

# Oh, What a Tangled Web We Weave: USUFRUCT UNTANGLED

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**O**utright ownership of an asset consists of three separate rights: 1) the right to possess the asset; 2) the right to derive income from the asset; and 3) the right to alienate or sell the asset. In Latin, these would be the *usus*, *fructus* and *abusus*. Usufruct, the right to use an asset and collect its fruits for a limited time, is commonly used by estate planners for a variety of purposes.

A usufruct is established by law in favor of a surviving spouse when a community property spouse dies intestate, whereupon the decedent's children become the "naked owners" subject to that usufruct. The granting of a usufruct is not constrained to the laws of intestacy, however. An owner of property can transfer the usufruct to another by virtue of a sale or by donation, either *inter vivos* or *mortis causa*.

### The Basics

The basic concept of usufruct is illustrated when one considers the usufruct of a home. One who possesses a usufruct (*i.e.*, the usufructuary) has the right to live in the home (use) and collect rents from leasing the home (fruits). However, the usufructuary does not have the right to sell the house. Unless that right is specifically granted to the usufructuary in the document establishing the usufruct, right belongs to the naked owner(s).

Usufruct is easily understood as it pertains to residential real estate, but when a usufruct attaches to other assets, the rights and obligations of the usufructuary and naked owners can be difficult to grasp.

Although a usufruct generally terminates without incident, when the assets subject to the usufruct include investment accounts holding marketable securities, competing claims of naked owners and the usufructuary can be difficult to sort out, thus placing investment firms and fiduciaries that are in possession of the securities in a precari-

ous position. To illustrate, consider the following example.

### Example: The Smiths

Mr. and Mrs. Smith were married. Mr. Smith, who had children from a previous marriage, passed away. Mr. Smith's estate consists of his undivided one-half interest in the community which existed between him and Mrs. Smith, and which community included an investment account at Bull & Bear Brokers holding \$2 million in a balanced portfolio and a checking account at Riverside Bank with \$200,000.

In his will, Mr. Smith granted Mrs. Smith the usufruct for life of his entire estate. Mr. Smith's two children were granted the naked ownership of Mr. Smith's estate, subject to the usufruct of Mrs. Smith. Mr. Smith's testament further provides that the usufructuary shall have the authority to dispose of non-consumable property as defined by Louisiana law.

Accordingly, the probate court renders a Judgment of Possession recognizing Mrs. Smith as the owner of her undivided one-half interest in the community and granting Mrs. Smith the usufruct of Mr. Smith's estate.

Mrs. Smith takes the Judgment of Possession to Bull & Bear Brokers and Riverside Bank where the couple's accounts are each divided into two separate accounts: one account titled as "Mrs. Smith," and the second account titled as "Mrs. Smith, usufructuary/Smith children, naked owners."

On the advice of her investment advisor, Mrs. Smith periodically rebalances the usufructuary portfolio so that it is never too heavily weighted in one stock or one sector. The portfolio consists of a variety of bonds, stocks and mutual funds in which dividends are reinvested.

Twenty years later, Mrs. Smith dies. At the time of her death, the usufructuary investment account has grown to \$4,220,000 and the usufructuary bank account has a balance of \$62,000.

In her will, Mrs. Smith leaves her estate to her nieces, Susan and Sidney Green, in equal shares.

While Mrs. Smith's estate is under administration, Mr. Smith's children deliver a certified copy of Mrs. Smith's death certificate to Bull & Bear Brokers and request that the assets held in the usufructuary account be divided equally and transferred into two separate accounts—one for each of them—because Mrs. Smith's usufruct terminated upon her death.

As Bull & Bear is preparing the requested transfer, the branch manager receives a letter from the attorney representing Susan and Sidney Green individually, and in their capacity as co-executrices of the Succession of Mrs. Smith. The letter threatens legal action against Bull & Bear and Mr. Smith's children if Bull & Bear transfers assets out of the usufructuary account.

Although the threat of litigation is uncommon, the underlying issues, unfortunately, are not. Disputes stem, at least partially, from investment firms' efforts to shield themselves from claims by naked owners should the usufructuary dispose of assets to which the naked owners would be entitled. In doing so, firms and fiduciaries may unwittingly subject themselves to claims by the usufruct's heirs or legatees.

Louisiana Civil Code article 536 classifies money as a "consumable," something that cannot be used without being expended or consumed. With consumables, the usufructuary acquires ownership of the things and the naked owners become general creditors of the usufructuary. Specifically, Louisiana Civil Code article 538 provides:

If the things subject to the usufruct are consumables, *the usufructuary becomes the owner of them*. He may consume, alienate, or encumber them as he sees fit. At the termination of the usufruct, he is bound either to pay to the naked owner the value that the

things had at the commencement of the usufruct or to deliver to him things of the same quantity and quality. (Emphasis added).

