Real Estate Newsletter

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C/M/S/ Bureau Francis Lefebvre

EDITORIAL

Shopping centres are a vital element of the economic fabric of a country. Change is constant as they are renovated, extended, see new businesses open, invent new concepts - for some - and successfully manage a very diverse mix of interests.

This latest newsletter is devoted to this specific type of commercial real estate. Shopping centre management primarily entails managing relations between lessors and lessee-operators.

Accordingly we have focused on developments relating to the specific features of shopping centre leases, and in particular the practice of binary rents, exclusivity and non-compete clauses, as well as clauses derogating from Article 1723 of the French Civil Code.

We will note that the French Court of Appeals (*Cour de cassation*) upheld the principle according to which the obligations of a shopping centre lessor are not more extensive than those of an ordinary lessor.

Management of shopping centres also extends to the organisation of relations between retailers.

We will see that the lessor's obligation to maintain the common areas, a simple obligation of due care, has provided grounds for the development of marketing funds and pooled contribution funds by some lessors. Having set out the principles governing these tools, we will concentrate on a number of developments in retailers' associations, another management tool very commonly used in shopping centres, and, in general, amongst economic operators in shopping centres. We will also examine some specific features of their legal and tax regimes. The newsletter will look at the principle recently set out by the French Court of Appeals of the right to withdrawal of members of an economic interest grouping (EIG), a structure that may be used by retailers in a shopping centre.

On the taxation side, we will review the scope of the French Council of State judgement of 21 November 2012 on the tax regime governing sums paid by a lessee, in addition to rent, some of the tax parameters governing the acquisition of real estate assets located in a shopping centre, and some particular characteristics of local taxation.

It is also our intention to draw the reader's attention to the Court of Appeals's significant judgement of 19 September 2012, ruling on the ownership of buildings erected on divided ownership land, which should open the way for transactions using this technique between owners of shopping centres and operators needing to build new premises (extension, raising, etc.) in a framework providing an alternative to commercial leases.

As ever, the newsletter includes a section on international issues, focusing this time on the tax aspects of real estate investments in German shopping centres. Please read on.■

Richard Foissac, partner

Three questions for Patrick Humbert, Chief Executive Officer, Société des Centres Commerciaux France

What does Société des Centres Commerciaux do?

Société des Centres Commerciaux (SCC) is a company in the LSGI Group, founded by Robert de Balkany. It is the leading, fully independent, private shopping centre management company in France. The company's first major shopping centre under management was Parly 2.

As a shopping centre manager, SCC is at the nexus of change and an ideal barometer of developments in the sector. How are shopping centres faring?

Despite the 2008 crisis and its undeniable impact on household consumption, we feel there is no reason for pessimism regarding the future of shopping centres. While there is no denying difficulties, the words adaptation and refocusing seem more appropriate as a response.
The advent of e-commerce requires stronger complementarity and links between distribution channels. In addition, several studies show that consumers do not intend to change their shopping habits in the short term. While some sectors are certainly more affected than others, such as household electrical, electronics or culture (books, CDs), a counter trend is apparent in the decision by some luxury goods brands to establish a presence in major shopping centres, rather than remaining solely in prestigious city-centre shopping streets.
Some brands are also developing what we refer to as impulse buys, using sensory marketing techniques (perfume diffusion, the feel and proximity of products, outlet sound policy, etc.).
We have also noticed a trend towards developing and expanding major centres whose diversified and complementary mix of tenants and services to consumers is designed to sustain business through the crisis.
Mid-sized shopping centres that do not have a comprehensive commercial line-up, some of which are located a little further from urban centres, are no doubt being hit harder.

SCC concludes around 400 leases per year on behalf of its clients. What issues galvanised the profession?

A number of disputes galvanised the profession, including the question of retailers' associations and case law on the nullity of mandatory membership clauses included in leases. This case law is clearly understood in our centres, despite a trend for some lessors to adopt the practice of marketing funds. We remain very interested in retailers' associations and the part they play in the decentralised management of centres and in optimising relations between lessors, lessees and local economic stakeholders (town halls, préfectures, etc.).
We would also mention the nullity of some indexation clauses in leases, on the grounds of the supposed distortion between the index variation period and the interval between two revisions, which also seems to have been settled since the Paris appeal court's ruling of 4 April 2012.
Our leases show a trend towards an inflated number ancillary clauses covering environmental, energy efficiency, waste management and other audits and diagnostics. Costs are certainly rising for these line items, which points to the need for specialist multidisciplinary teams in asset-management companies such as ours.
The profession is also paying close attention to current discussions on article 6 of the draft bill on crafts, retailing and micro-businesses, which includes measures related to leases and particularly to rent renewals and rental charges with the intention of controlling them.■

