

# OPTION FINANCE

## REAL ESTATE NEWSLETTER

June 26, 2006

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### Editorial

François Fahys - Editor

#### Why a newsletter ?

For both corporate users and investors, the increasing development and growing complexity of legal and regulatory frameworks and case law applying to real estate assets and their operation has entailed the latter to lead a major role. With this in mind, and having regard to the increasing volume of litigation, calling for operators to be on their guard, we have considered it appropriate to dedicate a newsletter to commercial real estate issues. In this context, *Option Finance* has decided to revert to the lawyers of CMS Bureau Francis Lefebvre in consideration of their tax and legal expertise, enabling them to enjoy a global approach to the management of specifically real estate based transactions and of the real estate aspects of French and cross boarder dealings. In this frame of mind, the Real Estate Newsletter purports on a quarterly basis to address one or more topics which shall be offered in the form of analysis and pragmatic pieces of advice, of accounts from experts or professionals, of focuses on specific newsworthy items and of news on recent or forthcoming legal developments. In this context, this first edition shall be dealing with the various aspects related to the acquisition of a structure holding a real estate asset.

"Real Estate Newsletter: Lawyers of CMS Bureau Francis Lefebvre law firm untangle for *Option Finance* the legal and tax implications of commercial real estate."

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Acquisitions of structures holding real estate assets

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CMS Bureau Francis Lefebvre

Supplement to number 889 of June 26, 2006

## **Dossier: Acquisitions of structures holding real estate assets**

By Richard Foissac,

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The acquisition of a company which owns various buildings is a complex transaction involving various areas of expertise, including of course real estate law, but also corporate law and tax law, an excellent command of which has become an essential factor in the context of any transactions. The acquisition of a real estate company, despite the specific character of its underlying asset, is thus not a simple acquisition of the buildings held by the company, and it is now clear that negotiation techniques are quite similar whatever the type of company purchased. It is thus not surprising that purchasers are also willing to receive assistance from the M&A teams of their law firms when contemplating the purchase of a real estate company. Indeed, the acquisition is two fold, applying on the one hand to a building, involving a specific area of expertise, but on the other hand, to a company or to a group of companies when the ownership of the buildings is structured via subsidiaries and sub-subsidiaries. Certain real estate groups, including certain listed groups enjoying the special SIIC (REIT) status, have opted for the ownership of real estate assets directly and in the form of interests, some of which take the form of partnerships which are not liable for corporate income tax (for instance *sociétés civiles immobilières* – real estate partnerships). The issues involved thus cover the whole spectrum of difficulties related to the acquisition of groups of companies, whether concerning debt structuring, organisation of acquisition structures, tax optimization, renegotiation of leases and of rent capping rules, and finally negotiation of warranties.

We are seeing multidisciplinary teams being put together including: public notaries, lawyers, but also public accountants and even, in certain situations, financial analysts. The subject matter is indeed complex and purchasers need not only to grasp the substance with respect to the companies that they contemplate the acquisition of, but also their legal and tax regimes and the company background. Finally they must anticipate, insofar as possible, any necessary future management decisions, whether concerning assignments of real estate assets, changes to the management policy thereof (renegotiation of leases), or restructuring the target companies (merger, assignment, conversion ...). Acquisition due diligence is also becoming more and more important, especially with regard to tax aspects. According to the results thereof, a change in the tax regime and the corporate form may be necessary, unless the acquisition of the real estate assets directly should, more often than not, appear to be preferable to that of the real estate companies. However, we have decided, in the context of this special issue devoted to acquisitions of real estate companies, to only touch on some of the many issues encountered during acquisitions and which the command, or at least basic knowledge of, is necessary to avoid situations of inertia or failure during negotiations.

**"Acquisition due diligence is also becoming more and more important, especially with regard to tax aspects"**

## **Acquisition of the securities of real estate companies**

### **What impact for purchasers in terms of representations and warranties?**

By Philippe Rosenpick, partner, specialized in mergers and acquisitions and private equity. He provides advisory services to investment funds for their acquisitions in particular in the field of real estate and hotels, as well as to operators in this industry sector. In the context of these transactions, he works in particular with Christophe Blondeau, lawyer.

