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REAL ESTATE NEWSLETTER

Dossier on

Alternative methods for real estate acquisition

Recent developments

Editorial

Real estate companies or those companies wanting to invest in the real estate sector are not completely isolated from the difficulties encountered by any company in matters of asset financing or refinancing. We will discuss here essentially the issue pertaining to the deduction of interest expenses, but we could also mention the difficulties in obtaining financing facilities, the worsening of transfer duties, or yet still the inexorable limitation of depreciations. Even SIICs or SPPICAVs, although being exempted from Corporate Income Tax, are subject to tax rules determining the taxable base of their exempted profits and thus their distributive requirements or reducing their profitability. The difficulties are the same, but the long term cycles of the real estate sector and the discrepancies between yields can lead these difficulties having particular importance. Thus, we have decided, for this new issue of the real estate newsletter, to examine what we shall call the "alternative methods for real estate acquisition". After depicting in particular the dismal outlook regarding the various limitations on the deductibility of interests, that the draft finance bill for 2013 will not be improving to any extent, we will devote lengthy developments from a tax and legal standpoint to the mechanisms of dissociation of the financing of real estate assets and will thus compare real estate financial leasing, building lease and long-term leasehold transactions, whether as regards the conclusion of the contracts, their life-span, their transfer or yet still their termination. The conclusion will be that the needs in terms of financing are radically different and that the tax treatment of these transactions can constitute a genuine alternative to direct acquisitions of assets. We will not overlook the possible legal difficulties but merely to demonstrate that they do not constitute insurmountable barriers. We will also devote an article to operations using a subdivision of the right of ownership, operations which have experience a real development over recent years, to the extent where they have enabled to attract a source of financing from individuals and to thus mitigate the financing cost of certain real estate assets. Finally, and as per usual, we will devote a few pages to recent developments in case law and legislative activity. In a context which remains extremely rich, we have chosen three interesting topics, as particularly revealing as to the perpetual movement of the real estate tax environment: the definition of residential premises now extensive as making reference to the initially assigned use of the building, the diverging interpretation between the *Conseil d'Etat* and the *Cour de cassation* as concerns the transfer of land to the lessee under a building lease and finally the new liability for French social security contributions at the current global rate of 15,5 % for real estate income and capital gains of non-residents.
Please read on. ■

Richard Foissac, partner

Inventory of tax and legal obstacles to acquisitions financed through equity or borrowed monies

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Businesses wanting to invest in the acquisition of real estate assets or in the securities of predominantly real estate holding companies can either finance their investments with equity or with borrowed monies.

Equity financing does not call for any particular observations, apart from specifying that this is not what businesses are necessarily after as such a method does not enable any leverage effect and the French tax mechanisms do not include any incentives comparable in particular to what exists in Belgium (let us mention the possibility offered, on certain conditions, to Belgian companies, to deduct a fictional amount of interests calculated on the basis of a "corrected" equity figure, this measure being intended, according to the Belgian tax authorities, to mitigate a tax discrimination which exists between borrowed capital financing and venture capital financing). From a French tax standpoint, in the best case scenario, one could consider that the significance of equity presents an interest having regard to thin-capitalization rules, contemplated by articles 39-1-3 and 212 of the Tax Code. One can thus distinguish, as concerns borrowed funds, between third party financing and shareholder and/or related company financing. As concerns third party financing, the French system is a fairly open one, as interests are deductible to the extent that they have been borne in the interest of the company, that they conform to a market rate and that they are not intended to be incorporated into the cost price of stocks or fixed assets. Of course, the Authorities can always attempt, on the basis of illegal acts of management, to consider as non deductible those loan interests borne by a company, to the extent where it manages to demonstrate, which is extremely difficult in practice, that the level of indebtedness of the tax paying company should be such that it would exceed considerably its debt capacity and should de facto stop it from repaying its debt.