A number of specific characteristics of leases in shopping centres

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Commercial leases originally set out to protect independent retailers. Hence, besides article L. 145-48 paragraph 2 (which prohibits the first lessee of a shopping centre from requesting authorisation to exercise in the rented premises one or more different activities from those specified in the lease for a period of nine years from the date on which they took possession), the status of commercial leases contains no particular provision relative to the premises operated in a shopping centre.
Specific litigation has developed with the growth of shopping centres in France, and courts have taken the particular nature of shopping centres into account in lease law.
The frequent practice of binary rents in shopping centre leases has been upheld.
This type of rent consists of both a fixed and variable portion (also called a receipts clause), the latter depending on the lessee's sales. On 10 March 1993, the French Court of Appeals (*Cour de cassation*) ruled "that setting the rent renewal for this type of lease falls outside the provisions of the Order of 30 September 1953 and is governed only by the agreement of the parties (Théâtre Saint Georges judgment). Hence, the judge did not have the authority to rule on setting the amount of the renewed rent for a lease that included a binary rent, unless otherwise stipulated to the contrary in the contract.
Exclusivity and non-compete clauses were also upheld, provided they do not impede the state provisions on the partial exercise in the rented premises of one or more different activities from those specified in the lease (Court of Appeals, 3rd Civil Chamber, 15 February 2012).
Moreover, shopping centres may have to restructure. In this case, shopping centre leases often include a clause derogating from article 1723 of the French Civil Code, which prohibits the lessor from modifying the form of the item leased during the term of the lease. This clause is valid inasmuch as the lessor complies with their delivery and peaceful enjoyment obligations. Nonetheless, the Paris appeal court deemed that "the mere presence for a period of three years of a vast site in the immediate environs of the shopping mall was a sufficient deterrence for the customer, and as a result constituted abnormal disturbance of possession", making the lessor liable "in accordance with the provisions of article 1719, paragraph 3 of the French Civil Code" (Paris Appeal Court, 16th Administrative Chamber, 28 Jan. 1998.
Lastly, the question frequently arises as to whether the obligations of a shopping centre lessor are more extensive than those of an ordinary lessor. In other words, if the shopping centre were deserted, can the lessee claim the lessor's responsibility on the grounds of his delivery obligation?

"The courts have taken the particular nature of shopping centres into account in lease law."

The Court of Appeals ruled on several occasions that, unless otherwise stipulated to the contrary, the lessor has no particular obligation, and that the lessor was bound only to ensure the delivery, maintenance and peaceful enjoyment of the item leased.
It confirmed that the lessor of a shopping centre was a lessor like any other. The Court of Appeals also considered the lessor's general maintenance obligation - covered by common lease law - as it applies to the "common areas of the centre, a necessary accessory to the use of the leased property" (Court of Appeals, 3rd Civil Chamber, 19 December 2012).
It also pointed out that the lessor's obligation to maintain a favourable environment is only an obligation of due care (Court of Appeals, 3rd Civil Chamber, 14 Feb. 2012). More recently, the Court of Appeals confirmed that, in order to be binding on the lessor, the specific obligation to maintain a favourable commercial environment must be stipulated in a clause in the contract (Court of Appeals, 3rd Civil Chamber, 3 July 2013). The Court therefore clarifies that, for now, commerciality is not included in the lessor's obligation to deliver.

Commerciality of shopping centres: a major issue

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It was long considered that, in the absence of specific stipulations, the lessor of a shopping mall was bound only by the legal obligations of the Civil Code, and therefore was not bound by a particular obligation to maintain a commercial environment favourable to the lessee when the lease did not include such an express contractual obligation connected with the existence of the shopping centre (Court of Appeals [Cour de cassation], 3rd Civil Chamber, 11 May 1995). Hence, it was considered that, even in the absence of any specific contractual provision requiring the lessor to maintain the common areas, the latter was obliged to offer the counterpart of what the lessee might expect, notably as regards the commercial environment, and, failing this, became liable (Court of Appeals, 3rd Civil Chamber, 31 October 2006). The Court of Appeals has clearly confirmed that the lessor of a shopping centre is obliged to maintain the common areas of the centre, which are considered a necessary accessory to the use of the leased property (3rd Civil Chamber, 19 December 2012). This is an obligation of due care: if the lessor demonstrates that they have taken the measures to ensure the commerciality of the centre, such as endeavouring to find new tenants, then they are not liable (3rd Civil Chamber, 14 February 2012).

