amortizable,²⁷ the problem of the creation of a new basis does not arise and there should be no reason for the application of the provisions of this section.

In analyzing the effect of this section on exchanges, taxable and non-taxable exchanges must be considered separately. In the case of taxable exchanges, the basis of the acquired property is the fair market value of property transferred.²⁸ Although there appear to be no cases directly on point, it seems that the basis of a usufruct acquired through a taxable exchange would be an amortizable basis in the hands of the purchaser just as any other purchased basis, and thus the zero basis provision should apply for the purpose of computing gain or loss.

In the case of non-taxable exchanges, the provisions of section 1001(e) appear inapplicable. If the exchange qualifies under

26. INT. REV. CODE of 1954, § 1001(e)(3). See text accompanying note 34 *infra*.

27. INT. REV. CODE of 1954, § 273 specifically forbids the amortization of the basis of property acquired by gift.

28. The basis of property acquired in a taxable exchange is determined under section 1012. "The basis of property shall be the cost of such property. . . ." INT. REV. CODE of 1954, § 1012. "The cost is the amount paid for such property in cash or other property." Treas. Reg. § 1.1012-1(a), T.D. 6265, 1957-2 CUM. BULL. 470.

the non-taxable provisions of the Code,²⁹ there is no taxable gain or loss. Just as in the case of the gift, if no gain or loss is recognized, then there is no need for a basis. Furthermore, the basis of the property received in a tax-free exchange is the basis of the property transferred plus or minus the boot and plus any gain recognized.³⁰ Since the foundation of the basis of the new property is the basis of the old property, it seems that this is not a new purchased basis which is amortizable. Although there appear to be no cases on point, the basis of the acquired property should be merely a continuation of the basis of the disposed usufruct; if the basis of the old usufruct was not amortizable, then the new basis should not qualify for amortization.

It is beyond the scope of this Comment to analyze all of the various transactions involving the acquisition of a term interest in property through gift or inheritance. However, the general rule appears to be that if no new amortizable basis is created, there is no reason for the provisions of section 1001 (e) to apply. It seems that the provisions of that section were intended to apply to sales and taxable exchanges, but not to gifts and non-taxable exchanges.³¹

Tax Planning After the Amendment

This new section should not have any material effect on present estate tax planning. Before this section becomes operative, four elements must be present: (1) there must be a term interest in property; (2) the term interest must have been acquired by gift or inheritance; (3) there must be a subsequent sale or other disposition of the term interest; and (4) the sale or other disposition must produce gain or loss. An absence of any one of these elements in a particular transaction would prevent application of the zero basis provisions of section 1001 (e).

The most obvious way to avoid the application of this section is not to create a usufruct at all. In many instances the creation of the usufruct may be avoided and the desired result achieved by donating the perfect ownership of a portion of cer-

29. The common nontaxable exchanges are set forth in Part III of Subchapter O of the Internal Revenue Code of 1954. See INT. REV. CODE of 1954, §§ 1031-1039.

30. This is the essence of the general provision of section 1031(d). The important concept to be noted is not the actual method of computing the basis of the new property, but rather that the basis of the new property is the basis of the old property.

31. See 4 P-H 1971 FED. TAXES ¶ 31,106-115.

tain property rather than the usufruct on the entire property. In attempting to remove the second element from the usufructuary interest, a transaction other than a gift or inheritance must be used. In some cases the outright sale of the usufructuary's interest and a later gift of the purchase price might be advantageous. Since the true value of the usufruct is indeterminable due to the necessary reliance on the estimated future income and the life expectancy of the usufructuary, the usufruct could be sold at a reduced price without violating the Louisiana law dealing with lesion beyond moiety³² or collation.³³ The third and fourth elements, a sale or other taxable disposition, arise only after the usufruct has been created. Thus, this area does not lend itself to estate planning, but rather to the income tax planning of the usufructuary.

As the above analysis indicates, estate planning around section 1001(e) is limited. The majority of the planning in this area will involve attempting to avoid the income tax consequences caused by the application of the zero basis upon the disposition of an existing usufruct which was acquired through gift or inheritance. Here, planning must center around the exception to the application of the zero basis provided in paragraph three of subsection 1001(e). That paragraph provides that the zero basis shall not apply where the sale or other disposition "is a part of a transaction in which the entire interest in property is transferred to any person or persons."³⁴ This exception clearly indicates that the usufructuary and the naked owner can join together and transfer the property in a single transaction to a third party who would become the perfect owner of the property. The reason for the exception is clear: Where the third party acquires the property in perfect ownership, no new amortizable basis is created because the usufruct no longer exists. Thus, there is no income tax avoidance. The Senate Finance Com-

32. Before lesion beyond moiety can be established, there must be a material discrepancy in the value of the thing transferred and the value of the thing received. Thus, the value of the thing transferred is the determinative issue. If lesion beyond moiety were to be alleged upon the sale of a usufruct, the person alleging such lesion must prove the value of the usufruct. See LA. CIV. CODE art. 1870. Due to the difficulty of ascertaining the value of the usufruct, it is almost impossible to establish lesion beyond moiety on the sale of a usufruct. See generally LA. CIV. CODE arts. 1860-80.