The source of the limitations on interest deduction lies essentially within the framework of intra-group relations (or of those between related businesses). Thus, the mechanism designed to combat thin-capitalization leads to limiting the deduction of the interests paid out where (i) the advances granted by related businesses exceed a limit set at one and a half times the amount of the company's capital equity, appraised at the business' choice at the commencement or close of the financial year, and (ii) the amount of the interest paid to these businesses exceeds 25 % of the current result before tax, marked up by said interests, by the amortizations deducted and by the share-fraction of rent under the financial lease taken into account for the determination of the sale price of the asset on the outcome of the contract, and (iii) the amount of interests paid out to related companies exceeds that of the interests received from these same companies. The fraction of interests exceeding the higher of the three aforementioned limits must be compared to the taxable result, being recalled that the mechanism will not apply if this excess fraction is inferior to 150,000 € or if the business demonstrates that its overall indebtedness is inferior or equal to that of the group to which it belongs. This mechanism was reinforced at the time of adopting the finance bill for 2011 via the extension of the scope of loans covered to loans granted outside the group but guaranteed or secured by a company of the group. One should also recall:
- on the one hand, the survival of the mechanism limiting deductible interests which is contemplated under the tax integration regime (article 223 B 7th subparagraph of the Tax Code), for acquisitions of the securities of companies becoming members of a tax group from a shareholder from outside the group which controls the group or from a company that this shareholder controls within the meaning of article L. 233-3 of the Commercial Code,
- on the other hand, the new system introduced by the amended finance bill for 2011 contemplating that the financial expenses pertaining to the acquisition of equity securities (real estate subsidiaries are thus not excluded from the system where they constitute equity securities) must be compared to the profits of the financial year where the business holding the securities is not in a position to prove by any means that it constitutes, for the administration of these securities, an autonomous decision making centre.

"The source of the limitations on interest deduction lies essentially within the framework of intra-group relations (or of those between related businesses)."

This environment, which is already dismal, will not be brightened up by the new system that the Government intends to adopt that should be aimed at limiting the deductibility of a fraction of the interests paid out irrespectively of the circumstances having led to the conclusion of a loan. This system will have to be confirmed but would be based on a plane-out mechanism entailing that beyond an amount of interest paid (3 million Euros) the interests would only be deductible for a fraction of their amount (85 % in 2013, then 75 % the following year) and thus irrespective of any over- or thin-capitalization. From a legal standpoint, the Market has experienced significant development of bond financing at the level of major listed corporations, but this type of financing remains scarce in the real estate sector, albeit constituting an interesting alternative source of financing in the current context. Indeed, such can be of interest having regard in particular to the regulatory framework on credits which imposes that a shareholder of a capital company (or *SARL*), other than a credit institution, must hold at least 5 % of the share capital of a company in order to be able to make current account advances in favour of the latter. This rule not applying to the issue of financial securities, a bondholder may therefore not be a

shareholder. Bond financing presents moreover certain attractive values both for investors and for issuers, such as the negotiability of bonds, the implementation of specific guarantees by the issuing company (i.e.: mortgage), the stipulation of safeguard clauses (covenants), the pooling of all holders into a body of bondholders in order to assert their rights, or yet still the possibility to provide for the convertibility of the bonds into shares so as to enable the investor to profit from the capital gains on the underlying asset and, thus to enable the loan to be remunerated otherwise than through interest.

However, the issue of bonds is only open to the following types of company: the SA, SAS, SCA and, subject to certain specific characteristics, to the SARL. Partnerships (*sociétés civiles*, SNC and SCS) – which are used on a regular basis in real estate transactions for tax based reasons, as well as their regime in matters of partner liability – are excluded from such. The structure of the operation will therefore have to take this into account. Moreover, a capital company not yet having established two balance sheets duly approved by its shareholders – which is generally the case as concerns companies created on an *ad hoc* basis for the purposes of a real estate operation – will have to resort to an auditor in charge of checking its financial situation and of issuing a report, to be filed at the registered office and at the clerk's office at least eight days prior to the general meeting to issue a decision on such issuance. Prior to law number 2012-387 of 22 March 2012 referred to as the "Warsmann II" Act, the auditor had to be appointed by the presiding judge of the *tribunal de commerce* on the basis of an application. Since such time, he can be appointed unanimously by the shareholders of the issuing company. The result will be that not only will one have one's chosen auditor, but also one will gain precious time. ■

The alternative of real estate financial leasing and/or of the building lease in real estate acquisitions: legal summary and impact on taxable profits

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"Acquisition" by means of a real estate financial lease

Acquiring property of a building ultimately on the outcome of agreed stages, after having made progress payments over the whole term of the contract, whilst benefitting straight away from enjoyment thereof, is what is possible under a real estate financial lease.
The operation is conducted by financial corporations (financial-lessors) which purchase a professional building or have such developed. We would recall that in theory, such an operation can be carried out, as a remote operation and on a one-shot basis, by any entity. But in this case, the transfer at the end of the contract will be subject to the urban pre-emption right, if applicable (Article L. 213-1 of the Planning Code), which, in practice, creates an all too significant element of chance for such operation to be considered to any real degree of comfort. The operation breaks down into the acquisition (or the construction) by the financial-lessor of a professional building, the rental of the latter and the promise of a sale thereof to the financial lessee. The essentially financial nature of this operation will lead to every element of this contractual structure escaping the legal provisions that would be applicable to it if it was taking place in an individual respect: thus the mandatory regime on commercial leases is not applicable to the organisation of the financial-lessee's enjoyment, and on account of the essentially financial role of the financial-lessor, its obligations are substantially mitigated in relation to those of a building landlord. Correlatively, virtually all of the technical and economic responsibilities will burden the financial-lessee, either directly, or through a repercussion on it by the financial-lessor.