"Assessing the structure best fitted to promote a shopping centre assumes a detailed analysis of the challenges for both the lessor and the tenants."

The shopping centre concept is also based on a specific sales promotion policy, usually implemented by a retailers' association, whose members are the tenants.

There are two long-standing concepts in a number of centres, namely a marketing fund and a pooled contributions fund. These funds came into very widespread use to circumvent the consequences of Court of Appeals case law, according to which mandatory membership of an association disregards the fundamental principle of the freedom not to join (3rd Civil Chamber, 5 December 2001), and the clause in a commercial lease obliging the lessee to maintain membership throughout the term of the lease was held to be null and void (3rd Civil Chamber, 12 June 2003).

Although seemingly identical, the two concepts are different in practice.

Usually, the "marketing fund" is designed as a supplement to the rent: the lease provides that the lessee is required to contribute to the marketing fund created and managed by the lessor, throughout the lease term or its renewed terms. Leaving aside the tax regime governing these inflows, the practice also has consequences for the lessor's responsibilities, who, assuming the responsibility for allocating these sums to marketing actions (directly undertaken by the lessor, or contracted by the latter to an authorised agent or service provider), must answer to the lessee for the effectiveness and efficacy of their use. In practice, the lessor must have a team of marketing specialists, dedicated in whole or in part to the centre in question. If not, lessors must select external professionals. Therefore, the marketing fund gives rise to the lessor's - at least minimal - involvement in the marketing action, and could make the lessor at least partially liable vis-à-vis the commercial lessee, in the event of a reduction in traffic to the site, and/or could have an impact on the rental value of the premises.

The pooled contributions fund, on the other hand, is a sum paid by the lessee to a third party specified in the lease, who is tasked with managing this pooled fund and with undertaking promotional actions. The fund is independent of the rental relation. Hence, the lessor, who may also contribute to this fund, is discharged from all responsibility towards the lessee for marketing the centre. The question then arises as to the choice of third party.

In fact, assessing the structure best fitted to promote a shopping centre assumes a detailed analysis of the challenges for both the lessor and the tenants. ■

Tax regimes applicable to shopping centre economic actors

Shopping centres are real estate developments housing different operators, governed by legal and tax regimes that justify or require specific solutions with regard to the management needs of the centre.
Schematically, the owners (lessors or operators) and operator lessees jointly occupy the centre.
By law, joint owners (excluding shopping centres with a single owner) are grouped in one or more associations of co-owners.
The purpose of associations of co-owners is to maintain the building and administer the common areas, in accordance with its mission under article 14 of French law 65- 557 of 10 July 1965.
Associations of co-owners may form unions, in accordance with article 29 of the aforementioned law of 1965. These unions are endowed with civil personality, and their objective is the creation, management and upkeep of joint facilities or services in the common interest. The law grants the possibility of forming a union comprising a single association of co-owners and other members, such as construction and sale companies, non-trading real estate companies granting joint property rights, and other co-ownership structures.

While the exercise of this mission poses no particular difficulties in a conventional association of co-owners (according to the tax authorities, associations of co-owners are simply agents of the co-owners in the performance of their mission, and not non-profit organisations – Rep. Coussain 29 July 1991), the situation may be different in a shopping centre, where the administration of the common areas (mail, parking, access roads, etc.) may result in the association of co-owners taking actions that could be viewed as commercial, and therefore as income-earning activity, leaving the association liable for the payment of commercial taxes.

This is the position of the French Council of State (notably the judgements of 30 December 2009 no. 294933 and 294934 9th and 10th s.-s., Saint-Vincent Langevin association of co-owners, and of 7 December 2001 no. 212273 sect., Réaux association of co-owners), which examines the position of the association of co-owners in light of the criteria traditionally used by case law and the administration to assess the non-income-earning nature of private organisations other than companies engaged in a commercial activity.
To avoid this type of risk, and depending on the projects that the association does not wish to handle directly, or that it cannot handle without incurring tax risk, partner-type structures formed by the co-owners may be used. For example, they would be granted the enjoyment of some of the common areas, in general based on unfurnished leases concluded with the association of co-owners, and would then carry out the relevant commercial activities in the area in question. Here again, prudence is the order of the day with respect to the tax regime governing some associations of co-owners, especially when some of them are formed as companies not liable for corporation tax, and particularly as civil partnerships not subject to corporation tax, a company form that could be ill-suited to participation in commercial partnership structures.

