Morgan Lewis
tax lawflash
alert
www.morganlewis.com

Reform of French Taxes on Wealth and Estates

3 June 2011

On 11 May, the French Government introduced before the National Assembly an Amending Finance Bill (n°3046) for 2011 (the Bill) that proposes a significant reform of taxes on wealth and estates. Pursuant to the Bill, the tax shield mechanism would be abolished, the wealth tax revised, the inheritance and gift duties increased, and a new tax on secondary residences for nonresidents established.

Below are summarized the main provisions of the Bill.

1. Abolition of the Tax Shield (Article 13 of the Bill)

The provision contained in Article 1 of the French Tax Code that caps the amount of direct taxes due by a taxpayer at 50% of his or her income would be abolished. This would come into force with respect to direct taxes to be paid in 2011 and 2012 on income earned in 2011.

2. Nonresidents; International Mobility

Exclusion of debts contracted by real estate investment companies with their nonresident shareholders for the calculation of wealth tax (Article 16 of the Bill)

The government is considering putting an end to the mechanism whereby nonresidents purchase immovable property in France through special-purpose companies which they fund with debt in order to avoid wealth tax. This scheme has allowed the reduction of the wealth tax base of nonresidents since, on the one hand, shares of companies are valued with their indebtedness deducted, and on the other hand, the corresponding shareholder claims are exempt as investments made in France by nonresidents pursuant to Article 885 L of the French Tax Code.

From 2012, debts contracted by real estate investment companies with their nonresident shareholders would not be taken into account for the purposes of assessing the wealth tax base (Article 885 T *ter* of the French Tax Code). This law is likely to apply to both future and preexisting loans.

Tax on secondary residences of nonresidents (Article 17 of the Bill)

A new property tax would be imposed on nonresident individuals owning residential property that they can enjoy in France from 1 January 2012. The new tax will be 20% of the cadastral rental value (a mathematical value calculated by the French tax authorities) of the secondary residence, and will be levied on those nonresident individuals whose French income represents less than 75% of their global income.

However, there would be an exemption for any taxpayer who lived in France continuously for at least three years during the 10 years preceding his or her expatriation. Such an individual would be exempt as for the year of expatriation and the five following years (Article 234 *sexdecies* of the French Tax Code).

If the Bill is passed, the current tax mechanism that subjects nonresidents to income tax on the base of three times the cadastral rental value of their residence in France would be repealed (Article 164 C of the French Tax Code).

Taxation of latent capital gains upon expatriation from France ("Exit tax"; Article 18 of the Bill)

Taxpayers who have transferred their tax domicile out of France as of 3 March 2011 would be subject to an immediate taxation on the latent capital gains on the shares they own in French or foreign companies.

Shares (i) representing at least 1% of the financial rights of a company or (ii) with value of more than €1,300,000 will fall within the scope of the new legislation.

A tax deferral could be granted, however, but guarantees might be required, mainly if the taxpayers transfer their domicile out of the European Union (Article 167 *ter* of the French Tax Code).

3. Wealth Tax Reform

Simplification and reduction of the tax rate (Article 1 of the Bill)

Any individual whose net worth exceeds €800,000 is currently subject to wealth tax at a progressive rate that ranges from 0.55% to 1.80% (Article 885 A *et seq.* of the French Tax Code).

The Bill aims at simplifying and reducing the tax rate. Only two rates would apply with respect to wealth tax to be paid in 2012 and onwards:

- 0.25% – applicable (from the first euro) to taxpayers whose taxable net worth is between €0 and €3,000,000
- 0.50% – applicable (from the first euro) to taxpayers whose taxable net worth is above €3,000,000

Taxpayers whose taxable net worth is below €1,300,000 would not be subject to wealth tax as from 2011. To this end, the deadline for the filing of tax returns and the payment of the tax will be postponed until September 30, 2011.

In order to avoid threshold effects related to taxation from the first euro as a result of the tax rate reform, an adjustment would be made for taxable net worth between €1,300,000 and €1,400,000 and between €3,000,000 and €3,200,000.

Tax returns would also be simplified for taxpayers whose taxable net worth does not exceed €3,000,000.

Taxation of assets or rights held in a trust (Article 6 of the Bill)

The Bill aims at clarifying the tax regime for assets, rights, and capitalized proceeds held in a trust. These items would be subject to wealth tax according to the same principles—of territoriality in particular—as those applicable in case of direct holding.

Moreover, items of a trust that have not been reported in the taxpayer's wealth tax return would be subject to a special levy at the rate of 0.50%.

Finally, some specific filings would be required from the trustees.

4. Gift/Inheritance Duties (Article 1, 2, 3, 4, and 6 of the Bill)

Gift and inheritance duties would be substantially increased as from the entry into force of the Bill:

- The rates applicable to inheritances and gifts in line of descent and the rates applicable to gifts between spouses would be increased (i) from 35% to 40% for the portion of the taxable base between €902,838 and €1,805,677 and (ii) from 40% to 45% for the portion of the taxable base above €1,805,677 (Article 777 of the French Tax Code)
- The period during which previous gifts can be taken into account in order to assess the gift or inheritance duties would be extended from six to 10 years (Article 784 of the French Tax Code)
- The tax reductions pertaining to a donor's age would be abolished (Article 790 of the French Tax Code)
- Inheritances and gifts via a trust would be subject to inheritance or gift duties (Article 792-0 *bis* of the French Tax Code).

Thus, the reform is likely to increase the French tax liabilities of nonresidents owning directly or indirectly real property in France (mainly because of the change in the wealth tax base and the new tax on secondary residences) and to prevent French residents from transferring their domicile out of France.

If you have any questions or would like more information on the issues discussed in this LawFlash, please contact any of the following Morgan Lewis Tax attorneys:

Paris

Olivier Couraud	+33 1 53 30 44 05	ocouraud@morganlewis.com
Eve-Laure Betat-Maysonnave	+33 1 53 30 44 94	elbetatmaysonnave@morganlewis.com

London

Charles G. Lubar	+44 (0)20 3201 5531	clubar@morganlewis.com

About Morgan, Lewis & Bockius LLP
With 22 offices in the United States, Europe, and Asia, Morgan Lewis provides comprehensive transactional, litigation, labor and employment, regulatory, and intellectual property legal services to clients of all sizes—from global Fortune 100 companies to just-conceived startups—across all major industries. Our international team of attorneys, patent agents, employee benefits advisors, regulatory scientists, and other specialists—nearly 3,000 professionals total—serves clients from locations in Beijing, Boston, Brussels, Chicago, Dallas, Frankfurt, Harrisburg, Houston, Irvine, London, Los Angeles, Miami, New York, Palo Alto, Paris, Philadelphia, Pittsburgh, Princeton, San Francisco, Tokyo,

Washington, D.C., and Wilmington. For more information about Morgan Lewis or its practices, please visit us online at www.morganlewis.com.