Treated from an economic point of view as a proprietor, the financial-lessee does not, for all that, benefit from the related prerogatives. Thus, in practice, the latter is not granted the right to freely assign the rights and obligations arising under the contract. The strictly personal character of financial leasing operations entails that an assignment is unconceivable without the financial-lessor's express consent and it is provided that in the event of assignment, the assignor will remain jointly and severally liable with its assignee. This shall not prohibit, in due course, after a detailed review of the assignee's characteristics, a release of such joint and several liability, which can not, for all that, be taken for granted. All things considered, a financial-lessee must not revert to this financing technique with the hope of escaping the constraints that should burden it as proprietor, if it is considering granting over the building thus "acquired" one or more commercial leases. Indeed, if it may only sub-let the building within the limits of the authorisations conferred by the contract, on the other hand the mandatory regime governing commercial leases applies to sub-rentals. The fact that the landlord is "only" a financial-lessee and not the full owner does not enable it to exclude sub-rentals from the mandatory regime. Of course, in the event of extinguishment of the financial lease agreement (termination, failure to exercise the option) such lease will end, but the financial-lessor can also accept to become the landlord of the tenant, preferring an occupied and operated building to a vacant building. But in the case, more widespread, where the option is exercised, the financial-lessee will be confirmed in its capacity as landlord with respect to the tenant, and the initial financial leasing "phase" will be indifferent with regard to the tenant's prerogatives. ■

Impact in terms of corporate income tax

	Real estate financial lease		Building lease based on a real estate financial lease (case where financial-lessee is the owner of the land)	
	Financial-lessor	**Financial-lessee**	**Financial-lessor**	**Financial-lessee**
Conclusion and life of the contract	• Tax period for depreciation of the buildings: normal period of use appraised in accordance with the customary practices of the trade or term of the contract • Taxation of rent and additional rent as operating income (continuous services)	• Absence of any element to be booked in the assets • Tax deductibility of possible pre-rental fees (due during the course of the construction period) • Deductibility of rent instalments over the duration of the financial lease • For offices in the Ile-de-France region, completed since 1st January 1995, the share-fraction of rent related to the land is not deductible (but possibility to define with the financial-lessor preferentially the allocation of rent over the construction part)	• No depreciation on the land as not owner • Possible rental charge	The rent instalments under the building lease are included in the taxable profits
Exercise of the option after the five year deadline	• Exit of deductible asset accordingly to Net Book Value (NBV), reduced by the price of the option • Possibility to anticipate the exit in the form of a provision (failing depreciation over the duration of the contract): constitution of a tax free provision to spread the expense of the loss borne at the end of the contract on account of an option exercise price which is lower than the NBV of the building. The provision is carried over in full at exercise of the option.	• Add back (into the results subject to corporate income tax (*IS*) at the full rate) of a fraction of the rent instalments paid and deducted during the contract. This is the difference between the theoretical NBV of the building (taking the normal duration of tax depreciation as if the financial-lessee had bee the owner from the very start) and the option exercise price. Exceptions: - "ex-SICOMI" contracts more than 15 years old concluded prior to 1996 (add-back capped at the cost price of the land) - contracts related to offices in the Ile-de-France region, completed since 31 December 1995 and contracts more than 15 years old for SME situated in certain zones (no add-back) • Building booked in the assets for the option exercise price but increase of the depreciable tax base accordingly to the add-back (and subject to the cost price of the land) • If re-sale of the building: transfer capital gains equal to the difference between the sale price and the cost price of the building, minus the depreciations practiced, subject to corporate income tax at the full rate (the add-back is taken into account to calculate the tax cost price of the building) if the selling company is subject to corporate income tax or to the regime of professional capital gains if the selling company comes under Personal Income Tax (*IR*) (outside a private estate context)	The exit shall not take into account the value of the land	• The term of the building lease can not be inferior to 18 years (thus whatever the close-out date of the real estate financial lease) • The term-end of the two contracts coinciding, the exit tax liability applicable will be that contemplated for real estate financial leasing contracts even if accession to ownership of the constructions operates without the exercise of an option being formalized
Assignment of the lessee's rights (during the course of the contract)	Neutral, authorisation depending on the terms of the contract.	• Assignor: - transfer capital gains generally equal to the price of transfer of the contract (unless contract acquired from a previous lessee) subject to corporate income tax at the full rate - if enterprise subject to Personal Income Tax: application of the rules contemplated for capital gains on the transfer of depreciable elements of fixed assets • Assignee: - contract price booked in the assets, with possibility to depreciate over the remaining term of the contract: the depreciation may only apply to the fraction of the acquisition price of the contract representing the constructions (over the normal period of use of the constructions at the date of the transaction). On the other hand, the rights pertaining to the land are not depreciable - at exercise of the option: same tax add-back to be operated (such as described above) but pro rata to the holding period of the contract by the assignee over the whole term of the contract	Neutral, authorisation depending on the terms of the contract.	• The transfer would apply concomitantly to the land • If capital gains: taxation of the difference between the price of transfer of the land and the initial cost price • No depreciation of the land

