FRENCH CONNECTIONS

Using a trust to own French real estate does not particularly change the ownership situation in France regarding wealth tax and inheritance tax, and may bring potential drawbacks in terms of corporation-tax issues and increased disclosure obligations. Nonetheless, trusts can remain good vehicles through which to own French real estate when considering estate planning

BY FREDERIC MEGE

ABSTRACT

- *The new French tax legislation applicable to trusts has given greater visibility on how trusts should be understood in France.*

- *For many years, providing advice on the ownership of real estate through trusts was quite a risky exercise, given the lack of legal provisions. Although the new legislation is not perfect, as it still needs some further development, we now have enough material to address the general position of the ownership of French real estate through trusts.*

Non-French tax residents are subject to wealth tax on their French-sited assets if the net value of these assets exceeds EUR1.3 million. Progressive tax rates apply from 0.5 per cent up to 1.5 per cent for property in excess of EUR10 million.

French inheritance tax (IHT) also normally applies at progressive rates. In the direct line, i.e. transfers to children and parents, the rate rises from 5 per cent to 45 per cent, depending on the value of a beneficiary's share of the estate.[1] Death transfers between spouses are not taxed, and assets that pass to an unrelated beneficiary are

1. The rate of 45 per cent applies on a share exceeding EUR1,805,677

taxed at a flat rate of 60 per cent, regardless of value.

TRUSTS IN FRANCE

Although the concept of a trust does not exist in the French *Civil Code*, French law does not prohibit the ownership of assets, in particular French real estate, through trusts. In the past, case law has ruled that trusts set up abroad can have legal effect in France, provided they do not conflict in any way with French public policy. It is therefore legally possible to own French assets in trust. The main difficulty in respect of trusts lies in knowing the French tax treatment that will apply to them.

For many years, French tax legislation was characterised by the lack of provisions applicable to trusts. Even the word 'trust' was quasi-non-existent in the French *Tax Code* (FTC). Some rules were given by more or less reliable case law, but, overall, the tax treatment was quite uncertain. For many years, it has been very difficult to provide definitive advice on trusts issues in France.

France enacted specific tax legislation applicable to trusts in 2011 (the law was contained in article 14 of *Bill 2011-900 of 29 July 2011* and came into force on 31 July 2011). As the legislation was introduced in the context of the international fight against tax evasion, it does not make trusts attractive tools for French tax planning. However, lawmakers did not necessarily want to penalise the use of trusts in France. Although the legislation is not perfect, as it still needs some further detailed provisions and clarification on some issues, there is now definitely greater certainty (which was much needed) around the taxation of trusts in France. We now have enough material to address the general position of the ownership of French real estate through trusts. This was not possible, and was quite risky, a couple of years ago.

When considering the ownership of French real estate in trust, the trustees (often a trust company) would not own French real estate directly. They would own shares in a company that owned the French property directly or indirectly. This might be a French company, e.g. a French *société civile immobilière* (SCI), a foreign company or even a foreign company owning a French company.

Independently of the number of companies used (depending on each situation), the key element of structuring is that a foreign corporate entity would be involved, i.e. the trust company itself owning a French company, or a foreign company owned by the trustees. A corporate entity would be the ultimate owner of the French estate. From a French tax perspective, this would be an important element to consider.

Let us now address the tax consequences of such structuring in respect of the main taxes that foreigners must consider when owning French real estate. Comments apply to both residential and commercial properties.

> 'For French wealth-tax and IHT purposes, the settlor would be regarded as the owner of the shares in a company as if they owned the shares directly'

IMPÔT DE SOLIDARITÉ SUR LA FORTUNE (FRENCH WEALTH TAX)

In respect of wealth tax, the general principle is that the settlor of the trust is still regarded as the 'owner' of the trust assets and, consequently, is potentially liable for wealth tax on the value of these assets as if the trust did not exist. The beneficiaries (at least during the lifetime of the settlor) do not have to worry about wealth tax, even if they are French tax residents.

