

OPTION FINANCE

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Editorial

Jean-Yves Charriau

Real estate outsourcing transactions existed long before the implementation of the regime applicable to SIICs (French equivalent of REITs) or to OPCIs (French equivalent of open ended fund) (of which the first should see the light of day within the next few months) and of the system for the taxation of capital gains on building assignments at a reduced rate as contemplated by article 210 E of the Tax Code. However, the combination of these two regimes fulfils, in particular ever since article 210 E has been applicable to sales and not only exclusively to contributions, a dual objective. Such is, on the one hand, to facilitate for undertakings the unlocking of financial resources enabling the latter to clear debts, to refocus on their "core activity" or to invest and, on the other hand, to professionalize real estate holding and management, which generates economic activity, whilst mobilizing more, and more long term private savings. The legislator was inspired by the United States' example, where over 60% of operating assets are managed by investors, in particular by Real Estate Investment Trusts (REIT), approximately half of the shareholders of which are individuals.

"The forthcoming months promise an intense level of activity and increased competition."

CMS Bureau Francis Lefebvre

Supplement to number 901 of October 9, 2006

An assessment of the SIIC regime shall be conducted within the forthcoming weeks with the government. This assessment, which shall confirm the considerable development of SIICs within the stock exchange sector, both with regard to the number of market operators (approximately 40 to date), and to overall market capitalization, could lead to the development of the regime. Several topics shall be discussed or are already currently being discussed, concerning in particular the possible extension of the article 210 E mechanism over time, and a restriction, eventually, of the holding percentage of share capital of SIICs by one or several shareholders acting in collusion. As concerns this issue, it should be noted that our English and German counterparts, tempted by the adoption of a REIT regime, are contemplating stringent restrictions on the composition of shareholding in respect of such REITs (a 10% holding stake per shareholder), and thus with the declared objective of avoiding a loss of tax revenues in case of excessive holding by foreign

investors. In the Netherlands, the current 25% cap for foreigners could be increased to 45% by 2007, in-line with the restriction which is already applicable to Dutch shareholders. It thus seemed important to us to describe the general legal and tax environment of real estate outsourcing transactions, whilst also addressing the features which are specific to block sales of residential buildings and to assignments of financial lease agreements, as well as the appeal that the SIIC regime has from the point of view of an individual. Even if the focus is on SIICs, we would however recall that the tax incentive regime under article 210 E also benefits OPCIs, and even certain SCPIs (unlisted companies for collective investment in real estate). Institutional investors and investment funds being still extremely active on the market, the forthcoming months promise an intense level of activity and increased competition, which certain property owners shall most certainly use to their advantage. ■

"SIIC 3": a tax incentive?

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Succeeding, since January 1st, 2002 to the "SIIC 2" regime, set forth by the finance bill for 2005, the regime known as "SIIC 3" stemming from the amended finance bill for 2005 (which remains codified under article 210 E of the Tax Code) appears to be an outsourcing tax mechanism with much more incentive for real estate owners. Indeed, the new regime offers a clearly extended scope of application, as such concerns "assignments" of buildings or of rights in relation to financial lease agreements, thus covering also sales and no longer exclusively contributions, the latter keeping the advantage (if they are simple contributions without liability attached – *apport pur et simple*) of not making transfer tax enforceable at the proportional rate. The taxation of capital gains at the reduced rate applicable to such regime (16.5% plus social contributions), is thus inclined to become a vendor requirement in the context of real estate transactions. However, the conditions for the application of the SIIC 3 regime remain restrictive. Firstly, this regime is reserved for companies which are liable to corporate income tax, when outsourcing assets to companies raising funds from the public or licensed by the French Market Regulator (AMF), and which have as their main purpose the acquisition or construction of buildings with a view to the rental thereof (or to holding companies having the same purpose). In practise the only "eligible" purchasers, at the present time, are SIICs – but not their subsidiaries – and certain SCPIs, to which shall be added in the short

term SPPICAVs (predominantly real estate investment companies with a variable share capital).

Secondly, the purchaser must enter into the covenant to hold the assets purchased during a five year period, at the risk of a fine of 25% of the assignment value of the asset.