Long term leasehold or building leases: genuine alternatives to the acquisition of a site

When should one make an "acquisition" under a long-term leasehold or a building lease?

There are several reasons which can lead a land owner, whether a private or public individual or legal person, to choose not to sell a site. First of all, the desire not to be exposed to criticism for having definitively disposed of a property estate that its future successors or assigns will not be able to benefit from. Secondly, the fact that the amount of the capitalized rental charge paid at the signature of a long term lease, or of a building lease, for 99 years is not too far from what the sale price of the same asset would be, and thus from the patrimonial interest of a recurring income, even if the centennial periodicity can, quite logically, appear *prima facie* to be quite lengthy. Nevertheless, yet again, the "regeneration" of the capacity to procure an income on the outcome of the 99 year period is not to be overlooked. In practice, this will lead certain land or building owners, whether private or public, including the State, public undertakings and local authorities, to confer a lease rather than to proceed with a sale. The interest of the site concerned for the commercial or industrial enterprise, will then cause the latter to carry out as a mere "lessee" what it would have carried out as owner if it had been in a position to purchase. This is how, in particular, a certain number of commercial, industrial, hotel or leisure complexes have been created. There are no legal obstacles, should this need to be recalled, on the implementation of long term leaseholds or building leases with an extremely long term including the payment of a capitalized rent in a single instalment at signature, referred to as "one shot" payments. The other case in which a long term leasehold or a building lease can constitute an alternative to acquisition is that of the situation of a coveted building in a sector in which a pre-emption right applies, the exercise of which appears likely (one should however avoid waiting for a pre-emption decision subsequently to a declaration of the intention to dispose of property before considering such a scheme). Indeed, neither the conclusion of such leases nor their subsequent assignment operate a perpetual transfer of property right; these operations therefore have the decisive advantage of not coming under the ambit of any pre-emption rights and are not contestable by the holders of such a right[1][2]. One must however see to it that any fraudulent structuring is excluded[3], which implies that each party has duly comprehended the necessary long-term character of the situation thus put into place.

Situation which proves to be quite similar to that of a proprietor

In the event of investment by means of this type of contract, the lessee will have prerogatives which are extremely close to those that he would have if he had acquired full ownership: freedom to mortgage; freedom to transfer and contribute; property of improvements made and of constructions developed. Correlatively he will have to assume similar responsibilities: preserving the good state of upkeep; service charges and repairs; etc. The long term leaseholder has extremely extensive rights with respect to enjoyment and use of the property and can not receive any restrictions as regards the use that he may assign the rented assets to; their situation is thus in this regard extremely close to that of a proprietor. On the other hand, in building lease related matters, it is allowed for a clause to be able to impose restrictions on the lessee's activity[4]. The long term leaseholder may freely build a new building on a bare piece of land, heighten a building, carry out underground works or carry out major renovation on a building. They may operate any and all conversions of buildings, all changes of intended use, of the rented building. The only limit which is imposed upon them is to not adversely affect the value of the business concern (Article L. 451-7 subparagraph 1).

The freedom of the building lessee will not always be as extensive, as it is possible to subordinate the development of new constructions to the lessor's prior authorisation[5]; however, where the contract remains silent, they will hold in this regard prerogatives similar to those of a long-term leaseholder. The lessees under these two types of lease have absolute freedom regarding the rental of the constructions, whether these already exist or whether they are developed at their initiative. This freedom to rent extends to the rental of the land base which supports no buildings[6]. Without having the virtually absolute perpetual characteristics of the right of ownership, the title that the long term leaseholder and the building lessee hold is not easily altered. The stipulation of an automatic termination clause in favour of the lessor in the event of failure to pay the rent (if periodic rent is contemplated) will affect indeed the enjoyment of these lessees with an instability which is considered incompatible with the constitution of an *in rem* right, irrespective of the fact that the instability that one should want to impose upon the lessee originates in the latter's own fault[7], that is to say his default with respect to one of his material obligations. ■

[1] *Cour de cassation*, 3rd civil chamber, 2 July 1977, *Bull. civ. III*, no. 245.
[2] Urban pre-emption right, of land intended for retail space, of SAFER, of the Conservatoire du Littoral on "commercial" land ("LME" law) etc.
[3] *Cour de cassation*, 3rd civil chamber, 7-11-2002 no. 1718 : Constr.-urb. 2003 no. 78). *Conseil d'Etat* 30 December 2002, application no. 232584 *Sté civile immobilière d'HLM de Lille et environs*, BJDU 3/2003, p. 192.

