French tax optimisation upon sale of a building by a foreigner

Following the enactment of the second French Finance Amendment Act on September 21 2011, Nicolas Message of FTPA analyses the increase in real estate taxation in the country.

Is there still any need, in the present world, to make long developments on the increasing tax pressures on Western European taxpayers? Despite the fact that the new rigorous plan disclosed by the French Prime Minister on November 6 2011 does not really contain any additional taxation on real estate (except for the increased VAT rate from 5.5% to 7% on building-linked works or for the increased personal or corporate income tax pressure), French real estate taxation has been particularly and recently increased in France following the enactment of the second French Finance Amendment Act on September 21 2011.

This legislation has strongly reduced the relief available upon sale of a French real estate for sales to occur after February 1 2012. From that date, if, for instance, the property being sold has been owned for four years, the full gain is taxable in France; if owned for eight years, 6% of the gain is exempted. If the property has been held for 10 years, 10% of the gain is exempt; after 20 years of ownership, 36% of the gain is exempt, and once held for 30 complete years, the gain is exempt in full. The relief applies where the property is held directly by French or foreign individuals, or through a pass-through partnership (such as a *Société Civile Immobilière)*, as long as it has not become subject to corporation tax.

As to French real estates owned through corporate holdings, the business capital gains rules apply without relief, irrespective as to whether – in substance – the seller is French or foreign. In these cases, the capital gain realised upon sale of the property is taxed at the rate of 33.33%, i.e. without benefitting from the relief. As it is common that non-French tax resident individuals invest in France either through a French or a foreign corporation subject to corporation tax (or through a French "transparent" SCI, the shares of which are held by a foreign corporation subject to a corporate tax in its country of residence which is similar to the French corporate income tax), they often try to optimise their investments in getting the same advantages as would have been available to them had they invested directly in the real estate or indirectly through a pass-through partnership.

This question is even more poignant in the present context of increasing tax pressure and, therefore, the question arises as to whether these taxes can be reduced or at least minimised through capital gains tax basis reduction.

Capital tax basis reduction of the building through real estate distribution

A solution would consist in distributing the French real estate held by the foreign corporation to another foreign legal entity.

As far as foreign taxes are concerned and if both entities are EU companies, such as Luxcos for instance, the beneficiary of the distribution would obviously benefit from the parent-subsidiary dividend exemption regime. And because the building is a French real estate, France normally attracts any capital gain tax eventually due upon exit of the French real estate from the balance sheet of the distributing company, pursuant to most, if not all, of the tax treaties entered into between France and third countries.

However, a tax is only due in France provided there is a legal ground allowing France to levy it. To cut a long story short, there is no obvious legal ground allowing this taxation.

Indeed, although Section 244 bis A of the French General Tax Code is aimed at taxing French real estate capital gains, it only applies to transfer "for consideration" (*à titre onéreux*) as set forth by the conjunction of Sections 164-B and 150-U of the French Tax Code. As a dividend distribution does not purport any consideration from the beneficiary to the distributing company, this transaction shall not be characterised as a transfer "for consideration". This analysis has been confirmed by a recent case law rendered by the Supreme Judicial Court (Cour de Cassation, *Société HF Participation* dated February 12 2008, no.05-17.085).

French real estate taxation has increased following the second French Finance Amendment Act

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One considers, however, that the capital gains tax may be levied under Section 38-2 of the French Tax Code allowing general taxation of profits. But, in accordance with the French territoriality principle, a profit shall necessarily be realised by a French enterprise (in other words, a French permanent establishment) pursuant to Section 209-I of the French General Tax Code to be taxable in France under Section 38-2. As a French real estate does not constitute a permanent establishment in France pursuant to constant case laws from the Supreme Administrative Court (for instance: Conseil d'Etat, *Société d'Investissement Agricole et Forestier* dated March 18 1994, no.79-971), we see no legal grounds here, even in the situation where the building is rented for consideration. Indeed, a rented building does not constitute a permanent establishment either, even if, in this context, the foreign company owning the building needs to file annual corporate income tax returns and is imposed on the rental incomes.

