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Foreign Situs Real Property in the Estate of a U.S. Individual

FRANCE

STEP – Los Angeles - July 13, 2006

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REAL ESTATE IN FRANCE OWNED BY US INDIVIDUALS

This article discusses the French legal and tax issues which may arise when US individuals own French real estate.

I. Legal aspects

Direct or Indirect ownership?

French real estate can be owned directly or indirectly through a French entity (generally a *Société Civile Immobilière* “SCI”, a partnership) or a US entity (generally an LLC). The main difference lies in the inheritance law treatment. While the prevailing French forced inheritance rules (see below) apply in case of direct ownership, the holding of units in a real estate “partnership” is outside their scope. For that reason, the use of an entity is generally favored.

Under international case law, the inheritance law of the country of location of the real property prevails in case of conflict with the law of the country of residence of the decedent¹. French and US law conflict since French inheritance law requires that a fraction of the decedent’s estate must be allocated to the heirs (the “*réserve héréditaire*”). The portion of the decedent’s estate which must be allocated to the heirs depends on the number of surviving children of the decedent. It is equal to 1/2 of the decedent’s estate when there is only one surviving child, 2/3 when there two surviving children and 3/4 when there are at least three surviving children (section 913 of the French civil code)².

Since holding shares or units in an entity, whether French or foreign is not treated as holding real estate, inheritance law governing the ownership of real estate no longer applies and rules of residence of the decedent apply. As a result, the French forced inheritance rules are ignored. The use of a legal entity to hold the real property allows a US individual to avoid the French forced inheritance rules and to be bequeath the shares of the entity as the individual wishes.

Therefore, French real estate is generally indirectly held.

¹ French and US rules differ and conflict on this point. In such a situation, international case law has determined that inheritance rules are submitted (i) to the *lex rei sitae* for real property (i.e., the law of the State where real estate is located) and (ii) to the law of the last residence of the deceased for personal property.

² In absence of child, the surviving parents benefit from a fraction equal to 1/4 of decedent’s estate if they are from the same line and to 1/2 if they are not from the same line (section 914 of the French civil code).

The Notaire, Who is he?

Under French civil law, the purchase agreement should be executed before a Notaire so that a deed for the conveyance of property is created (“*acte Authentique*”). A *Notaire* is a lawyer and a public official. Under French law, a *Notaire* has authority to legalize certain agreements such as real estate sales which cannot be enforced any other way. The *Notaire* ensures that the parties are sufficiently informed of the legal aspects of the transaction and that they agree freely and knowingly to the transaction. Along with the parties, the Notaire executes the document and thereby certifies its date of execution, the authenticity of the document and its content. Transfer tax along with fees are paid to the Notaire at the time of the execution of the deed and the Notaire takes care of the publication and registration requirements. The deed is filed with the minutes of the Notaire.

II. Tax treatment

Tax on Acquisition: Transfer Tax

In case of direct acquisition of the real property or **direct ownership**, a transfer tax of 5.09% of the purchase price is due upon execution of the deed before the Notaire. This tax is due by the purchaser, whether it is a legal entity or an individual, unless the parties to the transaction agree otherwise.

In case of **indirect ownership** with the acquisition of shares of an entity owning the real property, three situations may arise:

- The transaction is subject to a 5% transfer tax if the entity is a private “real estate company” i.e., a private entity the whole assets of which consist, directly or indirectly, for more than 50% in French real property. Real estate used within the course of a business is taken into account.

The tax authorities took the position that the French transfer tax is due even if the transaction involves the sale of a foreign entity and therefore disregard the level of interposition. This position is debatable since it contradicts the territorial principle which generally restricts transfer tax to French assets (subject to exceptions).

- The transaction is subject to a 5% transfer tax when the entity is a French partnership (purchase of units) such as an SCI.
- The transaction is subject to a transfer tax equal to €4,000³ when the entity is a corporation⁴.

³ The transfer tax is 1, 1 % of the sale’s price of the stock capped at euro 4,000.

⁴ See however page 5 for the corporate income tax treatment.

