

# New French Tax legislation applicable to trusts

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## Some thoughts on how the new law should be interpreted

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The new law was approved by the French Parliament in July 2011 and came into force on 31 July 2011 in respect of French IHT, Gift Tax and Income Tax, and will apply as of 1 January 2012 in respect of French Wealth Tax and Trustee's filing requirements. As predicted, the application of the new law in practice gives rise to many uncertainties and unanswered questions for Trustees of existing trusts, as well as their Settlers and Beneficiaries.

This is because the current text of the new law is quite basic and we are waiting for written guidelines (known in France as a "Tax Instruction") to be issued which will indicate how the French tax authorities wish to interpret and apply the new law. We have been told that the Tax Instruction will not be finalised and released before the end of this year.

On this basis, the purpose of this article is therefore, not to provide tax planning solutions which could be considered for implementation before the end of this year (these are for the moment unclear and their efficiency remains uncertain), but to provide some general thoughts on how we think the law should be understood.

Let us start with the first issue to consider when applying the new law: the question of the identification of the deemed Settlor of the trust when the initial Settlor has died before 31 July 2011.

### Identifying the deemed Settlor

The general idea of the new law is to consider that the death of the initial Settlor triggers a "transfer of ownership" of the assets held in trust to the Beneficiaries who consequently become deemed

Settlers if the assets remain in the trust. For French IHT and Wealth Tax purposes, the Settlor (or deemed Settlers) of the trust is treated as the "owner" of the assets held in trust.

In respect of trusts where the initial Settlor is still alive, the "transfer of ownership" would occur on the date of his death, and the Beneficiaries in existence at that time would become deemed Settlers or owners of the assets.

In respect of trusts whose initial Settlor (being defined as the individual who initially set up and/or transferred his assets into the trust) died before the law came into force (31 July 2011), the new law does not indicate which date should be used to determine the Beneficiaries who should now be treated as "owners" of the assets held in trust. Two dates could be relevant: the actual date that the initial Settlor died (which may be many years ago) or 31 July 2011. Although this would need to be confirmed, for the sake of simplicity, it seems that the French Tax Authorities are likely to retain the 31 July 2011 as the relevant date.

Thus, there are currently many trusts whose initial Settlor died before 31 July 2011 and whose Beneficiaries in existence on that date should now be considered, from a French tax perspective only, as deemed Settlers (i.e. "owners") of the trust assets as from 31 July 2011.

This interpretation has given rise to another unpredicted and complex issue: what are the French tax consequences of the exclusion, before the end of this year, of a Beneficiary of the trust who has been considered since 31 July 2011 as an "owner" of all or part of the assets held in

trust? Can such an exclusion be considered as a "transfer of ownership" triggering the application of the sui generis IHT/Gift Tax addressed below. Indeed, it should be noted that in respect of French IHT and Gift Tax the new law has applied since 31 July 2011 and the sui generis tax is aimed to apply to any "transfer" which cannot be treated, under French civil law principles, as a transfer on death or a lifetime transfer.

Another issue that the new law does not address is how the assets held in the trust should be divided when various Beneficiaries become deemed Settlor and when some of them are French tax residents. Should the French tax resident deemed Settlor be taxed on all the assets within the trust or only on a portion of them? We believe that the nature and the terms of the trust should provide the answer. For example, where the trust is discretionary in nature, the trust assets will most likely be treated as being divided equally between the deemed Settlor for these purposes.

It is only when the "owner" of the assets held in trust has been clearly identified that the relevant tax treatment can be determined. The application of the new law therefore presupposes this first and necessary analysis.

## Wealth Tax

As of 1 January 2012, the Settlor or deemed Settlor would be liable to Wealth Tax under the **normal regime** on the assets held in trust (or only on the portion owned or deemed to be owned) if the **net value** of the assets, including the assets owned directly, exceeds the €1,300,000 threshold.

If the Settlor or deemed Settlor is French tax resident, Wealth Tax applies on worldwide assets. If not, this only applies to French sited assets (except French financial assets, which are exempted if disclosed by the Trustees). A Beneficiary (wherever he resides) is not liable to Wealth Tax if he cannot be considered as a deemed Settlor.

If the trust assets have not been disclosed by the Settlor or deemed Settlor, a sui generis tax applies at a flat rate of 0.50% regardless of the value of the assets. As this taxation works as a sanction for non disclosure under the normal regime, we believe it would apply on all the assets held in trust if the Settlor or deemed Settlor is French tax resident, and only on French sited assets if he is not. Tax reductions and exemptions which can

apply under the normal Wealth Tax regime will not be available here.

