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TECHNICAL UPDATE N° 3 **May 2013**

ACCOUNTING AND TAXATION OF FRENCH USUFRUCTS AS APPLIED TO MANAGED PORTFOLIOS OF STOCKS AND SHARES

1.0 Basic facts relating to dismemberment of property

1.1 Dismemberment of ownership is an old feature of French law. It consists of splitting full ownership of an asset into two distinct rights: the usufruct on one hand (owned by an *usufruitier*), the bare ownership on the other (owned by the *nu-propriétaire*).

1.2 Per the civil code: the usufruct is the right to enjoy assets of which somebody else has the ownership, as if you were the owner yourself but subject to the condition of conserving the substance of the assets for eventual onward transmission to the *nu-propriétaire*.

1.3 *Usufruitier* and *nu-propriétaire* each have real legal rights over the assets concerned. There is no indivision between *usufruitier* and *nu-propriétaire.*

1.4 The sale of a dismembered asset requires the agreement of both *usufruitier* and *nu-propriétaire*.

1.5 The civil code states that a usufruct expires on the death of the *usufruitier.* Consequently a usufruct does not form a part of the succession of the deceased *usufruitier*. A *usufruitier* may not leave his usufruct to his successors.

1.6 Quasi-usufruct: a quasi-usufruct is a usufruct where the *usufruitier* has a right to consume a part of the asset without being required to restore it at the end of his usufruct.

1.7 Quasi-usufruct is said to exist when a *usufruitier* cannot "use" the fruits of an asset without also consuming the asset itself (this has its origin in agricultural production). In such a case the *nu-propriétaire* loses his rights over the asset concerned (because it no longer exists) and only holds the right to a debt for the same value payable at the time of expiry of the usufruct.

1.8 The *usufruitier* of a share portfolio is entitled to dividends from the shares and interest from bonds forming part of the portfolio. In practice the *usufruitier* acquires the right to each dividend at the time the dividend is paid (as opposed to when it is declared).

1.9 In the case of unit trusts or other collective funds which roll up their income and make no distributions, the *usufruitier* has no right to enjoy those rolled up distributions. They accrue for the ultimate benefit of the *nu-propriétaire*.

1.10 The basic rule is that the *usufruitier* may not on his own initiative sell the shares in the portfolio, but this is subject to an important exception (see 1.13 below).

1.11 Rights of the *nu-propriétaire*. During the existence of the usufruct the *nu-propriétaire* may not on his own sell the shares in the portfolio. He only has the right to dispose of his own *nu-propriété* over them.

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1.12 The court decision in the *Baylet* case of 12 November 1998. This was a landmark decision which gives general guidance to portfolio managers in cases of dismembered ownership.

1.13 In *Baylet* the court authorised the *usufruitier* of a managed portfolio to manage the portfolio as a whole and consequently to sell shares on his own initiative provided they were replaced by others. The involvement of the *nu-propriétaire* is not required to do this.

1.14 The court nevertheless confirmed that shares in a portfolio may not be treated as "consumable" by the *usufruitier*. Therefore the *usufruitier* of a share portfolio is not a *quasi-usufruitier* (see 1.6 above). The *usufruitier* may not freely dispose or pay away capital without the agreement of the *nu-propriétaire.*

1.15 Legal sources are not in agreement as to the possibility of creating a contractual quasi-usufruct between a *usufruitier* and a *nu-propriétaire*. Such a contract would, for example, permit the *usufruitier* to spend capital gains made on unit trusts or other non-distributing investments.

1.16 One consequence of *Baylet* is that a share portfolio is to be treated as an entity in its own right, as distinct as from the individual stocks and shares comprising it. Consequently the dismemberment of ownership is over the portfolio as a whole as opposed to over the individual shares.

1.17 The court decided that the *usufruitier* has the right to sell the shares provided that the proceeds are reinvested. Therefore the *usufruitier* may neither give away nor use for himself the sale price of shares which are sold. He is under the obligation to replace such shares by others. This is the fundamental difference between a pure usufruct and a quasi-usufruct.

1.18 The duty of a *usufruitier*, in exercising his right to manage the portfolio, is to maintain a balance between both the substance of the portfolio (i.e. the asset allocation) and of its absolute value. The *usufruitier* must render the portfolio to the *nu-propriétaire* at the end of the usufruct at at least the value at which he received it in the beginning. This may be said to militate against investment in risky shares which could cause a fall in value of the portfolio.

1.19 The court recognises the right of the *nu-propriétaire* to request information from the *usufruitier* regarding both value and composition of the portfolio without having to wait for the extinction of the usufruct.