When someone has the usufruct over cash, she can treat the cash as her own. She can spend it on whatever she wishes, she can invest it, or she can give it away. All the time knowing that at the termination of the usufruct, she (or her estate) will be obligated to deliver to the naked owners the value of the cash at the commencement of the usufruct.

Mrs. Smith's usufructuary bank account originally held \$100,000, but by the time of Mrs. Smith's death, as the result of periodic withdrawals, the balance had declined to \$62,000. But, regardless of the balance in the account at the time of Mrs. Smith's death, Mrs. Smith's estate is obligated to deliver \$100,000 (the balance of the account at the beginning of the usufruct) to Mr. Smith's children.

Unlike cash, stocks and bonds are classified by Civil Code article 537 as "non-consumables," *i.e.*, things that may be enjoyed without alteration of their substance. Louisiana Civil Code article 539 provides that, as non-consumables, the usufructuary has the right to possess stocks and bonds and to derive the utility, profits and advantages that they may produce, under the obligation of preserving their substance. In other words, a usufructuary who has a usufruct of stocks or bonds which pay interest or cash dividends can receive and collect those dividends as the usufructuary's own property. The usufructuary, however, does not have the authority to sell non-consumables without the consent of the naked owners unless that authority is specifically granted in the act which creates the usufruct, as it was in Mr. Smith's will. Consequently, unless the usufruct includes the right to dispose of the assets, at the termination of the usufruct, the usufructuary must deliver to the naked owners the non-consumable property which is the subject of the usufruct.

## Handling Potential Problems

Laws governing the usufruct of non-consumables are problematic not only for usufructuaries and naked owners but for investment firms as well. The estates of Mr. and Mrs. Smith illustrate some potential problems.

Mr. Smith's will granted Mrs. Smith the usufruct of an investment account with \$1 million of marketable securities, and, throughout the years since Mr. Smith's death, Mrs. Smith periodically rebalanced the portfolio to maintain an allocation of securities that were commensurate with her investment objectives.

When Mrs. Smith first sold securities in the usufructuary account, the usufruct was converted to the usufruct of cash, *i.e.*, the usufruct of non-consumables was converted to a usufruct of consumable property. At that point, Mrs. Smith became the owner of cash with an obligation to deliver to the naked owners the value of that cash at the time of the conversion.

For example, if Mrs. Smith's broker sold 100 shares of XYZ Corp. stock for \$10,000, then, at the termination of the usufruct, Mrs. Smith (or her estate) is required to turn over \$10,000 to Mr. Smith's children. This is true regardless of what was done with the proceeds of the sale. If Mrs. Smith invested that \$10,000 in the stock of ABC Corp., and the value eventually grew to \$70,000, then Mrs. Smith is obligated to turn over only \$10,000 to Mr. Smith's children. The appreciation, *i.e.*, \$60,000, belongs to Mrs. Smith's estate. Alternatively, if shares of ABC Corp. stock had declined to only \$5,000, then Mrs. Smith (or her estate) is obligated to deliver \$10,000 to Mr. Smith's children. The same holds true if Mrs. Smith simply spent the money on entertainment, food or travel; she is still obligated to deliver the full \$10,000 to Mr. Smith's children at the termination of the usufruct.

Suppose that at the beginning of the usufruct, Mrs. Smith's broker liquidated all the portfolio holdings (\$1 million)

and transferred the cash proceeds to a managed or "wrap" account. Then, at the termination of the usufruct, on Mrs. Smith's death, Mr. Smith's children would be entitled to the proceeds from the sale of the investments, *i.e.*, \$1 million, and, to the chagrin of Mr. Smith's children, Mrs. Smith's legatees would be entitled to the appreciation of the re-invested assets, *i.e.*, \$3,220,000.

Frequently, estate planners add language to wills providing that, if non-consumable property is sold, then the usufruct shall not terminate but shall attach to the proceeds of the sale *and the reinvestment thereof*. This provision, however, raises yet more issues.

First, the additional language is vague. Is it the testator's intent simply that the usufructuary shall continue, *i.e.*, that the usufructuary will not have forfeited the usufruct by converting the form of the property subject to the usufruct? Or, is it the testator's intent that when sale proceeds (consumables) are used to purchase non-consumable property, the usufruct then transforms again to the usufruct of non-consumable property? If the latter is the testator's intent, then at least one treatise suggests that the testator should specifically state as much: "... the proceeds may (or shall) be reinvested in non-consumable property to continue subject to usufruct and the law applicable to non-consumable property." 2 La. Prac. Est. Plan. § 6:5 (2022-2023 ed.)

