Everything You Always Wanted to Know About Trusts with a French Connection[1] (But Were Afraid to Ask)[2]

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Introduction

The trust is a very strange animal for civil lawyers who have not (yet) discovered how useful it can be for estate planning purposes. It explains why they often prefer to affirm that trusts are not recognized in France or that using a trust is detrimental for French tax purposes.

The ambit of this report is to show that trusts can be used in a civil law environment (1) and that they are far from being detrimental for French tax purposes (2) even if reporting requirements are due by the trustees of trusts with a French connection (3).

1. Use of Trusts in a civil law environment - Trusts are not known but are recognized in France

In order to apprehend the French legal system, it should be remembered that France is a Civil law country which has very different fundamentals inspiring its laws compared to Common law jurisdictions.

- **Why France is different?**

The Civil Code's spirit is meant to apply to everyone equally, with a special focus on protecting the most vulnerable people. Of course, it is possible to derogate from Civil Code provisions, provided that they are not considered as part of the public order ("*ordre public*").

Whereas in almost all common law countries, inheritance laws provide for absolute freedom of testation, in France freedom of testation is subject to some imperative restrictions designed to protect public order. The most important of these, in practice, is by far the forced heirship rules, under which a certain portion of the estate is reserved for certain heirs ("*la réserve héréditaire*").

Civil law also provides the list of heirs (the ultimate remaining successor being the State of France) who inherit from the deceased in the absence of a Will. The legal ownership of the deceased's estate is immediately vested to his/her heirs. There is no such procedure as probate in France.

[1] Inspired by William Friedkin's movie "The French Connection" (1971)
[2] Inspired by Woody Allen's movie "Everything You Always Wanted to Know about Sex (But Were Afraid to Ask)" (1972)

As a consequence, it is not common practice in France to prepare a Will. In most cases, the settling of an Estate is, after the death of the deceased, dealt with by "*notaires"* and/or French lawyers, who apply the law governing the succession.

As a reminder, the *notaires* have an exclusive competence for the registration of real estate properties' transfers of ownership. A "*notaire*" is however not needed when an intermediate company and/or a trust has been set up by the deceased in order to hold French real estate properties.

Having said that, we strongly recommend that our clients prepare a Will regardless of their country of habitual residence, their tax status and their citizenship.

- ***General comments on the French succession law***

As from 17 August 2015, the European Union (EU) Regulation n°650-2012 on successions and Wills (hereinafter so called the "Regulation") considerably modified the rules regarding jurisdiction and applicable law governing matters of succession in France.

Under the Regulation, as a general rule, the law applicable to the succession as a whole (i.e. movable and immovable) shall be the law of the country in which the deceased had their habitual residence ("*résidence habituelle*") at the time of death, irrespective of whether this country is (or not) a Member State of the EU.

In addition to the above, the EU Regulation allows a person to choose the law of the country whose nationality he/she possesses at the time of making the choice, or at the time of death, as the law to govern their succession.

As a consequence, since 17 August 2015, a person who is not a French citizen (i.e. a US citizen) and whose habitual residence is in France can opt for the law of the State of his/her citizenship (the law of the US State in which he/she has the closest interests) as the law governing their whole Estate.

When the law applicable to the succession is the law of one of the US States (e.g. when the French deceased opted for this law by virtue of the EU Regulation n°650/12), the *notaire* and/or French lawyer must apply the law of this State to the whole French Estate, including immovable assets.

To summarize the situation since August 17, 2015:

- French succession law does not apply to French assets owned by individuals having their habitual residence abroad.

  Movable assets and real estate located in France owned by a deceased person having his/her residence in New York upon their death are, as a general rule[3], subject to New York's succession law, irrespective of their citizenship.

  However, a French citizen may elect for the application of the French law to govern his/her succession.

[3] Subject to the possible application of a « Renvoi » rule, referring back to the law of the situs of the real estate

- The succession law of New York may apply to movable assets and real estate located in France owned by a US person who has their habitual residence in France upon his/her death, provided he/she elected for the application of the New York succession law during their life.

- ***Trusts are not known but are recognized in France***

The concept of trust is alien to the French Civil Code. This is because there is no distinction between legal and equitable ownership.

However, although it is impossible to create a trust under French law and France has not ratified the Hague convention on the recognition of trusts, French courts recognise the effects in France of common law trusts, provided they comply with the mandatory provisions of French law (e.g. forced heirship rules, when applicable [see our comments above]).