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2.0 French taxation of a share portfolio subject to dismemberment (e.g. following a death)

2.1 For French tax purposes the value of a portfolio is attributed to *usufruitier* and *nu-propriétaire* in the following proportions:

Age of *usufruitier*	**Value of *usufruit***	**Value of the *nu-propriété***
Less than:		
21 years old	90%	10%
31 years old	80%	20%
41 years old	70%	30%
51 years old	60%	40%
61 years old	50%	50%
71 years old	40%	60%
81 years old	30%	70%
91 years old	20%	80%
More than 91 years old	10%	90%

2.2 The *usufruitier* is taxed on the investment income arising from the portfolio under the same rules as an outright owner would be. The *nu-propriétaire* does not declare this income and is not taxed on it. The abatements and reductions for French resident taxpayers that apply to outright owners of investment income also apply to *usufruitiers*.

2.3 In contrast to the taxation of income, the taxation of capital gains arising in a dismembered portfolio has always been complicated. It is to some extent clarified by an official instruction dated 13 June 2001.

2.4 In the situation where shares are sold at a profit and the sale price is reinvested in the portfolio, the *nu-propriétaire* must pay the capital gains tax.

2.5 It is possible for the parties to opt for the capital gains tax to be paid by the *usufruitier*. This may be appropriate given that it is the *usufruitier* who has triggered the gain through his ongoing management of the portfolio. However, the *usufruitier* does not have the right to the cash produced from the sale. The option of taxation of the *usufruitier* has to be explicit and irrevocable, made by both *usufruitier* and *nu-propriétaire* and addressed to the bank or fund manager running the portfolio. The option must also be over the entire portfolio, not just certain shares within it.

2.6 Calculation of the capital gain. In the typical situation where neither the *nu-propriétaire* nor the *usufruitier* possessed the full ownership of the shares before the dismemberment (e.g. where a husband dies leaving his wife the usufruct over the portfolio):

- Sale price is taken to be the sale price in full ownership.
- Cost price is taken to be the value used in determining succession duty at the time of the death which gave rise to the dismemberment.

2.7 In a situation where shares are sold and the proceeds split by agreement between *usufruitier* and *nu-propriétaire*: each party must pay his share of the capital gains tax arising. The sale price is equal to that proportion of the total price which is attributed to each of the parties. This comes either from an actual agreement or from the application of the tax scale according to their respective ages (para 2.1). Purchase price is taken to be either the actual price where the shares were bought or the value used for death duties.

2.8 Brought forward capital losses. There is no official statement on the matter. Logically, therefore, the person liable for the tax arising on a capital gain has the right to deduct any available brought forward losses.

2.9 Wealth tax. The market value of a portfolio subject to a usufruct is to be included in the wealth tax return of the *usufruitier*. The *nu-propriétaire* has nothing to declare under this head.

2.10 The French tax administration accept that a *usufruitier* and *nu-propriétaire* may agree between themselves, as a private matter, to share the cost of wealth tax. Nevertheless it is the *usufruitier* who is legally liable for the payment of the tax.

2.11 Succession duty. The basic position is that upon the death of a *usufruitier* no French succession duty falls due. No tax is payable either by the *usufruitier* or by the *nu-propriétaire*. Complications may arise where the usufruct was created other than by will.

2.12 The death of a *nu-propriétaire* during the life of the *usufruitier* gives rise to succession duty based upon the *nu-propriétaire's* proportion of the value of the portfolio according to the official actuarial scale in 2.1.

2.13 In the event of the death of a *quasi-usufruitier*, his succession will include the remaining portfolio of shares on the asset side at full value and, as a deduction, the debt due to the *nu-propriétaire* for capital consumed during the usufruct. This debt will need to have been acknowledged in a notarised deed prior to the death. The liability of the succession to death duty in the case of a quasi-usufruct is therefore a totally different situation to the non-taxability of a pure usufruct.

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2.14 Deferred payment of succession duty. Surviving spouses, supposing they are the *usufruitier*, have no liability to French succession duty. The *nu-propriétaire* may request a deferral of payment of succession duty until six months after the death of the *usufruitier*. The tax authorities will require security over French land before agreeing to the deferral. Strictly speaking the sale of any of the shares in the portfolio brings to an end the right to deferred payment, but the tax administration now permit continued deferral provided that the whole of the sale proceeds are reinvested in new shares. The loss of the right to deferred payment can only occur if it is formally established by the administration that certain sale proceeds have not been wholly reinvested in new shares. To enable the inspector of taxes to confirm the continuing deferment of payment the *nu-propriétaire* has an interest in supplying the tax office annually with bank statements or other documents demonstrating that all sale proceeds have been reinvested.

