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French recent tax reform: the survival kit

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France is in the process of changing its tax landscape and now faces the tax reforms promised by President Hollande in his 2012 presidential election campaign. There is an increasing atmosphere of tax insecurity and on 28 September 2012 the new draft of the 2013 Finance Bill was released to practitioners and tax payers. The Finance Bill was finally adopted on 20 December 2012. It gave rise to a decision of the Constitutional Council (*Conseil Constitutionnel*) (CC) dated 29 December 2012 (*n° 2012-662*) which struck down numerous of its provisions including the 75% millionaire tax. The third amended Finance Bill for 2012 was adopted on 19 December 2012 and was also reviewed by the CC (*decision n° 2012-661 of 29 December 2012*).

While seeking to reduce the state deficit to 3% (the level required for Eurozone members), the Government must find approximately EUR30 billion of savings or additional income. Two thirds of this targeted amount will come from tax increases, of which EUR10 billion will be aimed at individual taxpayers (and, according to the Government, more specifically the wealthiest of those). Only a third of this amount will be derived from spending cuts. At the time of writing, reactions to the decisions of the CC have yet to be proposed by the Government and voted by the Parliament. Against this background, this article describes the main tax changes from 2012 on and methods on how to prepare and to respond to the tax increases.

Notably, for foreign persons and non-residents, the Bill will apply retrospectively as from 1 January 2012 (subject to highlighted exceptions).

INCREASES TO TAXATION AIMED AT INDIVIDUALS

From 2012 and to at least 2013, taxes aimed at individuals will be substantially increased.

75% taxation on activity remuneration

One of the landmark measures pledged during the presidential campaign was the "75% millionaire tax" (a 75% tax on compensation income above EUR1 million), with 62% of the French population agreeing that it was a fair measure.

This exceptional contribution was intended to be a temporary "supertax" applying on compensation income only (and not on financial/investment income) to tax years 2012 and 2013 (as currently set out).

In practice, this supertax would have amounted to an additional 18% charge which would have applied in addition to:

- The regular income tax brackets (a new tax bracket of 45% is introduced).
- The existing special tax on high income of 3% or 4% (that is, income exceeding EUR250,000 for non-married taxpayers and EUR500,000 (joint income) for married taxpayers), introduced by former President Sarkozy's Government and which remains in force.
- The social tax of 8% on compensation.

The aggregate of all the above income taxes would bring the overall rate to 75%.

The proposed tax applied to employment/business/pension income above EUR1 million per beneficiary and not per household (which would have taken the threshold to EUR2 million). Some exceptions were discussed for artists and sportspersons but were not adopted.

Although the 75% taxation was a major pledge of the presidential campaign, its results would have proved modest if not counter-productive (given that successful individuals might have been tempted to move from France and successful foreign individuals might have been deterred from settling in France).

According to the Report of the Finance Committee on the draft Finance Bill for 2013, the estimated gain for the budget as a result of this measure is about EUR210 million per year.

The CC struck down the implementation of the additional 18% surcharge (and accordingly the 75% millionaire tax) as breaching equality between taxpayers, since the supertax was assessed on individual income and not based on household figures, which is the traditional unit for tax purposes in France. As a consequence, the surtax might be due or not due depending on how overall household income is spread between spouses. The President made clear that he would re-introduce the surtax in a compliant manner in 2013 even if it might prove to be complicated.

Income tax brackets

From 2010, income tax brackets have not been adjusted to take inflation into account, which, in fact, disguises a general increase of income tax in real terms.

As from tax year 2012, a new maximum tax bracket of 45% will apply for income above EUR150,000 for non-married taxpayers or EUR300,000 (joint income) for married taxpayers.

Income re-categorisation (share options and free shares)

Gains on the exercise of qualified share options and attribution of free shares are no longer eligible for the reduced fixed rate (which ranged from 18% to 41%). Instead, gains are now treated as employment income and social contribution at 8% applies rather

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than at 15.5%. The Finance Bill also provided for an increase of the employee social contribution from 10% to 17.5%. However, the CC overturned this increase as bringing the overall tax burden to a confiscatory level.

