

The new French rules of taxation for trusts: wide (scope), heavy (tax) and severe (penalty)

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Abstract

The French Amended Finance law for 2011 provides for new rules on the taxation of trusts, mainly consisting in:

- subjecting the trust's assets to inheritance tax (in France) at the time of death of the settlor (subject to the application of the territoriality rules and of double tax treaties), whether these assets are immediately transferred to the beneficiaries or remain in the trust (at rates up to 60%);
- including (under certain conditions) the trust's assets in the settlor's taxable estate subject to wealth tax (ISF);
- providing for duties to declare for the trustees, which will notably have to disclose to the French Tax Authorities (FTA) information on (i) legal documents of the trust and (ii) the value of the assets held by the trust, if the settlor and/or one of the beneficiaries is/are French resident(s) or when part of the trust's assets is located in France;

Non-compliance with these duties will be sanctioned by a fine amounting to 5% of the value of the trust's assets or at least €10,000;

- establishing a specific 0.5% tax in principle to be paid by the trustee in the event the settlor fails to disclose the trust's assets in its ISF tax return or in case of non-respect of the duty to declare mentioned under the third point above.

Introduction

The French Amended Finance Law for 2011¹ has implemented a new legislation aiming at taxing assets held or transferred through a trust.

Although the concept of trust does not exist under French law,² the existence and effects of foreign established trusts are generally recognized in France.

France nevertheless did not have a comprehensive tax regime with respect to trusts. Indeed, French tax law provisions dealing specifically with trusts essentially concerned the taxation of income distributed to French residents from a foreign trust.³ The taxation of

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1. Law n°2011-900 dated 29 July 2011.

2. The Fiducie regime introduced in French law in 2007 presents a number of similarities with the trust regime. However, the Fiducie should not be assimilated to the trust notably because it must be expressly created by law or by contract and there must be no intention to create a gift when the Fiducie is set up (it must not have an 'intention libérale').

3. Eg art 120 of the French Tax Code which qualifies trust's income as foreign investment income ('revenus de capitaux mobiliers') regardless of the consistency of the trust's assets. Note that this article is also modified by the new law to specify that only income distributed by a trust shall be subject to income tax (and not the trust's income that is re-invested into the trust).

ownership in connection with trusts was not provided for by any article of the French Tax Code (FTC).

The main issue regarding the determination of the tax consequences of foreign trusts in France is that trusts (based on a duality of ownership⁴) do not fall within the existing legal categories related to the right of property as defined under French law.⁵

This situation raised difficulties as regards the application of French tax law, which tends to tax the holding (ISF) and the transfer (gift and inheritance tax) of ownership.

These difficulties were resolved by the jurisprudence on a case by case basis.⁶

The French government considered that the uncertainties surrounding the tax regime applicable to foreign trusts could facilitate tax evasion. It therefore proposed a new set of rules providing notably for a definition of the trust and specifying the tax treatment of trusts with respect to gift and inheritance tax and the tax regime of the assets 'located' in trusts.⁷

Definition of trust and settlor

The term 'trust' refers to the legal relationships created—*inter vivos* or upon death—in a state other than France, by a person, the settlor, with a view to placing assets under the control of a trustee for the benefit of a beneficiary or for a specified purpose.

This definition derives from Article 2 of the Convention on the Law Applicable to Trusts and on their Recognition concluded on 1 July 1985 in La Haye (not yet been ratified by France).

Its purpose is not to authorize the creation of trusts in French law but to allow the qualification of foreign entities as trusts under French law.

The scope of this definition must, however, be clarified as to whether it includes entities such as foundations or 'Anstalt'. In our opinion this definition should be interpreted strictly and the application of the new law should therefore be limited to trusts.⁸

The new law defines the 'settlor' as either the individual who has settled the trust or the individual whose estate has been transferred into the trust when it has been settled by an individual as a business activity or a legal entity. This specification would entitle the FTA, should the case arise, to assess the economic materiality of the trusts relationship (eg when the assets of an individual are placed in a trust but the settlor mentioned in the trust deed is a legal entity acting on his behalf).

