OPTION
FINANCE

Monday 20 June, 2011

REAL ESTATE NEWSLETTER

Dossier on
A guide to the sale and acquisition of real estate

Recent developments

Editorial

We have decided, for this 21st issue of the real estate newsletter, to return to our roots and to thus devote the entire issue to the topic of sales and acquisitions of real estate assets. Indeed, a deed of purchase or of sale remains, in despite of an extremely buoyant market and of the general feeling of a certain standardisation or even simplification of the deeds which are currently executed, a complex operation which is liable of involving multiple tax and legal mechanisms and reflective input.

Selling or buying a real estate asset, today implies first of all extensive knowledge of the property, hence the necessity in particular to establish a great many surveys, to provide the contents thereof or failing which to assume the consequences thereof. But such also implies reviewing the conditions of occupancy of the building, infringements of disclosure obligations and invalid occupancy being likely to entail major consequences in law, which may go as far as avoidance of the sale. Hence the particular interest that lies in addressing these issues.

However it is also making sure that the asset is not acquired by a third party. This encompasses the whole issue of pre-emption rights, which have continued to develop, both with respect to location and to consistency, and the inobservance of which can entail “radical” consequences.

It is also making sure that one buys or sells at the right price, and for this purpose implies being able, as the case may be, to reserve the right to buy. To these effects, parties have at their disposal a certain number of legal devices, which take the form of additional price payment or price revision clauses, of immobilisation indemnities to be paid within the framework of call option agreements. Finally, such implies, once having become the owner, the necessity sometimes to have the asset vacated, and to thus end ongoing leases, by paying in this respect, eviction indemnities or termination penalties.

We will therefore examine successively those obligations which are binding on vendors in matters of surveys and the related consequences in law, the interest that lies in checking the conditions of occupancy of the building, the pre-emption regime, and finally the legal and tax treatment of additional price payment and price revision clauses, and of immobilisation indemnities, eviction indemnities or termination penalties.

Purchasing real estate often also implies an obligation to co-inhabit and we have therefore decided to examine three innovative rulings in matters of co-ownership law.

Finally, and as always, buying or selling a real estate asset, will necessarily involve the question as to what tax system applies to the sale and to the parties. Our readers will find a summary table of all the taxes related to sales of buildings both in matters of direct taxation, registration duties and VAT and a few words concerning international tax aspects of real estate.

The purchase or sale of real estate is a long and winding road. ■

Richard Foissac, partner

The underlying interest of checking the conditions of occupancy of a building prior to its acquisition

By **Jean-Luc Tixier,** partner, specialized in real estate law and public law. He provides advisory services to a great many commercial and industrial corporations, as well as property developers in matters of planning, construction, sales and rentals of buildings, long-term leaseholds and building leases. He lectures at Paris University - Paris I.
jean-luc.tixier@cms-bfl.com

and by **Sophie Talpe**, lawyer specialized in real estate law. She provides both litigation and advisory services in matters related to the law of commercial leases and construction law.
sophie.talpe@cms-bfl.com

Investors looking to purchase premises for a use other than for a residential use must check, before signing a preliminary agreement, whether this use has been authorised. Indeed, cases where the effective occupancy of a building does not comply with articles L.631-7 et seq. of the Construction and Housing Code are quite common in practice. However, compliance of the effective occupancy with the aforementioned rules is a condition to the validity of a sale and to the utilisation of the premises.

The change of use of a residential building into another use is subject to a regime of prior authorisation governed by articles L.631-7 et seq. of the Construction and Housing Code when the building is situated in Paris or in those municipalities listed under said article of the Hauts-de-Seine, Seine-Saint-Denis and Val-de-Marne counties or yet still in cities of more than 200,000 inhabitants and in other municipalities "*by decision of the administrative authorities enacted on the proposal of the mayor*" (article L.631-9).

Invalid occupancy having regard to the aforementioned provisions is sanctioned severely. Those deeds (sales but also leases) concluded in violation of said article are null by absolute nullity (article L.631-7-2, subparagraph 5). Such nullity may be invoked by a third party to the deed such as a co-ownership board[1], but also by the counterparty who has caused such invalidity[2]. Any party in infringement of article L.631-7 of the Construction and Housing Code will be exposed to a civil fine of 25,000 Euros (article L.651) and may be ordered to a "forced reconversion" of the premises illegally occupied into accommodation[3].

> "***Checking the compliance of the building's occupancy will enable potential future uses to be identified."***

Moreover, the occupancy of a building within the framework of a commercial lease can not validate an invalid commercial occupancy[4] even where this occupancy is a longstanding one, the commercial character of premises not being able to be acquired by means of acquisitive prescription (article L.631-8)[5]. Purchasers must therefore check, when necessary, whether the commercial occupancy has been authorised by the city hall or by the prefecture (for authorisations prior to 1st April 2009)[6], but also whether this authorisation is attached to the beneficiary thereof or to the building, depending on the date of the authorisation and depending on whether or not the authorisation was combined with a compensation[7] or granted within the framework of works subject to a planning authorisation or to a prior declaration of works (article L.631-8).

