FRENCH TAX REFORM CONCERNING TRUSTS AND NON-RESIDENTS

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The *loi de finances rectificative pour 2011* contains several important provisions for non residents owning French immovable property and also for Trusts.

1. The proposal to abolish Article 164C and replace it by a form of rating system for non residents having French property available to them has been withdrawn. This means that the current unsatisfactory confusion as to whether a declaration is actually possible when a non resident has a French property available to them, but no declarable French source income other than the deemed three time s annual rental income liability remains. It is curious that M Barouin is on record as saying that the three times annual rental income assessment was introduced as a "tit for tat" measure during the tensions between the US and France over nuclear triggers in the De Gaulle administration, and has never actually been enforced. He may be a little out of touch with his administration"s interpretation and attempted application of the text!

2. The Sénat has voted the text of the trusts régime in a final article 21 of the "Petite Loi", which is unlikely to be further modified before its publication and coming into force. The implementing decrees will probably contain further detailing of the scope and effect of the general anti-avoidance proposals. This article is therefore based on the final text before its publication.

3. Generally, the reader should not forget the context from which the proposals sprang. The reason for the deliberate ambiguity in the term "adminstrateur" chosen is that certain so-called trust structures using civil law "trustees" have administration and management agreements in place by which the so-

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called "settlor" contracts with the so-called "trustee". Whilst this is anathema to the English trust concept, which is one of property law, not of contract, and would immediately be at risk as a sham, this type of structure is commonplace in the jurisdictions with which the Cellule de Regularisation was confronted in 2009 and 2010. There may have been disclosures of Liechtenstien quasi-contractual structures called trusts, seeking recognition as such under the Hague Convention, which has led to this alarming hiatus of terminology. Given that hiatus, it is difficult to avoid using English trust terminology in the analysis of this article which unfortunately covers other "arrangements" as well. Certain other commentators have already noted that the concept of an Estate can be caught, of particular interests to probate specialists in jurisdictions such as the United Kingdom, the United States and Canada, where the tax treaties in force with France may override certain aspects of the general régime.

Despite its obvious conceptual failings, it is clear that there is now a statutory framework for the taxation of trust-like entities. It may now be possible to plan more effectively on this basis. However, until there has been a change in the forced heirship rules, which is politically unlikely, the use of trusts over French assets by French nationals who are non-resident settlors may still be subject to a legal risk.
The following is a fiscal analysis of the position; it does not address the legal recognition or non-recognition of trusts. As France has yet to ratify the Hague Convention, it is unlikely that there will be any change in the legal situation until ratification is made. In the author‟s view this is unlikely in the current context. Were ratification to take place, then the position of English style property law trusts, as opposed to their continental counterparts would become more defendable and stable in the fiscal context.

The changes for trusts

The prior changes proposed in the draft *loi de finances rectificative pour 2010* to treat trusts as entities for income tax and capital gains tax purposes have been held over. That this is still a live issue is demonstrated by the structural treatment in the amendment of article 120 9° to tax *produits de trusts* as *revenus mobiliers* on their "distribution", which inherently assumes that the trust is considered to be a form of entity, with an as yet undefined fiscal identity. This is further bolstered by the treatment of accumulated income in the wealth tax area.

However, the definition of the concept as an entity was not included in this amendment. Whilst the main body of the definition remains applicable throughout the *Code general des impôts*, the definition of the *constituant* of a trust is now limited to the Title of the *Code* concerning Wealth tax and gift and succession duties.

The legislation is framed to apply both to trusts of which the settlor was resident at the time of its constitution, and also those, which whilst constituted by a non-resident settlor have French situs assets.

What is an "asset" is determined by French law, generally this is by reference to the law governing it, but there is no doubt that, given the scope of the tax, the *assiette materielle* test will not be applied to foreign companies whose balance sheet comprises French immovable property. The law has been framed to work alongside, and undergird the 3% tax on immovable property holding entities. Whilst this looks straightforward, there are still large issues as to whether certain trusts are entities or *organismes* or not, and whether these fall within the scope of the 3% tax. Again, the disclosure régime may be responsible here, in that there is no doubt that the disclosure of certain Helvetic domiciled structures will have "queered the pitch" for genuine property law trusts from the English stable.