"The taxation of capital gains at the reduced rate of 16.5% is inclined to become a vendor requirement"

It should, however, be noted, that the authorities would be willing to allow for such covenant to be transferred, for instance, to a subsidiary, on the occasion of a transaction coming under the favourable tax regime of mergers. The DLF (*Direction de la Législation Fiscale – Tax legislation Directorate*) has also announced that in the event of acquisition of rights in respect of a financial lease agreement and of exercise of the option before expiry of the 5 year period, the covenant could be carried over onto the building. These issues shall have to be confirmed upon publication of the decree and of the guidelines clarifying the system. We would, moreover recall that this regime does not apply to assignments of predominantly real estate holding companies. This having been said, capital gains resulting from these assignments are, as the case may be, eligible under the long term reduced rate (15% plus social contributions), it being however observed that the purchaser will, in this case, be looking to negotiate a discount on the price to take into account the latent taxation

which has not been unlocked on the underling buildings.

The SIIC 3 regime is only yet another temporary regime, as it should in principle come to an end on 31 December 2007... before, maybe, the implementation of SIIC 4. ■

Interview with Dorian Kelberg,

General delegate of FSIF (*Fédération des Sociétés Immobilières et Foncières*)

What is FSIF's role ?

FSIF is a professional organization in charge of representing the interests of its members (near to forty to date), which are essentially private property corporations and most SIICs. The Federation worked with the public authorities on the implementation of the SIIC status and the regime of article 210 E of the Tax Code, mechanisms which it took the initiative for.

What are the results of these mechanisms to date? Have they had an impact on the market?

The main objective of creating the status was, and remains, the financing of the real estate industry via the mobilization of long term savings. On these grounds, the listed property company sector needed to be revived.

From around ten companies in 2003, there are now approximately 40 SIICs today. The sector's market capitalization has been multiplied by four, from 12 billion to an approximate 50 billion euros over the same period. As for the outsourcing regime, which has been up and running since 2005, 2006 shall see an extremely significant rise in connection with the extension of the regime to sales of buildings. These mechanisms have enabled listed property companies to make a comeback onto the property investment market, in which they represented 50% during the first quarter of 2006.

With regard to outsourcing transactions, who are the main operators and which assets are concerned?

Transactions completed since 2005 concern virtually all types of operating buildings: retail/shopping malls, offices, hotels, retirement homes, clinics, restaurants. Firm profiles include listed companies (*Accor, Générale de Santé, Casino*), private groups, investment funds... and in terms of sectors, the mass retail industry, the hotel industry, the health industry and the franchised food service industry (*Buffalo Grill*). I also believe that one can anticipate an increase of transactions in the residential rental property sector (8% of SIIC assets in 2006), to the extent such sector benefits from a stable regulatory framework.

Has there been a change in the profile of SIICs?

Absolutely. There are several varieties of SIIC: besides "incumbent" property companies, which opted for the status as early as 2003, and which continue to represent, by far, the major share of market capitalization in the business sector (*Unibail, Klépierre, Gecina...*), the sector has, since then, started to be made up of "dormant companies reactivated" by investment funds (*Société de la Tour Eiffel, Mines de la Lucette*), of "start ups" (*SFPI, FDL, Foncière des Murs*), of companies stemming from industrial groups (*Mercialys*) and of private property companies which decide to go "public" (*Altarea, Foncière Masséna*).

Among the effects induced by the combination of the SIIC status and the article 210 E regime, which the SIICs are, before OPCIs appear, the major beneficiaries of, we have noted that "captive" SIICs have been multiplying. Do these companies correspond to the objectives of the law?

The arrival of "captive" SIICs, controlled for the major part by one or more shareholders, contributes

to animating the sector and to the transfer of property estates. The situation of these companies constitutes a problem when the creation thereof has the effect of "crystallizing" a property estate or is exclusively aimed at using the regime benefiting SIICs simply as a tax exemption godsend. FSIF considers that up until now, these companies have made a contribution to the development of the property sector, but that in the long run they must align themselves more clearly with the underlying objectives of the regime, that is to say the creation of a stock exchange sector, which is strong and dynamic, thus liquid, and the mobilization of individuals' long term savings. The story behind *Société de la Tour Eiffel* and *Mercialys* seems to be to be a good example of the virtuous circle created by the SIIC regime.

Is there anything you can say about the prospective outlook for the legal framework of SIICs, in particular with regard to these effects?

