French tax reform concerning trusts and non-residents

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The latest version of the *loi de finances rectificative pour 2011* contains several important provisions for non-residents owning French immovable property and also for trusts.

1. Repeal of the three times annual rental value income tax liabilities for non-residents: The French Minister of Finance announced in May that Article 164C is to be abolished, and replaced by a form of rating system for non-residents having French property available to them. The basis is the cadastral value used for rating purposes. The rate itself will be fixed at 20% of that value. This forestalls future litigation in Luxembourg on article 164C, but may encourage issues as to this effective discrimination. This will be in addition to the present rating system, but will only apply to non-residents who do not otherwise pay French income tax on a significant proportion of their income (75%). Article 164C presently assesses non-residents to income tax on a deemed basis of three times the annual rental value of the French situs properties available to them.

2. The Minister also stated that the current technique of financing SCI property purchases by member's loan, rather than capitalisation, with the intention to avoid wealth tax will be curtailed. This will not apparently affect the estate duty exemption remaining available under the United Kingdom treaty.

3. The Minister also announced that trusts will now be subject to taxation under a new régime with effect from 1 January 2012. The terminology used in the legislation is lax. The term constituant is employed for the settlor, and a term administrator employed, apparently to catch a trustee and other persons involved in a trust's administration, without admitting the nature of a trustees' estate under the foreign law concerned.

A previous draft, in the *loi de finances rectificative pour 2010*, contained provisions assimilating a trust to an *entité dépourvue de personnalité juridique,* or entity lacking juridical personality for income tax and capital gains purposes, but this has been held over until the reform of the taxation of French *sociétés de personnes* is finalised. There remain conceptual links between the two proposals.

The changes for trusts

The previous changes to income tax and capital gains tax proposed are not included in this amendment, which is limited to the issues related to wealth tax and gift and succession duties.

I wish to stress that I am simply setting out the logic underlying the proposals, however, it should be said that the effects of the proposals themselves can be challenged, and that the proposals are by no means a "code" which will work to the administration's advantage. The fundamental concept of a trust is not catered for in the structure, which is based on an application of a combination of the trustees as being no more than an administrator of an asset, rather than the owner itself, and upon a notion of French law known as the *propriété apparente,* in other words the person who appears to be the owner of the property, by exercise of rights or receipt of benefit, is treated as the owner in law. Mme Lagarde, previously a partner of Baker & McKenzie Chicago, may be less sensitive to certain fundamental notions of English property law. A trust is generally founded on the legal ownership of an asset by a trustee against which the beneficial rights can then be claimed or asserted. The pragmatic and empirical approach adopted by the French legislature may yet fail when confronted with both the legal substance and form of the foreign legal concept addressed.

The régime will firstly modify an income tax provision, Code Général des Impôts, (CGI) article 120 9°, to read: « 9° *les produits distribués par un trust défini à l'article 792-0 bis, quelle que soit la consistance des biens ou droits placés dans le trust* ; ». This means that accumulated income will not be taxable, until distributed, but it does introduce the notion of distribution of a *"produit"*. The reasons for this are technical, but important, as it prefigures the future treatment of a trust as an entity, rather than as a concept of property law. It certainly begs the question as to whether they currently are entities, as the current drafting tends otherwise. It will remain possible, however, for income to remain outside this definition, and obtain a wealth tax advantage, provided income is paid directly to beneficiaries rather than via the trustees income accumulation account, and the beneficiaries are not otherwise considered usufruitiers of the capital of the fund.

The main issue will be the general definition of a trust to be inserted into the CGI, which is as follows:

D. Après l'article 792, il est inséré un article 792-0 bis ainsi rédigé :
« Art. 792-0 bis.- I. – 1. Pour l'application du présent code, on entend par trust l'ensemble des relations juridiques créées, dans le droit d'un Etat autre que la France, par une personne, qui a la qualité de constituant, par acte entre vifs ou à cause de mort, en vue d'y placer des biens ou droits, sous le contrôle d'un administrateur, dans l'intérêt d'un ou de plusieurs bénéficiaires ou pour la réalisation d'un objectif déterminé.
« 2. On entend par constituant du trust, soit la personne physique qui l'a constitué soit, lorsqu'il a été constitué par une personne morale, la personne physique qui y a placé des biens ou des droits.
.....

The remainder of article 792-0 *bis* then lays down certain technical deeming provisions for wealth tax and gift and estate duty purposes.

Whilst this is within the stamp duty section of the French tax code, it is clear that its scope is wider, and it is the first attempt by a civil law tax jurisdiction to define the tax consequences of the concept - without specifically recognising it. This, or an amended version, will serve as the basis for any further income tax and capital gains tax ramifications in further legislation.

The proposal has two aspects: i) the deemed succession and gift duty treatment of deemed transfers within the trust, and ii) the annual wealth tax assessment provisions. Each tax has separate compliance and tax recovery provisions.