"Operators, irrespective of whether they are owners or tenants, should organise to defend their material and moral interests, but also and especially to organise joint promotion actions."

Moreover, in view of the complexity of the organisation of some shopping centres under urban planning laws, specific legal structures may be suitable, such as AFULs (independent property management associations), whose primary objective is to carry out joint works to be made available to their members. These may include the construction, management, maintenance and replacement of infrastructures, including roads, public lighting and green areas such as often surround shopping centres. In principle, all of these works are funded by subscriptions from members, the owners of the lots.

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Authorised associations of co-owners have the legal status of public institutions, but AFULs have the status of private law corporations. The tax authorities do not treat them like non-profit organisations under the urban development code.

The fact remains that the administration intends to make AFULs liable for corporation tax in accordance with ordinary law, as well as for the *cotisation foncière des entreprises* (CFE - company property tax) and, where relevant, the *cotisation sur la valeur ajoutée des entreprises* (CVAE - tax on corporate value added) when they engage in income-earning activities.

This is the case, according to the administration, when the services provided by the AFUL to its members result in lower charges, the fact that the AFUL also acts in the collective interest and is not formed to make a profit notwithstanding.

Operators, irrespective of whether they are owners or tenants, may have to organise to defend their material and moral interests, but also and especially to organise joint promotion actions.

Such initiatives may include promotions during certain periods (holidays, sales, promotional days), the organisation of temporary mail facility rentals, management, with the agreement of the co-owners and their representatives, of parking hours in the parking lots, or the introduction of collective marketing systems.

These retailer groupings are usually in the form of associations governed by the law of 1901, or of economic interest groups.

According to consistent case law, retailers' associations are considered to be subject to corporation tax at the rate under ordinary law and are governed by the same fiscal obligations as the majority of companies, once their activities procure direct or indirect material profit for their members (Inst. 25 November 1980, 4 H-5-80; D. adm. 4 H-1161 no. 41 and 42, 1 March 1995; BOI-IS- CHAMP-10-50-10-30 no.110 and 120).

"Retailers' associations are considered to be subject to corporation tax at the rate under ordinary law and are governed by the same fiscal obligations as the majority of companies, once their activities procure direct or indirect material profit for their members."

The same is true for VAT, except specific exceptions. Retailers' associations are also subject to *the contribution économique territoriale* (CET – regional economic contribution) under the same conditions.

Economic interest groups (EIG) formed by the retailers to provide a number of services to their members have the advantage of constituting transparent tax structures (which means that their tax gains or losses are recognised directly by their members) provided however that pursuant to article 239 quater of the French General Tax Code they are formed and operate under the conditions set out in articles L. 251-1 to L. 251- 23 of the French Commercial Code.

The objective of the EIG is to facilitate or develop its members' economic activities, to improve or increase their income.

Hence its activity must be related to its members' economic activity and may not be ancillary to it. It may not substitute for it or constitute an independent activity. Otherwise, the EIG is subject to corporation tax.

The dividing line is never easy to comply with in the context of activities carried out in a shopping centre, which means that the formation of EIGs is actually fairly uncommon. ■

Shopping centres and local tax

Shopping centres are a very significant source of tax revenues for the local authorities in which they are located, which can create an appetite that is difficult to satisfy, with the rate and range of taxes continuing to increase.

Shopping centres generate a range of local taxes, such as the property tax (TF), the company property tax (CFE), the household waste removal tax (TEOM), the tax on corporate value added (CVAE), the tax on commercial areas (TASCOM), the local tax on outside advertising (TLPE), the tax on commercial premises in the Paris region, and very soon, the storm water tax, calculated based on the area of the parking lots and roof.
Generally erected in areas devoid of commerciality, shopping centres act as magnets for the creation of economic activity where previously there was none, thereby generating significant tax revenues for local authorities not accustomed to managing this fiscal manna.
Taxation abhors a vacuum, and local authorities have demonstrated great imagination in finding additional expenditure. Few among them have not offered reduced tax rates to take advantage of these new arrivals.
In general, the question soon arises as to the property valuation of the buildings used as the basis for the calculation of the TF, TEOM and CFE taxes. Using the 1970 revised land registry values in 2013 yields property valuations disconnected from the realities of the market. Moreover the archaism of the applicable rules encourages the tax authorities to skirt them in producing valuations.
It took 11 years for the courts to accept that the Evry 2 shopping centre was not comparable with Parly 2 in Chesnay, but rather with the Trois Fontaines centre in Cergy-Pontoise, much to the mayor's surprise, since he estimated that the revised valuation would fall short of his requirements to fund the public expenditure commitments that had been based on the previous erroneous valuations.
It is high time that the current overhauled land registry values were applied.

