

TIRARD, NAUDIN

STEP BAHAMAS

12th December 2002

**THE LEGAL AND TAX TREATMENT
OF TRUSTS IN FRANCE**

Jean-Marc Tirard

Avocat au Barreau de Paris
Chairman of STEP France

Maryse Naudin

Avocat au Barreau de Paris
Branch Secretary of STEP France

TIRARD NAUDIN

Société d'avocats

10 rue Clément Marot
75008 PARIS

Tel : 33 (0) 1 53 57 36 00
Fax : 33 (0) 1 47 23 63 31
E-mail : tirard.naudin@online.fr

TIRARD, NAUDIN

INTRODUCTION

Before considering how a trust could be used for tax planning purposes by Frenchmen or by foreigners to hold French assets it is essential to determine whether it is possible to use a trust in these circumstances.

THE FRENCH LEGAL TREATMENT OF TRUSTS

Although it is not possible to constitute a trust under French law, for a long time now French courts have agreed to recognise the effects in France of foreign trusts provided they comply with the mandatory rules of French law and do not constitute "*une fraude à la loi*" (*Fraus legis*).

Duality of ownership in common law and in equity, which is the basis for the Anglo-Saxon trust, is in total opposition with the French concept of unitary and absolute type of ownership (Art. 544 of the Civil Code). The Napoleonic Code lays down a right of ownership ("*droit de propriété*") which is so absolute and complete that it appears to be one with the asset on which it is based ("*propriété*"). Moreover, Article 543 of the Civil Code lays down a limitative list of ownership rights (*numerus clausus*). Therefore it is not possible in France to create a divided ownership right different from the division of ownership recognised by French law (usufruct and bare-ownership). As Professor Motulski wrote "the trust cannot and never will be able to extract from French law that which it does not contain" (*nemo dat quod non habet*). However, when French courts find themselves confronted with foreign trusts concerning French assets or established in favour of French beneficiaries, such trusts will be complied with.

The leading case regarding the acknowledgement of the validity of foreign trusts and their effects in France is the case of Courtois and others v. De Ganay Heirs decided by the Court of Appeal in Paris in January 1970. According to this decision, the trust is a bi-lateral agreement, creating respective obligations for the parties. Although such analysis would be far from satisfying and changes the trust relationship, its practical interest is to subject the trust to the law of autonomy, namely the law chosen by the parties, which complies with the principles laid down by the Hague Convention.

In the "Ziesennis" case of February 20, 1996, the *Cour de Cassation* (supreme civil court), although it set aside the qualification of the trust as a contract continued to admit that the trust is subject to the law of autonomy, namely the foreign law chosen by the parties. In this particular case, which involved a revocable trust, the *Cour de Cassation* judged that the trust realised an indirect gift dating from the date of the settlor's decease.

In accordance with the above mentioned case law, foreign trusts are therefore recognised as such and seen as a specific legal arrangement in their own right. Since a trust cannot be set up under French law it will necessarily be governed by the law of a jurisdiction which recognises the concept. Applicable law is the foreign law chosen by the parties or, if not, the one with which the trust shows the closest links.

TIRARD, NAUDIN

Nevertheless the foreign law has to comply with French mandatory law (*ordre public*) and the constitution of the trust should not be deemed to constitute a "*fraude à la loi*". It is essentially in inheritance matters that the mandatory rules of French law are likely to limit some of the trust's effects.

- **Substitutions**

Article 896 of the Civil Code prohibits so-called "*substitutions fideicommissaires*", that is, any provisions by which the donee or the heir is obliged to conserve a property and render it up to a third party. Dominant doctrine nevertheless considers that the trust is not concerned by Article 896 of the Civil Code since it cannot be construed as a gift.

- **Prohibition of covenants on future inheritance**

Article 1130 of the Civil Code prohibits any covenant allocating assets which belong to a future inheritance to the future heirs.

According to case-law, only the agreement which has the aim of allocating a possible right on all or part of a unopened succession is a covenant on a future inheritance. Whereas in the *intervivos* trust, the rights allocated by the settlor are present and not possible rights.

- **Forced heirship rules ("*réserve héréditaire*")**

The principle of the hereditary reserve laid down by Article 913 of the Civil Code requires that the deceased's descendants or parents, if there are no descendants, are entitled to a minimum portion of the estate, called the hereditary reserve. This rule being mandatory, its application may be requested by any reserved heir in the event the provisions of the trust infringe the reserve. This only concerns property situated in France but also all the movables if the settlor is domiciled in France, from a civil law point of view, at the time of death. A law of 14 July 1819 furthermore provides that in an inheritance, the assets have to be divided among the co-heirs, both foreign and French, the latter being entitled to deduct from the assets situated in France a portion equal to the value of the assets situated abroad for which they would be deprived of their "reserve" by application of a foreign law.