As a consequence, one may set up a foreign trust to own assets wherever located, notably in France.

As long as the settlor of the trust does not have his/her habitual residence in France[4], or has his/her habitual residence in France but opts for the application of a Common law (see below) to govern his/her succession, the limits provided by the French public order ("*réserve héréditaire*") do not apply.

In addition, even if French law is to apply to the settlor's estate (his/her last habitual residence was in France and he/she did not [or was not able to] elect for another succession law), and that the foreign trust does not comply with French forced heirship rules, only the excluded heirs may complain. If they do not complain, the trust may apply as decided by the Trustees, following, as a general rule, either the trust settlement or the wishes of the Settlor.

If one of the heirs does not agree with the Trustees' decision and, provided that the settlor had his habitual residence in France upon his/her death and had not opted for a succession law other than the French one, the excluded heirs should go to French courts and ask to reduce the effect of the trust.

The French judge would recognize the effect of the trust, but will attribute to the excluded heirs the portion of the trust's assets he/she should have received by application of the forced heirship rules.

Assuming he/she wins the case, he/she should then go to the judge of the jurisdiction of the Trustees to obtain the application of the French decision.

To conclude, a US citizen may set up trusts owning assets located in France.

However, real estate properties located in France cannot be directly owned by the trust, because the French Civil code does not differentiate between legal and equitable ownership. At least one (French or foreign) company should be interposed between the French real estate and the trust.

[4] Subject to the possible application of a « Renvoi » rule, referring back to the law of the situs of the real estate

2. Tax treatment applicable to Trusts with a French connection

- **Why is France different?**

  - The tax treatment in France is different depending on the tax domicile or residence of the taxpayer. Their citizenship is irrelevant. The definition of domicile for French tax purposes is provided by article 4 B of the French tax code (FTC). The definition of residence is given by tax treaties signed by France with other countries.

  - The US tax treatment has no influence on the French tax regime applicable to US trusts. For example, what is considered as "income" in the US can be qualified as "principal" ("*capital*") for French tax purposes. Neither the French law nor the French tax authorities' guidelines provide a definition of what should be regarded as "capital" and "income".

    We consider that the market value of assets upon their transfer by the settlor to the trust should be considered as capital. Accumulated income remains, in our opinion, income for French tax purposes even if accrued in a "capital account" by the trustees.

    However, there is no doubt that the market value of trust's assets upon the settlor's death (or upon the beneficiary deemed settlor's death), before inheritance tax, qualifies as capital for French tax purposes (see §2.3.).

  - In 2011, France introduced a Law relating to the tax treatment of foreign trusts with a French connection (Law n°2011-900 of 29th July 2011 [hereinafter so called the "New Law]).

    The New Law also introduced the concepts of "beneficiaries deemed settlors" ("*bénéficiaires réputés constituants*") and of "attribution of assets" ("*attribution des actifs*") which seems very strange to our US colleagues. But complying with the French tax authorities' requests when a US trust has a connection with France is essential to reduce the tax burden of trusts' members (see § 2.3 and 3).

The New Law, which entered into force on 31st July 2011, created a whole new body of rules, in particular with respect to wealth tax ("*impôt de solidarité sur la fortune*" [ISF] and "*impôt sur la fortune immobilière*"[IFI] (2.2.) and transfers for no consideration (gift tax and inheritance tax) made through a trust (2.3.). It also provides reporting obligations on the Trustees (3.). However, the regime applicable to trusts for income tax purposes has not been modified by the New Law (2.1).

2.1. Income tax

- ***Income tax on the trust fund***

Individual income tax, corporation tax or withholding taxes can be levied in France on income and capital gains derived from French assets owned in trust.

The tax treatment would be different depending on the quality of the Trustee (individual or corporation) and the ownership structure chosen to hold French assets.

The provisions of treaties signed by France with other States may override the tax rules applicable. A tax treaty dealing with income tax has been signed between the US and France on 31 August 1994 (lastly modified on 13 January 2009).

- ***Income tax on distributions from trusts***

Distributions from trusts qualifying as distribution of income (as defined in introduction) benefiting French resident beneficiaries are subject to French income tax (article 120.9 of the FTC).

