Foreign Affairs

Usufructs Part 1—UK Capital Gains Tax

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This article analyses the UK capital gains tax position of French usufructs through the case study of a UK-domiciled and resident taxpayer who retains a usufruct in a French property. The UK inheritance tax position will be considered in the next issue.

The establishment of a usufruct (or *usufruit* under French law) is a common way of holding property in France, particularly amongst members of the same family. Usufructs are often equated with life interest settlements established in England and Wales. This comparison is, to some extent, valid and the usufructuary will have the right to occupy the property during their lifetime, with the property reverting to the bare owner on the usufructuary's death. However, the interest of a usufructuary, unlike that of an English life tenant, is, due to its connection to the person of the usufructuary, usually inalienable and will often subsist only over one property and for the benefit only of the usufructuary. A life tenant's interest, on the other hand, is alienable as it is connected only with the life of the life tenant, rather than actually with their person. Any attempt to analyse the tax implications of a usufruct based on an English life interest settlement should be treated with caution.

Usufructs are encountered by English Private Client practitioners with increasing regularity and it is therefore surprising that their effect under UK taxation is not more widely established. The position of French usufructs under English inheritance tax (UK IHT) has been strongly debated, with little consensus and will be the subject of a later article. The position with regard to UK capital gains tax (UK CGT) has been little discussed, albeit that the position would now seem clear.

Article 6(2) of the UK/France Double Tax Convention of June 19, 2008 confirms that, for UK CGT purposes, a French usufruct will be considered to be an interest in land.[1] In general, therefore, the UK CGT treatment of a French usufruct will accord with that of land owned outright in the United Kingdom. However, due to the unique nature of a French usufruct, this will not always be the case and, in some instances the UK CGT position may even reflect to some extent the position of a life interest settlement.

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[1] Article 6(2) states that a usufruct of immovable property "shall have the meaning which it has under the law of the Contracting State in which the property in question is situated". In France such an interest would be considered to be an interest in land.

In order to better illustrate this point, a case study is used below to demonstrate the UK CGT effect of a not untypical family arrangement.

A French property is owned by a UK-domiciled and resident taxpayer (F) who makes a gift of the bare ownership of the property to his son (S) in 2000, retaining a usufruct in it. F dies in June 2011. Alternatively, instead of F dying, the property is then sold in June 2011. As a further alternative, the usufruct is terminated in May 2011 and the property then sold in June 2011. At the time that F acquired the property in 1995, it was worth £100,000. In 2000 it had increased in value to £200,000. In both May and June 2011 it was worth £400,000. At all times, F and S are UK-domiciled and resident.

The UK CGT implications of each stage of the case study listed above are considered below.

F's gift of the bare ownership in 2000: retaining a usufruct

Since, for UK CGT purposes, a usufruct is considered to be an interest in land, there would be a potential UK CGT charge on the value of the property given away in 2000. Although F retains a usufruct in the property which gives him the right to use the entire property during his lifetime, it is necessary to look to French law to determine the extent of his interest. In France, in the event that a property is sold subject to a usufruct, the usufructuary and the bare owners will be considered to be entitled to specific shares of the property.[2]

Under French law, the value of the respective shares of the usufruct and the bare ownership depend on the usufructuary's age as defined by art.669 of the *Code Général des Impôts*. In this example, F was aged 53 in 2000 which meant that his usufruct was valued at 30 per cent of the property. Given that, for UK CGT purposes, it is necessary to quantify the value of an interest in land, these figures should be followed and F would therefore be considered to have retained an interest of 30 per cent of the property in 2000, making a gift of 70 per cent to S. Since, for UK CGT purposes, a French usufruct is an interest in land, the part disposal rules under Taxation of Chargeable Gains Act 1992 (TCGA 1992) [s.42] would apply here for the calculation of the allowable expenditure on the transfer.

Assuming that F was UK resident at the time that the usufruct was created, he would potentially be liable for UK CGT on the chargeable gain in relation to the 70 per cent given away.