As mentioned above, in the context of French real estate owned in trust, the trustees will not own the property directly, but through shares in a company. That company could be a French SCI or, more likely, a foreign company owning the French SCI or real estate directly. As far as wealth tax is concerned, we then have to deal with shares.

For wealth-tax purposes, and this will be the same in respect of French IHT, the settlor would be regarded as the owner of the shares in a company as if they owned the shares directly. The existence of the trust would then be ignored. For this reason, the use of a trust to own French real estate would not dramatically change the situation in France.

Non-French tax residents are subject to wealth tax on their French-sited assets only. On the assumption that the settlor is a non-French tax resident, they would only be subject to wealth tax if they own French-sited assets (including the trust assets). In this respect, the basic rules described below apply.

Shares in a French company (such as a French SCI) are regarded by French tax law as French-sited assets. This does not trigger difficulties. The situation is, however, different in respect of shares in a foreign company.

French tax law provides that shares in foreign companies whose assets mainly consist of French real estate are, in principle, treated as French-sited assets and are thus subject to French wealth tax. These rules[2] concern so-called French real-estate companies.

In short, the basic rules are that shares in a non-quoted foreign company that owns, directly or indirectly, French real estate or rights over French real estate, the market value of which exceeds 50 per cent of the total market value of any other French assets (including the French real estate), are regarded as French-sited assets. French real estate, for this tax purpose, excludes real estate used for the purposes of a business activity (a vineyard for instance). Letting activities, even if the property is furnished, are not regarded as business activities. Therefore, a commercial or residential property that is let out to tenants is still regarded as French real estate for the purposes of this legislation.

If, in addition to a French residential property, French-sited assets also include other movable valuable assets (such as art works, collectors' items or financial assets) whose total market value exceeds 50 per cent of the total French-sited assets, then the shares in the foreign company owning these assets (movable and immovable) should not be regarded as French-sited assets.

Having said that, the application of these rules also depends on the situation of the tax residence of the owner – the settlor of the trust in our case – and the provisions of a potentially applicable double-taxation treaty (DTT). Where there is no DTT or the applicable DTT does not cover wealth tax, French tax legislation provides for a French tax anti-avoidance provision that allows the taxation of French residential property owned indirectly by a foreign company, even if that foreign company cannot be regarded as a French real-estate company. This can apply when more than 50 per cent of the shares in that company are owned by members of the same family, such as spouses, parents or grandparents, descendants, and siblings.[3] Although article 750 ter FTC seems also to apply in respect of assets owned in trust, the legislation does not clearly address how the 50 per cent must be determined when assets are owned by trustees. It seems that, in accordance with the transparency approach mentioned above, we should ignore the existence of the trust for this purpose.

Once it has been determined that the shares in the foreign company can be regarded as French-sited assets (and are thus taxable in terms of wealth tax), we then need to determine the net value of the shares to which wealth tax applies.

CALCULATING SHARE VALUE

The net value of the shares is computed as follows: market value of the real estate minus any qualifying debts. As far as debts are concerned, only bank loans can qualify as deductible debts. The question as to whether a loan from a trust is deductible raises complex issues and uncertainties. The French tax authorities might take the view that, for wealth-tax purposes, the settlor is regarded as the owner of the trust assets, and a loan from the trust could be regarded as a loan to the settlor (thus a non-deductible loan).

Wealth tax applies if the net value of the shares (and, eventually, the value of other taxable French-sited assets owned by the settlor) exceeds the threshold of EUR1.3 million.

2. *French Tax Code*, article 750 ter 2°

3. *Id*, paragraph 2

'A commercial or residential property that is let out to tenants is still regarded as French real estate for the purposes of this legislation'

Having said that, it should also be noted that French tax legislation provides that DTTs eventually signed by France and the state of residence of the settlor can apply normally (as the trust is ignored). This is particularly relevant if the settlor is a resident of certain countries in the Gulf Cooperation Council (GCC). Indeed, France has signed special DTTs with some of the GCC countries;[4] these DTTs provide specific and singular wealth-tax exemptions. These exemptions should also apply even if the French real estate is held in a trust.