The verification of compliance of the building's occupancy with article L.631-7 will also enable potential future uses of the building to be identified. If effective occupancy is valid, it will be possible to envisage development projects on the building implying a change of assigned use. Verifications prior to the sale will enable the examination of the complexity and the cost of the change of assigned use. In Paris changes of accommodation into another use can involve providing other premises "returned to housing" in compensation for the same or double (in "*reinforced compensation sectors*") the floor area[8].

The purchaser of a building whose use is invalidly assigned will be exposed to the aforementioned sanctions without being able to sell or rent the building for a use other than for accommodation, save validating the existing and effective occupancy before envisaging a change of use. ■

[1] *Cour de cassation*, 3rd civil chamber, 15 January 2003, AJDI, 2003.426
[2] *Cour de cassation*, 3rd civil chamber, 24 June 1992, Bull. civ. 1992 no.219
[3] For a recent example : Paris Court of Appeals, 1st February 2011, no.10/13565
[4] Paris Court of Appeals, 15 April 2010, no.09/08921
[5] See also circular no.2006-19 of 22 March 2006
[6] Law for the acceleration of public and private construction and investment programs no. L 2009-179 of 17 February 2009
[7] Final authorisations granted subsequently to the entry into effect of the order of 8 June 2005 (on 10 June 2005) are attached to the building when combined with a compensation.
[8] Municipal regulations of the City of Paris dated 16 December 2008 and 7 and 8 February 2011.

Pre-emption, a contingency to be reckoned with

By **Vanina Ferracci,** Lawyer specialising in public law. Vanina focuses on planning and urban development law and has provided advisory and litigation services, within the context of a longstanding relationship, both to corporations and to local authorities
vanina.ferracci@cms-bfl.com

and by **Julia Pelpel-Moynot**, lawyer specialized in real estate law. She is involved in the various aspects of real estate law (commercial leases, co-ownership, construction, sales) providing both advisory and litigation services. She lectures on the topic of commercial leases at Paris University - Paris I and X.
julia.pelpel-moynot@cms-bfl.com

Whereas the parties have reached an agreement regarding the terms of the sale, the scenario can be entirely re-written due to the exercise of a pre-emption right where that party exercising this right will evict the potential purchaser, whilst being entitled to offer a lesser price.

What is more, pre-emption rights have developed considerably over recent years, affecting assets of greater variety, both with regard to location and consistency. Various verifications prior to any sale are therefore essential, both for that party looking to sell and for the party hoping to purchase.

As concerns the urban pre-emption right (DPU) and the pre-emption right in a Deferred Development Zone or ZAD (or within a provisional perimeter), the following are potentially subject to pre-emption:

- assignments for valuable consideration of buildings or groups of corporate interests entitling to the allocation of title or enjoyment to a building or to part of a building, whether or not developed;
- assignments of joint interests when they concern a building or part of a building whether or not developed (save the case of assignment to a joint owner);
- rent to buy contracts.

On the other hand, a whole series of specific cases are excluded from the scope thereof, plus various exclusions specific to the DPU (professional or mixed use apartments or premises situated in a building under co-ownership for more than ten years; shares or partnership shares of a tax transparent real estate company (*société d'attribution*) entitling to the allocation of residential or professional use premises; buildings developed and completed for less than ten years; assignments of the totality of the partnership shares of a real estate partnership whose assets are made up of a single property unit, whether developed or not).

However, local authorities can decide to submit these exclusions to pre-emption via a substantiated deliberation. It is therefore important, when the transfer concerns such assets to determine whether a reinforced DPU has been instituted.

"Once the necessity to clear a pre-emption right has been confirmed, particular care will have to be taken with regard to the declaration of the intention to dispose of property."

Moreover, certain movable assets, such as a business concern, a crafts concern and commercial leases, are now capable of being pre-empted where the municipality has instituted a perimeter for the protection of trades and crafts.

We would specify that, within these perimeters, can also be pre-empted land which bears or which is intended to bear retail ventures with a sales area comprised between 300 and 1,000 m². For these cases it is the very objective of the assignment which carries the necessity to clear the pre-emption right.

Once the necessity to clear a pre-emption right has been confirmed, particular care will have to be taken with regard to the declaration of the intention to dispose of property (DIA).

The DIA constitutes indeed a tender to contract: if the authority holding the pre-emption right exercises its right, for the original price and on the original terms, the sale will then be final and binding. Thereafter, any component of the sale which should not have been mentioned therein (for instance insurance broker's fees) will not be enforceable against it.
In addition, any errors in the DIA affecting the identity of the owner or the terms of the disposal can entail the annulment of the pre-emption decision and, as the case may be, the reassignment of the asset and of the price.

Finally, the administrative authorities can tender the acquisition at a different price, determined by the Estates Department (*Domaines*). In this case, the vendor may either accept this amended price, or waive the right to the sale, or maintain his price. However, the period that he will benefit from for this choice is only two months, which is relatively short for a decision, all the more so that the absence of response within the allotted period will operate a waiver of the sale.

This is why, before deciding to sell, we recommend checking whether a pre-emption right exists and, if one does exist, to have the asset appraised beforehand, so as to be in a position to make an adequate decision in a timely manner. ■

Can the validity of a real estate sale be called into question for failure of disclosure?