[4] *Cour de cassation*, 3rd civil chamber, 7 April 2004, RD imm. 2004. 22, observations C. Saint-Alary-Houin. p. 454
[5] *Cour de cassation*, 3rd civil chamber, 5 December 2007 no. 06-19 728 : RJDA 5/08 no. 501.
[6] In matters of long term leasehold, see Court of Appeals of Bordeaux 21-4-1983 : Gaz. Pal. 1984 p. 128.
7. *Cour de cassation*, 3rd civil chamber, 14 November 2002 no.1655 : RJDA 2/03 no. 124.

Direct taxation of building leases and long term leaseholds

During the course of the lease	**Building lease:** lessees will enter the constructions into their assets and will depreciate these over the term of the lease (Art. 39 D sub. 2 Tax Code) **Long-term leasehold:** constructions on ground belonging to someone else are depreciated over their normal period of use (Art. 39 D sub. 1 Tax Code)
At expiry of the lease	**Building lease:** if the term of the lease is superior or equal to 30 years, the handover, free of charge, of the constructions developed by the lessee shall not give rise to any taxation at the level of the lessor. If the term of the lease is comprised between 18 and 30 years, the handover shall analyse as additional rent. Tax will only be due on the cost price of the constructions after deduction of a discount equal to 8 % per year of the lease beyond the 18th. The taxation can, at request, be spread out over a period of 15 years. These rules apply also to lessors liable for corporate income tax. Moreover, invalidating the administrative doctrine (MOA meeting of 17/12/1998)[8], the *Conseil d'Etat* has just ruled that the exemption within the limits of the cost price of the constructions applies including in the case of entry of the constructions under the assets section for their fair market value (*Conseil d'Etat* 26/03/2012 no. 340883). **Long-term leasehold:** whatever the duration of the lease, the delivery of the constructions developed by the lessee shall entail the taxation at the level of the lessor of an income equal to the fair market value of the constructions.
Extension of the lease	**Building lease:** date of taxation of the additional rent resulting from the handover, free of charge, of the constructions developed by the lessee (valid also for lessors liable to corporate income tax) : – for the administrative authorities: in respect of the expiry year initially contemplated save extension on economic grounds (MOA meeting of 30/09/1998)1 ; – for the *Conseil d'Etat* : in respect of the financial year or of the year of the new term agreed (*Conseil d'Etat* 25/01/2006 no. 271523). **Long-term leasehold:** at the date at which the lessor recovers the free disposal of the assets rented (*Conseil d'Etat* 16/11/1981 no. 16111).
Assignment of rights/early termination	**Building lease:** confining oneself to a legal analysis, the assignment of the rights of the lessor or of the lessee should in all cases generate a capital gain. But consistent case law of the *Conseil d'Etat* considers however that certain operations produce, from a tax standpoint, the same effects as a voluntary termination of the lease implying the hand over of the buildings to the lessor prior to the sale. Thus ruled in the following cases: –simultaneous assignment of the rights of the lessor and of the lessee to a same purchaser (*Conseil d'Etat* 21/11/2111 no. 340777) ; – sale or contribution of the land to the lessee (*Conseil d'Etat* 5/12/2005 no. 256916 ; *Conseil d'Etat* 11/04/2008 No. 287967) ; – takeover of the lessor by the lessee (*Conseil d'Etat* 7/02/2007 no. 288067). Where the lessor is an individual, the consequences of accession will lead to the realisation of an income which is taxable at the progressive income tax rate schedule and not a capital gain taxed at a proportional rate. NB. The *Cour de cassation* has on the contrary ruled that the assignment of the land to the lessee does not entail any transfer of title to the constructions whose value can thus not come within the taxable base for registration duty (*Cour de Cassation*, commercial chamber, 12/06/2012 no. 11-18978). **Long-term leasehold:** the *Conseil d'Etat* having transposed to an ordinary lease the principle set forth for the building lease according to which the assignment of the land to the lessee will entail the premature handover, free of charge, of the constructions to the lessor prior to the sale, the solution should apply in the case of the long-term leasehold (*Conseil d'Etat* 28/07/2011 no. 330824).
Assignment of the land to the lessee (lease sales)	**Building lease:** when the lease includes a clause contemplating the transfer of the land to the lessee at the end of the lease in consideration for an additional rent, the monies thus paid are considered not as rent but as the price for the assignment of the land. **Long-term leasehold:** not applicable.