Similarly, the provisions of treaties signed by France with other States may therefore override the tax rules applicable. As mentioned above, a tax treaty dealing with income tax has been signed between the US and France on 31 August 1994 (lastly modified on 13 January 2009).

Ordinary income or capital gains distributed by the trustee to non-resident beneficiaries are not subject to French income tax.

Finally, we draw your attention to the fact that under the French CFC legislation (provided for by Article 123 *bis* of the FTC), resident individuals who directly or indirectly own more than 10% in a foreign tax driven entity established in a low tax jurisdiction are taxable on a *pro rata* share of the income realised by the foreign entity whether or not distributed. The French tax authorities consider that foreign trusts enter into the scope of this legislation, although we do not share this view.

Under these rules, the income realised by the foreign entity is determined either on a real basis or on a notional basis, depending on whether the entity is established in a so-called non-cooperative jurisdiction, and is taxed in the hands of its French resident shareholder based on 125% of the amount of income calculated. If the entity is located in a non-cooperative state, the 10% participation requirement is deemed to be met.

2.2. ***Wealth tax (ISF and IFI)***

Up until 2017, the former French wealth tax ("*impôt de solidarité sur la fortune*" ["ISF"]) introduced in French tax code in 1981, was due by non-French tax resident settlors, as a general rule, when the market value of their French assets (movable or immovable assets either owned directly or through a trust) exceeded € 1.3 million. They benefited from an exemption on French financial assets.

Since 1st January 2018, the former wealth tax was repealed and replaced by a new wealth tax of which the scope is limited to real property ("*impôt sur la fortune immobilière*" ["IFI"]). Since that date, non-resident individuals are only liable to French wealth tax when the market value of their French real properties, held directly or indirectly, exceeds € 1.3 million.

Up until January 1st 2011, neither settlors or beneficiaries of irrevocable and discretionary trusts were subject to wealth tax on the trusts' fund. It was one of the reasons why trusts have sometimes been misused and set up only for French tax purposes.

As from January 1st 2012, settlors of trusts are subject to wealth tax (ISF and subsequently IFI) on assets held through a trust, as if the settlors were owners of the trust fund. It does not mean that the legal regime as described in §1 was modified. This assumption is for tax purposes only, as mentioned in the administrative notice for the New Law.

Upon the Settlor's death, the Trustees should appoint the "beneficiaries deemed settlors" chosen among the Beneficiaries listed in the settlement. The Trustee should also allocate the trust's assets to each "beneficiary deemed settlor" ("*allocation d'actifs au profit des bénéficiaires réputés constituants*").

It does not mean that the trust should be wound up. On the contrary, it may continue to exist. However, beneficiaries deemed settlors should pay French taxes (except income tax on accumulate income and capital gains on the trust fund) as if the trust did not exist.

Each beneficiary deemed settlor will become, upon the death of the Settlor, subject to wealth tax on the portion of the trust's assets attributed to him/her by the Trustees. The same will happen upon the death of each beneficiary deemed settlor ("*bénéficiaires réputés constituants*").

For example, assuming the Trustees allocate the full trust fund to the surviving spouse of the Settlor upon the death of the Settlor, he/she will become subject to wealth tax on the full trust fund.

Upon the surviving spouse's death, if the Trustees allocate ¼ of the trust fund to each of his/her four grandchildren, each of them would become subject to wealth tax on ¼ of the trust fund.

2.3. French gift and inheritance tax due in relation to trusts with a French connection

Gift tax (2.3.1.) and inheritance tax (2.3.2.) may be due in France in relation to Trusts.

2.3.1. French gift tax

Distributions of capital (as defined in introduction) decided by the trustee that benefit beneficiaries who are not the settlor may entail the payment of gift tax in the three following circumstances:

- The settlor is a French tax resident
- The beneficiary receiving the distribution is resident of France for tax purposes.
- French assets are transferred by gift.

One should be aware that the full exemption benefiting the spouse for inheritance tax purposes (see §2.3.2.) does not apply to gift tax. It is levied at the marginal rate of 45%.

Between parent and children the same rates apply for gift tax and for inheritance tax (see § 2.3.2.).

Of course, tax treaty provisions like those provided by the tax treaty signed between US and France (see our report from La Quinta, March 2019) may alter the French domestic rules.

2.3.2. French inheritance tax

By virtue of the New Law, the passing of the settlor is a triggering event for inheritance tax (Article 792-0 *bis* of the FTC).