Inward expatriate regime

There were rumours before the release of the Bill about a possible cancellation of the favourable tax regime for inward expatriates. In 2007, President Sarkozy introduced special exemptions for qualifying inward expatriates who come to France for professional reasons and who have not been tax resident in France at any time during the previous five years to improve the business attractiveness of France. The regime can result in the exemption of up to 50% of the compensation (base salary, bonuses and allowances) from tax. It can also lead to a 50% exemption on foreign source investment income for five years. Also, foreign based wealth does not come within the scope of the French wealth tax over the five first years of domicile in France. This exclusion was already provided in some tax treaties signed by France. Under the Finance Bill, the regime remains untouched.

Investment income

The reform aims at applying the standard tax brackets to financial income.

Under the new regime, dividends and interest are subject to progressive tax rates (up to 45%) and social contributions at the rate of 15.5% with no possibility to elect the application of final and reduced rates of respectively 21% and 24% (before the social contribution of 15.5%).

For dividends, an allowance of 40% applies (regardless of the number of years the shares have been owned) in order to mitigate double taxation. The new treatment was supposed to apply as from 1 January 2012. However, the CC prohibited it for dividends and interest for which taxpayers elected the fixed and final rates of respectively 21% and 24%. Therefore, the new rule applies as of 1 January 2013.

The reduced capital gains tax of 19% (before the social contribution of 15.5%) on disposal of securities (mainly shares) is increased to 24% for disposals incurred in 2012. However, the reduced capital gains tax rate of 19% survives for entrepreneurs meeting certain holding and management duty requirements.

As from 2013, disposal of securities are subject to the standard tax brackets. The 3% to 4% contributions on high income may also apply if the high income threshold is met (*see table, Summary of French tax reforms to individual income*). This potentially increases the taxation on capital gains to 64.5% from where it stands at present (up to 39.5%). A progressive allowance on a period of holding may apply up to 40% after six years, which drops the overall highest tax burden to 44.2%.

Real estate capital gains

Before the Finance Bill, capital gains on real estate were subject to a capital gains tax of 19% (an effective rate of 34.5% with the additional social contributions of 15.5%, which became applicable from July 2012 to non-residents). Several allowances were applicable to the capital gains based on the holding period which resulted in a full exemption after 30 years. The Government also investigated the possibility of reducing this period from 30 to 22 years. However, no such measure has been retained in the Finance Bill.

The Finance Bill maintained the 19% capital gains tax for all real estate capital gains until 2015 where sale of constructible real estate (that is, a plot of land on which houses can be built) would have been subject to standard tax brackets. Other restrictive measures were provided for constructible real estate. For other real estate, a special 20% allowance was also provided for sales in 2013 (as an incentive to sell). However, the CC considered that this "two-speed measure" was a breach of equality between taxpayers and the provision was therefore removed. Therefore, the regime, as existing prior to the Finance Bill (as described above) survives.

The Third Amended Finance Bill for 2012 also introduced a specific surcharge on real estate capital gains exceeding EUR50,000. The rate of this surcharge varies in accordance with the amount of the gain. The maximum rate of 6% applies where the gain exceeds EUR260,000.

Caps on tax allowances

Taxpayers can offset their income tax liability with tax credits up to a certain cap. For income earned in 2012, tax credits are limited to EUR18,000 and 6% of taxable income (*Article 200-0 A, French Tax Code*). Some of the most used tax credits covered by that cap are the tax credit for the interest paid on:

- The acquisition of a principal residence.
- Investments in rental real estate.
- Investments in venture capital funds.

The Finance Bill reduces the tax allowances cap against income tax to EUR10,000 per year for income earned in 2013. This cap will not apply to tax credits granted for investments in French overseas departments and territories which will still be capped at EUR18,000. The French overseas departments include French Guyana, Guadeloupe (including the islands of St. Barthélémy and St. Martin), Martinique, Réunion and Mayotte. The overseas territories include French Polynesia, New Caledonia, St. Pierre and Miquelon, and Wallis and Futuna.

Social security increase

Further to the bill for financing of the social security system, social security contributions will also be increased, particularly for self-employed workers.

Wealth tax rates increase

Taxpayers are currently subject to the wealth tax for a net estate exceeding EUR1.3 million. The tax rates range from 0.25% to 0.5%. The Finance Bill sets a new lower threshold of EUR1.3 million and five new tax rates ranging from 0.5% to 1.5% (for net wealth over EUR10 million), but with a capping mechanism to ensure that these households will not pay more than 75% of their income on taxes (including the wealth tax). See also box, *Exceptional contribution*.