It is worth emphasizing that the new law does not provide for any definition of the trustee whereby he may be personally liable to tax (inheritance tax and/or 0.5% tax) and subject to a duty to declare (see below).

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Trusts' liability to gift or inheritance tax

The new law aims at taxing any transfers made through a trust irrespective of whether they may be qualified as gift or inheritance under ordinary French taxation rules:

- on the one hand, the new law confirms that the ordinary taxation rules shall apply where the

4. Legal ownership to the trustee and equitable ownership to the beneficiary.

5. Which only distinguishes between usufruct and bare ownership ('nue-propriété').

6. For instance, as regards inheritance tax, the French Supreme Court (Cour de Cassation) held on 15 May 2007 n°05-18.268 FS-PBIR that the constitution by a French resident settlor of an irrevocable trust with assets distributable to beneficiaries upon the settlor's death was to be considered as an indirect donation from the settlor to the beneficiaries which was completed upon the death of the settlor.

As regards wealth tax, the Tribunal de Grande Instance de Nanterre held on 4 May 2004 n°03-9350, 2e ch that a French resident who was a mere discretionary beneficiary under a US trust could not be assessed to French wealth tax on any part of the trust's assets.

7. The FTA will probably issue guidelines on the new law that may contain commentaries and specifications that it is not possible to anticipate at the time of writing.

8. In this respect, it is relevant to underline that Report No 3503 on the proposed Amended Finance Law for 2011 registered at the French Assembly on 1 June 2011 sets out that charity trusts shall be distinguished from foundations.

transfer of assets through a trust can be considered as gift or as inheritance (ie inheritance tax according to the family relationship with the deceased settlor).

- on the other hand, the new law creates a new rule of taxation of the trust's assets upon the death of the settlor where the qualification of gift or inheritance does not apply.

In this respect, the new law establishes that if these transfers may not be qualified as gift or inheritance, the assets, rights or capitalized income placed in a trust will be subject to inheritance tax at the time of death of the settlor, whether these assets are immediately transferred to the beneficiaries or remain in the trust.

The tax regime implemented by this new rule is analysed below.

Taxable basis

Inheritance tax will be due at the time of the settlor's death on the overall assets or rights constituting the trust when the settlor is a French resident for tax purposes.

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If the settlor is not a French resident, this tax would be due:

- on the overall assets and rights constituting the trust when the beneficiary is a French resident at the time of transfer and has been a French resident for at least six of the previous ten years;

In practice, the implementation of this provision may raise some difficulties especially when the

trustee has the power to add or exclude beneficiaries at any time during the trust period (discretionary trusts): it is feared that in this situation, the mere reference to a French resident beneficiary in the letter of wishes (although not binding) could lead to taxation in France;

- on the sole assets or rights constituting the trust located in France in other cases.

The above-mentioned rules should be subject to double tax treaties for the avoidance of double taxation with respect to taxes on inheritance that may have been concluded between the relevant contracting states.⁹ These tax treaties are generally based on the 1982 OECD Model and provide that the deceased person's estate shall in principle be liable to inheritance tax only in the state in which the deceased was last resident; except for immovable property that is liable to inheritance tax in the state in which it is located.

Modalities of taxation

Specific tax rules are established for transfers that may not be qualified as gift or inheritance.