[8] The date of delivery of this document has not enabled us to check whether these solutions are reinstated in the new data base BOFIP-impôts. Failing which, they must be considered as carried over.

Subdivided acquisitions: an attractive method of mitigating financing costs

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The formula which consists of offering investors the possibility of acquiring bare-title to an accommodation is growing more and more successful, due in particular to the evolution of individual taxation. In order to create an incentive for individuals to invest their savings in the construction of accommodation units temporarily assigned to the social sector and to thus nurture the development of social housing stocks, mitigating the investment of low-rent housing organisations, bare-title property investment came into existence a decade ago. Within the framework of this practice, investors, generally individuals, acquire bare-title to an asset for a 50 to 60 % share of its value with undivided ownership, the usufruct of the asset being acquired by a social housing lessor which will hold the right to the enjoyment of this same asset, within the framework of a temporary usufruct agreement. The social housing lessor will thus place the asset under rental and will collect alone the income during a period of 15 to 30 years. This system enables the social housing lessor to temporarily increase social housing stocks, at no cost for the general public, as the social housing organisation will benefit, during the course of the usufruct period, from the rents paid by the tenants. The rents will in principle cover in full the loan expense pertaining to the acquisition of the usufruct over the accommodation. In addition, the acquisition of the usufruct over the accommodations thus created can, in certain conditions, be the subject of a government approved loan which will benefit from the reduced VAT rate of 7 % since 1st January 2012, as well as from an exemption from real estate tax on developed property. This regulated loan can be composed of a State subsidy combined with an aided loan from the *Caisse des dépôts et consignations* or with a loan from such organisation granted after a favourable decision of the minister in charge of Construction and Housing or of the Prefect. The success in relation to this investment technique is due to the multiple benefits thereof for investors. First of all, besides the notable interest that lies in the reduction of the purchase price, the investor will not be required to commit any expenditure and shall not be exposed to any rental risks during the whole term of the usufruct. On the outcome of the contract, the investor will become the undivided owner of the accommodation, which will have been in principle upkept and reinstated at the expense of the lessor.

"In a period of economic and financial crisis, an investment in a subdivided property right can appear to be an interesting solution procuring a sense of security for investors whilst enabling the development of the general offer in terms of social housing."

The bare-title holder may, six months prior to the expiry of the usufruct, either offer the tenant a new lease entering into effect at the end of the usufruct, or serve notice to vacate for the purpose of selling or occupying the accommodation. However, in order to protect the tenant, three months prior to the end of the usufruct, the lessor must offer tenants who have not concluded a new lease with the bare-title holder, an accommodation corresponding to their needs and to their possibilities. If the tenant has neither concluded a new lease with the bare-title holder, nor accepted the lessor's re-housing offer, the latter will then lose all rights to occupy the accommodation at the expiry of the usufruct. This structure also includes a great many tax benefits for investors. Indeed, the latter is exempted from all tax liabilities during the usufruct. In the absence of rent, the investor will not be taxed on income and as a bare-title holder he will not be required to pay real estate tax on property (which is in principle established in the name of the usufructuary, subject to the exemption that it may benefit from within the framework of the social housing sector). Since 2008, it is also possible for the latter to deduct the interests under the loan taken out to acquire bare-title against any other rental income, if he has any, thus procuring a tax saving. This new regime codified under article 31 I-1° d of the Tax Code does not fall within the scope of application of the cap on tax loopholes. In the event of a loss being recorded, in accordance with the principles governing the offsetting of real estate losses, the fraction of loss resulting from these loan interests will only be off-settable against real estate income for the following ten year period (article 156 I-3° of the Tax Code). Expenditures for major repairs such as these are defined in article 605 of the civil Code, which are in principle incumbent upon the bare-title holder, do not benefit from the deduction regime contemplated by article 156 II-2° quater of the Tax Code for the calculation of taxable income, to the extent where the subdivision of the property right does not result from a succession or from a gift. However, in practice, the contracts proposed within the framework of these operations sometimes provide that these expenditures will be borne by the social housing lessor, as usufructuary, which constitutes yet another benefit for investors.
Besides the benefits concerning income tax, it is also provided that the asset is excluded from the taxable base used for wealth tax (ISF) of the bare-title holder for as long as the latter has not recovered the usufruct thereof (subject anyway to the investor not proceeding with the acquisition of the asset from an owner who should retain usufruct, which is not the case in principle within the framework of investments concerning social accommodation). Moreover, in the event where the investor should borrow to finance the purchase of the bare-title, such loan can however be included among those items of his liabilities which are deductible in respect of wealth tax, even where the asset thus acquired does not appear under his taxable assets. In summary, this constitutes for the investor a reduction of his taxable estate accordingly to