“The area of shops' external signs are monitored by the local authorities, who have the option to automatically tax external signage for "commerciality".”

The revision is expected to elicit a range of reactions, since recourse to the 2013 rental market should result in substantial increases, which should be tempered by the neutralisation factor for each local authority.
The practice of applying variable rents based on revenue for shops in shopping centres will have an inflationary impact not only on future valuations, but also on the value added used to calculate the CVAE.
Local authorities claim that they have little control over the amount of tax revenues since the abolition of the business tax, the property value imposed for the CFE remaining stable. They have therefore turned their attention to new local taxes, namely the TLPE and TASCOM.
The area of shops' external signs are monitored by the local authorities, who have the option to automatically tax external signage for "commerciality".
Some have even been taxed for signs indicating the exit, opening hours, etc.
Audited by the tax authorities since 2010, the TASCOM is increasingly the subject of checks. It is not unusual for the tax authorities to question the exemption granted to shops established prior to 1 January 1960, requesting retailers to provide proof in 2013 that the shop existed at the address at the end of 1959. Evidence is very frequently rejected by the authorities, including for example a copy of the telephone directory for 1959.
Extra vigilance is required in the matter of local taxes to contain soaring costs in a sector that does not have the option to relocate. ■

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Shopping centre transactions: a very diverse range of tax situations

The fiscal parameters of the acquisition of real estate located in a shopping centre may represent a major factor in the negotiations, depending on the conditions of ownership of the asset.

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There are a number of possible forms for the acquisition of a co-ownership lot in a shopping centre, in respect of both the identity of those involved (institutions, private individuals, owner-operators or investors) and the holding structures.

In some cases, due to the taxation of the capital gains on the transaction, the vendor may decide to sell a company that holds the assets, instead of selling the goodwill and/or the premises. Two types of situation may arise in this case.

In the first, the vendor sells shares in a partnership which is not liable for corporation tax and owns the premises, e.g. a real estate investment trust (SCI). Here, the main topic for discussion on the tax side would be the transfer duties on the sale of shares in companies investing predominantly in real estate, levied at 5%. As at 1 January 2012, the tax base for the calculation of these transfer duties is no longer the sale price of the shares but the actual value of the company's real estate assets, less only the liabilities assigned to the acquisition of these assets, plus the actual value of the company's other gross assets (article 726 II of the French General Tax Code). This definition, on which the tax authorities have yet to officially comment on, is flawed on a number of counts (for example, the incorporation of the company's circulating assets, but not its current liabilities), and introduces a number of uncertainties (e.g. the need to accurately retrace the financing and refinancing of the acquisition of the building; the uncertain situation of the debts used to fund works), which could influence the purchaser's perception of the acquisition cost.

In the second situation, the vendor sells securities in a company subject to corporation tax.

> ***"In some cases, due to the taxation of the capital gains on the transaction, the vendor may decide to sell a company that holds the assets, instead of selling the goodwill and/or the premises".***

This type of acquisition is also subject to transfer duties at 5%, if the company only holds the real estate asset, or if it also holds the goodwill, but the actual value of the goodwill is less than the value of the premises.

The purchaser is then faced with the same uncertainties outlined for the first situation, with respect to the tax base for the calculation of the duties. The unrealised tax on the building held by the company must also be examined.

This is often posted to the company's assets for a low historic value, and amortised for the most part. Therefore, the purchaser cannot recognise a capital cost allowance for the cost of the acquisition and, if the building is sold by the company, the purchaser would be liable for tax on the capital gains well above the gain actually realised. This potential penalty could not be eliminated by prior restructuring (for example the liquidation or merger of the acquiree), unlike what is permitted in principle by the tax rules applicable to partnerships not liable for corporation tax ("Quémener" case law).