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This is one of the recurrent questions that all investors must ask themselves when intending to purchase a real estate asset through the acquisition of the securities of the holding company, rather than via a direct sale of real estate. If the choice of the acquisition method is often dictated by tax and financial considerations, the impacts with regard to warranties is not one to be taken lightly. Indeed the acquisition of a company does not entitle the purchaser to the benefit of the statutory regime of warranties applicable to sales of real estate. It is thus up to purchasers to obtain by contractual means, the appropriate level of warranties and protection in consideration of the investment, which, after all, remains of a real estate nature.

First of all, in order to do so and on account of the specific features of the asset (office or residential building, land, complex site), the purchaser will need to define the scope and nature of due diligence to be carried out in order to identify in a satisfactory manner the possible risks. In addition to the customary due diligence operations in respect of the company *per se*, due diligence shall be led with regard to the legal aspects of the building (title deeds, compliance with legal and regulatory frameworks, insurance, rental situation) and to the technical aspects (flying freehold division, environmental audits, technical compliance of facilities and developments). Once these due diligence operations have been completed, the purchaser will be in a position to define the level of warranties that it will need to solicit from the vendor.

Subsequently, negotiations shall be started with regard to the warranty agreement. In most cases, the latter shall be composed of representations made by the vendor, which in the event of inaccuracy thereof entail an indemnification in favour of the purchaser. As concerns a real estate company, the representations made in respect of the real estate asset shall mainly apply to the following subjects: title deed and root of title, mortgage situation, description of the asset in order in particular to ascertain conformity between the legal title deed and the material reality of the asset, easements, rental situation, absence of structural disorders, compliance with various applicable legal and regulatory frameworks, validity of the constructions, respect for the environment, health and safety, commonhold, planning, insurance.

Moreover, purchasers may request specific warranties when faced with specific issues. Thus, for instance, a rental warranty may be contemplated when there are vacant floor surfaces which have nevertheless been taken into account in the pricing process, a warranty for the consequences of a possible 3% tax reassessment (articles 990 E et seq. of the French Tax Code) or a warranty whereby the vendor shall be responsible for compliance or decontamination works.

The other aspects of the warranty shall also have to be adapted to the specific features of the relevant asset. Thus if a term of 12 to 36 months is common within the framework of "non real estate" warranties, the term applicable to warranties in the real estate field shall generally be much longer due to the statutes of limitation which are applicable to such matters. Finally, on account of the costs that may be related to certain risks (in particular in the field of environmental matters), the cap on indemnification may be higher, or even uncapped with regard to certain matters, in particular in the event of adverse affect on the ownership of the asset.

"The warranty needs to be adjusted to the issues which are specific to the assets of the target company."

## **Analysis of leases with regard to security of rent flow**

Within the framework of the acquisition of a real estate company, the legal analysis of the leases enables the purchaser to assess the security of rent flow over a given period of time and the amount thereof.

By Philippe Riglet, partner, specialized in real estate law. He advises on a regular basis significant corporate brand names, hotel groups and investment funds, more specifically in the fields of commercial leases and real estate transactions.

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The determination of rent flow over a given period of time implies the prior verification of the validity of the tenant's covenant with regard to term. The latter may have entered into a 9 year commercial lease (article L 145-4 of the Commercial code). If, however the lease is qualified as a professional lease, the term thereof is actually only of 6 years and the tenant is entitled to serve notice to break the lease at any moment, provided it gives six months prior notice (article 57A of the law of 23 December 1986). Another case scenario: the tenant is a public entity which has entered into a covenant for a firm term. In the presence of derogatory clauses being inserted into the lease, the lease is an administrative lease and, in this instance, the tenant, as a public body, is entitled to break the lease at any moment. Moreover, even if the parties have chosen one legal regime applicable to the lease, the mandatory rules of public policy, which naturally apply to the rental relationship, may prevail over the term chosen by the parties. As a consequence, during the due diligence process, it is in the best interests of purchasers to perform an accurate analysis of the legal qualification of leases. The "quantitative" flow of rent can be assessed on the basis of the initial rent as determined by the parties. It is important to check that the terms chosen by the parties, according to which the rent is determined, do not impede implementation of the mandatory rules of public policy which are applicable to the lease, such as the mechanism for triennial revision of rent which is applicable to commercial leases (L 145-37 of the Commercial code). The analysis of the rent clause allows checking whether the economic outlook of the parties is feasible or not. The security of rent flow also depends on the presence or not of clauses enabling the landlord to protect itself against the risk of the tenant being insolvent (guarantees, collateral...). In this respect, it may be interesting to analyse to what extent the lease may be transferred to a third