The modalities of taxation will depend on the part to be passed to living or future beneficiaries of the trust:

- When at the time of death of the settlor, the part due to one beneficiary is determined, it will be liable to inheritance tax according to the family relationship with the deceased settlor. In this case, inheritance tax will be paid by the beneficiary, and the ordinary rules of taxation apply. As a result, if the beneficiary falls under Article 795 of the FTC (charitable entity¹⁰) the transfer of assets could be exempt from inheritance tax.
- When at the time of death of the settlor, the part of the assets, rights and capitalized income is globally

9. France has concluded about 40 of such Double Tax Treaties.

10. See below the definition of the entities that may qualify as charitable entity within the meaning of art 795 of the FTC.

transferred to the settlor's descendants, inheritance tax will apply at the maximum rate applicable to direct line (45%). In this case, inheritance tax will be paid by the trustee; the beneficiaries will be jointly and severally responsible for its payment where the trustee is subject to the law of a non-cooperative state or territory (within the meaning of Article 238-0 A of the FTC) or of a state with which France has not concluded a convention on mutual assistance in the collection of taxes.

- In other cases, (ie either there is no transfer and the assets remain in the trust, or there is a transfer of a non-determined part to beneficiaries that are not the settlor's descendants), inheritance tax will apply at a rate of 60%. In this case, inheritance tax will be paid by the trustee; the beneficiaries will be jointly and severally responsible for its payment where the trustee is subject to the law of a non-cooperative state or territory (within the meaning of Article 238-0 A of the FTC) or of a state with which France has not concluded a convention on mutual assistance in the collection of taxes.

Notwithstanding the above (points 1 and 2), a 60% tax rate will apply in the two following particular cases:

- the trustee is subject to the law of a non-cooperative state or territory (within the meaning of Article 238-0 A of the FTC);
- the trust was created after 11 May 2011 and the settlor was a French resident for tax purposes at the time the trust was created.

Successive transfers

- As regards future transfers, if the assets and rights remain in the trust after a transfer, taxation will be made according to the same modalities between successive beneficiaries.

Indeed, the beneficiary will be considered as the trust's settlor with regard to the assets, rights and capitalized income that are the object of a transfer subject to gift or inheritance tax.

In practice, the application of this provision in case of several beneficiaries will lead to the recognition of several settlors and a 60% taxation of the trust's assets at the time of death of each of them; each death would moreover lead to the recognition of yet additional settlors.¹¹

- As regards past transfers, the beneficiary will also be regarded as the trust's settlor with respect to trusts whose settlor is deceased at the date of entry into force of the new law. In this situation, the assets transferred to the beneficiary upon the settlor's death have not been subject to tax (as the assets remained in the trust). The law makes no provision for retrospectively taxing such transfers occurring before its entry into force.¹²

Entry into force

The new provisions apply to gifts made and deaths occurred as of 31 July 2011.

Taxation of the holding of the trust's assets

The new law sets out three rules:

- the trust's assets shall be included in the settlor's taxable wealth for wealth tax (ISF) purposes;
- a new declaration on trusts shall be filed by the trustee;
- a new 0.5% tax shall be payable by the trustee on the trust's assets where they have not been included in the settlor's taxable wealth for ISF purposes (when the settlor is liable to ISF) or regularly declared (when the settlor is not liable to ISF).

11. Report No 3503 on the proposed Amended Finance Law for 2011 (174) registered at the French Assembly on 1 June 2011.

12. cf n 12.

Wealth tax (ISF)

Taxation of the settlor

Before the new law, case law¹³ considered that discretionary and irrevocable trusts should not be included in the taxable wealth of the settlor or in the taxable wealth of the beneficiary for ISF purposes.

Pursuant to the new law, when liable to ISF, the settlor¹⁴ will have to include in his taxable wealth the assets or rights placed in a trust as well as the capitalized income.¹⁵

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The new law does not distinguish between revocable/irrevocable, discretionary or non-discretionary. The trust's assets are deemed by the law to be part of the settlor's taxable wealth. In this respect, the trust's assets will never be included in the beneficiary's taxable wealth, even when the circumstances or the reality of the trust management could lead to establishing the beneficiary's ownership.

This provision may therefore lead to the taxation of the settlor regardless of the fact that he does not have any legal right of ownership on the trust's assets.