On the basis of an assessment in respect of the SIIC regime which is about to be presented, within the next few days,

several topics shall be discussed with the public authorities: i.e. the appropriateness as to whether or not to extend the article 210 E regime beyond 2007, the possibility for several SIICs to go into partnership together in the context of a business corporation (*société de capitaux*) benefiting from the regime, which should enable small and medium sized property companies to conduct large scale projects and, finally, the limitation, eventually, of the share capital that may be controlled by one single shareholder, or even by several shareholders acting in collusion. The outcome of these negotiations depends of course on the sovereign discretion of the public authorities. Now that the stock exchange compartment of SIICs is a reality and a success, for all to admit, in France and abroad, these issues help not to lose sight of the initial objectives which enabled the creation of the SIIC. Such is the only condition to ensuring the continuity of the regime. However, for now, it cannot be said whether or not there will be an additional layer to this SIIC regime before the end of 2006. ■

The SIIC for private individuals: savings platform or device for private estate management

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When adopted in December 2002, one of the objectives of the SIIC status was to constitute a savings platform for small shareholders looking for a relatively safe long term investment. The public authorities thus intending to stimulate markets by attracting savers which are cautious by nature, or which are cautious by reaction. Tax issues were not neglected in respect of such objective, so much so that the tax regime which was reserved to partners of SIICs, which are individuals, is rather appealing. We would thus note that as concerns income tax, the dividends distributed by a SIIC benefit from the 40% tax rebate, even though the distributing entity has been exempted from corporate income tax. For an individual, income from SIICs is thus globally taxed at a lower rate than rent which is governed by the regime of property income. The maintaining of the 40% rebate constitutes a favourable measure to the extent that such mechanism normally aims to suppress, with regard to dividends, the corporate income tax and then individual income tax cascade. In this respect, SIIC shareholders, who are natural persons, are treated better than their artificial person counterparts, which are denied the benefit of the parent-subsidiary regime. Moreover, if the capital gains realized by such shareholders upon assignment of their corporate ownership interests are normally taxed at the global rate of 27% (fixed rate of 16% increased by social contributions), it should be noted that the securities of companies which benefit from SIIC status are eligible to a share-save plan (PEA).

"It is true to say that the tax regime reserved to partners of SIICs, which are individuals, is appealing"

This possibility, expressly contemplated at law, offers an accumulation of tax advantages rarely encountered.

In addition to this favourable tax treatment there is, for natural person investors, as for all partners of the SIIC, an assurance as to a certain profitability. The SIIC only obtaining the corporate income tax exemption on condition that it distributes a significant fraction of its exempted income, shareholders are sure to benefit from a regular and effective up-flow of dividends.

In practise, however, one is forced to note that these advantages have not, at present, enabled most SIICs to develop a shareholding predominantly made up of individuals. Immediately, the flight of enthusiasm of institutional investors for this regime has been such that it has overshadowed investment by individuals, but this situation could develop over time. Finally, in between individual savers and institutional investors, are those individuals who own a rental property estate of high net worth. For such persons, the possibility of incorporating, for private estate management purposes, a dedicated SIIC, is beginning to be outlined. The idea would be for the latter to take advantage, on a large scale, of the fact that income derived from SIICs are, in a final respect taxed at a rate which is much more advantageous than for "classic" rental income.

Of course, in order to use the SIIC status as a device for private estate management, one has to be prepared to submit to stock exchange regulations and to the highly demanding constraints thereof. To which should be added the tax cost of penetrating

the regime. These disadvantages are not negligible but must be assessed on a case to case basis in light of the advantages which are anticipated. ■

Lease agreements, key factor to outsourcing strategies

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Commercial property outsourcing is a highly complex transaction which requires a great deal of thought on the part of the owning undertaking with regard to financial balance.

1. Upstream, the undertaking has to anticipate the consequences of its future user capacity

Thus in a context of intensification of information and warranties to be handed over or granted to tenants, in particular within the field of environmental issues (ordinance of June 8, 2005 reforming property audits, which entered into effect on June 1st, 2006, law of July 30, 2003 related to the inventory on natural and technological hazards and decree of September 5, 2006 on protection of property purchasers against termites), the vendor, and future tenant, will need to succeed in combining diverging interests. The vendor, and future user, will attempt to minimise warranties granted to the investor, leaving the latter the responsibility of assessing itself its risk, whereas the investor shall emphasize its own obligations as landlord, among which that of compliant delivery (article 1719 of

the civil code). How could the landlord-investor enter into a covenant to hand over the premises free of any defects (miscellaneous pollution, compliance in relation to administrative, health, hygiene ad safety rules, assigned use) if the tenant-vendor has refused to provide a warranty on these issues? In practise, in order to determine a position, the future user will ask investors which are interested to send it a price offer along with a draft standard lease.

2. From this moment on, the "investor" lease will be central to discussions, which shall also lead to a partnership agreement being drafted between the user and the investor, and to the determination of the price

However, the sale price is the expression of a strategic choice: which is either to obtain the highest price, which implies accepting an "investor" lease in which rent flows are secured, or to negotiate a lease operating an apportionment of service and investment charges between the landlord and the tenant.