Gift and succession duty regimes

The trust "definition" at 792-0 *bis*. II then lays down deeming provisions for the attribution of capital as between the

settlor and the beneficiaries, and also for deemed transfers for gift and succession duty purposes. It also defines the rates at which these transfers are taxable. Whilst some of these are fixed at equivalent rates to those on equivalent transfers between related persons, there will inevitably be some increase in the tax burden, as the top rates are used in each category where there is a class.

The corresponding amendments are made to the taxing provision at article 750, and specifically the receipts basis for French residents, where these have been resident in France for a period of six out of the ten preceding years. There is therefore a window of opportunity for capital distributions here. What is more the amendment appears to have removed French resident "legataires" or legatees from the exemption provision, which is curious and unfortunate. It may be that the French administration's exposure to American will trusts, rather than the wider international trust formats has lead to this error. What is clear is that if the legislation remains unchanged, the present exemption from the receipts basis of taxation will be lost to those legatees taking under foreign wills who have been resident in France for less than six out of the ten tax years preceding the receipt. Heirs and beneficiaries will retain the exemption under the proposed wording.

Note that where a settlor was tax resident in France at the moment when he constituted the trust, the succession duty and gift rates on transfers internal to the trust are fixed at 60%, as they are for trusts in non co-operative jurisdictions. In other words, the constitution of any trust by a French resident settlor will be economically compromised, and penalised, if the aim is for the trust to survive him. The intention here is retroactive.

The draft legislation provides for taxation of transfers deemed to take place within trusts on the decease of the constituant, or those beneficiaries considered as such.

The rates applied to these deemed transfers under the proposal are also heavy, where the trust does not vest or allocate rights on beneficiaries on the decease of the settlor: 40% in some cases, but up to 60% in others. The trustee is responsible for paying these.

The definition employed makes no reference to the recognition features contained in the Hague Convention on the Recognition of Trusts, and may be flawed in that the fundamental question of the transfer of property to the trustee; a necessary part of the constitution of the trust, is not addressed. As France has not ratified the Convention, it is not required to give full legal effect to a trust, but merely to give the recognition available under its private international law. The definition is drawn from the judgment in the *Poillot* case, but is not subject to the express limitation that the TGI Nanterre imposed prior to making the general description now employed as a form of "deeming" definition. The concepts attacked are wider in their scope than a trust. What is more, the term "*administrateur*" of a trust is employed rather than that of a trustee. This indicates that the French administration are taking a doctrinal position that the property ownership and rights issues are to be governed by their interpretation of *la propriété apparente,* in other words, the apparent owner of the property or right, rather than embroiling the statutory definition in the distinctions between legal and beneficial ownership and interests. Whether this issue becomes a fatal flaw in the legislation will be determined by the courts, who will need to navigate between the trust provision, this definition and the "entity" definitions being proposed in other areas of the tax code.

Note that a French tribunal or court does not have the same interpretative and enforcement capacity over a trust as a Court in a trust jurisdiction.

Press reports have disclosed how foreign nationals residing in France have organised their inheritance through trusts as "tax optimisation" tools to avoid paying taxes. These also indicate that the French government, which concluded TIEAs with Jersey and Guernsey last year, will not target all trusts, but only those which are used for untaxed inheritance schemes. What the press reports do not mention is any progress on the parallel proposals for taxation of trusts in the income tax and capital gains tax area in connection with the changes from "translucid" to "transparency" in corporate taxation.

Wealth tax

This is, at first glance, orientated toward placing the property, and debts, in trust within the wealth tax basis of the settlor. An amended article 885 G *ter* will provide that assets or rights placed in trusts, with accumulations, will fall to be taxed in the hands of the settlor, or, if he died prior to 1 January, 2012, in the hands of the beneficiary or beneficiaries thereafter deemed to be settlor. The legislation frames the liability as being that of the settlor, not that of the beneficiaries, and trusts constituted by non-resident settlors in favour of beneficiaries who are or become resident in France may still have an advantage for wealth tax purposes, as the *Constituant* is the primary taxpayer. However, care needs to be taken here where there are trust assets in France.

The wealth tax rate applicable to trusts is penal, as it is fixed at 0.5%, not the progressive 0.25% - 0.5%, on attributed net assets exceeding EUR1.3 million. This is the maximum rate, which would otherwise be applicable on amounts over EUR3 million. It is therefore discriminatory and punitive.

There is also a specific administrative provision requiring a payment by way of *prélèvement* which fixes the compliance and payment obligations for wealth tax as to individuals resident in France, and also as to trust assets situated in France. It is no coincidence that this is next to the equivalent *prélèvement* provision for insurance contracts. This will attempt to ensure that any settlor or beneficiary resident in France is jointly and severally liable to wealth tax on the trust, alongside the trustee, and also to ensure that tax is collected as appropriate upon French situs assets subject to the tax, where the trust has no resident settlor or beneficiary. The legislation does not apply any *prélèvement* for succession or gift duty purposes, as these are dealt with by declaration.