Taxable basis

Wealth tax will be due on the overall assets constituting the trust when the settlor¹⁶ is a French resident for tax purposes (as far as the settlor's wealth is equal or superior to €1,300,000).

If the settlor¹⁷ is not a French resident for tax purposes, wealth tax will be due exclusively on the trust's assets located in France (if their value is equal or superior to €1,300,000), except for financial investments (ie French financial investments—even if they

are presumed to be located in France—are not taxable).

Exemption

This provision (wealth tax due by the settlor) does not apply to irrevocable trusts whose exclusive beneficiaries fall within the scope of Article 795 of the FTC (Charity Trusts) when the trustee is subject to the law of a state with which France has concluded a convention on mutual administrative assistance and the prevention of tax fraud and fiscal evasion.

This exemption is subject to three conditions:

- the beneficiary shall fall within the scope of Article 795 of the FTC.

Public charitable entities, mutual insurance companies and other companies officially recognized as of public interest (*'reconnus d'utilité publique'*), whose resources are allocated to social work (assistance), environment protection or animals' protection may notably fall within the scope of Article 795 4° of the FTC. The FTA considers that Article 795 4° also applies to non-public interest associations whose purpose is exclusively related to charity and social work;¹⁸

- the trustee shall be subject to the law of a state with which France has concluded a convention on mutual administrative assistance and the prevention of tax fraud and fiscal evasion; and
- the charitable entity shall be the exclusive beneficiary of the trust.

This strict definition prevents the application of this exemption notably when the transfer from the settlor's assets is not irrevocable (ie the settlor may recover the trust's assets) or when a

13. Case law TGI Nanterre 4 May 2004 n° 03-950, cf n 6.

14. Or possibly the beneficiary reputed to be a settlor as set forth above (cf *successive transfers*). The beneficiary would also be reputed to be a settlor with respect to the assets or rights constituting a trust whose settlor is deceased at the time of entry into force of the law.

15. ISF would be based on the net market value of these assets as of the 1st of January of the taxable year. The assets, rights or capitalized income constituting the trust could however benefit from exemptions provided for in several provisions of the FTC in relation to certain assets.

16. cf n 15.

17. *ibid.*

18. D adm 7 G-261 n°28, 20 December 1996.

non-charitable entity (for instance the settlor or one of his friends or relative) is entitled to benefit from the trust's income or assets.

Trust's duty to declare

The trustee of a trust whose settlor or at least one of the beneficiaries is a French resident for tax purposes, or includes an asset or a right located in France, will have the duty to declare:

- the creation, modification or termination of the trust as well as the content of its terms (that may not only include the content of the trust deed but also, if necessary, the other provisions regulating the trust operations¹⁹); and
- the market value of the assets, rights and income that may fall within the scope of the 0.5% tax²⁰ as of 1 January.

The modalities of application of the duty to declare shall be established by decree.

The non-compliance with the duty to declare will be sanctioned by a fine of €10,000 or, if higher, an amount equal to 5% of the assets, rights and capitalized income constituting the trust.

The settlor and the beneficiaries that are subject to the 0.5% tax will be jointly and severally responsible for the payment of the fine, with the trustee.

The declaration by the trust of its assets, rights or income placed in the trust is the requirement for the application of the exemption of the 0.5% tax for individuals that are not liable to the ISF (cf. following text).

The 0.5% Tax

The provision of the 0.5% tax (corresponding to the maximum rate on the ISF tax scale) is mainly intended as a sanction to be imposed when the trust

assets have not been included in the settlor's taxable wealth for ISF purposes (when the settlor is liable to ISF) or regularly declared (when the settlor is not liable to ISF).

The provision of the 0.5% tax is mainly intended as a sanction to be imposed when the trust assets have not been included in the settlor's taxable wealth for ISF purposes or regularly declared

Taxable basis

The 0.5% tax may be due on:

- the overall assets, rights or capitalized income constituting the trust, (whether they are located in France or abroad), for settlors and beneficiaries resident in France for tax purposes;
- the assets and rights located in France (other than financial investments as defined in Article 885 L of the FTC, that would be tax exempt) for settlors and beneficiaries that are not French residents for tax purposes.