The limit of taxation to 50% of the taxpayer's income (the so-called "tax shield") was heavily criticised during the presidential campaign. However, the 75% limitation derives from the same logic, although the "shield" is less protective.

Analysis

Gift and inheritance duties

Inheritance and gift taxes were increased in 2011 to 45% for gifts/inheritances between parents and children. The new Government has gone further and reduced the rebates applicable in direct line from EUR159,325 to EUR100,000. In addition, the period during which previous gifts form part of the transferor's cumulative total to determine the available allowance has been raised from six years to ten years.

METHODS TO REDUCE TAX LIABILITY

While the new system of individual taxation substantially affects individuals with high professional incomes (its aim was to combat unreasonably high remuneration of companies executives), it does not seem to take into account that these individuals are highly internationally mobile.

Business re-organisation

In recent years, some French companies or French subsidiaries of foreign companies have, for business reasons, moved their headquarters, functions, teams or, more modestly, certain of their executives overseas. Re-organisations, because of the economic crisis and new markets or competition are still in process. Split-pay contracts with possibly a transfer of the employee's residence can efficiently contribute to the business's needs and also reduce an employee's tax (and social security contributions) burden. Any re-organisation must be for genuine business reasons (rather than being mainly tax driven) or be supported by economics, and duly documented.

However, the French tax authorities carefully examine split-pay contracts and the effectiveness of any change of residence based on family ties, location of assets and income, and the presence test (that is, where the executive is effectively present). Therefore, any re-organisation must be carefully structured and documented to be effectively implemented.

Certain companies simply terminate French contracts and enter into new contracts overseas with some of their employees. As French companies are currently finding it difficult to hire foreign executives, some new employees, instead of being hired under a French contract, may join a foreign subsidiary. In this situation, the fact that an activity is taxable in the country of exercise of the duties, except where a treaty provides otherwise, must be borne in mind.

In addition, given that the 75% taxation (which might be reintroduced with some amendments in the course of next year) is supposed to be a temporary measure (which, further to the Government's indications, should last for two years), it cannot be excluded that certain exceptional remuneration will be deferred. This means that employees will have to accept the risk that the exceptional remuneration may be forfeited (an inherent part of incentive plans), for income which would have otherwise been acquired in the near future.

Holding companies

Investment income may also be received through exempt holding companies which, by limiting their dividend distributions, have effective control of the received (and therefore taxable) income. However, the structuring must be examined and the jurisdiction of the holding company chosen to limit the risks of double taxation of income at the level of the holding company and then on distribution of dividends to the shareholder. The vehicle may also be an efficient method for wealth tax planning purposes to reduce the reference income on which the 75% shield is assessed (as it used to be). The Finance Bill for 2013 provided that if an individual held 33.33% or more of the distributable income in a company (either directly or indirectly), then the total distribution right must be divided pro rata between all taxpayers. However, this measure was also deleted by the CC.

If any of these methods are deemed to be exclusively tax driven (among other things), they can be challenged as an abuse of law. Therefore, these steps must be carefully planned to limit the risk of challenge.

Transfers of residence (which are reportedly increasing) may limit exposure to income tax, wealth tax and inheritance/gift tax particularly in relation to non-French source income or French movable assets. However, this implies a change of life style and a certain discipline in order to support the reality of the transfer. The family and personal aspect must not be forgotten, tax being only a tool not a goal.

Anti-abuse measures

Anti-abuse measures are increasing and must be borne in mind, for example:

- Reporting obligations in relation to trust assets, where the settlor, a beneficiary or the trust assets are French, have been in force since September 2012. Penalties up to 5% of the trust assets apply for failure to comply. This measure provides the tax authorities with information necessary to collect wealth tax (payable by the trust's settlor irrespective of the trust's nature) and inheritance duties. Therefore, the possibility of a wealth tax exemption for settlors of irrevocable trusts residing in France has been repealed.
- Transfers of residence outside France were previously tax efficient, particularly in relation to capital gains on movable assets, which became taxable in the country of residence and not in France. However, transfers of residence occurring from March 2011 trigger an exit tax, including for the French income tax purposes potential capital gains on shareholdings of potential expatriates. The exit tax is calculated, for transfers occurring between 28 September 2012 and 31 December 2012, by application of a fixed rate of 39.5% and thereafter (that is from 2013) by application of the progressive income tax rates (plus 15.5% additional contributions), unless the taxpayer can benefit from the holding period-dependant rebate and/or from the reduced rate of 34.5%.