"Combine diverging interests through the negotiation of an "investor" lease, strategic tool."

Maximizing the sale price implies that the undertaking accepts to enter into an "investor" lease, of which the specificity is to provide a net rent, whereby all expenditure related to the building (all works, repairs or replacements including works for compliance, works falling within the scope of article 606 of the Civil Code, replacements due to wear and tear, insurance of the building, all contributions and taxes including real estate tax on property and annual tax on office space,

management fees, or commonhold or condominium manager's fees...) is borne by the tenant. Moreover, investor leases usually provide for a firm term of at least six years, compelling the tenant to waive its triennial break right as contemplated by the Commercial Code. However, it is not necessarily in the interests of the user to commit, over a long term period, to assuming the same costs that it was responsible for when it was the owner, whilst on the other hand paying out rent. Thus, an expert command of commercial leases and inventiveness are indispensable to the success of outsourcing transactions.

■

Contributions as a means of outsourcing: the question of the urban pre-emption right

The need for external growth of SIICs, as well as their strategic orientations provide companies with opportunities to outsource their property estate, which, according to the objectives pursued, generally results in a sale or a contribution (I), and which in any event raises the question of the urban pre-emption right ("UPR") (II).

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I. If sales remain the most common of transactions and do not call for any particular comments, contributions can, from a legal standpoint, take the form either of a partial contribution of assets ("PCA") or of a contribution in kind ("CK").

I.1. PCA and universal transfer of assets

A PCA generally applies to a corpus of assets and liabilities forming a branch of

activity¹ thus enabling to convert such into a subsidiary, even if, according to certain experts, such could be limited to one or several separate assets. It shall be up to the

¹ The notion of full and autonomous branches of activity has only been defined from a tax standpoint within the framework of the favourable tax regime that a PCA may benefit from, and not from a legal standpoint.

parties² to expressly submit said contribution to the legal regime of demergers. The main effect thereof lies in the universal transfer in favour of the beneficiary company of all rights, property and obligations pertaining to the assets contributed.

I.2. The mechanics of contributions

One or more auditors have to be appointed by the presiding judge of the *tribunal de commerce* (commercial court) in order to check that the values retained for the contributions are not overvalued and that the remuneration which is offered is fair³. The relevant corporate structures of the companies concerned will then have to authorise the signature of the contract. It should be noted that a PCA affords the creditors of participating companies reinforced protection, as they benefit from a thirty day adverse claim period between the publication and the completion thereof. Contributions being remunerated by the issuing of shares, such will in all cases have to be approved by the Extraordinary General Meeting of the SIIC, it being recalled, as concerns CKs, that the delegation⁴ entrusted by the Extraordinary General Meeting to the corporate structures for the purpose of deciding on a share capital increase in remuneration of a CK only concerns contributions of stocks and securities and is limited to 10% of the share capital.

As for the contributor, competence is granted either to the Extraordinary General Meeting for a PCA, or to the managing structures for a CK.

Finally, one should recall that the contribution of a building requires the

involvement of a notary public, in particular with regard to land registration formalities.

I.3. Specificities in connection with listed companies

An information note (the "E document") shall have to be annexed to the report of the corporate structure presented to the Extraordinary General Meeting of the SIIC, it being specified that if the shares issued do not represent more than 10% of the shares already listed, a press release shall replace the E document⁵.

Contributions entailing an alteration to the allocation of the share capital of the SIIC, they shall trigger obligations with regard to stock exchange law, from declarations of exceeding threshold values to the compulsory filing of a takeover bid if the threshold of 33.33 % in share capital or in voting rights was to be exceeded. In this respect, the AMF general regulations contemplate exemptions in the event, in particular, of "contributions of assets subject to the approval of the general meeting of shareholders" which are granted by AMF on a case to case basis.

I.4. Subsequently to the contribution

The contributor shall be able to benefit from liquidity mechanisms (by virtue of promises to purchase and to sell) enabling the shareholders of the SIIC to be "undiluted". Furthermore, a shareholder agreement may cover "typical" subject matters such as share transfers, governance or management, or more specific areas (maintaining listing, building holding period, right of first refusal in the event of resale...).

² Parties must be a company limited by shares (*société par actions*) or a limited liability company (*société à responsabilité limitée*).

³ It should be noted that the requirement of a report on the remuneration for a CK operation results from a recommendation of the AMF (the French market regulator) for the purpose of informing the shareholders of the SIIC which shall be diluted.

⁴ Article L225-147, paragraph 6 of the Commercial code.