Income Tax

The régime will firstly modify an income tax provision, 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 retained in trust will not be taxable, until "distribution", but it does introduce the notion of distribution of a "*produit*". The reasons for this are technical, but important, as it portends the future treatment of a trust as an entity, rather than as a concept of property law.

The impact of this amendment is structural, and is designed to enable a future assimilation of a property law trust to a fiscal entity. It has other technical ramifications.

The Stamp Duty Chapter amendments

The main issue will be the general definition of a trust to be inserted into the Code Général des Impôts, which is now, after amendment as follows:

> *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 État 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. Pour l'application du présent titre, on entend par constituant du trust, soit la personne physique qui l'a constitué soit, lorsqu'il a été constitué par une personne physique agissant à titre professionnel ou par une personne morale, la personne physique qui y a placé des biens ou des droits.*
> .....

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 concept of a trust - without recognising it. For the title concerned, the amendment by the *Commission Paritaire Mixte* level now renders the settlement of a trust by a professional individual, a settlement by the individual providing the funds.

The main principle behind the régime is that where the trustee, or rather the trust, under present French interpretative principles, is subject to the law of a cooperative territory, the trust is given a less extreme treatment than where the trust is subject to eth laws of a non cooperative state of territory.

One further point, the proposals do provide exemptions and specific adapted treatment for trusts which qualify as *caritative*, at best charitable, and also for certain types of group pension plan arrangements, which would otherwise be caught for Wealth tax purposes. However, an important point, whilst the pension plan arrangements can still provide for a limited form of succession planning as to entitlement on decease of the retired employee, it would seem that internal transfers of entitlement on the death of the employee can still be taxed as successions, although they can benefit from a Wealth Tax exemption during his lifetime. This may be further detailed in the implementing decrees.

To what does the definition purport to correspond?

Put shortly, very little of any real authority. It is an amalgam taken from different sources, and is therefore subject to criticism, particularly as it is likely to be asserted by France as valid in such fora as the IMF, the OECD and the European Union.
The definition makes no reference to the badges of recognition contained in the Hague Convention on the Recognition of Trusts on 1985, and may be flawed in that the fundamental question of the transfer of property ownership to the Trustee; a necessary part of the constitution of the trust, is not addressed. The underlying tendency is to assimilate the concept to a form of contractual mandate, rather than a property law concept.

Contrary to what has been affirmed in the Parliamentary process, which has been inflated with the political enthusiasm reserved for the suppression of criminal evasive activity, the definition is not that of the French text of the Hague Convention, which, for the sake of comparison reads as follows:

Article 2 (French text)	*Art 792-0 bis. I –*
Aux fins de la présente Convention, le terme « trust » vise les relations juridiques créées par une personne, le constituant - par acte entre vifs ou à cause de mort - lorsque des biens ont été placés sous le contrôle d'un trustee dans l'intérêt d'un bénéficiaire ou dans un but déterminé.	*1. Pour l'application du présent code, on entend par trust l'ensemble des relations juridiques créées, dans le droit d'un État 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.*

What is equally perverse is that France signed the 1985 Hague Convention and, what is more, is aware that the use of the term "legal" relationships was included only to satisfy the imperative of classification to enable recognition of a foreign legal concept, not to define what a trust is. The Hague Convention "definition" is therefore being deployed outside its agreed scope and, were the French to have ratified the Convention itself, would be an *abus* and unconstitutional. What is equally if not more, perverse is that the French used a proposal made by the Commonwealth representatives to include "a set of legal relationships", at a very early stage of the *travaux préliminiares*, which was never adopted even at an early stage of discussion: that is where the term *ensemble de relations juridiques* stems from. Fortunately there is another Hague Convention, on agency, which France has ratified that actually excludes a trustee of a trust from the concept of agent or *adminsitrateur*, which is the same term that the French definition has utilised. It may yet be possible for the English style trust to escape the definition as a matter of French constitutional law alone. However that means finding a Parisian Lawyer up to the task of understanding the trust as it is rather than attempting to apprehend it by civil law principles alone.

For memory, the Hague Convention continues the definition as follows, most of which is conveniently ignored in the French definition.