2.15 Portfolio management charges.
In current French private banking practice:

- Custodial services are charged to the *usufruitier*.
- Transaction costs (brokerage commissions) are shared between the *usufruitier* and the *nu-propriétaire*.
- Management fees are charged to the *usufruitier*.

3.0 **Private contract regulating the administration of a dismembered share portfolio**

3.1 With a view to avoiding disputes or awkwardness between the *usufruitier* (often the widow of the deceased) and the *nu-propriétaire* (often the child or children of the deceased) an agreement may be drawn up regulating the way the dismembered portfolio is to be administered.

3.2 Such a contract between *usufruitier* and *nu-propriétaire* may be made either by private contract or by notarised deed. In practice there may well be advantage in such a contract being drawn up by the notary who prepared the relevant will (and its then being translated into English for the benefit of English portfolio managers and the clients). The terms of the contract will be subject to French law.

3.3 Matters which could usefully be dealt with in the contract include:

(a) A statement of the origin of the dismemberment of the portfolio. (e.g. a will)
(b) Statement that the *usufruitier* is empowered to buy and sell stocks without the approval of the *nu-propriétaire.*
(c) The investment objectives (i.e. high income, balanced or capital growth) and asset allocation.
(d) The style of management (i.e. defensive, balanced, dynamic or risky).
(e) The choice of stocks (e.g. direct holdings in equities or unit trusts); permission or not to purchase stocks on commodity markets or leveraged investments.
(f) Geographical diversity.
(g) Currency of account.

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3.4 The contract may authorise the *usufruitier* to sell a fixed amount of capital per annum without reinvesting it and to withdraw the proceeds for personal spending. It may provide that the *nu-propriétaire* authorises the selling and payment out to the *usufruitier* of a specified annual yield e.g. 3%. Or it may provide for the *usufruitier* to withdraw not only all the income but also the capital gains made by the portfolio.

3.5 The contract may provide for sales of shares at a profit to be split between *usufruitier* and *nu-propriétaire* according to an agreed percentage e.g. the tax actuarial table. The simplest solution: the contract may authorise the *usufruitier* to receive the capitalised income element of roll-up funds. e.g. the *usufruitier* may be authorised to sell non-distributor funds and withdraw the capital gain made on the sale.

3.6 Contract of quasi-usufruct. In this type of contract the *nu-propriétaire* authorises the *usufruitier* to exercise wide powers over the portfolio. The *usufruitier*, thereby becoming a *quasi-usufruitier*, may thus withdraw capitalised income, capital gains and even reduce the capital value of the portfolio. The *nu-propriétaire* substitutes for his legal rights a debt which he may call in from the estate of the *usufruitier* upon the latter's death. The *nu-propriétaire* becomes a *quasi-nu-propriétaire* and has less certain rights than he had before. The contract may provide for the protection of the debt due to the *quasi-nu-propriétaire* by granting charges over the *usufruitier*'s personal share portfolios, land holdings etc. The contract may also authorise inflation indexation of the value of the debt.

3.7 A specific clause requiring the reinvestment of sale proceeds in the portfolio is useful in demonstrating the intentions of the parties to maintain the dismemberment and protect against an assertion by the tax authorities that the parties in fact had intended to keep the proceeds for themselves and possibly bring the dismemberment to a premature end.

3.8 The contract may set out precise details of the information to be provided to the *nu-propriétaire*, frequency of reporting etc.

3.9 Notwithstanding the application of general tax law to the dismemberment (i.e. income taxable on *usufruitier*, capital gains tax payable by the *nu-propriétaire*) the parties may wish to provide for a different split of the tax liabilities arising e.g. the contract may provide for the *usufruitier* to pay the capital gains tax.

3.10 The contract could also specify that wealth tax is to be paid wholly or partly by the *nu-propriétaire* or charged to the capital fund.

3.11 The contract may also specify the proportions in which professional fees (e.g. legal, professional, fund management) are to be borne by the *usufruitier* and the *nu-propriétaire*.

3.12 The contract will often provide for annual accounts of the succession to be drawn up and signed by the parties as ongoing evidence of their agreement to the actions of the *usufruitier* and those charged with the administration of the portfolio.

3.13 Contracts between *usufruitier* and *nu-propriétaire* should be approached with caution as the tax authorities have in some instances been able to demonstrate that they amount to disguised gifts which are liable to gift duties.