⁵ Article 212-34 of the AMF general regulations: their terms of diffusion, and registration are specified under Title 1 of Book II of the AMF general regulations as well as in AMF's guidelines number 2005-11 of 13 December 2005.

"The contribution of buildings to a SIIC inevitably raises the question of releasing the urban pre-emption right"

II. The contribution of buildings in favour of a SIIC, which is the disposal thereof for financial gain⁶, is subject to the prior release of the Urban Pre-emption Right (DPU), the latter reasonably having to constitute a condition precedent to the completion of a contribution. The contributor shall first have to address a declaration of intention to dispose of property (DIA) to the various DPU holders.

II.1. Impossibility for the DPU holder to purchase the buildings forming the subject matter of the contemplated contribution in its own right

When receiving a DIA prior to a contribution, the DPU holder can only waive the right to exercise its pre-emption right or declare that it intends to purchase such at a price which it must put forward⁷. Indeed a DIA is not an offer to enter into a contract; such is simply for information purposes which may trigger an offer to enter into a contract on the part of the DPU holder; this is why such is known as the "informative DIA". Faced with the DPU holder's proposal to purchase, the contributor must give up performing the contribution; on the other hand, it may either refuse the purchase offer, or accept such at the price offered by the pre-empting party, or finally accept such but maintaining its original offer and thus accepting the price to be determined by the judge having jurisdiction for compulsory purchase orders⁸. There is thus no risk of having the DPU holder purchase the

building without the agreement of the potential contributor thereto.

II.2. Incidence of multiple buildings being contributed

When, as is the case in the case scenario of a contribution in favour of a SIIC, the contribution includes several buildings, market practise falls into line with the recommendations of the Ministry of Equipment and reverts to the establishment of a DIA per property unit; such DIA must mention the value of the latter.

Contributors considering that the disposal applies in an indissociable manner to several properties subject to a DPU, may want to indicate this indivisibility in the various DIAs; the actual effect of this indication is currently under debate.

II.3. Absence of effect of the valuation appearing in the DIA and judicial determination of the price

The estimate in respect of each of the buildings contributed has no particular effect in the context of the judicial determination of the price. Only the DPU holder is entitled to solicit the judge in charge of compulsory purchase orders, within a time limit of 15 days as from reception of the owner's response. Proceedings necessarily include an inspection of the premises by the judge. In the event where the owner does not provide a memorandum, it will be deemed to confirm the estimate appearing in the DIA⁹.

Various rules delimit and restrict the judge's assessment of fair value. Thus the reference date for estimating the value of

⁶ Article L 213-1 of the Planning Code.

⁷ Article R 213-9 of the Planning Code.

⁸ Article R 213-10 of the Planning Code.

⁹ *TGI* (court of first instance) of Bobigny, 11 October 1994, *City of Aubervilliers v. SA Ets Barres et Frères*, number 3794, *AJPI*, 10 October 1996, p786.

the building is that at which the latest act which published, ratified, revised or amended the Urban Development Plan (POS) or the Local Planning Regulations (PLU) was rendered enforceable against third parties. Moreover, improvements, transformations or changes of assigned use are not deemed to have a speculative character, whereas such is the case as concerns compulsory purchase orders. The judge is neither bound by proposals of amicable offers, nor by the value of the property as mentioned in the DIA. He or she may determine a price which is higher¹⁰ or lower¹¹. Finally, once the price has been determined by the judge, the parties still have two months as from the judicial decision having become final to accept or give up carrying out the transaction. ■

¹⁰ *Cour d'appel* (Court of appeals) of Paris, CPO section, 24 September 1987, OPHLM City of Paris v. Belny et al, AJPI, 1988, p277, *Cour d'appel* of Versailles, 10 June 1997, DNID v. SCI La Fauconnière, AJPI, 10 December 1997, p1097.

¹¹ This has in particular been put forward by Claude Morel, honorary chamber president of the court of appeals of Paris in an article published in AJPI, 10 April 1992 "Determining the price of a pre-empted property", p72.

Outsourcing real estate financial leasing contracts: an extremely favourable regime

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The outsourcing of a real estate financial leasing contract by means of a sale or of a contribution, benefits from a favourable context, in particular if such is carried out in favour of a SIIC. Such a transaction is eligible, under certain conditions, to the regime of article 210 E of the Tax Code which enables the benefit of the reduced rate of taxation on assignment capital gains (16.5% excluding social contributions). As concerns the 5 year holding covenant, to which the application of the regime is subordinated, the DLF (*Direction de la Législation Fiscale – Tax legislation Directorate*) has specified that in the event of exercise of the call option before expiry of said time limit, the covenant could be carried over onto the building. The transfer of a real estate financial leasing contract is liable partly to registration duty and partly to VAT.