FRENCH IHT

From a French IHT perspective, the settlor would also be regarded as the 'owner' of the trust assets (i.e. the owner of the shares in the company owning, directly or indirectly, French real estate).

French IHT issues might arise on the death of the settlor. From a French tax perspective, the death of the settlor triggers a 'transfer' of the trust assets to the beneficiaries. If the assets remain in trust after the death of the settlor, the beneficiaries of the trust then become the new owners of the trust assets (or deemed settlors).

French IHT can only apply on French-sited assets when neither the settlor nor one of the beneficiaries is a French tax resident.[5] The definition of French-sited assets is the same as the one applicable in respect of wealth tax (i.e. the French real-estate company rules and the 50 per cent family-owned company rules). Therefore, the shares in the foreign company owning, directly or indirectly, French real estate can potentially trigger French IHT issues on the death of the settlor.

DOUBLE TAXATION TREATIES COVERING DEATH TRANSFERS

French tax legislation makes it clear that, in the trust context, DTTs covering death transfers signed by France with the state of the last residence of the settlor can apply (and might provide some exemptions). This is particularly relevant in respect of the DTTs signed by France with the GCC countries cited above. These DTTs provide a very interesting French IHT exemption when French real estate is owned through a company and not by an individual.

> 'The shares in the foreign company owning, directly or indirectly, French real estate can potentially trigger French IHT issues on the death of the settlor'

When IHT is due in France on the trust-sited assets, French tax law addresses the following three situations:[6]

- **If, at the date of the death of the settlor, a specific trust asset is attributed to an identified beneficiary, French IHT applies under the normal regime (which is the most favourable situation). The rate of tax depends on the relationship between the deceased settlor and the beneficiary.**
- **If, at the date of the death of the settlor, a specific trust asset goes 'globally'[7] to various beneficiaries who are the descendants of the settlor, but it is not possible to identify the share of the assets attributed to each beneficiary, French IHT applies at a flat rate of 45 per cent. Although more detailed comments on this situation are needed, it seems to cover the situation where, on death, a determined part of the trust asset goes 'globally' to a class of beneficiaries all consisting of descendants of the settlor.**
- **In all other cases, taxation applies at a flat rate of 60 per cent. This situation might apply in two cases: (i) when the assets remain in trust after the death of the settlor without being attributed to an identified beneficiary (or beneficiaries); and (ii) when the assets remain in the trust but go 'globally' to various beneficiaries who are not descendants of the settlor.**

In the context of French real estate owned in trust, advice must obviously be taken in advance to

4. Including Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and the United Arab Emirates
5. I will not address the situation of French tax resident beneficiaries in this article for reasons of brevity
6. In these situations, the term 'trust asset' must be understood to mean shares in the company owning, directly or indirectly, French real estate
7. French law uses the term *globalement* to say that all the assets without distinction are 'overall' attributed to the beneficiaries

ensure that, on the death of the settlor, the second and third situations noted above do not apply. Providing this is done correctly, the existence of the trust should not really change the situation.

FRENCH CORPORATION-TAX ISSUES

A trust structure would not raise *impôt sur les sociétés* (corporation tax) issues by reason of the existence of the trust itself, but because of the interposition of corporate entities (i.e. the trustees as corporate trustees and/or the foreign company owning, directly or indirectly, the French real estate). Foreign corporate entities owning French real estate directly or indirectly are potentially subject to French corporation tax. This is a consequence of the application of two articles of the FTC.[8] These issues are primarily of concern in respect of residential properties, as corporation tax does not normally apply to them. Indeed, it is not usual for corporation tax to apply to residential properties for two main reasons: for the free use of the residential property and on the sale of the property.

FREE USE OF THE PROPERTY

Under French tax law, the free occupation of residential real estate does not trigger taxation on any benefit in kind received from the free use of such real estate.

This income-tax exemption also applies where real estate is owned by a French SCI and used free of charge by its individual shareholders. On the other hand, the exemption is not possible when the shareholders of the SCI are corporate bodies (as would be the case in a trust structure).