The transfer tax is normally assessed on the net value of the shares. Therefore, if the entity is leveraged, the net value of the shares normally is lower than the real property value. However, in one case, the High Court, *Cour de cassation*,⁵ determined that transfer tax had to be assessed on the fair market value of the real property, the related liability being disregarded for the purpose of transfer tax. This look through approach is debatable and remains to be confirmed.

- In practice, the 5% transfer tax does not apply if the entity which issued the shares being sold owns assets of a higher value than the French real property (i.e. does qualify as a real estate entity), or is a corporation.

Tax on “Ownership”:

French Wealth Tax may be due by US individuals if the net value of the French real estate assets is €750,000 or more. Wealth tax applies in case of direct or indirect ownership of a real estate company i.e., “*a company the [French] assets of which consist at least 50 percent of real property situated in [France], or derive at least 50 percent of their value, directly or indirectly, from real property situated in [France], may be taxed [France]*” under U.S. - France Tax Treaty, article 23. Real estate used within the course of a business is not taken into account.

Tax brackets apply with a marginal rate of 1.8%.

- The use of debt upon the acquisition such as a shareholder account within the entity owning the real property generally lowers the value of the taxable assets and may even result in a wealth tax free treatment subject to anti-abuse provisions.

Disclosure requirements / 3% tax

When real estate is owned through a legal entity – whether French or foreign – which is regarded for 3% tax purposes as a “real estate entity”, disclosure requirements apply and failure to comply exposes the entity to a 3 % tax assessed on the fair market of real property. For the purpose of the 3 % tax, a real estate entity is a private legal entity, the French assets of which consist at least 50 % directly or indirectly of real property. Real estate used within the course of a business is not taken into account.

With US owners, the entity is required to disclose yearly information on the real property (situation, description and value) and on the shareholders/partners (name, address and number of the shares they hold) of the legal entity. With the use of a French SCI (French partnership) as the owner of real property, this yearly disclosure requirement may be waived.

⁵ Cass. Com, 10 décembre 2003, n°1806 F-D, Chicoyneau de Lavalette and CA Toulouse, 9 mai 2005, 1ere chambre, section 1, SCI Faure Bas.

Leasing of the property: Income Tax

Rental income deriving from the leasing of a French real property remains taxable in France under Article 6 of the France / US tax treaty and personal or corporate income tax applies depending upon the status of the direct owner.

In case of **direct ownership**, the individual is subject to the progressive rate of French income tax. Tax brackets apply with a marginal rate of 48.09%.

In case of **indirect ownership** with a French entity subject to corporate income tax, the rents are subject to the 33 1/3 % rate (or 34.43% depending the level of rental income). When the legal entity is a partnership (a French partnership or a US one), the partner is liable to French income tax on its share of the profits in the partnership.

Deemed Rental Income: If the real property is held by a corporation, the corporation would have to recognize a deemed rental income for corporate income tax purpose if the property is used as a private residence. This issue does not arise with the use of a SCI for instance where the operating agreement states that one of unit holders intends to use the property as a private residence. That is the reason why corporation are generally not used by individuals.

Tax on Sale: Capital Gains Tax⁶

The tax treatment differs depending upon the ownership structure. The tax treaty between the U.S and France allows France to tax gains on real estate located in France. The same solution applies in case of disposal of units in “*a company the assets of which consist at least 50 percent of real property situated in [France] or derive at least 50 percent of their value, directly or indirectly, from real property situated in France*” under article 13 of the tax treaty.

In case of **direct ownership** with the sale of the real property, the US individual seller is subject to a one third levy withheld by the *Notaire* at the time of the execution of the deed.

- Gain on disposal of property held for more than 15 years at the time of the transaction may be exempt. The taxable basis is reduced by 10% for each year of ownership starting from the fifth year. Therefore, there is no taxable gain after the 15th year of ownership.
- Gain on disposal of a residence in France by a non resident as may also be exempt if the US individual was domiciled in France for tax purposes for at least two years any time prior to the year of the transaction. The

⁶ Section 244 bis A and B, 150 U and 150 UB and 150 VC of the French tax code.
Guidelines of the French tax authorities: 8M1-04 and 8M1-05

exemption applies to the two first sales. It aims at French and EU passport holders but also applies to US residents through the non discrimination clause of the tax treaty.