party, either within the framework of the assignment of the lease, or within the framework of a sub-rental with regard to the rights of the sub-tenant to the renewal of a commercial lease (article L 145-32 of the Commercial code). Finally, rent flow must also be construed in light of the obligations of the landlord concerning the compliance of the premises with administrative standards. In the absence of a clause placing the compliance works on the burden of the tenant, these works shall be incumbent on the landlord in application of its obligation to deliver the premises which is contemplated under article 1719-1° of the Civil Code (*Cour de cassation*, 3<sup>rd</sup> civil section, 10 May 1989, III, number 102, p.57). The purchaser would, moreover, be well advised to combine the analysis of these clauses with a technical survey of the premises in order to detect any expenditure that will need to be incurred by the landlord during the course of the lease in application of its obligation to deliver the premises.

"During the due diligence process, it is in the best interests of purchasers to perform an accurate analysis of the legal qualification of leases."

## **En route for a European lease**

### **Interview with Charles Romney, partner of CMS Cameron McKenna LLP, London**

Charles Romney is in charge of the real estate division of CMS Cameron McKenna. He specializes in cross border real estate transactions, real estate development, Public-Private Partnerships and real estate investments.

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**Can you explain the concept of a "European lease"?**

Charles Romney: what is concerned is a standard lease, which, subject to various adjustments taking into account local legislation and customary practices, could be used in all European countries.

**What is the use of such a document ?**

On account of the growing number of cross border investments, investors need to be in a position to compare with ease the correlative performance of their investments. With the arrival of the Euro, one of the main impediments to such comparisons, that is to say monetary instability, has disappeared. Comparisons can now be made in a much more direct manner. The other major impediment lies in the substantial discrepancies which exist between various European countries with regard to the legal framework for landlord/tenant relationships, to customary practises and to lease contracts. This lack of harmonisation is particularly obvious when an investor carries out a lease-back operation and attempts to apply identical conditions in different countries.

### The European harmonisation process already applies to many sectors, why add lease contracts?

A lease contract governs the return on an investment; in this respect, it is a key factor to the value of this investment. The "European lease" would be a valuable tool for investors, as it would enable them to compare returns and to identify the net income of an investment with ease. Moreover, it could be used as a reference document setting out all the rights and obligations of the parties in relation to a given asset, which would enable to save time and money, in particular as concerns international portfolios managed by the same team.

**"The "European lease" is intended to offer investors an instrument for comparison and optimisation of management."**

For all of the above reasons, I consider that the origination of common European lease contracts is inevitable. Logically, they shall present a homogenous approach to business issues, shall include a consistent definition of net income and shall contribute to transparency which shall help real estate investor and financial backers in reaching their decisions.

### What are the advantages of such a standard lease ?

They are considerable :

- for investors, simplification of comparisons and management;
- for financial backers, better visibility of available income for debt servicing;
- for the local market, increased attractiveness for international investors.

### Have you already prepared a standard contract?

If legal and commercial environments differ country by country, the needs of investors and financial backers are the same; lawyers and real estate valuation specialists will be ready and able to apply the necessary creativity to prepare contracts which correspond to these needs. The Real Estate practice group of the CMS alliance has drawn up a lease contract which is used in several countries. This contract provides solutions to a certain number of practical difficulties which have arisen out of the disparity between rules which govern the relationships between landlords and tenants in different countries. It also lists all of the main obligations of the parties.

### What would you like to say to sum up?

Investors are calling for the European market to be more open and governments shall have to respond by relaxing the restrictive rules that apply to real estate leases. In doing this, an official pan-European lease contract shall become, I am sure, standard practise.

## **Relevance of assessing the situation of the building with regard to planning issues**

The assessment of real estate assets held by an assigned structure and the scope of the assignor's warranty are closely related to the results of the detailed examination of each building's situation with regard to planning issues; this is illustrated by the following examples.

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"Two essential precautions should be taken: checking the actual potential for improvement of the building and the effective possibility of rebuilding."