> *Le trust présente les caractéristiques suivantes :*
>
> *a) les biens du trust constituent une masse distincte et ne font pas partie du patrimoine du trustee ;*
>
> *b) le titre relatif aux biens du trust est établi au nom du trustee ou d'une autre personne pour le compte du trustee ;*
>
> *c) le trustee est investi du pouvoir et chargé de l'obligation, dont il doit rendre compte, d'administrer, de gérer ou de disposer des biens selon les termes du trust et les règles particulières imposées au trustee par la loi.*

> *Le fait que le constituant conserve certaines prérogatives ou que le trustee possède certains droits en qualité de bénéficiaire ne s'oppose pas nécessairement à l'existence d'un trust.*

The French definition omits the fact that the Trustee has to be the owner of the assets for the trust to be constituted, but attempts to employ the term *administrateur*, which in English law is no more than one of the prerogatives of the legal owner. It is at this point that Equity, as a discipline, should take over. Had there been more discipline in the drafting of the Hague Convention, then the French would have been forced back to treat the trust as a mere relationship, not a legal relationship, as it is described in all of the European regulations in which it is cited.

The definition is also drawn in part from the description of a trust provided in the judgement 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. The term "*contrôle*" is borrowed from the judgement, which was deliberately wide. Whether the use of the term "*administrateur*" of a trust rather than that of a trustee in any given circumstances will become a fatal flaw in the legislation will be determined by the Courts, who will need to navigate between this definition, the constitutional position, and the "entity" definitions being proposed in other areas of the tax code.

The succession and gift duty treatment meted out to trusts can be classified according the residence of the settlor, and the date of settlement of the trust. Any deemed disposal within a trust settled by a French resident settlor after 11th March; 2011 will be taxed at the maximum rate of 60%. Any trust settled under the laws of a non-cooperative jurisdiction at any date will suffer the same fate. Wealth Tax is treated separately, and is applied irrespective of the law applicable to the trust.

The proposal has three aspects:

i) the deemed succession and gift duty treatment of deemed transfers within the trust, and

ii) the Wealth tax assessment provisions;

iii) Each tax has separate compliance and tax recovery provisions.

i) 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 the actual mechanisms of taxation were amended throughout the Bill‟s progress through the various stages, the fundamental tax status of a trust remained unchanged, as where the taxable „event‟ could be declared as either a gift, inheritance or legacy, that treatment is retained:

> *Art 792-0 bis. II. – 1. La transmission par donation ou succession de biens ou droits placés dans un trust ainsi que des produits qui y sont capitalisés est, pour la valeur vénale nette des biens, droits ou produits concernés à la date de la transmission, soumise aux droits de mutation à titre gratuit en fonction du lien de parenté existant entre le constituant et le bénéficiaire.*

To that extent, certain structures may continue to function as initially planned, provided that their fiscal consequences can be declared in a compliant manner.
However, where that is not the case, the article provides for a fall back system of taxation, which resembles a straitjacket. It does not cater for trust where the spouse is a beneficiary, and only enables favourable standard estate duty rates to apply to certain beneficiaries. Technically speaking, the law does not admit rate reductions to beneficiaries, or classes of beneficiaries outside the bloodline. The regime has therefore been developed to cater for family dynastic trusts, but does not address the spouse's position. This means that there is a technical risk of any transfer within a trust to a spouse on the settlor's decease being taxed at 60%.

Note that where a trust was constituted after 11th May, 2011; the settlor was tax resident in France at the moment of its constitution; and the trustee is subject to the law of a non cooperative territory, the succession duty and gift rates on transfers internal to the trust are fixed at 60%, as they are for trusts in non cooperative jurisdictions. In other words, the constitution of any „offshore‟ trust by a French resident settlor after 11th May 2011 is economically compromised, and penalised, if the aim is for the trust to survive him.

> *Par exception, lorsque l'administrateur du trust est soumis à la loi d'un État ou territoire non coopératif au sens de l'article 238-0 A ou lorsque le trust a été constitué après le 11 mai 2011 et que, au moment de la constitution du trust, le constituant était fiscalement domicilié en France au sens de l'article 4 B, les droits de donation et les droits de mutation par décès sont dus au taux applicable à la dernière tranche du tableau III de l'article 777.*

As the system is settlor orientated, deeming provision are included to determine in whose estate the trust fund is considered to remain, where the settlor deceased prior to the coming into force of the law.

