

Key tax aspects for cross-border investments in french real estate

Recent regulatory changes reflect the goal of the French authorities to encourage the development of foreign real estate investments in France. This applies to both individual and corporate foreign investors.

- *As from 2004, capital gains realized by individual investors on French real estate investments are taxed at 16% and benefit from a 10% tax deduction per year after five years of ownership. This favorable regime applies to foreign individual investors located in the European Union, Norway and Iceland as well as to French tax residents (with a 11% surcharge for the latter).*
- *Several recent measures may also lead to new tax regulations for corporate investors in France. Starting from January 1, 2005, long term capital gains realized on the sale of shares in real estate companies are subject to corporate income tax at a reduced rate of 15% tax. It should also be mentioned that since 2004, real estate companies have the possibility of stepping up the tax basis of their assets subject to a 16.5% exit tax (instead of the standard corporate income tax rate of 33,33%), on the recognized capital gain (step-up basis for future depreciation expense deductible at a full rate¹).*

- *Since 2003, a special exemption regime allows major French and European listed real estate groups to be structured as REITs. This new and attractive tax regime was selected by the existing key listed groups on the French market. Other companies will soon follow, as a result of the most recent change implemented by the 2005 and 2006 Budget Acts which provides that contributions in kind and sales of real estate assets to REITs having elected for the special regime are subject to a 16.5% exit tax until December 31, 2007. This favourable regime also applies to companies listed on the French Stock Exchange or that have been approved by the French Securities and Exchange Commission ("Autorité des Marchés Financiers" or "AMF").*

Although these new measures indicate that progress has been made, France has a complex taxation system which requires careful tax and legal structuring to meet investors' objectives. This overview highlights the potential tax implications of direct or indirect investments in French real estate by non-resident investors. For this purpose, we have outlined below the main tax issues raised by the acquisition, rental and sale of French real estate by cross-border players, both individual and corporate. We have also included a brief presentation of the optional regime for REITs.

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Acquisition taxes on french real estate

Acquiring French real estate may trigger registration taxes or value added taxes, depending on the type of project.

Registration taxes

Registration taxes are payable upon the:

- Acquisition of buildings which are not new or recently renovated at the rate of 5.09% as from January 1, 2006 (plus notary fees and expenses of approx. 1%).
- Acquisition of shares in a “real estate” company at the rate of 5% as from January 1, 2006. A “real estate” company is defined for transfer tax purposes as an unlisted company, 50% of the assets of which consist of French properties or shares of an unlisted company which itself is a “real estate” company. The registration tax basis consists of the fair market value of the shares or interest in the real estate company, and thus takes into account the indebtedness of the company. In practice, from a registration tax perspective, acquiring shares in a real estate company would require paying less registration duties than acquiring the asset directly if the real estate company in question is genuinely leveraged. Yet, the purchaser can not amortize the shares he has purchased.
- Mortgages trigger registration tax at the rate of 0.715% as from January 1, 2006 on the amount of the secured debt and a 0.1% tax assessed based on the amount of the secured debt to be paid to the registrar of mortgages.

Value added tax (VAT)

VAT is payable at the rate of 19.6% on the:

- Acquisition of land to be developed, subject to a commitment to complete the building operations within a four-year period; or

- First purchase of a building less than five years old from a person other than a property developer; or
- Sale of a building in-progress before completion of the building operations (“*ventes en l'état futur d'achèvement*”).

In such cases, no transfer taxes are payable except for the real estate tax (“*taxe de publicité foncière*”) at the rate of 0.715% as from 2006 (and 0.1% to be paid to the registrar of mortgages).

VAT incurred on the acquisition of real estate or building operations can be recovered, provided that the real estate is used for the purposes of activities subject to VAT (e.g., rental activities subject to VAT). A partial repayment of the VAT initially deducted on the purchase of real estate may be due in the event the sale of the real estate asset should trigger registration duties (out of the scope of the VAT regime). As a general practice, the amount of VAT to be paid to the French Tax Authorities may be invoiced to the new purchaser and recoverable by the latter if subject to VAT.

Specific rules applying to real estate agents

Real estate agents may benefit under certain conditions from a decrease in registration taxes down to 0.715% as from January 1, 2006. However, in addition to corporate income tax, their profits may also be liable to VAT on the margin realized. Under certain conditions, the purchaser may recover such VAT. Trading of real estate by cross-border agents requires that careful attention be paid to how the deal is structured.