But is such a charge on the proceeds of the sale of non-consumable property permissible? Civil Code article 538 provides that "[i]f the things subject to the usufruct are consumables, *the usufructuary becomes the owner of them. He may consume, alienate, or encumber them as he sees fit.*" (Emphasis added.) Note that article 538 contains no qualifying language, *e.g.*, "unless otherwise provided in the instrument which creates the usufruct." Hence, when the property subject to a usufruct is cash, the usufructuary owns the cash. At the termination of the usufruct, the usufructuary must return to the naked owners the value of that cash as of the time that the usufruct



over the consumable is created; but until the termination of the usufruct, the usufructuary's enjoyment of the cash is of no concern to the naked owners.

The definition of "reinvestment" may also prove problematic. Is "reinvestment" limited to stocks, bonds and other marketable securities, or does it extend to real estate, jewelry and fine art? Does reinvestment extend to other non-consumables, *e.g.*, automobiles, furniture or clothing? If so, then as the value of these less-prudent non-consumable "investments" decline with normal wear and tear, so does the value of the usufruct property that must be delivered upon the termination of the usufruct. Such a provision allows the usufructuary to manipulate the usufruct property to the advantage of her successors.

Suppose Mr. Smith's testament provided that the usufruct would attach to the reinvestment of the cash proceeds from the sale of stocks and bonds. To provide the greatest value for her own legatees, Mrs. Smith would have been able to withdraw cash proceeds as investments are sold in the usufructuary account and use proceeds for her own enjoyment or to purchase assets that are more likely to depreciate over time, while leaving her own assets fully invested to maximize their value upon her death.

Another potential problem arises from the imposition of capital gains tax. Civil Code article 616, provides, in relevant part as follows:

Any tax or expense incurred as the result of the sale or exchange of property subject to usufruct shall be paid from the proceeds of the sale or exchange and shall be deducted from the amount due by the usufructuary to the naked owner at the termination of the usufruct.

When a usufructuary account is opened with an investment firm, income is reported to the Internal Revenue Service (IRS) under the usufructuary's Social Security Number, and capital

gains from the sale of securities are reflected on IRS Form 1099-S. The capital gains are then included on the usufructuary's Federal Income Tax return and taxed accordingly. Although article 616 provides that the tax shall be paid from the proceeds of the sale, sale proceeds are usually reinvested in their entirety, and the usufructuary pays the tax with her own funds as part of her Federal Income Tax payment. This ultimately gives rise to a claim for reimbursement by the usufructuary (or her estate) for the tax paid, *together with the increased value of the investments* which were acquired with the reinvested amount of that tax.

Reimbursement claims are triggered not only by the sale of assets. Recall that at the commencement of her usufruct, Mrs. Smith's usufructuary investment account held mutual funds. Often, the owners of mutual funds choose to reinvest dividends into additional shares of the fund. Interest and cash dividends, however, are the property of the usufructuary, in full ownership — not subject to her usufruct. When interest payments or dividends are reinvested in additional shares of the mutual fund, the additional shares likewise belong to the usufructuary. New shares are not the subject of the usufruct even though they remain in the usufructuary account. As reinvested dividends grow or appreciate, another complicated claim arises.

It is not difficult to see the confusion that would ensue after 20 years of sales and purchases, tax payments, and the reinvestment of interest and dividends, and why Mrs. Smith's legatees object to the delivery of the usufructuary account *en masse* to Mr. Smith's children.

## Conclusion

Potential conflicts can ultimately be resolved if the usufructuary maintains detailed records. Rarely, however, is a usufructuary so thorough and tenacious as to keep and maintain contemporaneous records over many years. And, it is difficult, if not impossible, to piece together an accurate accounting of several

decades of purchases, sales dividends and taxes after documentary evidence is lost, destroyed or otherwise unavailable.

Parties often presume that securities held in a "usufructuary account" belong to the naked owners when the usufruct terminates. As illustrated above, however, that presumption is misguided. While this may be of little consequence where the naked owners and the heirs of the usufructuary are one and the same, if they are not, and the usufructuary's estate asserts a claim to those securities, investment firms and advisors will find themselves in the midst of acrimonious litigation between the usufructuary's estate and the naked owners, who both claim ownership. Firms that find themselves in this predicament can limit their exposure and reduce potential legal fees by depositing the disputed securities in the registry of the court and instituting a concursus proceeding pursuant to La. C.C.P. art. 4651. Nevertheless, assets held in a usufructuary account should not be delivered to the naked owners without first obtaining written acknowledgment and consent from the usufructuary's succession representative.

On the front end, planners may want to consider avoiding the usufruct altogether in favor of a trust, where the rights and obligations of the interested parties are more easily defined, and the accounting rules are more easily understood and implemented.

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