"The outsourcing of the contract gives rise to savings both in respect of transfer tax and of corporate income tax."

Indeed, such transfer breaks down into two transactions:

- the transfer of a right of enjoyment over the building for the remaining term of the contract, liable to registration duty at the rate of 5% in the event of sale, and at the flat rate sum of 500 € in the event of a simple contribution (without any liability attached);

- the transfer of a call option agreement, liable to VAT at the rate of 19.6% (VAT being in principle recoverable). In practise, the nearer the date of expiry of the contract, the higher the part of the price of assignment allocated to the assignment of the call option (liable to VAT) shall be.

The sale of a financial leasing contract can thus enable substantial savings in respect of registration duty as compared to the sale of a building (liable to a 5.09% duty, save in the event of a transfer coming under real estate VAT). However, one should check whether the transfer entails an obligation to publish (in particular if the remaining term of the contract exceeds a twelve year term).

The assignment of a real estate financial leasing contract may also be of interest with regard to the add-backs to be performed upon exercise of the option (article 239 *sexies* of the Tax Code).

According to administrative guidelines, in the event of acquisition of a real estate financial leasing contract, the fraction of rent to be added back is determined by applying the ratio that exists at the date at which the option is exercised between the period during which the rights were held by the financial lessee/purchaser and the overall term of the contract (which boils down to "clearing" part of the add-backs). On the other hand, in the event of outsourcing in favour of a SIIC, the add-backs at the end of the contract come under the exempted sector subject to the obligation to distribute up to the amount of 85%. Thus the latent taxation of the initial

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financial lessee shall be cleared due to the assignment to the SIIC.

The transfer of the real estate financial leasing contract enables the "creation" of a basis for tax amortization at the level of the purchaser. Thus, in the event of acquisition of a contract in effect, the purchase price is booked into the assets section of the purchaser's balance sheet as an intangible asset (whereas within the framework of a contract entered into from the very beginning, the property is not booked in

the assets section of the financial lessee's balance sheet). From an accounting point of view, this intangible item is not amortizable. On the other hand, from a tax point of view, the acquisition cost is an intangible item which is amortizable for the fraction corresponding to the constructions. We would recall that generally the transfer of the contract requires the consent of the financial lessor.

Restrictions on foreign real estate investment in China

May no longer purchase real estate assets in China: foreign companies which do not have an entity within the country and foreign individuals which have not been residents there for more than one year

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On alleged grounds of containing real estate speculation and of avoiding the market from overheating in the larger Chinese cities, the Chinese government has just enacted new legislation extensively restricting foreign real estate investment. Six ministries thus jointly promulgated on July 11, 2006 a statute, applying immediately, entitled "Decision related to foreign Access to and Investment on the real estate market". These measures will most certainly slow foreign investment down in this sector. However, this framework does not apply either to citizens from Hong Kong, Macao or Taiwan, or to overseas Chinese citizens – "foreign" investors of significance on the real estate market – looking to purchase dwelling accommodation. It is therefore uncertain whether these measures will fulfil their declared objective. Moreover, if this statute was adopted by the centralised authorities, its implementation shall be ensured by the local authorities, and the latter, often on the look out for investment projects - which are a source of tax income within their locality – could have a more flexible view point as to the interpretation thereof. Up until now, foreign individuals or companies were free to purchase or sell real estate assets in China. From now on, the new statute imposes the following restrictions: a foreign company can only purchase a real estate asset if it has a representative office or a branch in China and thus exclusively for its own personal use. Moreover, an individual of foreign

nationality can only purchase a real estate asset if he or she has held a valid residence permit for China for at least a year and thus exclusively for his or her own personal use. Such individuals are only entitled to purchase one real estate asset in China. This statute not applying retroactively, foreigners having already purchased real estate assets in China, but which do not fulfil these new conditions, are entitled to keep all of their real estate assets. Foreign companies or individuals which do not fulfil these conditions shall have no other alternative, *a priori*, but to incorporate beforehand a real estate investment company in China.

"From now on, foreigners will only be able to purchase a real estate asset in China under restricted conditions."