UK CGT on F's death in June 2011

On the facts, F died in June 2011, bringing the usufruct to an end. S, as the bare owner, became entitled to the full value of the property. Where an English property was held subject to a life interest that was created in 2000, it would be expected that the entire value of the property would benefit from an uplift in value on the date of the life tenant's death, without any UK CGT being payable.[3] As set out above, however, for UK CGT purposes at least, a French usufruct cannot be considered to be analogous to an English life interest. Conversely, where an English property was co-owned (for example with the deceased owning 30 per cent and their son owning 70 per cent) there would be an uplift in value of the deceased's interest, but not on the remaining portion of the property which would retain the original co-owner's acquisition value.[4]

Neither of the above scenarios accurately reflects the true position of a French usufruct on death for UK CGT. In their own guidance, HMRC confirm that, for UK CGT purposes, where a deceased possessed a non-trust life interest,[5] it is necessary to compare the interest to an English or Scottish interest to consider

[2] Article 621 of the French Civil Code.
[3] TCGA 1992 s.72.
[4] TCGA 1992 s.62.
[5] A concept included by HMRC in their Capital Gains Manual to refer to interests under UK law which share some of the characteristics of an English life interest but which are not, for UK CGT purposes, treated as settlements (HMRC's Chargeable Gains Manual CG31300). HMRC consider that this category includes Scottish proper liferents and English leases for life, for example.

its effect for UK CGT purposes.[6] According to HMRC, "if the correct analogy is that the particular arrangement has the characteristics of settled property then it is treated as such". Usefully, for the purposes of the present article, HMRC further state that:

> "... a usufruct governed by French law would be regarded as a non-trust arrangement as it is broadly similar to a Scottish proper liferent."

Based on this statement, it would seem clear that the UK CGT effect of a French usufruct on the death of the usufructuary must be considered by analogy to a Scottish proper liferent.

A Scottish proper liferent, which usually involves a liferenter being granted the use of a property during their lifetime, with it passing to *a fiar* (i.e. a remainderman or bare owner) on their death, is in many respects similar to a French usufruct. For UK IHT purposes, a Scottish proper liferent is treated as a settlement.[7] This is not the case for UK CGT. However, TCGA 1992 s.63 states in relation to Scotland that:

> "(1) The provisions of this Act, so far as relating to the consequences of the death of ... a proper liferenter of any property, shall have effect subject to the provisions of this section.
>
> (2) ... On the death of any such ... liferenter ... the person (if any) who, on the death of the liferenter, becomes entitled to possession of the property as fiar shall be deemed to have acquired all the assets forming part of the property at the date of the deceased's death for a consideration equal to their market value at that date."

It is therefore possible for a Scottish proper liferent to be considered not a settlement for UK CGT purposes and for an uplift in the value of the entire property still to be available on the death of the liferenter. Given HMRC's own statements above and the similarities between a Scottish proper liferent and a French usufruct it seems certain that, on the death of a usufructuary, the property subject to the usufruct would similarly benefit from an uplift in value over the entire property. Using the case study, therefore, for UK CGT purposes, on F's death, S's acquisition value for the entire property is uplifted to the value at the date of F's death: £400,000. Equally no UK CGT would be payable in relation to F's death.

The property is sold in June 2011 whilst still subject to the usufruct

The position would be very different in the event that, instead of the usufruct being brought to an end in June 2011 as a result of F's death, the property was sold. In this case both F and S would be considered to have made a disposal of their percentage shares (as calculated using F's age as set out above). They would each potentially be liable to UK CGT, assuming that both were UK-resident at the time that the disposal was made.