Under this default regime the Trustees must disclose the assets and pay the 0.50% tax before 15 June of the relevant tax year. If the tax is not paid by the Trustees, the law provides that the Settlor or deemed Settlor and the Beneficiaries might be jointly liable to pay it.

## Inheritance Tax and Gift Tax

This is without doubt the most complex part of the new law. The new law provides for taxation on any "transfer" made through a trust whether or not such a transfer can be treated, under French civil law principles, as a transfer on death or a lifetime transfer. Here too, the law provides for a sui generis tax if the normal rules cannot apply.

When the normal rules can apply, taxation occurs under the normal regime according to the relationship between the Settlor or deemed Settlor and the "Beneficiary(ies)". However, given past difficulties with successfully applying French civil law principles to trusts, we believe the application of the normal regime should be marginal in practice.

This is why the new law provides for a sui generis tax which will cover all cases. Under this default regime, the rates of tax (from the normal progressive rates up to a flat rate of 45% or 60%) would depend on various situations which are currently not very clear, namely whether, for example: the share attributable to a Beneficiary can be determined; the Beneficiary is a descendant or not; the assets are globally due to various Beneficiaries; and the assets are to remain in the trust.

## Filing requirements for the Trustees

A new Article 1649 AB of the French Tax Code provides for specific filing obligations which apply directly to the Trustees in two cases:

- When the Settlor and/or at least one of the Beneficiaries are French tax residents regardless of where the assets held in trust are situated (French and non French sited assets); and
- When the trust comprises French sited assets even if the Settlor and/or the Beneficiaries are not French tax resident. The concept of "French sited assets" is the same as that applicable

in respect of French IHT and Wealth Tax.

For the purpose of the filing requirements the concept of deemed Settlor considered above does not apply. The Settlor is the initial Settlor of the trust (whether or not he has died).

The Trustees will have to disclose to the French tax authorities the constitution, modification or termination of the trust as well as the terms of the trust. The Trustees must also disclose the value as at 1 January each year of assets and rights held in the trust. In respect of a French tax resident Settlor or Beneficiaries, all assets within the trust will have to be disclosed.

The new law provides a high penalty for Trustees who fail to comply with these filing requirements (a fine of €10,000 or 5% of the value of the assets held in trust if the application of this percentage gives a higher amount). If the tax is not paid by the Trustees, the law provides that the Settlor and the Beneficiaries might be jointly liable to pay it.

## Taxation of trust distributions

To a certain extent, the new law clarifies the Income Tax regime applicable to income received from a trust. Only "proceeds" distributed to a French tax resident Settlor or Beneficiary are subject to French Income Tax (regardless of the nature of the income received by the Trustees: interest, dividends, gains etc). The concept of deemed Settlor does not apply in this case.

Although the Tax Instruction should define the term "proceeds" we believe this should not apply to capital distributions from the trust. Capital distributions (on termination or during the existence of the trust) should be considered from a French IHT, Gift Tax or Capital Gains Tax perspective.

Income tax should arise in France only when there is a distribution of income to a French tax resident Settlor or Beneficiary. These rules have applied since 31 July 2011, thus in respect of distributions of proceeds (and/or terminations) made since this date.

Under the new law, accumulated income or proceeds within the trust should not therefore be taxed. However, there is another provision of the French Tax Code which might allow taxation of the accumulated income. This is anti-avoidance legislation contained in Article

123 bis thereof. However, this Article has existed within the French tax legislation for a while now and was not introduced by the new law. The question as to whether this Article can apply in respect of trusts is a separate matter (see however a judgment of the Court of First Instance of Nanterre of 4 May 2004, the *Poillot* case).

## Conclusion

Given all the uncertainties surrounding the application of this new law and the **number of issues which are still unclear**, it is most difficult to advise on this subject with certainty.

In certain circumstances, terminating a trust or excluding a Beneficiary before the year end might be envisaged, **but definitely not** in all cases. Planning undertaken before the year end with the intention of escaping the scope of the new law as of 1 January 2012 might actually exacerbate the tax situation in the future.

In any case, we believe that having a good understanding of how the new law will affect a particular trust situation is always a preferable first step. Indeed, the better view may simply be to do nothing for the time being.

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Frederic Mege, the Author, and Rose Chamberlayne of LG's Monaco and London offices have been working together to advise Trustees, Settlers and Beneficiaries on the impact of the new French tax law on existing trusts, potential tax planning opportunities and the practical steps that will need to be taken to ensure compliance with the new laws next year.

These notes are for general information only and are not intended to provide legal advice.

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