In case of **indirect ownership** and if the real property is sold by a partnership held by a US individual, a one third levy applies on the gain on disposal of the real property.

- If the gain is derived by a French or foreign partnership, the same exemptions (as seen above) may apply if the real estate is used as a residence by the US partner.
- If the gain is derived by a US corporation⁷, these exemptions no longer apply. However, a reduction of the taxable basis of 2% per year of ownership applies. French corporate income tax applies after deduction of the levy. Any excess is refundable.

However, in case of a share deal (with a disposal of the interest of the entity owning the real property), the one third levy applies only if the seller (whether corporate, partnership or any other entity) qualifies as a “real estate entity”, i.e., a private entity the assets of which consist at least 50% directly or indirectly of French real property, over the three-year period preceding the year during which the sale occurs. Real estate used within the course of a business is not taken into account.

- Failure to meet the real estate entity test, such as a disposal before 3 years, may result in the exemption of the gain in France since gains on shares or units are generally taxable in the residence country namely the U.S. by virtue of the tax treaty.
- In case of disposal of units of French partnership, the exemption based on the 15 year holding (as seen above) is applicable. The disposal of units of a US partnership should be eligible to the same treatment. However, the exemption based on the French residence of non residents does not apply in case of a share deal.

Ownership structures with entities in Denmark, Belgium or Luxembourg may result in capital gains tax free treatment.

Gifts and inheritance Tax

Gift and inheritance tax are unified and are governed by the same rules. In France gift and inheritance tax are due by the beneficiaries. The French tax authorities

⁷ Note that for French tax purposes, a corporation owning a real property is supposed to derive rental incomes and free use by a shareholder may give rise to a deemed taxable rental income (and possibly withholding tax).

assess gifts and inheritance tax on the fair market value of the assets at the time of the transfer, i.e., upon decease or gift.

French real estate owned by US individuals may give rise to French gift or inheritance tax under the tax treaty whether the property is held directly or indirectly.

The protocol amending the US-France tax treaty (the “Protocol”) extends the real estate treatment to real estate indirectly owned by a “*a company or legal person the assets of which consist directly or through one or more other companies or legal entities, at least 50 % of real estate situated in one Contracting State or rights pertaining to such property*”. As a consequence, transfer upon death of interest in the SCI or in an LLC (owning French real estate) from one US tax resident to another one should be taxable in France. One option might be to dilute directly or indirectly the French real estate so that the entity no longer qualifies as a real estate company for purpose of the tax treaty.

Progressive rates apply and differ whether transfers are in direct line (from parents to children) (marginal rate is 40%), between spouses (40% as well), or between siblings (45%) and other (60%). There is also a main allowance and reduction of tax.

Generally, French tax gives rise to a credit against the US tax which might also be due under the tax treaty.

A new feature brought by the Protocol is the benefit of a marital deduction in connection with transfers of “qualifying property” to the surviving spouse who is not a US citizen. “Qualifying property” is property which would have qualified for the estate tax marital deduction under US domestic law if the surviving spouse had been a US citizen. For the tax treaty to apply, the decedent must have been, at the time of death, domiciled in either France or the US, or must be a citizen of the US. The surviving spouse must be, at the time of the decedent’s death, domiciled in either France or the US. If both the decedent and the surviving spouse were domiciled in the US at the time of the decedent’s death, at least one of them must have been a citizen of France. The executor of the decedent’s estate must elect the benefits of this marital deduction provision and waive irrevocably the benefits of any estate tax marital deduction that otherwise would be allowed under US internal law.

The amount of the marital deduction is equal to the lesser of the value of the qualifying property or the “applicable exclusion amount” as defined under section 2010 of the IRC. As an exception, a special retroactive effective date applies with respect to the provisions on the marital deduction (applicable to deaths occurring and gifts made after November 10, 1988) as a possible alternative of a QTIP election or a QDOT election.

The Protocol will take effect once France ratifies it, most likely before January 1, 2007.

III. Trusts

Trusts are not a feature of French law. The split of ownership rights under a trust arrangement does not match the civil law concept of ownership and related rights. Therefore, the French tax treatment of French source income derived by trust requires special care and an in-depth analysis of the terms of the Trust Deed.

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07/10/06