The purchaser should therefore negotiate a discount on the acquisition price of the securities to take account of this underlying cost. From this point of view, the purchaser would be in a better position if they were covered by the exemptions granted to listed real estate investment trusts (SIIC), according to which they could tax the unrealised gain on the building at the lower tax rate of 19% (instead of 33 1/3%) if they opted for the target under this SIIC tax regime (article 208 of the French General Tax Code), thereby reducing the discount to be negotiated. ■

Shopping centres: how to invest in Germany

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In Germany, the acquisition of premises in a shopping centre is one of the most complex real estate transactions, and we do not intend to cover all the problems involved in this newsletter. We will simply confine ourselves to examining a number of the tax aspects - both in Germany and in France - to consider when investors resident in France purchase a real estate asset intended to house a shopping centre in Germany.

German tax aspects

The acquisition of a German real estate asset is subject to registration duties of 3.5 to 5.5%, depending on the Land in which the building is located. The same principle applies to the sale of securities in companies that own a property. Hence, the direct or indirect transfer of at least 95% of the shares of a partnership to new partners over a period of five years, or when at least 95% of the shares in a company that owns a building are owned by the same shareholder, are both situations subject to transfer duties.

The duties are calculated based on the market value of the buildings, or in the case of a transfer of securities, on a specific tax value, which is often less than the market value. Generally speaking, the sale of a building is exempt from VAT in Germany, except when the vendors chooses the option when the asset is sold to an entity that is liable for VAT. If the building sold is already rented, the sale falls outside the scope of VAT, and therefore the option is not available. In principle, individuals and legal entities not resident in Germany are subject to the same taxes as German residents. Accordingly, for individuals, income from property is taxed according to the income tax scale, i.e. at a rate ranging from 14.77% (for an annual income of more than €8,004) to 47.47% (for an annual income in excess of €250,731). The tax rate is 15.82% for companies.

If the income from property can be deemed commercial income, the business tax (from 7% to 17.15%) will also be payable, depending on the location of the shopping centre.

As a general rule, income from property and real estate capital gains are not considered to be commercial income in Germany. However, when the owner is engaged in ancillary commercial activities (services to lessees, such as management of a food service outlet or an 'information booth'), the business tax is payable. The same applies to the construction or expansion of a shopping centre followed by its resale within five years. Saving exceptions, the tax is also due when the beneficiary entity legally falls within the scope of the commercial income tax system (business corporation or commercial entities). For individuals, the business tax is charged against income tax, which is not the case for business corporations. In addition, non-resident investors who do not have a permanent establishment in Germany are not liable for the business tax.

Avoiding payment of the business tax is one of the main difficulties for foreign investors acquiring shopping centre properties in Germany. Using non-commercial entities is a possibility in cases where there is a risk of a permanent establishment in Germany (for example, if major construction or reconstruction is required). Conversely, a foreign business corporation or partnership offers the best option if there is no risk of forming a permanent establishment and if the owner is engaged in commercial activities (in addition to simply leasing the building). The taxable income is generally determined by deducting the operating costs, financial expenses and amortisation expenses from the rental income. The German 'interest barrier' limits deductions of financial expenses, i.e. interest is deductible if it is under the annual ceiling of €3 million, or for the surplus, up to 30% of the company's operating income. Amortisation can be applied only to the value of the building at a rate varying between 2 and 3% depending on the building's use and age.

For individuals, capital gains on real estate are taxable in Germany under the conditions of ordinary law, if the building is owned for a period of less than 10 years. After this time, the capital gains are exempt, unless the building is attached to a permanent establishment in Germany, or if the foreign entity is comparable to a cooperative, a retirement fund or a German mutual insurance fund.

When the capital gains are realised by a commercial entity, a specific provision is possible to neutralise the tax on the capital gains, the amount of which will be deducted from the cost price of a replacement asset, in the case of re-investment within four years. Lastly, the sale of shares in a German partnership is deemed to correspond to a partial sale of the real estate asset by the partner in question.

French tax aspects

Pursuant to the combined application of Articles 3 and 20 of the tax treaty between France and Germany, income and gains from real estate assets located in Germany are only taxable in Germany[1] .

In the case of the direct acquisition of a building by an individual resident in France, the property tax is levied at the German income tax rate under the conditions of ordinary law, while the capital gains could be exempt after the property is held for a period of 10 years. In the case of the direct acquisition of a German building by a French business corporation, it will be liable for corporation tax in Germany on the rental income, even in the absence of a permanent establishment, as well as for capital gains tax, unless they are reinvested within four years.

If a German partnership is an intermediary, the share of income attributable to each partner (individual or company) will be taxed in Germany in their name, including in the absence of any actual distribution of income. Such distribution is not normally taxed in France. The capital gains on the sale of the shares is also taxable in Germany. Article 4 § 3 of the tax treaty provides that a partner's share in the profits of a company formed as a partnership is only taxable in the State where the company has a permanent establishment, and only in proportion to that partner's entitlements to the establishment's profits.