However, the purpose of such company can only be the acquisition of buildings or the development of property. Moreover, foreign investment is authorised in this domain but is the subject of numerous restrictions. According to the new statute, for an overall investment upwards of USD 10 million, the share capital shall have to represent at least 50% of the overall investment. In addition, such company shall only be able to obtain a loan in China or abroad, if its share capital has been fully paid up, if it has obtained the right to use

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the land or if its share capital represents at least 35% of the investment. The new statute contemplates moreover that the price of acquisition of an interest in such

company must necessarily be paid in one single instalment.■

The planning law reform continues

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The planning law reform currently underway continued over the summer months: law of 13 July 2006, carrying a National Undertaking for Housing known as "NUH law or *loi ENL*", and decree of 31 July 2006, amending the rules of expiry applicable to planning permissions. We shall only deal here with the new rules concerning planning permits and existing constructions.

The two statutes contemplate new rules, applicable immediately, which differs from the new mechanism contemplated by the ordinance of 8 December 2005, which should only enter into effect in July 2007 at the latest.

Litigation

1. Inadmissibility of actions initiated by "ad hoc" associations.

In order to be entitled to act, an association will have to have lodged its articles of incorporation at the *Prefecture* before the application for the planning authorisation which is attacked, is displayed within the city hall (article L600-1-1).

Proceedings which are pending are not concerned, to the extent that the principle which should remain is that according to which the capacity to act is assessed at the date of the originating application.

2. Possibility for judges to partially cancel a permit (article L600-5).

3. Suspension of the validity period of planning permissions in the event of legal action.

From now on, in the event of a motion to void before the administrative courts (or of a motion before the civil courts in application of article L480-13), the validity

period of the planning permission shall be suspended until notification of the irrevocable court ruling, i.e. in respect of which the time limits on appeal and appeals to Supreme Courts (civil or administrative) have expired. These provisions are applicable "to planning permissions which are currently valid" as at 2 August 2006.

Other amendments

1. The regime applicable to illegal building developments has been relaxed.

The obligation to obtain a validation permit, which was previously unlimited in time, is now limited to 10 years. Various material exceptions are however contemplated, such as the absence of a planning permission.

2. The regime applicable to demolitions has been amended.

The demolition of a construction, developed by virtue of a planning permission which is subsequently judged as illegal, can now only be ordered against the owner thereof if the action for the demolition has been initiated within two years as from the decision of the administrative judge (L480-13). As concerns developers, an action for damages before the judicial courts on grounds of an illegal construction can only be initiated two years after completion of the works, if the latter has occurred subsequently to 16 July 2006. Finally the Prefect can initiate a civil action for demolition (L600-6).

3. Time limit on withdrawal.

As from 31 July 2007 at the latest (the new rule being included within the framework of the ordinance of 8 December 2005), the time limit on withdrawal by the administrative authorities of a planning permission shall be reduced down to three

months (L424-5) instead of four currently (Ternon case law).■

Hazard inventory now compulsory (since 1st June 2006)

Since June 1st of this year any vendor or landlord of a real estate asset must inform his, her or its purchaser or tenant of the potential situation of the asset within zones covered by a plan for the prevention of technological hazards or by a plan for the prevention of foreseeable natural hazards, whether such has been prescribed or approved, or in zones of seismic activity (article L125-5 of the Environmental Code). A hazard inventory based on the information made available by the Prefect is

annexed to any call option agreement to sell or to purchase, to any contract completing or recording the sale and to rental agreements drawn up in writing making a recording of the new tenant's entry into the premises. This system leads to a certain number of queries: thus, one can wonder how it should be applied in the context of a lease off plans, which by nature, does not record the tenant's entry into the premises at the time of signature thereof, or in the event of renewal of a lease. Is the consequence in law of non compliance

with this system (rescission of the contract or reduction of price or of the rent) left to be decided on freely by the co-contractor? In the affirmative will the latter have to justify the grounds of its choice in favour of one or of the other of these solutions? Difficulties as concerns access to relevant information in certain prefectures have already been observed (inaccessible website, or which contains inaccurate data, impossibility to reach the right person on the telephone ...).■

VAT regime applying to buildings included in a transfer of totality of assets

News update by [Philippe Tournès](#), partner, specialized in VAT issues, in particular with regard to real estate. philippe.tournes@cms-bfl.com

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Since January 1st, 2006, the transmission of buildings carried out on the occasion of transfers of the totality of assets (mergers, partial contributions of assets, dissolutions carried out by merger of assets – *dissolution par confusion de patrimoine* - ...) no longer give rise to liability under real estate VAT (when the building is new), or to any adjustments by application of the twentieths rule (when the building has exited the scope of application of real estate VAT), or to margin VAT taxation when it belongs to a real estate dealer, subject to fulfilling the following conditions: the transmission of assets must occur as between two tax payers which are liable to VAT in respect of the totality of assets thus transmitted, and the transfer has

to be carried out in favour of a person which intends to operate the totality of assets thus transmitted and not simply to immediately liquidate the activity concerned. Subsequently to the transfer, the beneficiary of the transmission is deemed to replace the assignor by continuing the operation of the totality of assets transferred as concerns the count down with regard to periods of adjustment in twentieths, in the event of subsequent assignment. ■

"Today, transfers of totalities of assets elude entirely any VAT."