Although the hereditary reserve is a mandatory rule, the heirs may waive it after the death. It is therefore only after death that it becomes mandatory. Thus it cannot have the effect of rendering the constitution of a trust invalid. Moreover, in the event the trust would have been constituted without complying with the hereditary reserve, the penalty would in principle be the reduction of the trust, which is to say the allocation to the reserved heirs of the minimum reserved for them by French law and not that the trust would be disregarded, unless there is "*une fraude à la loi*".

In application of the general legal principle that "*fraude corrompt tout*" (*fraus omnia corrumpit*) a trust may exceptionally be disregarded in the event that the heirs deprived of their reserve may establish that this was precisely the intention in constituting the trust. The *Caron v. O'Dell* case is considered to be the main example of this type of attack.

As the concept of trust does not exist under French law, it is not possible for a real property to be held directly in trust. However, it is conceivable to use an intermediate company, which is itself held in trust, as a way of owning real property located in France.

TIRARD, NAUDIN

The difficulty with this structure is that any legal entity (whether French or foreign) owning real estate located in France whose value represents more than 50% of the total value of the French assets owned by that entity, is qualified as a "société à prépondérance immobilière". From a French tax point of view, whatever its state of residence, it is treated in the same way as property located in France and (under certain circumstances could) would normally be subject to a 3% annual tax based on the market value of the real estate it owns in France.

To avoid this qualification the property owning company must also own French movable assets of a value, on 1st January every year, exceeding that of the French real property. The movable assets may consist of antiques, works of art, furniture, paintings etc. and must be located in France.

In this case the property owning company is no longer considered to be a "société à prépondérance immobilière" and therefore the 3% tax is not due and there is no obligation to make any declaration.

THE FRENCH TAX TREATMENT OF TRUSTS

Taxation of trusts in France should be considered at the three essential steps of "**creation**", "**operation**" and "**liquidation**".

In the absence of specific tax provisions, there is, therefore, no means to determine the tax treatment of trusts in France other than to carry out a strict legal analysis of the rights and obligations of each party in the relationship and to draw-up the tax consequences.

1. Creation of a trust

The creation of a trust implies a transfer of legal ownership from the settlor to the trustee. Assuming such a transfer is made during the life of the settlor to an irrevocable trust the question arises as to whether or not it is subject to gift tax. On the other hand, capital gain tax is not an issue since, under French law, only capital gains arising from transfers for valuable consideration may be taxed. Under the provisions of Article 750 *ter* of the CGI when a donor has his tax residence in France, any real estate or movables situated in France or abroad are subject to gift tax. Under the same article, when the donor does not have his tax residence in France any real estate or movables situated in France are also subject to gift tax. If this was to be the case for trusts, the consequences of the creation of a trust by a settlor resident in France, or by a settlor residing abroad but concerning French property would be particularly heavy since the gift tax due in the absence of consanguinity between the donor and the donee is 60%. In fact, in our opinion, the creation of a trust cannot be analysed as a donation from the settlor to the trustee. Indeed the definition of what should be understood by the word "donation" is not given in tax law but in the Civil Code.

Pursuant to Article 894 of this Code, for there to be a donation, the donee, that is to say the beneficiary, has to accept the gift, which is naturally not the case when the trust is established. Nor can it be alleged that it concerns a donation in favour of the trustee in the absence of any intention on the part of the settlor to infer a gratuitous benefit on the trustee ("*animus donandi*"). The correct judicial analysis of the

TIRARD, NAUDIN

constitution of an irrevocable trust inter vivos with regard to the Civil Code leads us to the view that it constitutes a donation from the settlor to the beneficiaries subject to the condition precedent that the beneficiaries accept it. In accordance with the provisions of Article 676 of the CGI, the tax treatment applicable to such a donation and the taxable value will therefore be determined by treating the donation as taking place at the date of realisation of the condition, that is to say the date of the cessation of the trust or at the time of the delivery of the property by the trustee to the beneficiaries if this happens later. Indeed, in both these cases, once the beneficiary has effectively received the property it is necessarily deemed to have accepted the donation. Donations follows the same tax regime as successions. Gift tax must be paid by the donees. The maximum rate is 40% in direct line (children, grand-children and ancestors of the donor) and 60% in other cases. As from 1st September 1998 the rates have been reduced by 50% when the donor is less than 65 years old and by 35% when he is less than 75. In the case of a trust, gift tax should then, in principle, be calculated in accordance with the degree of relationship between the settlor and the beneficiaries, and not between the trustee and the beneficiary.