The question as to whether the 0.5% tax may be assimilated to wealth tax for double tax treaty purposes is yet to be determined. Should this turn out to be the case, a settlor domiciled in a State signatory to a relevant double tax treaty with France could have a good case—depending on the situation—for challenging this tax.

Tax rate

The tax rate would be established at 0.5% (corresponding to the maximum rate on the ISF tax scale) on the net market value of the taxable assets constituting the trust as of 1 January of the year of taxation.²¹

19. According to the Report No 3503 on the proposed Amended Finance Law for 2011 (177) registered at the French Assembly 1 June 2011.

20. Whether effectively subject to the 0.5% tax or not (due to an exemption).

21. Note that the exemptions provided in several provisions of the FTC in relation with certain assets for ISF purposes shall not apply to the 0.5% tax.

Exemptions

Exemption will first be available when the trust's assets have been regularly declared to the FTA: i.e. the 0.50% tax will not apply to assets, rights or capitalized income of trusts which:

- have been regularly included for ISF purposes in the taxable wealth of the settlor liable to ISF;²² or
- when the settlor's wealth does not reach the ISF tax threshold [€1,300,000 as of 1 January 2011],²³ and these assets, rights or capitalized income have been regularly disclosed to the French tax administration in the settlor's wealth (cf *Trust's Duty to Declare*).

Exemption will also be available concerning certain specific trusts: i.e. when the trustee is subject to the law of a state with which France has concluded a convention on mutual administrative assistance and the prevention of tax fraud and fiscal evasion, the taxation does not apply to:

- irrevocable trusts whose exclusive beneficiaries fall within the scope of Article 795 of the French Tax Code (Charity Trusts); and
- trusts constituted in view of managing pension rights acquired by the trust's beneficiaries with respect to their professional activity within the framework of a pension scheme established by a company or a group of companies.

Tax return and tax payment

The new law states that the settlor and the beneficiaries are liable to the 0.5% tax. However, it shall be paid in principle by the trustee.

In this respect, the trustee will have to disclose each year the composition and the value of the assets, rights and capitalized income placed in the trust.

The tax return should be filed with the competent tax authority on June 15 at the latest.

The filing of the tax return should be accompanied by the payment of the 0.5% tax. The trustee will in principle be the debtor, but the settlor and under certain circumstances the beneficiaries or their heirs, may be jointly and severally responsible for its payment.

The tax will be established and collected in accordance with the rules, penalties and guarantees applicable to inheritance tax.

Entry into force

These new provisions would apply as of 1 January 2012.

Conclusion

The scope of the new law is very broad as it encompasses all kinds of trusts and may lead to the taxation of the settlor, of the beneficiary as well as of the trustee. The tax liability established under the new law is also extremely high, especially with respect to the trustee (that may be liable to an inheritance tax rate of up to 60%, the 0.5% tax and a fine corresponding to 5% of the trust's assets).

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In this context, we would recommend that every trustee undertake a thorough analysis of the situation of the trusts having a connection with France (either a settlor or a beneficiary being French resident, or trust's assets located in France) as we consider that the consequences of the new law may only be assessed on a case-by-case basis.

22. However, if the trust's assets have been included in the taxable wealth of the settlor by the FTA following a tax reassessment, the trusts assets may be subject to ISF and to the 0.5% tax (double taxation).

23. Even if not expressly specified by the new law, this exemption may also apply where the trust's assets would not be liable to ISF as a result of the application of the territoriality rules (ie where the trust's assets are not located in France and the settlor is not a French resident for tax purposes) according to Report n 3503 on the proposed Amended Finance Law for 2011 (179) registered at the French Assembly on 1 June 2011.