By **Julia Pelpel-Moynot**, lawyer specialized in real estate law.
julia.pelpel-moynot@cms-bfl.com

and by **Géraldine Machinet,** real estate Lawyer. Géraldine is focuses more particularly on the negotiation and drafting of legal instruments, providing advisory and litigation services in the various fields of private real estate law.
geraldine.machinet@cms-bfl.com

Vendors have to inform purchasers, whatever the credentials of the latter, of any and all defects which affect the building that it should be or that it should have reasonably been aware of. This can just as easily concern pollution of the soil (hydrocarbons, toxic emanations, etc), or of developed parts (asbestos, lead, etc), and the lack of any authorization whatsoever (planning or co-ownership related) or of compulsory insurance. And thus, whatever the use of the building.

To make sure that a minimum amount of information is effectively communicated to the purchaser, the legislator has kept on continually increasing the duties to disclose which burden vendors through the requirement to present various technical surveys. If most of these are not required for the validity of the contract, in the event of infringement, the deed of sale may nevertheless not come through unscathed.

In the event of failure to annex the inventory of natural and technological hazards to the deed of sale, article L.125-5 of the Environmental Code provides for a radical solution, as the purchaser will be entitled to seek rescission of the contract, that is to say its retroactive cancellation, or to apply to court for a reduction of the price.

In the absence of a survey related to lead, asbestos, termites or to gas, electrical and sewer facilities, at signature of the notarized deed of sale, the vendor may not be validly exonerated from the warranty for hidden defects (article L271-4 of the Construction and Housing Code). Indeed, in this case, the purchaser will have the possibility to bring a warranty claim for hidden defects against the vendor and thus, even if the sale contract includes a clause exonerating the vendor from such. This claim will enable the purchaser to return the building and to obtain a refund of the price (annulment action) or to apply for a reduction of the price (reassessment action), provided that the action is brought within a period of two years as from the discovery of the defect and that it is proven that the building is unsuitable for its intended use or of a lesser value.

"If the legislator has provided for legal effects in the absence of technical surveys, nothing on the other hand has been contemplated where the survey delivered is inaccurate."

Only the failure to annex the energy performance survey to the deed of sale goes without legal sanction, the latter being provided for information purposes only.

If the legislator has provided for legal effects in the absence of technical surveys, nothing on the other hand has been contemplated where the survey delivered is inaccurate. In this case scenario, the standard rules of contracts shall be applied. The purchaser will be entitled to seek nullity of the sale on the grounds of vitiated consent (article 1116 of the Civil Code) provided that an error on the material qualities of the asset or the existence of fraudulent tactics or silence is demonstrated. Such action for vitiated consent must be brought by the purchaser within a period of five years as from the discovery of the vice. However if the vendor's erroneous data comes under the ambit of a hidden defect to the extent that this makes the building unsuitable for its intended use or that it reduces the value thereof, the warranty covering such defects will then be the sole legal grounds open to the purchaser, the latter not being entitled to invoke the benefit either of an error on the material qualities of the item sold or of the non conformity of the object sold (*Cour de cassation*, 3rd civil chamber, 7 June 2000, no.98-18966). Conversely, if the vice is not a nullifying vice, the purchaser will be entitled to invoke the benefit of the non conformity of the asset or of error regarding the item sold.

All in all, the legislator has sought to increase vendors' obligations for transparency. Accordingly, the legal certainty of legal instruments implies providing the purchaser access to all of the information in the possession of the vendor, it being up to the purchaser to know how to decipher these and to draw consequences from the documents communicated to him. ■

Title holding trusts: principle and benefits

By **Gregory Benteux**, lawyer in charge of the Financing and Structured Debt department. He specializes in structured financing and securitization transactions.
gregory.benteux@cms-bfl.com

and by **Alexandre Bordenave,** lawyer, *secrétaire de la conférence* (Barrister's association renowned for its mooting activity) at the Hauts-de-Seine bar. He is specialized in structured financing and securitization transactions both domestic and international.
alexandre.bordenave@cms-bfl.com

Trusts are defined by article 2011 of the Civil Code as "a transaction under which one or more trustors transfer assets, rights or securities, […] present or future, to one or more trustees who, keeping these separate from their personal assets, will act with a specified objective in favour of one or more beneficiaries". This instrument enables in particular the transfer, as security, of a real estate asset. The principle is quite simple:

- a debtor transfers, in a trustor capacity, one or more buildings to a trustee, who will hold them separately in a dedicated trust estate;
- this trust transfer is performed as security for an "obligation". The law does not define in any further detail what type of obligations are concerned, which leaves room for a broad use of the trust mechanism. Whereas the lien under article 2374-2° of the Civil Code benefits money lenders only, trusts provides security for a greater number of creditors, the relations between these creditors being organised around a trust document;
- this trust document can provide that in the event of the debtor/trustor's failure to pay, the buildings under trust can be transferred to the trustee (who shall then be able to freely dispose of these in the interests of the beneficiaries), be sold (all or part of the price being remitted to the trustee), or if the trustee is the secured creditor, become the property of the latter.

On the other hand, once all of the secured obligations are extinguished, the buildings remitted under the trust will return to the estate of the trustor.

"Title holding trusts represent significant potential for innovative solutions in structured finance."