Under Article 792-0 bis of the FTC, when the settlor passes, the trust funds are deemed to be "provisionally" allocated to the beneficiaries (although not actually distributed), the purpose of which is to serve as a basis for the potential inheritance tax due.

Such "provisional allocations" to the beneficiaries upon the settlor's passing are in practice formalized in a specific return to be filed by the trustees upon the settlor's passing (see §3.).

The French tax authorities' guidelines for the New Law specify that the tax treaties signed by France remain applicable in order to determine the inheritance tax treatment of the provisional transfers made (within the trust) upon the settlor's death. The provisions of the applicable treaties may therefore override the domestic tax rules applicable (See our report form March 2019 - La Quinta).

Any "allocation of assets" of a fraction of the trust's assets qualifying as located in France (see our comments in § 3) allocated to the surviving spouse benefits from a full exemption of inheritance tax. Consequently, assuming the entirety of the French trust assets are allocated to the surviving spouse, no inheritance tax would be levied in France.

Any "provisional allocation" of a fraction of the trust fund which is decided by the trustees to the descendants of the settlor (children or grandchildren) would be subject to French inheritance tax.

- *Tax consequences upon subsequent distributions made to the beneficiaries*

As explain in the introduction, when the settlor of a trust passes away, the entirety of the trust funds as existing at the date of the settlor's passing (which are deemed immediately transferred to the beneficiaries) must be regarded as capital, up to the market value of these funds on the date of death.

Should the total market value of the trust fund subsequently increases subsequently, the fraction exceeding the capital should be regarded as income for French tax purposes.

If the distribution is taken out from the "capital" account, i.e. from a fraction of capital which had been deemed allocated to another beneficiary, it may be qualified as a gift from this other beneficiary and, as such, be subject to French gift tax.

- *French reporting formalities arising from the settlor's passing*

As explained below (see §3.), an event-based return should be filed with the French tax authorities within 30 days of the death of the settlor. This return should also indicate the amount of the "provisional" allocation decided by the trustees to benefit each beneficiary.

Assuming the deceased was not a resident of France upon his death, an inheritance tax return must be filed with the French tax authorities by the heirs reporting not only the fraction of the trust assets which are deemed attributable to them by virtue of a decision of the trustees, but also all other assets (if any) that they may inherit from the deceased. This return should be filed within one year of a non-French resident's passing.

If the heirs do not file this inheritance tax return, French inheritance tax could be levied on the Trustee at the flat rate of 45% based on the market value of the fraction allocated to his/her descendants (assuming such a decision of allocation was formalised by the trustees), or at the flat rate of 60% based on the total market value of the trust fund, if no decision of allocation has been made by the trustees.

It is therefore essential that all formalities incumbent on the trustees and the beneficiaries, as set out above, be performed in due course.

Finally, trusts set up by French resident taxpayers after May 11, 2011 are subject to 60% inheritance tax upon their death. It is then also essential to set up the trust either before becoming a French tax resident or during a period when the taxpayer does not have his/her domicile or residence in France.

3. French reporting obligations incumbent to the Trustees of Trusts with French connections

Two different reporting obligations incumbent to the Trustees should be distinguished in France. First of all, trusts having a connecting factor with France should report the trust every year and under certain circumstances (3.2.1.). The trustee of trusts owning real estate located in France should also comply with the reporting obligations relating to the 3% tax (3.2.2.).

3.1. French tax and reporting obligations incumbent to the trustees of French connected trusts

- *Scope of the French reporting requirements on the trustee*

The New Law introduced certain specific reporting requirements bearing on the trustees of trusts which are deemed connected with France.

Under Article 1649 AB of the FTC, a trust is regarded as having a connecting factor with France if either:

- The settlor is a French resident for tax purposes;
- At least one of the beneficiaries is a French resident for tax purposes;
- The trust holds French located assets;
- The trustee is a French tax resident.

For the purpose of the trustees' reporting requirements, the notion of "French located assets" is to be read within the meaning of Article 750 *ter* of the FTC.

According to Article 750 *ter* of the FTC, works of art, furniture and real estate located in France are considered as French assets. Shares of companies incorporated in France, financial investments as well as receivables against French resident debtors also qualify as French assets.