the amount of the loan entered into. However, the draft finance bill for 2013 revisited this modality. Finally, if the investor should decide to sell the building after the expiry of the temporary usufruct, he will benefit from a favourable regime as the capital gains will be calculated, retaining as a purchase price the value of the undivided ownership at the date of acquisition of the bare-title, and that the taper relief applied to the capital gains will be computed from such date. In a period of economic and financial crisis, a real estate investment on these terms can thus appear to be an interesting solution procuring a sense of security for investors whilst enabling the development of the general offer in terms of social housing. Its growing success is kindled by the growing escalation of personal income tax and of wealth tax and by the curb which has been put on most tax loopholes, in particular real estate ones. In this context, certain operators are considering applying the formula outside the social housing sector, for instance in the field of serviced accommodations or of furnished rentals. Proposed investments will thus require a careful review, the tax benefits of the subdivision being for the major part subject to specific conditions, in particular as concerns the deduction of loan interests or the regime having regard to wealth tax. Moreover, the success of a tax regime is unfortunately not always a guarantee as to its long term survival. Investors must never forget that tax law is an extremely versatile sector, especially in times of crisis, and that no tax system can be guaranteed over a period as long as that generally defined for a temporary usufruct. Thus as safe and attractive as it may be, an investment in a subdivided property right will necessarily include a fair share of risk, including from a tax standpoint. ■

Investors: know your buildings' history!

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What does a prison, a tourist hotel, a furnished hotel and an old people's home have in common? No need to look very far: the answer is tax. They are all "residential premises" within the meaning of article 31 of the Tax Code, which organises the deduction of improvement expenditures in real estate income related matters. In order to deduct the corresponding expenditure from real estate income in accordance with paragraph b, 1°, I of this article, investors proposing to acquire a building are obliged to keep an eye on the nature of their works, so as to refrain from "*construction, reconstruction or extension works".* For all that, they can not be unaware that this same statute moreover confines *"deductible improvement expenditures",* essentially to those *"pertaining to residential premises".* Through the effects of this statute, the administrative authorities, like the judge having jurisdiction for tax related matters, will first of all see to it that those works which "*increase the volume or the habitable space*" of the building are non deductible. Then, they will deny such deduction for other "*extension works*", such as those entailing the creation of new residential premises: has thus already been rejected, the tax deduction for works, of any nature or scope whatsoever, entailing the conversion, into residential premises of premises previously assigned to any other use, such as offices, a cinema, a clinic, stables, a garage or a theatre. Finally, the improvement works will only be deductible fiscally if they are recognized as being dissociable from the other non deductible works (by reference in particular to the various documents of the architects and contractors, for which the importance of these being explicit on this issue must be underlined).

For all that, the judge in charge of tax related matters appraises the notion of residential premises liberally:
– on the one hand, by adopting an extensive definition of residential premises, exceeding that traditionally condoned in tax law, which has enabled, even quite recently[9], to consider that a *"former prison"* is to be deemed to have *"already been assigned to a residential use" ;*
– on the other hand, by referring, to appraise the residential criteria, to the initial assigned use of the building, with the consequence that a subsequent different assigned use does not take away the building's fiscal status as residential premises, subject to such being able to correspond to the following definition: "*Where a building is, on account of its design, its fit-out and its equipment intended originally for residential purposes, its temporary occupancy for another use is not likely, on its own, to withdraw this intended use, in the absence of works altering its design, its fit-out or its equipment[10]".* Thus, for instance, have been ruled as deductible those expenditures pertaining to works on the premises, the last use of which was a medical surgery.

For its part, the tax authorities have expressed their subscription to this case law trend[11]. Having regard to the tax liabilities applicable to improvement works subject to the rules on real estate income, investors will have to remember that:
–having tax deduction at heart, they must incorporate into their projects the fact that certain buildings which are not assigned to a residential use prior to the purchase may nevertheless give rise to deductible improvement works, as long as they were originally used as living space by their occupants ;
– each building has a history, knowledge of which will constitute a source of tax savings, if one can show that the projected works merely represent the return of the building to its original residential use. If Paul Valéry had been a real estate tax counsel, would he have been able to write that "*history is the science of what never happens twice" ?* ■

[9] *Cour administrative d'appel* of Lyon, 1st March 2012, no. 11LY01205
[10] *Conseil d'Etat, 20 June 1997, no. 137 749*
[11] Point 29 of sheet 8 of the Bulletin Officiel des Impôts 5 D 2-07, having become, on 12 September 2012, § 120 of the guideline with the reference 20-30-20-20120912 in the on-line data base named *Bulletin officiel des finances publiques – impôts*