The placement of real estate assets under a title holding trust represents indisputable legal benefits:

- the law enables the trustor to retain the enjoyment of the real estate asset placed in the trust. In this case scenario, as regards buildings for a professional use, the law has expressly excluded any risk of requalification as a commercial lease. In the same frame of mind, the trustee has to report regarding his assignment to the debtor/trustor on the terms set out under the trust document (the trustor can thus appoint a third party in charge of ensuring the protection of his interests). In the event of misconduct with respect to the management of the trust estate, the trustee will be liable out of his own personal funds. To limit this liability from an operational standpoint, the trustee can delegate all or part of such management to a professional real estate asset manager;
- the balance which has been found between the interests of creditors and those of the debtor/trustor limits the effects of insolvency proceedings on the trust. The principle is that the trust document shall not be adversely affected by the commencement of insolvency proceedings (safeguard, judicial reorganisation or liquidation). However, when the debtor/trustor has retained by contract the use or the enjoyment of the assets placed in the trust, the effects of the trust are largely neutralized;
- the freedom left to the parties for the purpose of organizing the modus operandi of the holding trust and in particular the possibility to "reload" the trust (that is to say to provide that it may benefit new creditors) enables the creation of a reserve of assets, isolated from the rest of the trustor's estate and backing the financing of its current and future projects.

An efficient tool, title holding trusts represent significant potential for innovative solutions in structured finance. It remains that the costs in connection with the implementation of a technique which is new and based on a transfer of assets restricts its use to situations which justify high technical added value, such as obtaining a credit facility in a critical financial situation or organising a real estate portfolio to finance successive transactions of a different nature. ■

Table of taxation for sales of buildings

By **Agnès Rivière-Durieux**, lawyer, **Gaëtan Berger-Picq** and **Christophe Lefaillet**, partners

<table>
<tr><th colspan="6">Regime of income tax / corporate income tax on sales of buildings</th></tr>
<tr><td>Assignment by an individual or an SCI (real estate partnership) not subject to corporate income tax of which an individual is a partner (taxation in the name of the individual of the share-fraction of capital gain realized by the SCI corresponding to his interests in the SCI)</td><td colspan="5">Articles 150 U et seq. of the Tax Code: taxation of the capital gains at the rate of 31.3% (19% of income tax and 12.3% of social deductions).
Exemptions: main place of residence, housing accommodation in France of non residents, expropriation under condition of re-use, replotting, sales which do not exceed 15,000 Euros, pensioners or invalids of modest means, damaged building, building intended for social housing (until 31/12/2011), sharing of a marital undivided ownership or of a succession and assimilated systems.

Capital gains:
- are equal to the difference between the price of sale net of expenses and the purchase price itself marked up by the acquisition expenses and by certain expenditure for works;
- are the subject of a 10% taper relief per year of holding beyond the fifth (full exemption vested on the outcome of a 15 year holding period) and of a fixed relief of 1,000 Euros per assignment.</td></tr>
<tr><td>Assignment by a real estate professional (subdivision developer, real estate dealer, property developer)</td><td colspan="5">Legal person subject to corporate income tax: the profits are taxed at the standard rate (33.3%).
Individual entrepreneur or legal person not subject to corporate income tax: progressive income tax rate schedule.</td></tr>
<tr><td>Assignment by an operating business (building entered as a fixed asset)</td><td colspan="5">Legal person subject to corporate income tax: the capital gains are taxed at the standard rate (33.3%), save application of the reduced rate of 19% in the event of assignment prior to 01/01/2012 to a special status property company, to a Low Rent Housing agency or a real estate financial leasing corporation renting it out to a special status property company (Tax Code, article 210 E and 219 IV).
Individual enterprise or legal person not subject to corporate income tax: regime of short term professional capital gains (progressive income tax rate schedule) and long term (28.3% with social deductions).
The long term capital gains of buildings assigned by an enterprise to its own operation are taxed after applying a 10% taper relief per year of holding beyond the fifth.
Lease-back: for assignments realized up until 31/12/2012, possibility to spread the capital gains over the term of the financial lease contract within a limit of 15 years (Tax Code, article 39 novodecies).</td></tr>
<tr><td>Landlords</td><td colspan="5">Non professional furnished renters: regime of capital gains of individuals (see above).
Professional furnished renters: regime of professional capital gains. If the activity has been conducted for at least 5 years, total or partial exemption possible depending on the amount of receipts (average over the last two years inferior to 126,000 Euros Excl. Tax).
SIIC: exemption under condition of distribution of 50% of capital gains.
Low Rent Housing corporations: exemption of transactions completed in respect of services in the general interests.</td></tr>
<tr><th colspan="6">Regimes of VAT and transfer tax on sales of buildings</th></tr>
<tr><td>Nature of the building</td><td>Assignment of a building completed for 5 years at most</td><td colspan="4">Assignment of a building completed for more than 5 years</td></tr>
<tr><td></td><td></td><td colspan="2">Standard regime</td><td colspan="2">Option for VAT</td></tr>
<tr><td>VAT</td><td>Yes
On the full price</td><td colspan="2">No
VAT exemption</td><td colspan="2">VAT on the full price or on the margin depending on whether or not the acquisition gave rise to a right to deduct VAT for the vendor</td></tr>
<tr><td>VAT adjustment with vendor</td><td>No</td><td colspan="2">Yes, as the case may be (period of 20 years)
The purchaser may deduct the VAT transferred by the vendor if it assigns the building to an activity giving rise to a right to deduct and if it is entered as a fixed asset in its accounts</td><td colspan="2">No</td></tr>
<tr><td>Tax on transfers for valuable consideration</td><td>0.715% on the price before tax if the deed includes a breakdown between the pre-tax price and VAT</td><td>5.09% on the price</td><td>0.715% on the price if the purchaser enters into the covenant to resell the building within 5 years or 125 Euros if he enters into the covenant to develop a new building within 4 years</td><td>5.09% on the price excluding tax, if the deed includes a breakdown between the pre-tax price and VAT</td><td>0.715% on the price excluding tax if the purchaser enters into the covenant to resell the building within 5 years and that the deed includes a breakdown between the pre-tax price and VAT or 125 Euros if he enters into the covenant to develop a new building within 4 years</td></tr>
<tr><td>Land registrar's fees</td><td colspan="5">0.10 % based on the same assessment basis as Tax on transfers for valuable consideration</td></tr>
</table>

