NEW MEASURES FROM THE FINANCE AMENDMENT ACT OF 30 DECEMBER 2009 OF INTEREST TO FOREIGN COMPANIES OR LEGAL ENTITIES OWNING FRENCH REAL ESTATE

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The French Finance Amendment Act of 30 December 2009 (i.e. "*Loi de finances rectificative pour 2009*") contains various important provisions which are highly relevant to foreign companies and other legal entities owning French real estate. Please note that for the purpose of this article we will use the term "entities" to include companies and other forms of legal entities. The new legislation clarifies two points which were otherwise unclear in French tax legislation and case law. In addition, in the context of the new measures concerning the fight against international tax evasion, the Act seriously tightens the rules regarding real estate capital gains and profits generated/earned in France by entities established in "uncooperative" States or territories.

1. Clarification of the territorial limits of French Corporation Tax

The territorial limits of French Corporation Tax ("FCT") are given by Article 209-I of the French Tax Code ("FTC"). Under this article, there are two situations whereby a foreign entity can be liable to FCT: (1) where profits are derived from an activity (an "*exploitation*") in France (French domestic test) or (2) where a Double Tax Treaty ("DTT") gives France the right to tax the French source profits (eg permanent establishment or taxation of real estate income in the State where the property is situated).

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Article 209-1 is now to be understood to include certain French real estate profits and capital gains. This specification concerns primarily entities situated in States or territories which have not signed a DTT with France. The new law interprets the existing tax legislation and therefore applies immediately to any litigation underway. The reason for this clarification lies in an arguable interpretation and application of another article of the FCT (Article 206-1) by the French Tax Authorities ("FTA") and the Courts.

1.1. The previous situation

Generally speaking, the courts and FTA consider that a foreign entity can be subject to FCT on profits derived from property owned in France, even where the property is merely passively owned (eg the mere managing and renting of a property). Further, on the basis of the "abnormal act of management" theory, a foreign entity can also be subject to FCT where the real estate it owns is made available to shareholders or third parties rent free. Very simply put, an entity liable to FCT is supposed, in principle, to make profits and the free disposal can be seen as being against the commercial interests of the company. The "abnormal act of management" theory enables the FTA to apply FCT to the rent that the entity would have earned if the property had been rented out, provided that they can prove that the conditions which constitute such an act are met.

The taxation principle applying to foreign entities comes from Article 206-1 which describes entities which can be liable to FCT. Under the provisions of this article, an entity can be taxable to FCT by virtue of its form or due to the "lucrative" nature of its activity:

- By virtue of its form: an entity may be liable to FCT by virtue of its legal form, regardless of whether its object is civil or commercial. Article 206-1 gives a list of French company forms which, in principle, are automatically liable to FCT regardless of the nature of their activity. This includes in particular the following French company forms: "*les sociétés anonymes*", "*les sociétés en commandite par actions*"; "*les sociétés à responsabilité limitée*".

- By virtue of the "lucrative" nature of its activity: forms of legal entity other than those listed above may be liable to FCT where their activity is "lucrative".

This provision primarily concerns French entities but also applies to foreign companies and other foreign legal entities. However, for a foreign entity to be liable to FCT pursuant to Article 206-1, it must either correspond to one of the French companies referred to in the text (eg have characteristics similar to a "*société anonyme*"), or, alternatively, if the entity cannot be

assimilated to a French form of company, it must be established that it has a "lucrative" activity in France. Under French law, the fact of an entity, with a commercial object, making available property which it owns, rent free, can be considered as a "lucrative" activity within the meaning of Article 206-1.

Difficulties and inconsistencies arise when Article 206-1 is applied in an international context in the light of territorial limits of FCT set out in Article 209-I of the FTC.

The position of the courts and the authorities on this point can be summarised as follows:

In the presence of a DTT between France and the State in which the entity is situated, Article 206-1 is applied, subject to the terms of the Treaty. Therefore France will impose tax if the DTT does not remove France's right to do so. This is generally the case if the DTT is drafted in accordance with the OECD model and provides that the provisions concerning income from immovable property to be applied to the income of an enterprise, which is the case of most DTTs signed by France. In such a case France maintains the right to tax even if the foreign entity does not have a permanent establishment in France (within the meaning of the DTT). However, if the DTT is not drafted in accordance with the OECD model, FCT is only due if the foreign entity has a permanent establishment in France (this is not usually the case for passive ownership of property). This solution has been confirmed by French courts in respect of two old DTTs signed with Italy and Luxembourg (which are no longer relevant).