> *3. Le bénéficiaire est réputé être un constituant du trust pour l'application du présent II, à raison des biens, droits et produits capitalisés placés dans un trust dont le constituant est décédé à la date de l'entrée en vigueur de la loi n° ... du ... de finances rectificative pour 2011 et à raison de ceux qui sont imposés dans les*

conditions prévues au 1 et au 2 du même II et de leurs produits capitalisés.

The beneficiary, as defined, is deemed the settlor of the trust, where the settlor died prior to the coming into force. It is therefore possible for certain trust constituted by a French resident to escape the full scope of the legislation where the surviving "beneficiary" is non-resident. Depending on the circumstances, this can have the effect of limiting the application of the régime to French situs assets.

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. Where the actual fund is not vested o, death, but remains in trust for a class of defined persons the top rates applicable to that blood relationship apply, however where the rights remain unallocated the residue in trust is taxed a 60%. However, where the trustee is subject to the law of a non cooperative territory, or to that of a state which does not have a treaty permitting assistance in recovery of taxes, the Beneficiaries are also liable for the tax. Care needs to be taken here, in that a non-resident beneficiary can also be affected by this if they are in a jurisdiction which permits recovery of taxation.

Press reports have indicated how foreign nationals residing in France have organized their inheritance through this useful "tax optimization" tool 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.

ii) Wealth Tax

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 the coming into force of the law, in the hands of the beneficiary deemed 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 a progressive 0.25% - 0.5%, on attributed net assets exceeding €1.3m. This is the

maximum rate, which would otherwise be applicable on amounts over €3 million. It remains therefore discriminatory and punitive. There had been a proposal to increase it to 0.7% which was not adopted.

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 trust 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 1st 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 €10.000 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, where there is no tax recovery assistance clause in the agreement with the jurisdiction to whose law the trust, and implicitly, the trustees are subject. The administrator also has to make a declaration of assets for the Wealth tax *prélèvement* as of 1st January of each year, either of assets situated in France, or a full disclosure where the Constituant is resident in France.

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

The 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, rather than merely signing it, it would have been unable to adopt this method of taxation.

These provisions come into force on the publication of the *loi de finances rectificative pour 2011*.

As a transitional measure, where the settlor of an existing trust has died prior to the coming into force of the *loi*, 2012, the remaining beneficiaries can be treated as *constituants* /settlors thereafter for both succession and gift duties and Wealth tax. The manner in which this is achieved is reminiscent of a Roman law family succession where the head of a family dies, and the senior members of the underlying class "move up". This is independent of the date at which the full 60% penal succession duty rate is inflicted upon disposals within trusts settled by French settlors, irrespective of blood line entitlement.

As with any change of such a fundamental nature, there is as much planning potential as there are risks, and advice should be taken in relation to offshore structures immediately to enable Trustees to review their compliance procedures and make necessary adjustment both to their accounting procedures and the beneficial classes and entitlements of trusts with French connections.

What is more, the "*administrateur*" 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. Failure to do so is subject to a penalty, and the *constituant* and the beneficiaries are jointly and severally 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 €30 Million in additional tax revenue from this new measure in 2012. This appears optimistic, but it is likely that the interrelationship between the trust tax mechanism introduced and its attempted correlation with the 3% annual tax on immovable property 'entities' will force some taxes to be paid where they were not recoverable before. France has to date stopped short of assessing a trust holding a BVI structure owning French property holding Sarls, with the risk of it being brought to the CJEU. Seen in the context of the freedom of movement of capital and payments under article 63 TFEU, the overall legislation may also be flawed.

By way of background, in March, the government proposed removing the first tax-band so that only those with assets above €1.3Million 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 is applied if total assets exceed €3 Million, but would also apply to trust assets over €1.3M. These rates would apply from the 1st euro after the €1.3 Million cap is reached. A "smoothing mechanism" will be in place for taxpayers with total assets between €1.3M and €1.4 Million and also for those between €3 Million and €3.1 Million.