Legal qualification of the immobilisation indemnity

By **Richard Foissac**, partner, specialized in tax matters, he deals in particular with acquisitions and restructuring of listed and unlisted real estate groups and provides advisory services in the context of their transactions. He lectures in tax law at the Universities of Paris I and Nice Sophia-Antipolis.
richard.foissac@cms-bfl.com

and **Sandra Kabla**, lawyer specialized in real estate law. She provides litigation, advisory, drafting and contractual negotiating services in the various fields of real estate and more specifically in the field of commercial lease litigation, for a client base of end user corporations and investors.
sandra.kabla@cms-bfl.com

Originally a Notarial practice, the immobilisation indemnity is often contemplated by the parties on the occasion of the signature of a call option agreement. In this type of agreement, the promisor covenants to sell but the beneficiary does not enter into a covenant to purchase. The latter benefits from the possibility to do so and will enjoy a time period in which to decide whether or not to purchase. The indemnity corresponds to a sum of money that the beneficiary of a call option pays over to the promisor and which will remain within the keeping of the latter where the beneficiary should not exercise the option.

The question arises, both from a tax and a legal standpoint, as to the nature of this indemnity and in particular as to whether this is in fact an indemnity. The stipulation of an immobilisation indemnity does not sanction the non-performance of an obligation as the beneficiary is free not to exercise the option. It is therefore not a liquidated damages clause within the meaning of article 1226 of the Civil Code, liable to be reduced by a Judge.

Despite its denomination, it has no indemnifying character and the beneficiary can therefore not avoid its loss on the grounds that the promisor has not sustained any harm, in particular if the latter should decide not to sell (*Cour de cassation*, 1st civil chamber, 5 December 1995, no.93-19 974).

The immobilisation indemnity is in fact considered to be the price of the exclusivity granted to the beneficiary of the call option (*Cour de cassation*, 1st civil chamber, 5 December 1995, no.93-19 974) and its purpose is to remunerate the promisor for the service rendered to the beneficiary by accepting not to sell the item concerned during the option period.

Finally, when the sale is concluded, the immobilisation indemnity will be offset against the purchase price. It shall then constitute a down payment on the price.

From a tax standpoint, the question as to the qualification of the immobilisation indemnity appears to be resolved, at least in matters of direct taxes, on account of the now settled case law of the *Conseil d'Etat*, for all indemnities deemed received in consideration for a call option agreement, a withholding to sell, or an exclusive option.

"Its purpose is to remunerate the promisor for the service rendered to the beneficiary"

For the defaulting beneficiary of the agreement, tax treatment shall not raise any particular difficulty. The indemnity paid is not deductible for a defaulting individual who is not acting within the framework of a professional activity. It is fiscally deductible, as a general operating expense, for a defaulting party acting within the framework of a professional activity to the extent where, on the one hand, the payment of the indemnity comes within the ambit of the normal course of management, that is to say that it is not unreasonably high, and on the other hand, where the conclusion of the call option agreement, or its non-completion are not contestable having regard to the interests of the business operation.

For the promisor, finding himself in a situation where he has to keep his property and where he has not sold it, the sum that he receives on this occasion from the defaulting beneficiary, does not have the nature, according to the *Conseil d'Etat*, of an indemnity. Such is deemed to constitute the remuneration of a service provided, that which consists of granting a right to purchase during a certain period, of covenanting not to sell the property during this same period, or even, but in different cases, of guaranteeing a price over a certain period. It is taxable under the category of non commercial profits.