The legislation will introduce collection methods, withholding liabilities, and penalties, and amend the French procedural rules accordingly.

Declaration and compliance rules concerning trusts where a settlor or a beneficiary is resident in France, or where a trust asset is situated in France are introduced. The constitution, modification or extinction of the trust as well as any change in its terms have to be declared, the trustee also has to declare the value of any assets falling within the *prélèvement* article 990J as at 1 January of each year. Whilst this is a wealth tax matter, it goes without saying that the information will also be used for succession and gift tax assessments. There is a minimum EUR10,000 penalty or, if higher, 5% of the French assets or accumulations, or the whole trust fund. To finish off, the settlor and the beneficiaries within the scope of article 990J are jointly and severally liable for the penalty. The administrator also has to make a declaration of assets for the wealth tax *prélèvement* as of 1 January of each year, either of assets situated in France, or a full disclosure where the *constituent* is resident in France.

Pension Plans: Wealth tax exemption

The draft legislation specifically exempts Pension Plans taking the form of a trust from certain of the taxing provisions. Article 990 J II will exempt French resident settlors and beneficiaries from the wealth tax *prélèvement* liability on assets in trusts set up to manage pension rights acquired during their professional life: salaried or otherwise, provided that this is within the framework of a pension scheme set up by an undertaking or a group of undertakings. This will need to be extended in practice by decree if it is to cover the multitude of professional pension plans prevalent in the

United Kingdom and other jurisdictions, contracted outside a corporate group of undertakings. It appears that, as a result, the trustee will not be required to make the annual wealth tax declaration of net value for the *prélèvement,* but will remain required to declare the existence, change or extinction of the trust pension arrangement or plan.

Finally, where a settlor or beneficiary dies, the existence of the trust assets will need to be declared in any succession duty declaration under the amended article L19 of the *livre des procédures fiscales*. The "receipt" mechanism of taxation in article 750 *ter* will also thereby be preserved.

The draft legislation adopts an entirely empirical approach to the question of the distinction between legal ownership and beneficial interests, purporting to reduce a trustee's status from owner to that of a mere administrator. Had France ratified the Hague Convention on the Recognition of Trusts, rather than merely signing it, it would have been unable to adopt this method of taxation, which is redolent of a past French heresy that a trustee is a mere *administrateur de biens d'autrui,* exercising control but not the prerogatives of ownership.

These provisions will come into force on the publication of the *loi de finances rectificative pour 2011*, which is assumed to be 1 January, 2012. I would suggest however that this date not be relied on, as it would be possible for the *loi* to be published earlier, and come into force on a prior date.

Clients should be made aware that certain issues can be forestalled, and that advice is best taken in good time, June or July, for any necessary resettlements, amendments and distributions to be made before the coming into force of the *loi.* It may be too late to take action later, and relying upon the foreign law to undermine the statutory deeming and assessment provision may prove a costly process, albeit certainly not impossible.

As a transitional measure, where the settlor of an existing trust has died prior to 1 January, 2012, the remaining beneficiaries can be treated as constituants/settlors thereafter. The manner in which this is achieved is reminiscent of a Roman law family succession where the head of a family dies.

What is more, the administrator of any trust with a French resident constituant or at least one resident beneficiary is required to notify the administration of the "constitution", amendment of terms or the "extinction" of the trust[1]. Failure to do so is subject to a penalty, and the constituent and the beneficiaries are jointly liable for it.

The French press note the numerous agreements regarding tax exchange of information between French Tax Authorities and their foreign counterparts, and how these exchanges of information should also help "uncover" some trusts. It reported that the French Finance Minister hopes to raise an additional EUR30 million in additional tax revenue of this new measure in 2012.

The official text of the reform is published in the download section of the website: http://www.assemblee-nationale.fr/13/projets/pl3406.asp#P415_61428 - trusts are examined on pages 23 and 24.

Parliamentary approval is expected in June/July 2011. By way of background, in March, the government proposed removing the first tax-band so that only those with assets above EUR1.3 million would be subject to wealth tax. The rates are to be reduced from the current 6 bands ranging from 0.55% to 1.8% down to just two rates (0.25% and 0.5%). The upper rate would be applied if total assets exceed EUR3 million, but would also apply to trust assets over EUR1.3 million. These rates would apply from the 1st Euro after the EUR1.3 million cap is reached. A "smoothing mechanism" is being proposed for taxpayers with total assets between EUR1.3 million and EUR1.4 million and also for those between EUR3 million and EUR3.1 million.

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ENDNOTE

1. Rumours of the extinction of the trust concept may notwithstanding be exaggerated.