Pursuant to article 7 of the treaty, income from the transfer of a share in a business corporation is only taxable in the State where the transferor is resident. There are no exceptions in the treaty for companies investing predominantly in real estate. The sale by a French investor of securities in a company investing predominantly in real estate is only taxable in France by virtue of this stipulation.

If the investor is an individual, the capital gains will be taxed according to French income tax rates (marginal rate of 45%), with no rebate for a holding period, in principle. If the French investor is a business corporation, the capital gains will be liable to the full corporation tax rate (article 219 I a sexies-0 bis of the French General Tax Code). ■

[1] *Tax levied in France with the tax credit equal to French tax.*

Not all lessee payments are taxable property income

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Lessees may pay amounts to lessors as admittance fees or compensation, in addition to rent payment. For tax purposes, these sums may not be considered as payment for the occupation of the premises.

In this case, they may not be taxable, at least when the lessor is subject to the property tax rules.

Recent case law has provided a timely reminder that, except for subsidies and allowances received to finance tax-deductible expenses, taxable income from property is restricted to the amounts a lessor may receive in payment for the "property granted" and that "neither the purpose nor the effect" of the provisions of the tax law are "to allow all amounts paid to an owner by virtue of their ownership rights to be characterised as income from property" (French Council of State, 21 November 2012, no. 329345).

Indeed, the lessee may have to compensate the lessor for damages, notably for depreciation of the lessor's assets, or may have to purchase a right heretofore possessed by the lessor.

Hence where i), at the end of the lease, the lessee whose fixtures and fittings, erected by him during the term of the lease, obstructed the view of the lessor's adjoining apartments, or ii) the lessee who, on taking over the lease, had demolished the existing buildings in a shopping centre that was in good condition (in accordance with the terms of the lease), both cases were recognised as having depreciated the lessor's property and the corresponding compensation was ruled not taxable for the lessors. At the end of the lease, the same tax treatment may apply to the amounts for the restoration of the premises paid by the lessee released from his contractual obligation to restore the premises to their previous state, on the express condition that, especially by their specific nature, the undemolished works result in actual depreciation of the lessor's building.

Similarly, when the amount is paid pursuant to a ruling of the court, in compensation for damages suffered by the owner, it is deemed to be damages and interest. As such, the portion in excess of the rent payment is not taxable. In principle, although the lessee of a new lease acquires the right to the commercial property, the admittance fee paid to the lessor on this occasion constitutes a rent supplement, once the agreement of the commercial lease does not in itself result in the depreciation of the premises leased. But, clauses in a lease contract that impose contractual requirements that exceed the usual clauses of a commercial lease, such as a longer term (30 or 40 years for example), without granting the lessor the option of early termination, are considered such as to depreciate the lessor's property. In more general terms, the lessee and lessor may be contractually bound by other agreements, in addition to the lease.

"The lessee and lessor may be contractually bound by other agreements, in addition to the lease. "

The lessee may also acquire a right heretofore possessed by the lessor. The same holds true for promises of sale for shopping centre premises, granted ahead of time to the lessor by the public development entity.

The compensation paid on resale to lessees occupying shopping centre premises was held not to constitute an additional payment for their occupation, but rather the transfer price of the promises of sale.

It is in the lessor's interests to first identify all damages caused by the lessee, or all rights transferable to the latter, since they would give rise to a separate payment, which would not be treated as taxable income from property. ■

The French Court of Appeals upheld the right of a member of an EIG to withdraw

Article L. 251-9 of the French Commercial Code recognises the right to withdraw of members of an economic interest grouping (EIG), a vehicle that can be used between retailers in shopping centres. Any remaining residual doubt as to the imperative nature of this article has been totally removed by the Court of Appeals (*Cour de cassation*), in its case law in principle, dated 20 March 2012 (Court of Appeals, Commercial Chamber, no. 11-11-097). Much to the regret of EIGs, the Court's position has the merit of clarity: the right of withdrawal is a public policy right, exercised with no deadline, insofar as the formation agreement does not restrict withdrawal by the grouping's members. This ruling also has the advantaging of clarifying article L. 251-9 paragraph 2 of the French Commercial Code, which provides that "*any member of the grouping may withdraw in accordance with the conditions specified by the agreement, provided that they have fulfilled their obligation*".