The analysis as an indemnity is therefore not retained, even where the promisor could provide evidence of effective harm. It should be noted that for reasons related to community law, the administrative court of appeals of Lyon ruled in a decision of 31 October 2007 (no.06-525, 5th chamber, minister v. SA SICP Marcel Faure: RJF 4/08 no.420) that the sum of money denominated "immobilisation indemnity" stipulated in the sale of a building as being vested with the vendor in the event of failure to complete the sale, constitutes a lump sum indemnity paid in compensation of the harm sustained further to the default of the client, without any direct link with any service rendered whatsoever for valuable consideration and, as such, not subject to VAT. ■

Tax and legal regime of price revision clauses or additional price payment clauses

By **Richard Foissac**, partner, specialized in tax matters.
richard.foissac@cms-bfl.com

and **Laurent Toulze**, lawyer specialized in real estate law. He focuses on the various fields of real estate law (sales, leases, construction, etc.) and more specifically on drafting, advisory and litigation services.
laurent.toulze@cms-bfl.com

At the date of the sale of a real estate asset, the price is not always determined precisely. This is the case when the parties choose to stipulate a price revision clause or an additional price payment clause. Accordingly great care will have to be taken when drafting these. The terms of adjustment of the price must indeed be clearly specified in order, on the one hand, to avoid subsequent disagreements, and on the other hand and above all, to eliminate the risk of cancellation of the sale due to an undetermined price (*Cour de cassation*, 3rd civil chamber, 4 October 1989, Bull. Civ. III no.148). Moreover, the parties must sometimes ensure compliance with certain specific provisions, such as for instance in the case of the contract for the construction of an individual house for which the terms of revision of the price are defined stringently (article L 231-11 of the Construction and Housing Code).

There are also cases in which the price can be the subject of an alteration without such being contemplated in the contract, in particular in the event of hardship or of error regarding the capacity of the item sold. Thus, when the vendor has been deluded regarding the purchase price by a fraction of more than seven twelfths thereof, he will be able to initiate a rescission action on the outcome of which the purchaser will have the choice, either to return the building, recovering the price paid, or to keep the latter by paying an additional price (article 1681 of the Civil Code). Likewise, where the capacity of the property sold exceeds by more than one twentieth what is set out in the contract, the vendor can lead the purchaser to withdraw or to pay an additional price (article 1616 et seq. of the Civil Code).

French tax practice addresses these different situations pragmatically.

"French tax practice addresses these different situations pragmatically"

Thus, where the price of assignment can not be determined precisely at the date of the sale, the authorities consider that it is the responsibility of the tax payer to appraise such under his own responsibility, on account of the elements stipulated under the deed. In the event where the price of assignment is marked up or down in application of the contractual stipulations contained in the deed of assignment, it will be the responsibility of the tax payer to file at the tax receiving office of his domicile a rectifying return. He will then be taxed on the additional capital gain or will obtain a rebate on the tax settled at the time of the land registry formality (Guidelines of 4 August 2005, 8 M-1-05 no.25). The solution is identical where the seller is an enterprise.

Similarly, in matters of registration duty, where the final price of the sale will depend on events occurring subsequently to the conclusion of the contract, the transfer taxes will then be liquidated on the basis of a valuation to be provided by the parties. Additional duty will then become chargeable if the monies effectively paid exceed the amount of the initial valuation (D. adm. 7 C-1222 no.11, 1st October 2001).

However, to the extent where, on the one hand, article 683, I, subparagraph 2 of the Tax Code provides that duty on the sale of a building is liquidated on the basis of the price expressed under the deed, by adding all capital charges as well as all indemnities stipulated in favour of the seller, and that, on the other hand, the administrative authorities can reassess this price where it appears to them to be inferior to the effective fair market value of the building (article L 17 of the Tax Procedure Code), it results that if the fair market value of the building can constitute the assessment basis of tax when such is superior to the price, the price shall remain the basis for collection where it exceeds this effective value. ■

Eviction indemnity: tax treatment with variable geometry

By **Agnès Rivière-Durieux**, tax lawyer specialising on issues of income tax and corporate income tax related in particular to real estate.
agnes.riviere@cms-bfl.com

If the tax treatment of an eviction indemnity paid by an owner depends on circumstances and on the objectives pursued by the latter party, the regime of taxation of the indemnity received by a tenant subject to income tax depends on the nature of the loss indemnified.

In the event of refusal to renew a commercial lease, the owner has to pay the tenant an eviction indemnity equal to the loss caused due to the non renewal. This indemnity includes in particular the value of the business concern, reasonable moving and reinstallation expenses, as well as the expenses and transfer taxes paid for a concern of the same value (article L.145-14 of the Commercial Code). For the owner paying this, and subject to the payment being in line with the normal course of management, the qualification of the indemnity depends on his motives and on the possible simultaneousness of the eviction with the acquisition of the building.

Where the landlord/owner is an enterprise, the indemnity will be deductible from taxable income when the objective of the owner is to rent the building on more advantageous terms or to settle in there itself to conduct a business activity grossing an income which differs from that of the evicted tenant.

On the other hand, the indemnity will be a component of the cost price of an asset where the owner wants to repossess the premises in order:

- to sell them (mark up of the cost price of the building);
- to demolish them (mark up of the cost price of the land or of the new constructions);
- to conduct there the same activity as the tenant (price of acquisition of the customer base);
- to settle in there where the eviction takes place at the time of the acquisition (mark up of the cost price of the building).

The landlord, as an individual, may deduct the indemnity from its gross property income if the purpose of the indemnity is to vacate the premises in view of their re-rental on better terms. It should be noted that the deduction of eviction indemnities is not contemplated by article 31 of the Tax Code which lists deductible property expenses, but results from the application of the general principle of deduction of expenses contemplated by article 13-1 of the aforementioned Code.