1. Consequences of the situation with regard to planning rules concerning subsequent fitting, restructuring or reconstruction works

If fitting or restructuring works are contemplated within the building, in the short or medium term, one must check whether the construction thereof was executed in a valid basis; indeed if such was not the case, a new planning permission may only be delivered if the works contemplated are intended, on the one hand, to regularise the situation of the whole of the building and, on the other hand, to do so with regard to the rules in effect at the date of delivery of this new planning permission. As local planning documents are developed constantly, the current rules often make such regularisation impossible to perform in practise. Buildings are often thus doomed to remain in their existing configuration without the possibility for any improvement, or the possibility of invoking any statute of limitations.

Likewise, the reconstruction thereof in an identical manner subsequently to an accidental event, if the local rules have not excluded such, depends on the valid character of the construction; it is only subject to this latter condition that it is possible to rebuild with the same land coverage, alignment, minimum building distances, floor areas, height and number and nature of parking spaces; however the constant changes to local rules with regard to these issues does not always allow for demolition/reconstruction in an identical manner outside of any accidental event.

What we have in mind is the case, which is quite frequent, of buildings which have been purchased after their construction but which have an insufficient land base to enable effective reconstruction potential.

2. Situation with regard to third party legal action

It is often asserted that the legal action of third parties against planning permissions disappears after two months. In reality, this is only true in the event of valid, continuous and provable display thereof, on site and within the city hall. Failing which the time limit on third party action continues and a cancellation may be applied for at any moment.

Moreover, even if the planning permission has not been challenged, planning law entitles third parties to apply for the demolition of the development erected in performance of an invalid planning permission, and thus, within five years from completion thereof; this type of legal action is effectively brought and has been successful. In reality, such action remains moreover possible during the first ten years as from completion. This demonstrates the importance of checking whether the initial planning permission has authorised the erection of a building which is badly sited, with excessive floor areas or dimensions, with a challengeable intended use, or which does not have enough parking spaces or green areas, and the valid completion of which revealed in fact to be impossible.

3. Consequences of irregular construction from the point of view of criminal liability : demolition or reinstatement

The case scenario of criminal proceedings must not be excluded either; indeed, it is not uncommon for certain works to have been carried out (construction, extensions, fittings, conversions), either without a planning permission, or in violation of the planning permission obtained. In such case a criminal offence is committed, which can lead to an order to demolish or to reinstate.

## **Assessment of certain tax issues in acquisitions of real estate companies**

By Richard Foissac

We have chosen to touch on three issues which are frequently encountered in acquisitions of real estate companies.

### **1 – Management of 3% tax consequences, which is due by corporations which hold buildings in France.**

This tax is contemplated by articles 990 E et seq. of the French Tax Code and can constitute a lengthy and impeding threat to purchasers, on account of the scope of application thereof, of the length of the statute of limitations, and of the joint and several liability provided for by law between the party liable for such tax and the company which holds the buildings.

The 3% tax applies, indeed, and in principle, to all companies, whether French or foreign, if the effective value of the assets they hold in France is made up of more than fifty percent of

French buildings. The amount of such tax is 3% of the fair market value as at January 1<sup>st</sup> of the buildings held directly or indirectly in France through a chain of interests. If companies which are listed or which are not predominantly real estate holding companies are placed outside the scope of the tax, other companies which are predominantly real estate holding companies and which are not listed are only exempted from such tax:

- if, having their place of effective management in France or, if being foreign, they are not, by virtue of a treaty, liable to taxation of greater significance than if their registered office had been in France, but only to the extent that these companies comply with certain tax return requirements, i.e. sending or entering into the covenant to send certain items of information;
- if, being foreign, they have their registered office in a country or within a territory having concluded a convention on administrative assistance to prevent tax fraud and evasion, but only to the extent that they file a return each year mentioning certain items of information (return form number 2746).

The return requirements to which the annual exemption from the tax is subordinated are binding on all the companies interposed in respect of the chain of interests and which come under the provisions above.

Any interposed company which does not benefit from one of the aforementioned exemptions or which has not complied with its return requirements is liable for the 3% annual tax,

**"Any corporation interposed between the tax debtor and the buildings is jointly and severally liable for the payment thereof."**

it being specified that when there is a chain of interests, the tax is due by the aforementioned corporation(s) which, in this chain, are the closest to the buildings or to the real estate rights.