EXCEPTIONAL CONTRIBUTION

For 2012, an exceptional contribution with rates ranging from 0.25% to 1.8% applies on taxpayers' net assets (the 0.5% wealth tax can be offset against this contribution). No capping mechanism is provided, which may lead to a situation where taxpayers must pay taxes higher than their income. The Constitutional Court has allowed this contribution precisely because of its exceptional nature. However, if a tax exceeds a taxpayer's income and the taxpayer must sell assets to meet its tax liabilities, it arguably may breach Protocol 1 of the European Convention on Human Rights, in relation to the right to respect an individual's property rights.

- The Government is examining the possibility to tax income and wealth of French citizens notwithstanding their non-resident status. The Finance Bill does not contain any provision in this respect and the timing of the measure is unknown. However, this reform may be difficult to implement as it contradicts EU and treaty law. For example, tax treaties entered into by France and which, (for a great majority of them) attribute the right to tax depending on the residence of a taxpayer and not with regard to his citizenship.
- The Government may also attempt to renegotiate a certain number of tax treaties to both:
  - discourage French citizens from becoming non-residents for reasons related to income tax, wealth tax or inheritance duties; and
  - reduce the use of certain tax optimisation schemes.

The first agreed draft deriving from the renegotiation of the inheritance tax treaty between France and Switzerland aims to fully apply French domestic law with no allocation of the right to tax between the two states, which is normally the purpose of an income tax treaty. From a Swiss perspective, this first draft confers no benefit.

CONCLUSION

In 2011, some of the most prominent and wealthy executives in France, including those of listed companies, signed a petition seeking to pay higher taxes and signalling that they were ready to contribute to the national effort aimed at reducing the national debt. In the broadest sense, their demands have been met.

However, the significant increase of taxes as against the lack of clarity in the fiscal policy to reduce state spending has created a feeling of injustice among some taxpayers. In addition to the insecurity triggered by increasing retroactive measures or measures implemented with short deadlines, this has led a certain number of French residents, be they French or foreign citizens, to contemplate an expatriation or a restructuring of their assets or life.

The fact that 50% of French taxpayers do not pay any income tax may help to explain why French residents are not affected enough to protest at income tax increases. However, this may prove to be an error of judgement in this economic climate.

Therefore, many re-organisations are expected in the next few years as well as the development of more complex tax planning for those who have no other choice but to stay in France.

Analysis

SUMMARY OF FRENCH TAX REFORMS TO INDIVIDUAL INCOME

	Before the reform	After the reform
Income tax rates	Progressive rates up to 41% (which applies for income above EUR70,830).	Progressive rates up to 45% (which applies for income above EUR150,000).
Special surtax on high income (3% to 4%)	Applicable.	Remains unchanged.
Exceptional contribution on very high income	None.	18% for income above EUR1 million per beneficiary leading to a global taxation of 75% of income above EUR1 million. This measure has been struck down by the CC but could be reintroduced retroactively in the Amended Finance Bill for 2013.
Taxation of share-options and free shares	Preferential rates depending on the nature of equity.	Application of progressive income tax rates plus a 3% to 4% surtax on high income. Maximum taxation up to 74.5%.
Investment income (including capital gains)	Taxation up to 39.5%.	Taxation up to 64.5%. However, certain types of investment income can benefit from a 40% rebate and/or from a tax rate of 34.5%.
Wealth tax	From 0.25% to 0.5%.	From 0.55% to 1.5%.
Gift and inheritance	Up to 45% between parents and children. Rebate of EUR159,325 per parent and child. Tax brackets and rebates renewable every six years.	Up to 45% between parents and children. Rebate of EUR100,000 per parent and child. Tax brackets and rebates renewable every ten years.

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- Lecturer on international taxation at the University of Paris II Assas and also a speaker at conferences on topics such as transfer of domicile, trusts, and assets reorganisation.
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- Acting for multinationals, funds, financial institutions and high net-worth individuals in relation to international planning.
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- Member of the scientific board of the *Association Française des Fiduciaires*.
- Frequent media appearances including television (TF1), newspapers (such as *Les Echos*, *le Figaro* and *Business Week*) and professional publications (such as *Tax Note International* and *Option Finances*).

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