Prior to this case law, the question arose as to members' rights in the absence of these conditions specified in the grouping's formation agreement. The Court of Appeals returns to the two aggregate requirements in article 251-9 paragraph 2:

– first that members of the EIG must comply with the withdrawal conditions specified in the formation agreement. The Court of Appeals specifies that when no withdrawal conditions are stated in the formation agreement, the right of withdrawal may be exercised with no deadline. The imperative nature of article L. 251-9 paragraph 2 contradicts the EIG's assertion that a retailer wishing to withdraw from the grouping could not do so before the end of the lease for the shopping centre premises in which the member's business is operated, without payment of financial consideration. The existence of a lease contract between the member withdrawing and the shopping centre in the framework of the activities carried out in the EIG was not seen as admissible by the judges, the explanation for which lies in the privity of contract, and more especially in the appeals judges wish to release the EIG members from all obligations not set out beforehand in the formation agreement;

– second, the legislature makes the withdrawal of a member of the EIG conditional upon prior fulfilment of their obligations. Besides a small explanation by the Court of Appeals in a ruling dated 24 September 2003 (Court of Appeals, Commercial Chamber, no. 1344), indicating that these obligations relate to those that are certain in their principles on the date of withdrawal, this requirement does not pose too many difficulties.

"The right of withdrawal is a public policy right, exercised with no deadline, insofar as the formation agreement does not restrict withdrawal by the grouping's members."

Note however that a member of a civil partnership is not covered by this rule. Article 1869, paragraph 1 provides that a unanimous decision of the partners is required to enable a member to withdraw, failing the inclusion of provisions in the partnership agreement on the conditions for withdrawal.

Less extensively published case law, but which nonetheless tends to grant rights to the members of an EIG, is the ruling of the Rouen Administrative Court of 22 June 2011 (1st Civil Chamber). In this judgement, the judges ruling on the merits of the case found that the fact of "invoking breach of the rules of the formation agreement in support of an application to nullify a resolution of the annual general meeting constitutes the exercise of a right granted to all EIG members and may not be described as abuse of minority position".

In the background to this case law creating rights for EIG members, or at least recognising the rights that heretofore may have been open to debate, is a warning to EIGs to increase their vigilance.

We can only advise authors of an EIG's formation agreement to take into account the possible withdrawal of the members, the terms and conditions for such a withdrawal, to include the obligation to provide prior notice or to obtain the prior authorisation of the grouping's members and to detail members' obligations.

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Towards a revival of beneficial ownership?

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1. Court of Appeals. 3rd Civil Chamber, 19 Sept. 2012, no. 11-15.460.a

Recourse to conventional usufruct benefiting a legal entity is uncommon. The thirty-year limit provides a partial explanation for this disaffection. Nonetheless, in a number of situations, this instrument provides an objective alternative to a long-term lease.
No particular difficulties arise as to the distribution of repair and maintenance charges between the bare owner and the usufructuary. The rules for the division of charges are not public order rules; therefore they may be adapted.
Moreover, in order to split obligations between lessee and lessor, practice derogates from customary rental law, whose obsolescence makes it unsuitable, and transposes some of the distribution rules provided in the French Civil Code between the usufructuary and the bare owner. Hence, there should be no substantial difference between what would rest with the usufructuary and with the lessee of the same asset, in view of how this point is most commonly drafted in leases. On the other hand, the usufructuary's and the lessee's (not allowed to make improvements) positions differ significantly as regards sub-leases and transfers (free by their nature), occupancy and resolution of their right in the event of breach of their obligations.
Often, recourse to this right was not seen as an option, especially due to the uncertainty surrounding ownership of constructions during the term of the usufruct. A particular fear was that these constructions would immediately be incorporated as part of the bare owner's property and that the usufruct would extend to them. The potential complexity of the situation thus created was sufficient to dissipate all vague desires to constitute such a right in the event of a construction project by the usufructuary.
Hence, we see the full scope of the Court of Appeals's (*Cour de cassation*) judgement of 19 September 2012[1], in which it stated that accession does not immediately operate in favour of the bare owner of the land, who shall take possession of the constructions only upon the extinguishment of the usufruct. Throughout the term of his right, the usufructuary-builder retains ownership of his investments, in exactly the same way as a lessee-builder.
The advantage of this solution exceeds the sole area of the transmission of assets without valuable consideration (the context of the ruling in question), and should enable transactions using this technique between owners of shopping centres and operators who may have to build new premises (extension, raising, etc.) as an alternative framework to commercial leases. ■

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