The statute of limitations applying to the tax authorities' right to recover in respect of the 3% tax is the ten year statute of limitations, if no return has been filed, there being a difference of opinion, as concerns companies having entered into a covenant to file returns, on the time limit during which the tax authorities can request the information concerned.

Finally the French system contemplates that any corporation interposed between the tax debtor(s) and the buildings or real estate rights is jointly and severally liable for the payment of such tax.

In application of these rules, a French real estate company, despite being in line with its own return requirements, may very well be sued on a joint and several basis, during a period of ten years, for the payment of the 3% tax due by an upstream company in the chain of holding.

The purchaser of a real estate company thus has to check, as the case may be, over a period of ten years prior to the acquisition, the situation with regard to 3% tax of all the companies which belong to the chain of holding of the real estate company.

When it appears that any of these companies were liable to such tax, or were not entitled to be exempted from such without any possibility to regularise the situation, the purchaser has no other alternative but to obtain a specific warranty from the assignors in this respect.

The cost of the warranty and the term thereof, which can theoretically be for ten years, may cause grounds for dispute with the assignor and lead to dropping the purchase of the real estate company in favour of the direct purchase of the buildings.

## 2 – Necessity for purchasers to have to take into consideration the assignors' tax situation

The assignment of a predominantly real estate holding company often leads to the realization of capital gains to the benefit of the assignors. This situation can not be completely ignored by purchasers when the assignment is carried out by assignors which are non resident individuals or corporations.

For non residents, the real estate capital gains regime applies, subject to international tax treaties, to capital gains realized on the assignment of all predominantly real estate holding companies, whatever their tax regime.

However, even if we are aware of the joint and several liability of assignors with regard to purchasers as concerns transfer tax, there is also a risk of a joint and several liability of purchasers with regard to non resident assignors, as concerns real estate capital gains.

If article 244 bis A of the French Tax Code does not expressly contemplate a joint and several liability for payments between the parties, on the contrary to what exists for the 50% levy on certain real estate profits of non residents (article 244 bis of the French Tax Code), article 244 bis A of the French Tax Code and article 171 quater of annex II of the French Tax Code which it refers to, contemplate (i) that the tax due is paid upon registration of the deed (failing registration, within one month as from the assignment), (ii) that the capital gains return is filed in support of the request to publish or of the presentation for registration if concerning an assignment recorded by a deed, (iii) that in this case, are applied the rules of enforceability and recovery contemplated by articles 1701 to 1712 of the French Tax Code.

Article 1705 of the French Tax Code contemplates that all parties having been identified in the context of a private agreement are jointly and severally liable for the payment of duty and article 635 of the French Tax Code lists, among those deeds which are necessarily the subject of registration, deeds concerning the assignment of ownership interests in companies, in particular which are predominantly real estate holding companies.

The reference by article 171 quater, mentioned above, to the rules of enforceability and recovery of registration duty, creates thus a risk of the tax authorities applying the joint and several liability of a purchaser of a company's securities for the payment of taxation related to capital gains realized, and thus independently from the intervention of the assignors' tax representative.

Indeed, in principle, non residents have to appoint a tax representative, which has to covenant to accomplish all formalities and to pay such tax on behalf of the non resident assignor.

This system implies however, establishing, on the one hand, that the capital gains on the assignment of the securities comes under the regime of real estate capital gains, on the other hand, that the assignor is duly subject to this regime in France, and finally that the capital gains realized, although falling within the scope of such tax, are however not exempted from such.

**"There is a risk of joint and several liability of purchasers with regard to non resident assignors, in respect of real estate capital gains."**

It is thus essential for purchasers to take stock of these situations and to contemplate, as applicable, an autonomous warranty system, for their benefit, for a term corresponding to the statute of limitations which applies to tax matters, i.e. three years as from the year following the realization of the capital gains, each time that there is a doubt as to the existence and to the amount of the taxable assignment capital gains.

On the other hand, it would appear that this issue is not relevant to assignments by individuals which are residents in France or by partnerships held by individuals which are residents in France by reason of the capital gains on the assignment of securities of predominantly real estate holding companies which are not liable to corporate income tax.