In the absence of a DTT, French domestic law applies without restriction. In such a case, in order to justify the application of FCT, the courts and the FTA do not in fact invoke Article 209-I but base themselves on the general character of Article 206-1 which is applied independently. A foreign entity which comes under the provisions of Article 206-1 can become subject to FCT merely by making available its property free of charge, even if the foreign entity cannot be considered as having an "exploitation" in France (within the meaning of French domestic law). It is sufficient that the foreign entity comes under the provisions of Article 206-1 to be liable to FCT while the territorial limits of FCT would require that the foreign entity has an "exploitation" in France. There are examples of entities found liable to FCT such as a Liechtenstein Anstalt; a company set up in Panama; even a Liechtenstein Foundation, unable to justify the non-lucritive nature of its activities. On the other hand, however, a Monaco *société anonyme* registered in the company registry for civil companies did not come under the provisions of Article 206-1 as neither its form nor its objects were commercial.

One can readily see the imperfections of the Courts' position with regard to the simple passive holding of French sited property. The Courts respect the rules of international taxation and the territorial limits of FCT where a DTT exists. However, they ignore these rules and principles where there is no DTT as only Article 206-1 is applied, without any reference to Article 209-I. However, under French tax law, Article 206-1 serves merely to determine the types of entity which can be subject to FCT and not to determine the territorial scope of this tax.

This position, though intellectually arguable, at least has the merit of avoiding a paradox. Indeed, a strict application of FCT territorial limits in respect of passive ownership would give the result that the foreign entity would not be subject to taxation in the absence of a DTT whilst it would be in the presence of such a DTT. Under French law, the simple passive ownership of property in France is not, in principle, sufficient to characterise the existence of an activity in France (an "*exploitation*" in France within the meaning of French domestic law). It is undoubtedly to avoid such a paradox, which would encourage the use of offshore structures, that Article 209-I has never been applied strictly by the Courts in the absence of a DTT.

Nevertheless, even if the intention underlying this interpretation is praiseworthy, it remains intellectually and legally arguable.

In the recent case of "Sté Overseas Thoroughbred Racing Stud Farms" of 31 July 2009, the Supreme Administrative Court appears to have called into question this approach and some commentators see this case as creating a precedent. The new law has put an end to any further ambiguity and has provided a territorial base to the application of Article 206-1 to foreign entities situated in a country which has not signed a DTT with France.

1.2. The situation now

The clarification of the territorial limits of FCT concerns primarily the passive income or capital gains of a foreign entity situated in a country which has not signed a DTT with France.

Now, Article 209-I provides that FCT is payable on income from French sited immovable property and capital gains made on the sale of French real estate and rights on French real estate (unless otherwise stated by a DTT provided that there is one applicable). Therefore, in the absence of a DTT, FCT would be due on such income and capital gains whether or nor the foreign entity has an *"exploitation"* in France (which is not in principle the case in respect of mere passive ownership).

The presence of a DTT does not change the situation. As explained above, France always has the right to apply FTC.

However, in both cases, in order for FCT to apply, it must be shown that the foreign entity is liable to FCT under the provisions of Article 206-1 (ie because of its form or the "lucrative" nature of its activity). Indeed, FCT does not apply to all forms of foreign entities (in the same way as it does not apply to all forms of French entity).

2. Stamp duty on the sale of French real estate or rights over French real estate

Until now there has been an issue as to whether or not stamp duty should be due on a sale made outside France of shares in a foreign company whose assets mainly consist of French real estate (ie described as a French real estate company). This was because the FTA and the Courts did not have the same view of this matter.

2.1. A difference of interpretation

The FTA considered the sale of shares of a foreign real estate company to be subject to stamp duty. But in two lower court cases (TGI Nice 27 September 2007 and TGI Grasse 4 September 2008), it was held that, provided the sale is not made in France, there is no requirement to register it and therefore pay stamp duty. This was confirmed by a decision of the Court of Appeal dated 19 November 2009. These different points of view are due to conflicting interpretations of the tax legislation.

Article 718 of the FTC gives the territorial limits of French stamp duty in respect of the sale of movable foreign assets (thus, shares of a foreign company). Pursuant to this Article, stamp duty is due in France if the sale is made in France. On the other hand (but this is not expressly mentioned in the article) if the sale is not made in France, stamp duty is not due.