More surprisingly, when a company (French or foreign) indirectly owns real property situated in France, it is deemed a "French asset" within the meaning of Article 750 *ter* of the FTC in two cases:

- First, if it qualifies as a "real estate company" ("*Société à prépondérance immobilière"*) under paragraph 2° *alinea* 4 of that Article.

  A company qualifies as a "real estate company" under Article 750 *ter* 2° *alinea* 4 of the FTC if the market value of the French real property that it owns (directly or indirectly) exceeds the market value of its other assets.

- Secondly, if the same "family group" owns more than 50% (directly or through intermediary companies or entities) of the company's share capital, even if the company is not a "real estate company" (paragraph 2° *alinea* 2 of the Article).

For the purpose of computing the movable assets vs. immovable assets ratio at the level of each intermediary company, the loans they granted should not be taken into account.

Article 1649 AB of the FTC provides for two kinds of reporting requirements:

- Annual returns, to be filed by 15th June, of which the main purpose is to report the market value of the trust's assets as of 1st January of each year.

- Event-based returns, to be filed within 30 days of the event, of which the purpose is to report any "modification" which occurred since the entry into force of the new Law (e.g. distributions, change of beneficiaries, change of trustee, death of the settlor, etc).

- *Tax requirements: the specific 1.5% tax*

Under Article 990 J of the FTC, a specific 1.5% tax is due each year by the trustee when the settlor of the trust (or beneficiaries deemed settlors of the trust when the settlor has passed) is liable to French wealth tax in respect of the concerned year but did not report the market value of the trust assets in his wealth tax return (and therefore did not pay wealth tax in respect of these assets).

The specific 1.5% tax is assessed on the basis of the market value of the trust assets which should have been reported for wealth tax purposes by the settlor. In practice, this tax only applies since 2012, which is the first year following the entry into force of the New Law.

- *Penalties for missing returns*

Failing to comply with the above reporting requirements triggers the application of a fixed penalty amounting to € 20,000 per missing return.

In practice, and based on our own experience, it is likely that no penalty should in any case be due if late returns are filed spontaneously by the Trustees. However, this cannot be guaranteed.

The limitation period for these penalties runs until 31 December of the 4th year following the date when the reporting is due (Article L188, al. 2, of the French tax procedure code). As a result, in 2019 the French tax authorities are still allowed to claim for such a penalty in relation to any return due to be filed since 1st January 2015.

- *The potential 80% surcharge*

In addition to the fine per missing return, since 31 December 2016, failing to report may also give rise to an additional 80% surcharge (with a minimum of € 20,000) applying to all French tax consequences bearing on the trustee(s), the settlor(s) or the beneficiarie(s) – income tax, wealth tax, inheritance/gift tax, trustees' specific 1.5% levy – which may be due in respect of the trust assets and distributions or reportable modifications which may have occurred.

This additional surcharge, if applicable, is exclusive of the fixed penalty for non-filing or late filing.

The statute of limitations for this surcharge is that applicable to the tax to which it applies (Article L188, al. 1, of the French tax procedure code). As a consequence, the limitation period for the surcharge runs until 31 December of the 10th year following the due date for the corresponding tax (i.e. income tax, wealth tax, inheritance/gift tax, trustees' specific 1.5% levy).

In practice, the limitation period for this surcharge would only be since 31 December 2016. However, this does not prevent the French tax authorities from applying, as from 2012, the standard penalties (which can be up to 80% in cases of abuse of law), when applicable.

3.2. The annual 3% tax

The 3% tax return should be completed every year by all companies, entities, foundations or trusts involved in your structure of ownership when they qualify as being "*entités à prépondérance immobilière*".

As opposed to the reporting obligations on the trustee, the annual 3% tax return is only due when one of the companies involved in the ownership structure or the trust qualifies as an "*entité à prépondérance immobilière*".

A decision of the French Tax Supreme Court ("*Conseil d'Etat*") ruled on May 9, 2019 that trusts are subject to the 3% tax reporting obligations despite the fact that trusts do not benefit from the legal personality. It has also been ruled that for the application of the 3% tax, trusts are deemed to have their head office in the country of the law by which they are governed.

Conclusion

Trusts with a French connection can be set up by US citizen. Trusts can be very efficient but three pitfalls should be carefully avoided, never set up a trust while resident in France, always interpose one intermediary company between the trust and the French real estate properly located in France and never forget the reporting obligations due to the French tax authorities.