### **3 – Liability to corporate income tax of predominantly real estate partnerships and representations and warranties**

When the acquisition concerns real estate partnerships which are not liable to corporate income tax, the tax representation and warranties usually granted by assignors is, as a matter of principle, simplified.

The profits and capital gains realized by partnerships are taxed at the level of the partners thereof, at closing of each financial year, and thus independently from any legal distribution of the income of the partnership to its partners.

Likewise, save express provision as to the contrary in the articles of incorporation, the partners which are present at the closing of the financial year of a partnership which is not liable to corporate income tax, are deemed from a tax point of view to collect the income of the partnership.

Thus, in the event of acquisition of a partnership during the course of a given financial year, the purchasers are, in principle, only likely to be liable from a tax point of view exclusively to the extent of the income in respect of the financial year of the acquisition, the assignors, in their capacity as former partners, remaining alone under the obligation to bear the consequences of any increase of taxable income in respect of financial years closed at the date of the assignment of the partnership assigned.

In principle, the representations and warranties should take due note of this situation and should not make any reference to taxes on income in respect of financial years prior to the financial year of the assignment.

However, this analysis only applies to the extent that the partnership purchased duly comes under the tax regime of partnerships and that it is not liable to corporate income tax, either due to the exercise of an option, which was not disclosed to the purchaser, or due to a past or present business activity which will have had the effect or the consequence of entailing, as of right, the application of corporate income tax to the partnership.

In this case, it is therefore the purchaser which shall bear indirectly the tax risk, as it is purchasing an entity liable to corporate income tax.

It is thus necessary for the acquisition due diligence, with regard to tax issues, to make reference to the situation, with regard to corporate income tax, of the partnership assigned, and each time that there is a doubt as to the risk of the latter being liable to corporate income tax, for such to be taken into account when drafting representations and warranties.

## **VAT impact on acquisitions and assignments of the securities of real estate companies**

In the context of acquisitions and assignments of securities of real estate companies, VAT neutrality should be ensured so as to avoid situations in which there is a non recoverable VAT burden.

By Philippe Tournès, partner, specialized in VAT issues, in particular within the real estate field.

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"The impact of VAT in transactions for the purchase of securities of real estate companies is not as directly visible as that of registration duty (5% for predominantly real estate companies), but should not be overlooked."

The impact of VAT in transactions for the purchase of securities of real estate companies is not as directly visible as that of registration duty (5% for predominantly real estate companies), but should not be overlooked.

The purchaser may, first of all, revert to the services of a broker in charge of negotiating the acquisition of the securities on its behalf. The fees of such agent shall be exempted from VAT as a financial service. Therefore, the purchaser must take care in ensuring that VAT is not invoiced by mistake, as it would not be entitled to recover such (VAT is only recoverable when rightfully invoiced).

Fees of advisors and audit firms are, for their part, subject to VAT. For a long time, there was a debate as to the possibility of recovering such tax. The tax authorities finally specified that these expenses had a direct and immediate link with the overall business activity of the purchaser and that, as such, they are general overhead expenses. It results that if the undertaking only receives revenues liable to VAT, it can recover the whole amount of VAT burdening such fees. On the other hand, if such concerns an undertaking with a partial tax liability (for instance a holding which receives financial proceeds exempted from VAT), the VAT burdening the fees shall only be recoverable in accordance with the *pro rata* of turnover giving rise to a right to deduct in respect of the overall turnover. By way of exception to this rule, the tax authorities allow however that a tax payer with partial liability may nevertheless recover all VAT on fees, if it establishes by means of objective evidence, that these expenses form a part of the price components of the taxable operations that are provided.

Moreover, the purchaser must be careful with respect to the fact that the income distributed by the company, which it holds the securities of, shall constitute revenues that may lead to liability for payroll tax if it receives more than 10% of exempted revenues and which are outside the scope of application of VAT.

The vendor of the securities of a real estate company must also pay attention to VAT on several counts, as assignments of securities are exempted from VAT (save the specific case of tax transparent real estate companies – *sociétés d'attribution*).

Thus, firstly, the tax authorities consider that the VAT related to fees that the vendor incurs on the occasion of such assignment is not recoverable, as concerning an expense which can be allocated to a revenue (the sale price of the securities) which is exempted from VAT. The first cases ruled on that we have at our disposal in this respect are favourable, but we shall have to wait for a ruling from the French Supreme Court for administrative affairs (*Conseil d'Etat*) or from the Court of Justice of the European Community for this question to be definitively settled.