"For the owner paying the indemnity, the qualification of the indemnity depends on his motives and on the possible simultaneousness of the eviction with the acquisition of the building"

Its deduction is however set aside where the indemnity has the character of a personal expenditure or of an expenditure which is committed in view of realizing a capital gain, which is the case where the owner intends to repossess the premises for his own personal use, in order to sell them with vacant possession or to enable the demolition thereof.

However the indemnity paid in view of a sale will come as a deduction of the sale price for the calculation of the taxable capital gains (Annex III, article 41, duovicies H of the Tax Code).

For the evicted tenant, this indemnity is of course an element of the taxable income over the period during which such appears as being uncontested both with regard to the principle and to the amount thereof.

For enterprises subject to income tax, the regime of taxation of the different components of the indemnity will vary according to the nature of the loss that this indemnity purports to compensate. The fraction of the indemnity purporting to compensate the loss of an item recorded as an asset (in particular leasehold) will follow the regime of short and long term capital gains. On the other hand, the fraction of the indemnity compensating an expense or a shortfall in earnings is comprised in the taxable income subject to the progressive income tax rate schedule. This distinction is no longer of any interest for companies liable to corporate income tax. On account indeed of the restrictions to the regime of long term capital gains, the eviction indemnity is always included in full under taxable income at the standard rate. ■

A guide to real estate investments abroad

By **Julien Saïac**, international tax partner. He deals more specifically with issues related to international restructuring and to real estate investment.
julien.saiac@cms-bfl.com

French companies, whose trade consists of investing in real estate, such as SIICs and SPPICAVs or business operating companies setting up abroad, often query the terms of acquisition of their buildings abroad. Without purporting to provide here a comprehensive review of this topic, it will nevertheless be useful to examine the main questions that need to be raised. These are traditional questions which are connected to those which are of interest to foreign investors in France.

What is the acquisition structure to be adopted?
In other words, is it advantageous, from the standpoint of upflows or of exit capital gains, to use a holding company situated in one country rather than another? This question comes above all within the ambit of an analysis of the clauses of the applicable tax conventions. One should indeed favour a structure that enables minimization of the tax friction on dividends or interests coming from the source country and which avoids, if possible, local taxation of the capital gains on assignments. We know that the capital gains on the assignment of real estate assets are generally taxable in the country where the building is situated by virtue of tax conventions which follow the OECD model. There are of course certain exceptions, but they are more and more rare.
Another case scenario can however arise, where the country in which the real estate investment is realized does not tax capital gains on assignments under its domestic laws. This is in particular the case in the United Kingdom.
The question is all the more relevant as concerns capital gains on the securities of companies.
Indeed, it is possible to invest abroad through a holding company situated in countries which exempt capital gains on the assignment of securities, even where the company assigned is a predominantly real estate holding company in a foreign country. The difficulty is then to identify a tax convention which "prevents" the State in which the building is situated from taxing the capital gains on the assignment of the securities of its predominantly real estate holding companies. Of course, one will have to ascertain that one has the necessary substance in the country where the holding company is situated, failing which the country where the building is situated (including France) may apply its anti-abuse rules.

> ***"French real estate investors abroad can structure their acquisitions in order to optimize upflows and the taxation of exit capital gains"***

What type of financing facility should be chosen?
This second question is equally essential. Should one favour a bank facility (in the country where the building is situated or in that of the investor), a shareholder's loan or an equity facility?
The answer to these complex questions depends in particular on the rate of taxation in the country of the investment in comparison to the corporate income tax rate in France. It is thus more advantageous to finance an acquisition through equity in a country where the rate of taxation is lower than in France. Financing via a shareholder loan from the French parent would indeed lead to deducting interests in the country with the lower tax liabilities and to their taxation in France, where the tax would be in this case scenario higher.

Another significant aspect to examine concerns the local rules related to thin capitalisation, which can limit the tax deduction of the interests paid to related entities. Beyond the limits imposed by local rules, it will be preferable to use a bank or equity facility.

Are local real estate structures which benefit from tax regimes (equivalent to the French SIIC or SPPICAV) of any interest?
These investment vehicles can prove to be extremely tax efficient but often require more complex structuring and are only justified where the real estate portfolio purchased is relatively important. ■

Housing finance companies, a new refinancing instrument in the field of real estate

By **Gregory Benteux**, lawyer in charge of the Financing and Structured Debt department.
gregory.benteux@cms-bfl.com

and by **Alexandre Bordenave,** Lawyer, *secrétaire de la conférence* (Barrister's association renowned for its mooting activity) at the *Hauts-de-Seine* bar.
alexandre.bordenave@cms-bfl.com

Introduced by law no.2010-1249 of 22 October 2010 for the regulation of the banking and financial sectors, the housing finance company (HFC), forming the subject matter of the new articles L515-34 et seq. of the Monetary and Financial Code (MFC) is a specialised credit institution refinancing banking groups via the issuance of debt securities named, for those debt securities issued under French law, "*obligations de financement de l'habitat*" – covered housing bonds (Article L 515-36 I of the MFC). More generally, the regime applicable to the HFC is a reference, as a matter of principle, to that of the property credit company (PCC) (article L55-34 of the MFC), subject to the specific provisions applicable to the HFC.