Others consider that the tax conventions themselves would be the ground of French taxation, despite the fact that local legislation may provide otherwise. It is true that the question as to whether a subsidiarity principle applies in an international context is still often debated. However, we are of the view that a tax treaty cannot itself lead to taxation: the French judge must first perform his analysis under French domestic law in order to determine whether the tax should be levied and under which qualification. Then, only if the domestic law test was successful tax-wise (which we consider is not the case in the present situation), should the judge apply the tax treaty to determine whether it finally gives to France the right to tax such income or not. This subsidiarity principle has been recognised under French law for a long time in numerous decisions (for instance: Conseil d'Etat, *Schneider Electric*, dated June 28 2002, no.232.276) even if recent case laws have seemed contradictory (Conseil d'Etat, *Overseas*, dated July 21 2009, no.296471), but applying in a permanent establishment context.

Finally, some authors consider that the last words of Section 209-I of the French Tax Code enlarge the scope of the French law, conferring an "aggravation power" to the international tax conventions. But is there a doubt that a tax treaty is intended to avoid double taxation and cannot be a legal basis for a decision pertaining to taxation? A positive answer would clearly be contrary to the spirit of international conventions, which can only apply after having determined whether France would have had the right to tax the income concerned under domestic law.

In any event, should we recognise the "aggravation power" of tax treaties, their terms should then at least allow the said capital gain to be taxed in France! And this is rarely the case in case of distribution in kind, as they often allow taxation of "alienations", which also refer to transfer for considerations pursuant to the OECD commentaries.

Provided that there is no French or international legal ground allowing capital gain taxes to be levied and that the tax convention cannot aggravate this situation, the real estate dividend distribution in kind would not attract any French corporate income tax. As to registration taxes, they would also not be due since the recent case law ruling out that this transaction is not made for consideration (Cour de Cassation, *Société HF Participation*, see above). This, however, neither applies for the land registration tax (*taxe de publicité foncière*) at the rate of 0.715% nor for the notary fees (approximately 1.1%).

Then, upon resale of the building by the foreign entity having benefitted from the distribution, the seller would calculate its capital gains taking into consideration the value at which the building has been booked in its balance sheet, i.e. the fair market value of the building at the date of the distribution. The capital gain would therefore be minimized by the difference between the fair market value of the building upon distribution and the tax value that said building had in the books of the distributing company.

Capital tax basis reduction of the shares in real estate companies through additional indebtedness to be incurred

Another idea – much more simple than the previous one – consists in minimising the capital gain tax basis upon sale of the shares in a corporation owing a real estate in France. Pursuant to this three-step structure, the corporation would re-evaluate the underlying French real estate, incur additional indebtedness and distribute as a dividend the reevaluation reserve to its shareholders.

The asset revaluation triggers the same tax questions as stated above, but is much less risky from a French tax standpoint as it implies no transfer from the real estate itself. Therefore, we believe that the gain deriving from the reevaluation should neither be taxable in the foreign country (provided this is the case in the particular jurisdiction of incorporation of the distributing company) nor in France.

Secondly, the additional indebtedness may easily be incurred by the foreign company from a bank or any third party and should comprise standard terms and conditions as to interest rate and repayment modalities to avoid any characterisation of the additional indebtedness as a non-deductible capital contribution.

The third step (distribution of reserve) is to be carefully settled. Pursuant to French legislation, reevaluations reserves cannot be distributed to the shareholders, by contrast to Luxembourg legislation in a certain extent for instance, or Swiss legislation provided the company is in a loss position. Taking into account a Luxembourg structure, the reserve may be distributed provided a tax may or may not be withheld by this jurisdiction depending on which jurisdiction the company benefiting from the distribution is incorporated.

But provided an appropriate benefiting structure is incorporated with no withholding tax levied by Luxembourg (involving a second holding Luxembourg or a Cypriot company), this structure allows the reduction in value of the shares of the legal entity owning the French real estate and, therefore, the corresponding capital gain tax basis upon sale of such shares.

Conclusion

There is no doubt that these structures may be seen as very aggressive and, for this particular reason, must not be driven for pure tax reasons to avoid abuse of law characterisation by the French tax administration. They should also be carefully reviewed and analysed in the context of the particular situation of each taxpayer, who should consider keeping the reevaluated company or the distributed real estate during a period of at least three years before resale.

Finally, we recommend taxpayers involved in the acquisition of a French real estate to anticipate the resale of the building in setting up a structure whereby they would be allowed to benefit at the end from Capital Tax Basis Reduction schemes.

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