It should also be noted that even if the assignor is a real estate dealer, the tax authorities now allow for the assignment of the securities of a predominantly real estate holding company to be exempted from margin VAT (with the exception of securities of tax transparent real estate companies).

Finally, the assignment of securities has an impact on the calculation of the vendor's pro rata if they were to be recorded as inventory (case of a real estate dealer), but not if they are long term shareholdings.

## **Specificities related to the acquisition of a company holding a financial leasing contract**

The tax consequences attached to the acquisition of the securities of a company which enjoys lessee status within the framework of a real estate financial leasing contract bring to light certain specificities in comparison to the acquisition of the securities of a company which owns a building.

By Jean-Yves Charriau, partner, focuses exclusively on real estate issues. He provides advisory services to a wide variety of foreign investment funds, within the framework of their investments in Europe, and of land corporations, in particular in respect of the tax issues related to the French REIT regime (SIIC).

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First of all, the interests held within the framework of a real estate financial leasing contract are of a "movable" nature until the call option to purchase has been exercised, which enables the financial lessee company to escape qualification as a predominantly real estate – or "immovable" - holding company (on the assumption that the company owns no other real estate assets). This analysis, which seems to be obvious from a legal point of view, has been expressly confirmed by the authorities in the guidelines commenting on the changes to the real estate capital gains regime for individuals<sup>1</sup>.

Thus, as concerns capital gains, the assignment by a company, liable to corporate income tax, of the securities of a company which is a financial lessee shall be eligible for the regime of long term capital gains on investment securities (taxation at the reduced rate of 8% in 2006 and exemption as from 2007 subject to a 5% fraction corresponding to expenses and charges), whereas the capital gains on the assignment of the securities of a predominantly real estate company shall be liable to corporate income tax at the rate of 15%.

### **"Financial lessee companies escape qualification as predominantly real estate companies."**

As concerns registration duty, the assignment of the securities of the financial lessee company shall, if it is a joint stock company, be liable to the 1.1% duty, capped at 4,000 euros, whereas the assignment of the shares of a predominantly real estate company is liable to transfer tax at the rate of 5%. It should be specified that the financial lessee company shall have to pay transfer tax at the rate of 5.09 % upon exercise of the call option to purchase, transferring the building to its legal estate. The taxable base of duties is however limited to the price of exercise of the call option (subject to the publication of those contracts which have a term in excess of 12 years and which have been entered into as from January 1<sup>st</sup>, 1996).

Moreover, the financial lessee company does not fall within the scope of application of 3% tax contemplated under article 990 D of the French Tax Code, which has the effect of withdrawing this complex aspect from the negotiation of representations and warranties.

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<sup>1</sup> Guidelines of August 4, 2005, 8 M 1-05, number 58

Secondly, the acquisition of the securities of a financial lessee company brings to light various specificities as concerns latent taxation liabilities that the purchaser shall have to take into account. Thus, for financial leasing contracts entered into since January 1<sup>st</sup>, 1996, the fraction of the rent instalments corresponding to the financial depreciation of the land is not, in principle, deductible from a tax point of view. Moreover, the exercise of the call option to purchase carries the obligation to reincorporate a fraction of the rent instalments paid into the income of the financial year in effect so as to place the financial lessee in a similar situation to that in which it would be, had it been the owner of the asset as from the conclusion of the contract.

Finally, it should be noted that case law has recently confirmed that in the event of sub rental of a bare immovable asset which is the subject of a financial leasing contract, the financial lessee company must opt for the voluntary payment of VAT in accordance with article 260-2° of the French Tax Code if it intends to be in a position to deduct the VAT which it is invoiced (in particular the VAT on the financial lease rental charges)<sup>2</sup>.

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<sup>2</sup> CE November 16, 2005, number 257532.

## ACTUALITY

News items put together by the team for doctrine in tax law, Jean-Yves Mercier, partner, and the team for doctrine in business law, Elisabeth Flaicher-Maneval, lawyer.