Taxation of rental income

Non-resident individuals

Non-resident individuals wishing to invest in French real estate can do so either directly or indirectly via shares in French or foreign companies or partnerships that acquire the property.

Individuals receiving rental income from French property are liable to French income tax at progressive rates of up to 48.09% (40% for rental income received as from January 1, 2007). However, according to French tax rules, non-resident individuals taxed on French sourced income may not be taxed at an effective rate below 20%. As an exception, non-resident individuals may be subject to a more favorable effective tax rate provided they can prove that should their French and foreign sourced income be taxed in France, the applicable effective French tax rate would be below 20%.

The basis of assessment is the calendar year. Most French double tax treaties allow France to exercise its right to assess this tax.

Non-resident individuals owning properties in France which are not rented commercially may be subject to income tax on three times the rental value of the properties, but no charge arises when the individual is a resident in a country with which France has concluded a double tax treaty.

Individuals who are partners in either a French or foreign partnership which has not elected to be subject to corporate income tax are also directly liable for income tax on their share of the partnership's rental income (pass-through entity).

Shareholders in French property-owning companies who receive their share of the income in the form of dividends may be subject to withholding tax on the dividends paid. French domestic rules provide for a 25% withholding tax, however, this rate is generally reduced by double tax treaties.

Non-resident companies

Corporate income tax is payable at a rate of approx. 34.43% (including surcharge) as from January 1, 2006 on rental income for the relevant accounting period by:

- Non-resident corporations investing directly in French real estate;
- Non-resident corporate partners in French or foreign partnerships (where the partnership has not elected to be subject to corporate income tax); and
- French resident corporations.

Generally, income that a foreign corporation derives or could derive from renting real estate in France is liable to corporate income tax, regardless of whether or not there is a permanent establishment in France.

Under the terms of certain tax treaties, such income may not be taxed in France in the absence of a permanent establishment (e.g., current tax treaties with Luxembourg and Denmark). Please note, however, that according to the French Tax Authorities, these treaties will soon be renegotiated or new Protocols will soon be signed with respect to rental income (especially with Luxembourg).

Calculation of taxable profits

Taxable profits for income and corporate income tax purposes are calculated as shown below. For corporate income tax purposes, losses can be carried forward indefinitely and offset against taxable profits from the same property, set against other rental profits or carried back over three years. For income tax purposes, losses can be carried forward and offset against taxable profits from the same property or any other rental profits.

Taxable profits for income tax purposes (direct investment by individuals or through a partnership that has not elected to be subject to corporate income tax)

Taxable rental profits (deriving from a property which is rented unfurnished) are mainly gross rental income received minus deductible expenses including:

- Repairs and maintenance;
- Interest paid on a loan taken out for the purpose of financing the real estate investment;
- Management expenses;
- Insurance premiums;
- Certain taxes;
- Expenses incurred for the improvement of the building; and
- Provision for co-ownership expenses.

As from January 1, 2006, the flat-rate deduction of 14% is no longer allowed (this was meant in the past to take into account the depreciation of the real estate assets).

Taxable profits for corporate income tax purposes

Taxable rental profits are calculated on an accrual basis, based mainly on gross rental income accrued minus deductible expenses, including:

- Repairs and maintenance;
- Transfer and real estate taxes;
- Management expenses;

- Interest paid on a loan for the purpose of financing the real estate investment; and
- Depreciation. The new accounting rules could limit the deduction of such depreciation expenses (see below).

Tax depreciation

For individual income tax purposes, there is no relief for depreciation. For corporate income tax purposes, land is not depreciable but relief is available for the depreciation of buildings on a straight-line basis, generally at rates between 2% and 5% per year.

It must be noted that land is not a component which may be depreciated under French rules.

For corporate income tax purposes as from January 1, 2005, new accounting rules for depreciation are now applicable. The value of assets must be broken down into several components (provided one or several components of the asset have different periods of use) and depreciated according to their actual period of use for the companies and not according to the common period of use of the assets as defined by the professional practices of the business concerned as was previously the case. In order to achieve the same level of deductible amortization as formerly accepted, a derogatory amortization allowance is allowed, however, this tolerance is limited to real estate assets other than “investment assets” (i.e. basically assets not used for the company’s own business operations but rented to an unrelated party).