Broadly speaking, under the corporation-tax rules and the 'abnormal act of management' theory, a company can be subject to corporation tax on the deemed profits deriving from the free use of the property it owns. Simply put, the company liable to corporation tax is supposed, in principle, to make profits, and the free disposal can be seen as being against the commercial interests of the company. This legal provision enables the French tax authorities to apply corporation tax to the rent that the company would have earned if the property had been rented out at market price.

8. Articles 206-1 and 209-I

However, expenses related to the property, in particular interest from a bank loan, can be deductible from the gross rental profits. Therefore, as the tax is due on the net rental profits, the negative effects of the application of corporation tax might be reduced by the deduction of expenses generated by the annual costs of the property.

SALE OF THE PROPERTY

Capital gains realised on the sale of the property are calculated and taxed under the French corporation-tax regime, which is less favourable than the private capital-gains-tax regime that applies when a residential property is owned by individuals directly or indirectly through a French SCI.

In addition to the fact that no taper relief applies, depreciation of the property needs to be taken into account. Given the effects of the depreciation rules, the longer the company owns the property, the higher the corporation-tax liability on any future sale. For long-term ownership, the application of corporation tax might not be the best option.

Having said that, one solution to avoid these corporation-tax issues on the sale of the property could be for the trustees to sell the shares in the foreign company owning, directly or indirectly, French real estate instead of selling the property itself. A sale of shares would not be subject to taxation in France, providing that the foreign company whose shares are sold cannot be regarded as a French real-estate company. It should be noted here that the definition to determine if a foreign company can or cannot be regarded as a real-estate company is different from the one given above in respect of wealth tax and IHT.

TRUSTEES' DISCLOSURE OBLIGATIONS

Under article 1649 AB al 1 FTC, trustees have to comply with disclosure obligations if, on 1 January of the relevant tax year, they administer a trust that has any of the following French connections:

- **the settlor and/or at least one of the beneficiaries of the trust is a French tax resident;**
- **an asset held in the trust is a French-sited asset within the meaning of article 750 ter FTC,**

even if the settlor and/or the beneficiaries are not French tax resident; or
- **the trust is administered by a French tax resident trustee (although this should be extremely rare in practice).**

In our case, the trustees of the trust own shares in a company owning, directly or indirectly, French real estate; the trustees themselves do not own French real estate directly. Therefore, assuming that neither the settlor nor any of the beneficiaries/trustees of the trust are French tax resident, the trustees will have to comply with the disclosure obligations if the shares in that company can be regarded as French-sited assets. The definition of French-sited assets is the one applicable to wealth tax and IHT.

It is important to mention here that, to determine if an asset can be regarded as a French-sited asset for the purpose of the trustees' disclosure obligations, only French domestic provisions under article 750 ter FTC apply. DTTs cannot be of any help. Therefore, if the shares in the foreign company can be regarded as French-sited assets under article 750 ter but cannot be treated as such under a DTT, the provisions of that DTT will be irrelevant. This is because trustees' disclosure obligations are not usually covered by DTTs.

When the disclosure obligations apply, the trustees have to comply with two different and separate filing obligations: a general declaration of existence and modifications of a trust, and an annual declaration of assets held in the trust. The obligation to comply with these two declarations is the responsibility of the trustees. Trustees who fail to comply with these filing requirements may be subject to significant penalties.[9]

THE GENERAL DECLARATION OF EXISTENCE AND MODIFICATIONS OF A TRUST

The tax guidelines state that the obligation to make a general declaration to the French tax authorities of the existence of a trust occurs if a trust has a French connection (i.e. a French-sited asset) on 1 January of the relevant tax year.

Once this declaration has been made, there is no need to make another declaration for the following years unless a modification is made to the disclosed trust. In such a case, the declaration must be made within 30 days following the modification. The term 'modifications of the trust' is drafted widely enough to include any changes affecting the terms of the trust, the settlor, the beneficiaries or trustees, or the trust assets.