In our opinion the above analysis is likely to apply only to accumulation and discretionary trusts when no beneficiary has the right to demand income or capital. On the other hand, when a beneficiary is given the right to receive income from the trust for life (life interest trust) and assuming he is able to sell his interest, he is likely to be subject to gift tax on the date of creation of the trust. In this case, the French tax authorities might take the view that gift tax should be assessed by reference to the capital corresponding to the income from which they benefit.

2. Operation of the trust

Assuming the trustees are not French residents, the operation of an irrevocable trust is only liable to have tax consequences in France when the beneficiaries are French residents. In this case, the question arises as to what should be the tax treatment of the latter with regard to income tax including withholding taxes as well as to wealth tax.

2.1. Income tax

When property is transferred to a trust, the income derived from it ceases to be that of the settlors but instead becomes that of the trustee. Assuming the trustee is not a French resident any French source income he receives is subject to French tax according to the rules applying to non resident individuals or companies as the case may be. When the income is paid by the trustees to the beneficiaries either at their discretion or because the beneficiaries have a vested entitlement to the income, the latter are subject to French tax under the provisions of article 120.9' of the CGI.

According to this article the proceeds ("*produits*") of trusts are assimilated to dividends from foreign sources taxed in their entirety within the hands of the beneficiaries resident in France. However, the scope of this provision is unclear.

First of all it should be noted that this wording does not make any distinction according to the origin of the proceeds distributed by the trust. A literal application of the text would therefore lead us to consider that all the amounts received by the beneficiary would be subject to income tax without making any

TIRARD, NAUDIN

distinction as to whether they correspond to income generated by the assets or to a distribution of capital. No doubt such an interpretation of Article 120-9° does not correspond to the spirit of the provisions, since this article is aimed at listing income from foreign sources which falls into the category of income from capital assets for income tax purposes. Nevertheless, even supposing that the tax authorities accepted that they should not tax distributions of capital, the beneficiaries would still have to demonstrate that the distributions were distributions of capital rather than of income.

These theoretical and practical difficulties have been resolved for income paid by American trusts. Indeed, in this case, the French tax authorities apply a regime of "fiscal transparency", described in an administrative Note dated 25 March 1981, intended to interpret the tax treaty between France and the United States. In application of this Note, France draws the same distinction as American tax law between "*simple trusts*" i.e. a trust which gives the beneficiaries the right to receive income as it arises in fixed shares (this is known in the UK as an "*interest in possession*") and "complex trusts" known in the UK as discretionary trusts. Income from simple trusts whose income is fully distributed is directly taxed in the United States in the hands of the beneficiaries following the same qualification as at the trust level thus producing "*fiscal transparency*". France applies the same treatment; in other words, when the beneficiaries of a "simple trust" are resident in France, the latter are treated as though they had owned the trust's assets personally and taxed in France, in compliance with the rules of the tax treaty applicable to the relevant source of income (for example, if it is US real estate income, it is exempt in France, whereas if it concerns dividends or interest, they will, on the contrary, be taxed in France).

The "*complex trusts*", which accumulate income are taxed at two levels by the United States; on the one hand on behalf of the trust itself, at the time of the realisation of income by the trust; on the other hand on behalf of the beneficiaries at the time of the distribution of this income by the trust. The tax paid by the trust at the first level entitles it to a tax credit which can be attributed to the tax due by the beneficiary. France applies the same rule of "*transparency*" with regard to "*complex trusts*". However it only grants French residents, who are beneficiaries of income arising from such an American trust, tax credits in respect of US tax paid by the beneficiary at the time of distribution. On the contrary, American tax paid by the trust itself during the realisation of income is not admitted as a tax credit for the taxation of beneficiaries. If a trust is of the, "*grantor trust*" type, France reserves the possibility of taxing the settlor in compliance with the provisions of the Convention.

Another problem is raised by the new article 123 *bis* of the CGI. The object of this provision is to tax individuals having their residence in France for tax purposes on income derived from monetary or financial assets held through the intermediary of structures set up in foreign countries and benefiting from a preferential tax regime, even if the income is distributed. It is an extension to individuals of the French "CFC legislation" (art. 209 B of the CGI) already applicable to companies.

TIRARD, NAUDIN

The ambit of article 123 *bis* is extremely wide as the structures covered include legal entities, "*fiducies*" and comparable institutions or organs.

For the disposition to be applicable, it suffices that there be a direct or indirect holding of at least 10% in the structure concerned. "Indirect holdings" include rights held through the intermediary of a chain of holdings as well as those held by the spouse, ascendants and descendants.