Financing

As a rule, deduction of interest payments on a loan to finance the investment is available for both individual and corporate income tax purposes. However, new thin capitalization provisions may limit the deduction for interest paid on loans.

New thin capitalization rules applicable in France as from January 1st, 2007 should have a significant impact on the leverage of French asset owning companies. Many funds will have to take adequate steps for the restructuring of equity, shareholder loans and bank debt before year end 2006. These new rules will apply to loans granted by *any* related entity. A maximum interest rate will be applicable together with a double limitation: the amount of interest would be limited if related debt finance is in excess of 1.5 times the net equity of the company, and for the portion in excess of 25% of the current results before tax. The law sets up a safe harbours and a deferred deduction mechanism for the interest in excess of these limits.

Withholding tax does not apply on interest payments made to a non-French resident lender, subject inter alia to specific conditions linked to the loan agreement.

Repatriation of net income to investors

Dividend distribution made by a French subsidiary to its foreign holding company may be liable to French withholding tax at the standard rate of 25%. However, most double tax treaties concluded by France reduce this rate considerably; even to zero in certain cases.

In addition, subject to certain conditions, the French Tax Code provides that profits distributed to a parent company having its registered office in an EU Member State will be exempt from withholding tax.

If the investment is made in France directly by a foreign company which is treaty-protected, the after tax income remitted abroad will not be subject to any withholding tax under the relevant treaty as long as the ownership of the building does not constitute a permanent establishment in France. If the foreign entity is not treaty-protected; it may be required to pay a branch tax of 25%.

Exit taxes

Any gains realized by non-resident investors on the transfer of French real estate are liable to French capital gains tax, subject to treaty relief.

Under French domestic tax law, companies which are not listed on a stock exchange and hold over 50% of their assets in the form of investment property are deemed to be “predominantly real estate companies”. The disposal of any equity interest in such real estate companies is treated as the disposal of French real estate, subject to treaty provisions.

Individual investors

As a rule, for individual investors located in the European Union investing as individuals or via a real estate partnership, the capital gain taxable in France is calculated on the disposal proceeds (net of expenses) minus the adjusted purchase price (inclusive of related acquisition costs). Once the asset has been held for five years, the taxable gain is reduced by 10% for each year of ownership. Therefore, there will be no taxable gain if the asset transferred has been held for more than 15 years by the seller.

Gains realized on an occasional basis by individuals who are residents of the European Union, Norway or Iceland are subject to tax at a rate of 16%. The tax is due when the transfer is recorded, or where no record is made, in the month of disposal.

According to French tax rules, where non-resident individuals regularly make chargeable profits from the disposal of French real estate or shares in real estate companies, a higher 50% tax rate applies (there is no formal definition of what constitutes occasional or regular disposals and each case is determined on an individual basis). However, this higher rate should not apply to European Union residents (in such a case, French progressive tax rates would apply) since this higher taxation is contrary to the fundamental EU principle of free establishment.

No additional personal income tax is payable on the capital gain realized.

Corporate investors

Capital gains for companies and corporate partners are calculated based on the difference between the disposal proceeds and the acquisition cost. For buildings, the purchase price is reduced by 2% for each year of ownership in order to reflect depreciation. An advance withdrawal tax is payable at 33.33% and is due when the transfer is recorded. The tax paid can be offset against the corporate income tax liability. The excess tax is refundable.

As for non-resident individuals, where non-resident companies regularly make chargeable profits from the disposal of French real estate or shares in real estate companies, a higher 50% tax rate applies.

For partnerships treated as transparent for tax purposes, the determination of capital gains differs depending on whether the partners are individuals or legal entities. Capital gains are taxed at the level of each partner.

Proper tax structuring may allow French capital gains tax exposure to be significantly reduced.

Tax representative

A tax representative will have to be appointed and would be held liable for any reassessment of capital gain tax when:

- The seller is a non-resident corporation or a partnership not located in France when its shareholder is a non-resident corporation;
- The seller is a non-resident individual or a non-resident partnership when its shareholder is a non-resident individual but only to the extent that the price of the sale is above € 150,000.