This is quite clear. However, the issue has arisen in respect of shares of foreign French real estate companies because another article of the FTC (Article 726) provides for a specific regime in respect of these shares. More generally, it should be noted here that for other tax purposes (in particular French wealth tax and French inheritance tax) shares of such companies are usually considered as French situs assets. Briefly, the FTA considered that Article 726 should override Article 718 to conclude that stamp duty is due in France. As the Courts considered that the only relevant article regarding the territorial limits of French stamp duty is Article 718, they concluded that stamp duty is not due in France.

2.2. The New legislation

The new legislation has put an end to the discussion. Article 718 is now complemented by Article 718 bis which provides for new territorial limits of stamp duty in respect of foreign French real estate companies. Since 1 January 2010, stamp duty is due on the sale, made outside of France, of the shares of a foreign company provided it can be considered to be a French real estate company under French tax legislation. In this respect, the analysis of the Courts was correct. Although, not surprisingly, the new law gives satisfaction to the FTA, it confirms that the territorial limits of stamp duty were missing from the French tax legislation to justify taxation.

The foreign company must be considered as a French real estate company within the meaning of Article 726 of the FTC.

This is checked on the day of the transfer or at any time during the year preceding the transfer of the company shares.

Stamp duty is not payable in respect of the sale of shares of quoted companies and legal entities which do not issue shares. This is notably the case regarding Associations and Foundations.

Where it is due, stamp duty applies at 5% on the sale value of the shares.
The new law also provides for tax credits deductible against French stamp duty corresponding to any stamp duty effectively paid abroad.

3. Situation of companies or entities established in an uncooperative State or territory

In the context of the new measures concerning the fight against international tax evasion, the new law introduces a new concept into French tax legislation, that of "an uncooperative State or territory" and provides for a more severe tax regime in respect of transactions carried out with such a State or territory.
Having said in the first section of this article that a foreign company or entity situated in a State which has not signed a DTT with France can be liable to FCT on profits or capital gains made from property, it is of interest now to look at the French tax regime which will apply to a company situated in an uncooperative State or territory.

3.1. The notion of "uncooperative" State or territory

The new law introduces a new concept into French tax legislation by providing for the creation of a list of uncooperative States or territories. This

list will set out the States which, as at 1 January 2010, have the following characteristics:

- They are not a member of the European Union;
- They have undergone some form of examination by the OECD in a fiscal context, as regards transparency or exchange of information
- They have not entered into an administrative assistance treaty with France, allowing the exchange of any information necessary for the application of tax legislation of each party;
- They have not concluded such a treaty with at least twelve other States or territories.

The list will be published shortly. France will take inspiration from the list published by the OECD which nevertheless excludes States or territories which signed an appropriate administrative assistance treaty with France before 1 January 2010. The initial list will be updated annually.

3.2. Taxation of French real estate profits or capital gains

The new law provides for an increased tax rate on habitual real estate profits and occasional real estate capital gains.

Habitual real estate profits

This targets notably real estate profits which are regularly made by "*marchands de biens*" (property dealers) and the like.

Until now, habitual profits made by non-residents were subject to 50% withholding tax. The new law reduced the rate from 50% to 33.33% except for entities established in an uncooperative State or territory where the rate remains at 50%.

Furthermore, withholding tax is normally deductible from the FCT due by the entity and where there is a surplus (ie the withholding tax is higher than the FCT effectively due by the company), that surplus is returned to the taxpayer resident in an EU Country or in a State that has signed a DTT with France. However, companies or entities established in an uncooperative State or territory are not entitled to this refund.

Occasional capital gains on real estate

Capital gains made by foreign legal entities are subject to withholding tax of 33.33%, subject to the presence of a DTT. The withholding tax is then deductible from the FCT due and any excess can be refunded.

Under the new law, real estate capital gains made by companies (or individuals) established in an uncooperative State or territory are subject to 50% withholding tax and any eventual surplus is non-refundable.

Therefore the law changes the way the capital gain is computed in respect of legal entities situated in an EU country or in a State which has signed a DTT with France which contains an administrative assistance provision.

This regime also applies to the sale of shares of a French real estate company (ie a company whose assets mainly consist of French real estate) and to other habitual profit made from French real estate.