Assignment of land to a building lessee: difference of opinion between the Conseil d'Etat and the Cour de cassation

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The assignment of a piece of land placed under a building lease by the lessor to a lessee during the course of the lease has been the subject of an interesting ruling rendered on 12 June 2012 by the Commercial chamber of the *Cour de cassation*. The scheme concerned is no novelty, and is even quite well known to the *Conseil d'Etat*. However, it is the first time that the *Cour de cassation* has had to deal with this issue, and it has conducted an analysis which differs quite noticeably from that of the administrative courts. From a tax standpoint, the operation is liable to impact the lessor's income tax (competence of the *Conseil d'Etat*) and transfer duty (competence of the *Cour de cassation*). The competence of two separate jurisdictions in charge of dealing with taxes leads today to two diverging analyses on the same situation. The *Conseil d'Etat* considers, in a manner which is now consistent, that such assignment procures, having regard to tax rules, the same effects as a tacit voluntary termination of the lease prior to the assignment of the land. The termination of the lease implies that the constructions are handed over to the lessor just before being assigned with the land. This analysis enables thus the tax authorities to tax the handover of the constructions to the lessor, free of charge, as real estate income, based on an amount equal to the cost price of said constructions (after application of a relief depending on the term of the lease).

"No transfer duty can be requested based on the value of the constructions"

The logical consequence of this approach would have led the assignee to settle transfer duty in respect of the assignment, based on the global value of the land and of the constructions. In the above mentioned ruling of 12 June 2012, the judicial judge departed nevertheless explicitly from the interpretation of the *Conseil d'Etat* and chose to conduct a strictly legal analysis of the situation. The assignment of the land to the lessee must not be considered as being preceded by a tacit termination of the lease. Such entails merely the concurrent holding by the same person of a dual capacity as both lessor and lessee, concurrent holding which has the consequence of extinguishing the lease. However, extinguishment is different legally from termination, and does not entail in particular any transfer of title to the constructions, from the assets of the lessee towards those of the lessor. The *Cour de cassation* therefore comes to the logical conclusion that no transfer duty can be requested based on the value of the constructions which did not leave the lessee's assets. This analysis which is consistent with civil law principles was that of the *Conseil d'Etat* during a great many years, until a surprising reversal of case law took place with the Fourcade ruling on 5 December 2005 (no. 256916). The judicial Supreme Court thus confirmed the relevance of the prior practice and the accuracy of the underlying reasoning. It will be hard, under these circumstances, to accept that the legal fiction created by the administrative judges in order to tax lessors should be upheld! Can one reasonably expect the *Conseil d'Etat* to reconnect with legal orthodoxy? Nothing could be less certain. ■

Assignment of land to the lessee

Conseil d'Etat Income tax	*Cour de cassation* Transfer duty
The operation analyses as the termination of the financial leasing agreement followed by an assignment of the whole (land + constructions) **1) Voluntary termination of the lease** Consequences: - the constructions return free of charge to the assets of the lessor - taxation of real estate income corresponding to the cost price of the constructions delivered **2) Assignment of the whole to the ex-lessee**	**The assignment of the land to the lessee entails the concurrent holding by the same person of both lessor and lessee capacity** Consequences: - **Extinguishment of the lease** - The constructions do not return to the assets of the lessor - transfer duty due based on the sole value of the land.

Social deductions now apply to real estate incomes and capital gains with a French source realized by non-residents

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The amended finance bill for 2009 subjected the assignment of the securities of foreign predominantly real estate holding companies in France to registration duty. In order to define the taxable base of these duties, the finance bill for 2012 then restricted the possibility to deduct debts of the company solely to the liabilities pertaining to the acquisition of these assets. A new tax burden now affects the French real estate assets of non-residents. Non-resident individuals in France are, save exception, taxable in France over their real estate income and their real estate capital gains with a French source. On the other hand, they were not until now, subject to social security contributions (CSG, CRDS, social deductions, etc.), to the extent where only French residents were concerned by these contributions. The second amended finance bill for 2012 provides that, from now on, real estate income and capital gains realized in France by non-residents will be subject to social security contributions, at the global rate of 15.5 %. This measure applies to income collected as from 1st January 2012 and to capital gains pertaining to assignments carried out as from 17 August 2012. Real estate capital gains realized in France by individuals who are residents of the European Union or of another State of the European Economic Area having concluded with France an administrative assistance agreement will therefore bear the same global taxation as French residents (tax at 19 % and social deductions at 15.5 %). On the other hand, other non-residents will bear a more significant global taxation (tax at 33 1/3 % and social deductions at 15.5 %) that apparently they should have grounds to complain about based on the free movement of capital guaranteed by the European treaties. ■

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