33. In the case of collation, as in the case of lesion, the value of the usufruct must be established. The difficulty in establishing this value gives one more latitude when dealing with a usufruct than with perfect ownership. See LA. CIV. CODE arts. 1227-88.

34. INT. REV. CODE of 1954, § 1001(e)(3).

mittee noted that "this exception is appropriate, since in this case [where the life tenant and the remainderman simultaneously sell their respective interests in the property] the purchaser acquires a single entire interest in the property and, therefore, he is not allowed to amortize the separate life interest. Thus, he is taxed on the income from the property."³⁵

Quite often when the usufructuary sells his usufruct, the naked owner will offer the highest price in order to acquire a perfect ownership by way of confusion.³⁶ The language of section 1001(e) (3) is not explicit as to whether the sale of the usufruct to the naked owner falls within the exception. The language contemplates a transaction where the "entire interest in property is transferred."³⁷ Where the usufructuary sells his usufruct to the naked owner, only the usufruct is transferred—not the entire interest. Thus, the Commissioner may attempt in his forthcoming regulations to exclude the sale of the usufructuary's interest to the naked owner from the transactions covered by the exception by relying on a literal interpretation of the language in section 1001(e). It could be argued that, in Louisiana, the application of a regulation which invokes the zero basis against the usufructuary when his interest is sold to the naked owner would be contrary to the intent of Congress in enacting the statute. The purpose of this exception, as expressed in the Senate Finance Committee Report, is to subject a transaction to the zero basis only when there is a new amortizable basis created in the usufruct.³⁸ Under the provisions of Civil Code article 619, the usufruct is extinguished by confusion³⁹ whenever the usufruct and naked ownership become vested, by whatever means, in the same person. If the usufruct is extinguished, then it becomes inconceivable to speak of any basis in the usufruct.

The purchase price paid by the naked owner for the usufruct is merely an additional cost of the perfect ownership of the property and is thus added to the naked owner's share of the

35. S. REP. No. 552, 91st Cong., 1st Sess. 204 (1969).

36. See note 39 *infra*.

37. INT. REV. CODE OF 1954, § 1001(e).

38. See S. REP. No. 552, 91st Cong., 1st Sess. 203-04 (1969).

39. LA. CIV. CODE art. 619: "The usufruct is extinguished by the usufruct and the ownership being vested in one and the same person, that is, when the owner acquires the usufruct, or when the usufructuary acquires the naked ownership. The reason is that no servitudes can be due by a thing to the owner of such things."

uniform basis to arrive at the basis of the perfect ownership of such property. This is no different from what occurs upon the termination of the usufruct by death of the usufructuary. When the usufructuary dies and the naked owner becomes the perfect owner of the thing, the basis of the perfect ownership is merely the adjusted uniform basis.⁴⁰ This reinforces the contention that there is no new amortizable basis created when the usufructuary sells the usufruct to the naked owner. There has been no double deduction of the basis and no tax avoidance has occurred. Thus, the zero basis of section 1001(e) should not be applicable to such a transaction. This writer suggests that in Louisiana, when the usufructuary must dispose of the usufruct which was acquired by gift or inheritance and it is not possible to convey perfect ownership to some third party in a single transaction, the usufruct should be sold to the naked owner and the basis of the usufruct should be used to offset the gain.

Conclusion

The zero basis provision of section 1001(e) was designed to plug a specific loophole in the taxation of the tenant where the life estate is disposed of. The legislation enacted appears to be an excellent solution to the problem, in that the imposition of the tax falls on the person who was avoiding income taxes. The creation of a new amortizable basis upon the sale or other disposition of a term interest in property should no longer loom as a tax loophole. However, in cases where a new amortizable basis is not created, such as in Louisiana where the usufructuary sells the usufruct to the naked owner, the zero basis provisions of that section should not apply.

J. Edgerton Pierson, Jr.

40. Assuming that neither the usufructuary nor the naked owner have made any additions or deletions to the uniform basis, then the basis of the perfect ownership will equal the original uniform basis.