Essentially, are eligible to be recorded in the assets of a HFC the following loans ("housing loans") (article L515-35 II of the MFC):

- those which are "*intended, in all or part only, to finance a residential property asset*" situated in France, in the European Economic Area or in a State benefitting from the highest credit rating, and
- which are secured by a first legal mortgage or a surety provided by a credit institution or an insurance company.

An HFC can also directly grant housing loans or refinance such by granting credit institutions a loan secured by the delivery, assignment or pledge of housing loan receivables.

"The housing finance company is a particularly reliable structure for investors"

The HFC is a particularly safe structure for investors: it is subject to derogatory rules in terms of insolvency proceedings (absence of accelerated maturity of monies due, absence of extension of bankruptcy proceedings in the event of bankruptcy of shareholders, etc) and the bearers of covered housing bonds benefit from a legal lien, which until then was reserved exclusively to the bearers of property bonds (*obligations foncières*) issued by a PCC; the monies coming from eligible assets will be assigned as a matter of priority to service the payment of the covered housing bonds (and other monies benefitting from this priority of payment) and, in the event of insolvency proceedings commenced against the issuing HFC, the bearers of covered housing bonds will be preferred over all other unsecured creditors of the HFC. Moreover, an HFC must ensure that its cash requirements are covered for a period of 180 days and must comply with an overcollateralization ratio between its eligible assets and its preferred resources of 102%.

The publication in the official journal of order no.2011-205 and of the bylaw amending the CRBF regulation no.99-10, both dated 23 February 2011, completed the legal arsenal applicable to HFCs: thus, their creation is now possible. This can take place either from scratch, or by using the option afforded by article 74 of the law of 22 October 2010 mentioned above, enabling within 12 months from its enactment, a financial company to opt on simplified terms for status as an HFC. This provision is intended to encourage issuers of structured covered bonds, the precursors in France of HFCs, to convert to the HFC form. The first conversions have just taken place, leading to the first issuance operations of covered housing bonds which will test the market's appetite for this new category of covered bonds. ■

Co-ownership: three innovative rulings

By **Charlotte Felizot**, real estate lawyer. She focuses on all aspects of real estate law and more particularly on commercial leases, residential and professional leases, co-ownership, construction and construction insurance. She lectures on the topic of preliminary contracts and residential leases at Paris University - Paris X.
charlotte.felizot@cms-bfl.com

The possibility to sub-delegate the right to vote
In a ruling of 16 March 2011, the *Cour de cassation* accepted, save an express prohibition, that the holder of a delegation of the right to vote in a general meeting of co-owners was entitled to operate a sub-delegation thereof, in application of the general theory on mandates.

The designation of a member of the co-ownership board who is not a candidate
In a ruling of 16 March 2011, the *Cour de cassation* ruled, for the first time, that, in order to be validly elected as a member of the co-ownership board, the co-owner must have performed some formal act of candidacy.

The notification of the minutes of the general meeting and usufruct
In the event of usufruct of a co-ownership unit, article 23, subparagraph 2, of the law of 10 July 1965 requires usufructuaries and bare-title holders to appoint a joint agent to attend general meetings of co-owners, save specific provision of the co-ownership regulations. In the case at hand, the latter provided that "in the event of joint ownership of an apartment, the bare-title holders and the usufructuary will also have to delegate one of them to represent them and, failing a delegation, they will be validly represented by the usufructuary to whom the convening notices will be sent." For a general meeting called on to issue a decision regarding the creation of a secondary board, the convening notice was sent to the usufructuary and the minutes were notified on the latter. The bare-title holder subsequently initiated a motion to void this general meeting after the expiry of the two month deadline contemplated by article 42, subparagraph 2, of the aforementioned law. The court of appeals retained that the notification of the minutes of the general meeting on the opposing or absent parties must be effected to the same persons as those convened. It inferred that in the absence of delegation, both the convening notice to the general meeting and the notification of the minutes had to be sent to the sole usufructuary. In a decision of 30 March 2011, the *Cour de cassation* quashed this ruling on the grounds that the co-ownership regulations only address the convening notice to general meetings and that in the absence of a joint agent appointed on the terms of article 23 of the aforementioned law, the minutes of the general meeting have to be notified both to the usufructuary and to the bare-title holder. ■

If you would like to contact the authors of this newsletter, please write to the editorial staff which shall pass your remarks on to the persons concerned. You can also write to:

CMS Bureau Francis Lefebvre
1-3, villa Emile Bergerat
92522 Neuilly-sur-Seine
Cedex, France
Tél : 01 47 38 55 00
Fax : 01 47 38 55 55
www.cms-bfl.com

M^e^ Grégory Benteux, gregory.benteux@cms-bfl.com
M^e^ Gaëtan Berger-Picq gaetan.berger-picq@cms-bfl.com
M^e^ Richard Foissac, richard.foissac@cms-bfl.com
M^e^ Christophe Lefaillet, christophe.lefaillet@cms-bfl.com
M^e^ Julien Saïac, julien.saiac@cms-bfl.com
M^e^ Jean-Luc Tixier, jean-luc.tixier@cms-bfl.com