### Changes of the assigned use of residential buildings

Ordinance number 2005-655 of June 8, 2005 (Official Journal of 9 June) relaxed the rules on changes of the assigned use of residential buildings : in particular such ordinance restricted the scope of prior prefectural authorisations to conversions occurring in municipalities of more than 200,000 inhabitants, as well as in the counties of Hauts-de-Seine, Seine-Saint-Denis and Val-de-Marne and generalised the compensation practise, which enables to subordinate an authorisation to change an assigned use to the simultaneous conversion of premises having a different use into housing premises (article 631-7 et seq. of the Construction and Housing Code).

Thus in Paris, any authorisation to change the use of residential premises is, save a few minor exceptions (this is in particular the case for premises located on the ground floor of buildings), subordinated to the conversion to a housing use of premises which had another use as at January 1<sup>st</sup>, 1970 and which have not already been used for a compensation. These premises must be of equivalent quality and size to those of the buildings forming the subject matter of the transformation (the surface areas being assessed in accordance with the "Carrez" law) and must be situated in the same *arrondissement*, or even in the same district if these buildings are located in administrative districts (such as *Champs-Élysées*, *Plaine-Monceau* or *Invalides*). No premises situated on ground floors may be used for compensation (prefectural bylaw number 2005-335-4 of December 1<sup>st</sup>, 2005).

As beforehand, any compensation of a financial nature remains prohibited and agreements entered into in infringement of the new rules are invalid as of right.

"The compensation system is confirmed, but can still not be of a financial nature."

### Real estate transaction within an environmental hazard zone

Since June 1<sup>st</sup>, 2006, owners of buildings situated within a zone of foreseeable natural or technological hazards are under the obligation to inform the purchaser or the tenant of an asset of the existence of these hazards: such owner is thus under the obligation to annex an inventory of the hazards which the building is exposed to, which is less than 6 months old and which has been drawn up on the basis of information provided by the Prefect, to any call option to purchase or to sell, to any sale contract and to any written lease agreement granting a new right of entry into the premises ; failing which the purchaser or the tenant shall be entitled to apply for the rescission of the contract or to apply to court for a reduction of the price thereof (article L 125-5 of the Environmental code and decree number 2005-134 of February 15, 2005).

Despite the fact that only assignments or rentals of buildings are referred to, it could be appropriate in practise to accomplish the same formality for the acquisition of a company

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holding buildings which are situated within such a zone, in order to avoid any risk of litigation in the event of occurrence of an environmental accident.

"The provision of an inventory of environmental hazards may be useful in the context of the acquisition of a company which holds buildings."

## Assignments of buildings to companies offering debt securities to the public: tax incentive policy

Article 210 E of the French Tax Code enables for the period 2005-2007, to carry out a contribution of buildings or real estate financial leasing contract with the benefit of the reduced corporate income tax rate of 16.5%, if such contribution is granted in favour of a company offering debt securities to the public with a rental purpose: Real Estate Investment Trusts (SIIC) or Unlisted companies for collective investment in real estate (SCPI). The company receiving such contribution must, in exchange, hold the asset for five years, failing which it shall bear a penalty corresponding to 25% of the contribution value.

The scope of application of this measure has just been extended (article 28 of the Amended Finance Bill for 2005):

- as from January 1<sup>st</sup>, 2006 the reduced taxation concerns any form of assignment granted in favour of the companies above (subject to the same holding constraint) ;
- predominantly real estate investment companies with a variable share capital (SPPICAV), which shall be incorporated in application of the ordinance of October 13, 2005 shall be entitled to purchase or to receive as a contribution the assets, the transfer of which comes under the 16.5% rate.

## Investment securities in predominantly real estate companies: definition expected

It is rare for a tax arrangement to be decided on long before its date of entry into effect. Article 39 of the law of December 30, 2004 innovated in this sense by deciding on the agenda for the progressive exemption for long term capital gains on assignments of investment securities: from 15% for financial years starting in 2005, the rate of taxation of such capital gains shall be reduced down to 8% for financial years starting in 2006 and then down to 0% as from 2007, subject to the taxation at the standard rate of a fraction of expenses and charges corresponding to 5% of the capital gains. A specific lot has been reserved by the law to capital gains on securities held in predominantly real estate holding companies. Such capital gains shall remain taxable at the rate of 15%. Sadly the Decree which is intended to define these securities has still not been released, whereas since the start of financial year 2006, the criteria that it will be retaining is liable to change the rate applicable to transactions from 8 to 15%.

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