Other taxes

Other relevant taxes include:

- **Wealth tax** - Payable by non-resident individuals with French assets in excess of K€ 750 at progressive rates up to 1.8% applied to the value of their French net assets (assets minus debts connected to the acquisition of the French assets).
- **Inheritance and Gift taxes** - French real estate owned directly or indirectly by a non-resident and shares in real estate companies are deemed to be French *situs* assets subject to inheritance and gift rules and taxed upon the death of the investor, subject to treaty relief. French inheritance and gift taxes range from 5% up to 60% depending on the value of the French Estate and the relationship between the parties.
- **3% annual property tax** - Entities registered in France or abroad are liable to a 3% annual property tax applied to the market value (on January 1 each year) of the real estate property owned in France either directly or indirectly. Among other cases of exemption, the tax may not apply to:
 - Individual investors;
 - Companies whose real estate assets located in France do not represent more than 50% of their total French assets;
 - Companies listed on a French stock exchange or a foreign stock exchange governed by similar listing rules; and
 - Subject to certain filing conditions, French companies or companies that are resident in a country whose tax treaty with France includes a mutual administrative assistance or non-discrimination clause.

Other real estate taxes include a tax on office premises in the Ile-de-France region, residential tax and various property taxes.

Optional regime for listed real estate companies

In 2003, a new regime was made available to listed real estate companies (“SIIC” or “REIT”) according to which qualifying companies may be entitled to an exemption from corporate income tax on rental income and capital gains subject to distribution duties.

Requirements to qualify

A real estate company is entitled to elect for this regime provided that the following conditions are met:

- The electing company must be listed on a French stock exchange;
- The company must have a minimum share capital of € 15 million;
- The main business purpose of the company must be the acquisition or construction of real estate for rental purposes, and/or direct or indirect shareholdings in entities (either corporate or pass-through entities) that have a similar business purpose.

Subsidiaries that are at least 95% directly or indirectly owned by a REIT and that have a similar business purpose and are subject to tax may also opt for the regime.

Ancillary activities, such as real estate trading or development, are permissible if the value of the relevant assets do not represent more than 20% of the gross value of the REIT’s assets.

Corporate income tax consequences of the election

Election of the regime is treated as a cessation of activities for corporate income tax purposes. As a consequence, an electing company must file a corporate income tax return within 60 days following the election.

As a result, an electing company becomes liable for tax on all previously untaxed items and on unrealized capital gains. However, the French Tax Code provides that unrealized capital gains on assets which fall within the scope of the regime are taxed at 16.5%. Payment of this “exit tax”, however, is spread over a four-year period, the first 25% instalment being due on December 15 of the year in which the election was made.

Corporate income tax calculation on post-election income

The REITs may be exempt from corporate income tax on rental income, capital gains and dividends from subsidiaries which have also opted for the regime subject to the following distribution requirements:

- 85% for net rental income;
- 50% for net capital gains; and
- 100% for dividends.

As from 2005, subject to certain conditions and depending on the date of conclusion of the finance lease, sub-leasing of assets held under a finance lease and capital gains realized on the sale of finance lease rights are within the scope of the exemption regime.

Restructuring involving REITs

Mergers between REITs can be carried out under a tax free merger regime and does not trigger the tax consequences of the departure from the REIT regime of the absorbed company (which would trigger the taxation of rental income and capital gains at the corporate income tax) provided certain distribution duties are fulfilled.

Contribution and sale of real estate assets and finance lease rights

The 2005 Budget Act also allows groups other than REITs to contribute their real estate assets to a REIT (and more generally to companies subject to public offering regulations) and benefit from a reduced taxation of 16.5% (plus additional contribution) on the capital gains realized on the contribution of the assets. The benefit of this regime is subject to a 5-year holding commitment made by the REIT either on the assets or on the finance lease rights.

The 2006 Budget Act has extended this favourable regime to sales to "eligible companies", which is expected to have the most significant impact on the attractiveness of the REITs regime for foreign real estate investors. Those provisions apply to any contribution in kind and sale performed between January 1, 2005 and December 31, 2007.

Please note that this regime also concerns any real estate entity listed on the Stock Exchange Market or that have been approved by the French Securities and Exchange Commission ("AMF"). To our view, this should concern not only the REIT (SIIC), but also the SPPICAV and listed real estate companies that have not opted for the REIT optional regime.

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Key points to address when investing in french real estate

Individual investors

- Transfer costs on the acquisition
- Holding and financing structures to minimize income tax
- Holding structure to minimize exit taxes
- Holding structure to avoid/minimize wealth tax and inheritance tax

Corporate investors

- Transfer costs on the acquisition
- Holding and financing structures to minimize corporate income tax
- Holding structure to minimize exit taxes
- Holding structure to avoid 3% annual tax