> 'To determine if an asset can be regarded as a French-sited asset for the purpose of the trustees' disclosure obligations, only French domestic provisions apply'

The declaration has to be made in a specific form provided by the French tax authorities[10] and must provide full information regarding the trust, such as identification of the settlor and the beneficiaries (full name, address, and date and place of birth); the main terms of the trust (revocable or irrevocable, discretionary or non-discretionary, and the rules governing the rights to assets and the rights from the trust property and its income); and any modification made to the trust.

THE ANNUAL DECLARATION OF ASSETS HELD IN TRUST

The trustees must lodge a declaration of assets held in trust on 1 January of the relevant tax year. The annual declaration must be filed regardless of the value of the trust assets or whether wealth tax is due on them.

The trustees have to disclose the value, as at 1 January of the tax year, of the shares in the company owning, directly or indirectly, the French real estate. In respect of a trust with non-French tax resident settlors, the declaration must be lodged by 1 September. Only French-sited assets of a trust have to be disclosed if none of the settlors, deemed settlors or beneficiaries are French tax resident.

The declaration must be made using a specific form provided by the French tax authorities.[11]

9. These penalties are not addressed in this article

10. Form no 2181-TRUST1
11. Form no 2181-TRUST2

THE 3 PER CENT TAX

Another issue triggered by the use of a trust is the 3 per cent tax. Under article 990 D FTC, foreign companies and other entities (such as trusts) owning French real estate directly or indirectly are potentially subject to an annual 3 per cent tax applied on the market value of the real estate, unless an exemption can apply. This anti-avoidance tax legislation was enacted many years ago to prevent the use of opaque structures to own French real estate with the aim of avoiding wealth tax and IHT.

A company is deemed to be located where it is effectively managed and not necessarily where it is incorporated. In respect of trusts, the French tax authorities appear to consider them to be established in the state or territory whose law applies to them. Indeed, for 3 per cent tax purposes, it is the law governing the entity that determines the location of that entity. This is a quite singular approach.

A number of exemptions apply to foreign companies and entities incorporated in a country that has signed a treaty with France that either provides an appropriate administrative assistance provision to prevent fraud and tax avoidance between both countries, or contains a non-discrimination clause. This is the case in most treaties signed by France.

It should be noted that, in respect of trusts, the benefit of such administrative assistance provisions or non-discrimination clauses is not straightforward and might give rise to various complications. Indeed, not all the treaties signed by France that contain such provisions may benefit such entities, since entities not endowed with legal personality (such as trusts) are generally outside the scope of treaties. To avoid the application of this tax, it is therefore important that the trust is governed by the law of a state that has signed an appropriate treaty with France.

In addition, the exemption is not an automatic right. To benefit from it, the trustees must comply with specific filing requirements (separate from the trustees' disclosure obligations). The formalities required are to either send an annual 3 per cent tax form[12] to the French tax authorities disclosing certain information, or to give an undertaking to provide this information on the French tax authorities' request.

Finally, there is another exemption that might benefit trusts in respect of the 3 per cent tax. Non real-estate companies or entities (as defined above in respect of wealth tax and IHT) are outside the scope of the 3 per cent. Therefore, if the company owning, directly or indirectly, French real estate cannot be regarded as a French real-estate company, the 3 per cent tax does not apply. This exemption applies regardless of the location of the trustees. Furthermore, unlike the above exemption, this exemption applies automatically without the need to comply with specific filing requirements.

CONCLUSION

These are the main issues to consider when using trusts to own French real estate. In this article, I have only addressed general points on complex matters; these points should not be taken as advice. What I can see from these points is that the use of a trust to own French real estate does not really change the ownership situation in France as far as French wealth tax and IHT are concerned. The general principle is that the settlor is still regarded as the 'owner' of the trust assets as if the trust does not exist. The main drawback would perhaps be the French corporation-tax issues, but not necessarily in all cases, as these disadvantages can be balanced against the non-tax benefits that trusts can bring, depending on the situation.

One other drawback with the use of a trust would be the increased disclosure obligations and the probable associated costs of maintaining the structure (which would only be justified in respect of valuable properties). Having said that, and with such tax issues/formalities aside, trusts can remain good vehicles through which to own French real estate when considering estate planning and family asset-protection and ownership.

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12. Form no 2746