A further complication is that the method for calculating proportions of ownership for a usufruct in France changed in 2004 (with the most recent table of interests coming into force in January 2011).[8] This change means that whilst in 2000, on the creation of the usufruct, F was entitled to a 30 per cent share of the property, in June 2011 in spite of his increased age, he was entitled to 40 per cent. This is problematic for UK CGT as, arguably, F can be considered to have retained only 30 per cent of the property in 2000 with a further 10 per cent being acquired (presumably at a different acquisition value) at the point when his interest increased to 40 per cent. However, it would seem more probable that, for UK CGT purposes, F is taken to have retained 40 per cent at the time that the usufruct was created and for S's interest to be in only 60 per cent of the property for UK CGT purposes for the entire duration of the usufruct. Based on this, F's acquisition value would be 40 per cent of the 1995 value of £100,000, with a current value of 40

[6] HMRC's Chargeable Gains Manual (CG31305).
[7] IHTA 1984 s.43(4).
[8] *Loi de Finances* (no 2003-1311 *du 30 décembre 2003*)/ French Finance Act which came into force on January 1, 2004.

per cent of £400,000 at the time of sale. Assuming that F had already used his annual exemption and that no other deductions apply, F would have made a chargeable gain of £120,000. UK CGT at 28 per cent would be £33,600. S would also be liable to UK CGT on 60 per cent of the 2000 acquisition value of £200,000. His chargeable gain (again assuming that he had used his annual exemption and that no other deductions apply) would also be £120,000, with tax at 28 per cent of £33,600. On the sale of the property double tax relief would be available where French Capital Gains Tax is also payable.

Terminate the usufruct in May 2011 before the property is sold in June 2011

Finally, one further scenario should be considered. In the event that F terminated the usufruct in May 2011 S, as bare owner, would become absolutely entitled to the entire property. F would for UK CGT purposes be considered to have made a gift of his 40 per cent interest in the property, triggering UK CGT. However, there is one difference to the calculation above. For UK CGT purposes, where property is co-owned it is common for a discount to be applied to the value of the property in recognition of the fact that it is more difficult to sell a share in a property and that the value of the share is therefore lower. Although these discounts are in no way guaranteed, it is common for HMRC to accept a 15 per cent discount where the co-owner retaining their share occupies the property and 10 per cent where neither co-owner occupies the property. Such a discount will only apply where one of the co-owner retains their share and not on any sale of the property.

It is questionable whether a usufructuary and a bare owner can be considered to be co-owners in accordance with the definition of co-ownership under English law which requires that they have simultaneous interests. One suggestion would be that the interests would, instead, be more akin to leasehold and freehold interests in a property, which are distinct interests in land. However, whilst a leasehold interest and a freehold interest in the same property have their own values, which are independent of each other, it is only possible to value the interest of a usufructuary and a bare owner in a French property in relation to each other. For example, each party's respective interest, which is calculated by reference to the usufructuary's age at the time that the usufruct comes to an end, is expressed as a proportion of the value of the entire property, something that would seem to suggest a form of simultaneous ownership that could be considered comparable to that of the English tenancy in common. Even in the event that the interests of the usufructuary and the bare owner were not considered to be co-ownership under English law, given the difficulties in valuing the usufructuary's interest, which is a non-assignable interest, it would seem likely that some discount should be applied.

Assuming that a 10 per cent discount can be applied, when F terminated the usufruct in June 2011 a 10 per cent co-ownership discount should be applied in recognition of the fact that S (his co-owner for UK CGT purposes) still retains his interest. F's chargeable gain would be £104,000 (calculated using the same assumptions as above). Tax at 28 per cent on this would be £29,120, a figure somewhat lower than that calculated on the sale of the property. In the event that the property was then sold the following month without any increase in value, F would have no further UK CGT to pay (as he would have no interest in the property). S would still be liable for UK CGT on his original 60 per cent share as calculated above. However, the 40 per cent share he had acquired on the termination of the usufruct would not attract UK CGT as there had been no increase in value from the date that the usufruct was terminated (S's acquisition value for that 40 per cent share).

Conclusion

Generally, the most tax efficient way of holding a French usufruct for UK CGT purposes will be for the usufructuary to retain it until their death in order to obtain an uplift in value of the entire property. However, it will be necessary to balance this potential UK CGT saving against the UK IHT liability and any French

taxes. As a simple step practitioners should ensure that, in the event that their UK resident clients intend to sell a property subject to a French usufruct, they consider terminating the usufruct in order to attempt to claim a co-ownership discount on the termination.