Where the foreign structure is set up or established in a State or territory not having concluded an administrative assistance treaty with France, the taxable income of the individual is a notional income, being not less than the sum obtained by multiplying that part of the net assets (or of the net value of the property of the structure concerned) corresponding to the rights of the individual to derived income, by a rate equal to that allowed as a deduction for interest on shareholders' current accounts.

Although the term "*fiducie*", accompanied by the expression "comparable institution", may be considered to include Trusts within the ambit of article 123 *bis*, it is difficult to see how beneficiaries of a discretionary trust, who have no vested right in the assets held in trust, could come within its field of application.

2.2. *Withholding taxes*

A withholding tax will be payable in most cases when a foreign trust receives income from a French source or realises a capital gain in France.

When the trust is established in a State linked to France by a tax treaty, the question arises as to whether the trust or the trustee can invoke the tax treaty signed between France and the state of residence of the trust or trustee.

2.3. *Wealth tax*

Individuals domiciled in France are subject to wealth tax once their assets exceed the tax threshold provided by law. Subject to international tax treaties, all their assets are taxable, whether situated in France or abroad. Individuals domiciled outside France are only taxed on their assets in France. Furthermore their financial investments are exempt. Companies are not subject to wealth tax.

Once a trust is irrevocable, the settlor is no longer the owner of the assets put into trust and, in principle, no longer possesses them. Therefore, he cannot be taxed on the assets in question. The trustee should not be taxable either since they have only a legal (not a beneficial) interest in the assets, provided that the Tax Authorities do not try to allege that the trustee is the apparent owner. According to the theory of "apparent ownership" the owner is the person who appears as such to third parties. In any event this risk is avoided when the trustee is a corporate trustee since corporations are not subject to wealth tax.

The question as to whether the beneficiaries are possibly subject to wealth tax is more difficult to answer. The reply to this question depends on the extent of the rights of the latter.

Although the beneficiaries are granted beneficial ownership which entitles them to claim the profits and use of the assets in trust and to dispose of all rights and

TIRARD, NAUDIN

actions necessary to defend their interests if the trustee does not correctly fulfil his terms of reference, the assets put into trust do not enter into the beneficiaries' assets (their personal creditors have no rights over such assets).

Nevertheless, when the beneficiaries have a life interest in a trust or in the event that the income produced by the property put into trust was regularly distributed to them, the tax authorities would doubtless be inclined to consider that the latter were holders of receivables which should be valued and liable for wealth tax by reference to the capital corresponding to the income from which they benefit. On the contrary, in the case of a trust under which the trustee has a discretionary power of distribution, the beneficiaries rights are a mere expectation, which should not, in our opinion, be subject to wealth tax in the hands of the latter.

3. Liquidation of a trust

When a trust is irrevocable and the settlor has not retained significant rights and powers under the trust the assets are no longer part of the settlor's assets and they are no longer included in the basis of the inheritance tax due at his death. The liquidation of the trust will allow the beneficiaries to determine what assets are included in it in the event that they had not been previously distributed by the trustee. Transfer of the assets to the beneficiaries cannot be considered as a donation made by the trustee since they were never part of the trustees personal assets and that the latter could not in any case be considered as having the intention of conferring a gratuitous benefit on the beneficiaries.

In accordance with the analysis developed above (see § 1 Creation of a trust) in our opinion the transfer of assets by the trustee to the beneficiaries would constitute the acceptance by the latter of the donation made to them by the settlor, and would entail liability for gift tax according to the rate corresponding to the degree of relationship between "*settlor*" and "*beneficiary*", depending on the value of the assets in trust at the date it is dissolved. The trustee having effectively managed the assets placed in the trust by the "*settlor*" in the interest of the "*beneficiaries*", the latter should be considered as having received the assets in question directly from the "*settlor*".

CONCLUSION

Although, contrary to what is often said, it is perfectly legal for a French resident to transfer French assets into a trust, it is clear that the French tax authorities are suspicious, if not hostile to trusts that they have a tendency to consider as a means of tax evasion. This suspicion was reflected in the tax provisions of the draft law on "*fiducie*" which would have rendered taxable not only the constitution of "*fiducies*" but also of trusts by French residents since the same rules would have applied to all foreign tax trusts or comparable institutions, as the legislator has specified in an excess of caution.

Because of this climate and the lack of test cases from a tax point of view to support the analysis of what we consider to be the proper tax treatment of trusts in France as developed in this paper, there is no doubt that the creation of trusts by French residents, particularly to hold French assets is aggressive. On the other hand, the

TIRARD, NAUDIN

creation of trusts by foreigners before establishing their residence in France may achieve worthwhile tax savings. Serious consideration should also be given by Frenchmen temporarily resident in a jurisdiction favourable to trusts to establishing a trust at least to hold his non-French assets prior to moving back to France.