Partnerships and their partners: a simplified relationship

The administrative court of appeals of Paris has recently rendered a ruling of great significance (ruling of 29 March 2006 number 01-3876), which has not been subject to an appeal, within the framework of financial relationships between partnerships which are not liable to corporate income tax and their business corporation partners. The situation was that of a business corporation, which had

accepted to stand surety, free of charge, for its subsidiary, a French *SNC* (unlimited partnership) which was not liable for corporate income tax, and the profits of which had been reassessed to include a theoretical amount of guarantee commissions. The court considered that to the extent where the advantage resulting from the guarantee commission exemption did not, up to the percentage of share capital held by the parent company, have

any tax effect at the level of the latter, as this advantage increased the income of the subsidiary, which income was taxable at the level of the parent according to the rules applicable to its own income, such could thus only be taxable at the level of the parent company exclusively to the extent that it also benefited the other partners of the subsidiary and exclusively within the limit of the fraction of interest to the profits held by the other partners. This solution, which is of interest to real estate acquisition financing transactions, also authorises from a tax standpoint, which up until now had only been the subject of an

implicit validation by the *Conseil d'Etat* (Supreme court for administrative affairs) (ruling of 31 March 1999 number 194517), interest free loans granted by parent companies to their wholly owned subsidiaries which are not liable to corporate income tax, solution which shall moreover enable to avoid the difficulties related to the application of the new thin capitalization rules contemplated by article 212 of the Tax code, partnerships being indeed concerned by these rules, to a strict degree.■

Block sales of residential rental buildings

By [Elisabeth Flaicher-Maneval](#), lawyer, legal doctrine team, she is involved more specifically in monitoring recent developments of main business law topics.

In order to curtail the speculative effects of block sales of buildings, followed shortly after by split sales, law number 2006-685 of 13 June 2006 (Official Journal of 14 June, p8944) has introduced a new set of obligations binding on landlords of residential buildings or buildings with a mixed residential and professional use which have more than 10 accommodations, in the event that they should decide to sell the building as a whole and in the context of one single transaction (article 10 new wording of law number 75-1351 of 31 December 1975). From now on building owners must, at the risk of cancellation of the sale of the whole building:

- either obtain from the purchaser a covenant to prolong the residential leases in effect so as to enable each tenant to enjoy his or her accommodation for another six years as from the signature of the deed of sale; any notice to vacate by reason of the sale delivered in infringement of this covenant being null *ipso jure*.

- or, inform individually each tenant by registered letter with acknowledgement of

receipt of the price and of the terms of the sale of the building and of the premises that he or she occupies. Such notification shall constitute an offer to sell the accommodation concerned; and must enclose a draft set of co-ownership (condominium or commonhold) regulations intended to govern the relationships between co-owners, if one at least of the tenants purchases his or her accommodation, as well as the results of a technical audit, drawn up by an independent expert valuer, making a record of the condition of the roof and siding, of the piping, communal lines and of the communal and safety equipment. The sale offer is valid during a four month period as from reception thereof; if such is accepted, the sale must be completed within two months (four months, if the tenant reverts to a loan for the purpose of financing the acquisition); beyond such time limit the

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offer is null *ipso jure*. Tenants which have not purchased, can benefit from a subsidiary pre-emption right, in the event of the building being placed under co-ownership after the sale of at least one accommodation to a tenant, if the landlord should decide to sell to a third party the units which are occupied at a more advantageous price and terms. The landlord (or the notary public) must then notify to the tenant such price and terms, at the risk of nullity of the sale. Such notification shall stand as a sale offer during a time period of one month; in the event of acceptance, the sale shall have to be completed according to the same time frame as in the foregoing case scenario. These new obligations do not apply in the event of exercise of the urban pre-emption

right which municipalities are now entitled to use to ensure that tenants are maintained within the premises (article L210-2 new wording of the Planning code stemming from the aforementioned law of 13 June 2006). On the other hand, in order to avoid this system for the protection of tenants being bypassed, such is applicable to assignments of all partnership interests or shares of companies when these securities entail the allocation of the ownership or of the full-time enjoyment of each of the accommodations (save as concerns assignments between relatives or in-laws down to the fourth degree included). ■

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