

# Real Estate Newsletter

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## EDITORIAL

The issue of valuing real estate or shares in real estate companies is key for all those involved in the sector, both professionals and private individuals. It clearly has a bearing on investment decisions and can therefore quite significantly reorient a saving where there is a lack of investment options.

However, the subject is not straightforward, given the fact that valuation of a property meets several distinct needs or requirements.

How much is my estate worth and should I keep it or trade it for other assets, which are viewed as more profitable or safer, or even more liquid?

We will see that there are diverse valuation methods for the properties in question and that there are different markets and types of real estate. Our interviewee, François Robine, provides us with a perfect explanation of the environment and development of real estate markets. Understanding the value of your property also means understanding the value of the rights granted to your tenants and, in order to do so, we have devoted an article in this newsletter to the impact of certain contractual clauses of commercial leases on the rental value of leased properties. Understanding the value of a property is also of particular importance where it represents the tax or assessment base for the owner.

It's no secret that real estate is one of the most heavily taxed economic sectors in France and that numerous taxes are based on the market value of a property: wealth tax (ISF), taxes on transfers and gifts, inheritance taxes, income tax or corporation tax in certain instances where there is a divergence between the transaction price and the estimated market value.

In light of this, we will examine the various valuation methods used by practitioners and points of contention with the tax authorities, relating primarily, beyond assessments of actual situations, to the impact of transfer taxes and latent tax liabilities, specifically on the valuation of shares in real estate companies. We will also look at specific developments in real estate valuation in terms of local taxation and the progress of work by the tax authorities in this regard. Once finalised, the revision of rental values will result in a genuine transfer of costs between taxpayers.

Failing amicable agreement between a compulsory vendor and purchaser of a property, it is also on the basis of the estimated market value of a property that the judge of compulsory purchase will determine any expropriation compensation, which mainly consists of compensation equating to the value of the property and additional compensation designed to redress other losses suffered by the compulsory vendor. The specific nature of the procedure applicable in such situations justifies an entire article devoted to this subject in this newsletter. Finally, we will briefly examine, on one hand, the valuation methods commonly used by the German, British, Spanish and Italian tax authorities and, on the other hand, the tax system applicable to early termination payments for commercial leases.

Richard Foissac, Partner

# Real estate in 2015



By **François Robine**,  
Managing Partner,  
François Robine & Associés

## How would you describe the real estate market in 2015?

There is no one real estate market, but several "real estate markets".

Everything only evolves in response to a favourable outlook, based on confidence as well as legal, financial and fiscal stability. A period of weak economic growth and unemployment represents a serious handicap. These markets are either consumer markets for housing or investors markets. Purchases for residential homes are down. Why? Primarily because real estate represents a long-term vision while societal changes in terms of economic needs and fiscal variations are more rapid and raise doubts regarding their sustainability (employment contracts that are too temporary, divorce rates, etc.).

Purchases designed to yield a positive income are providing security, as the rates offered are considerably higher than bank interest rates, above all since they fell below 2.5%. Therefore, there is still a significant margin of remuneration for investors. On the other hand, as it cannot be relocated, real estate is heavily but inconsistently taxed in the long term. This taxation is seen as complicated, unpredictable and prejudicial.

At present, the primary residence market is in decline despite a growing population and needs that are not met in dynamic regions.

## How can investment property be divided and what are the pros and cons?

Investment property can be divided as follows:

- housing (to generate a rental income) has such a regulated rental system that institutional investors withdrew from it years ago and private investors have been stung. Real estate really has the only advantage of retaining capital for the future.

As for new investment in housing, this is only supported by tax incentives, which are seen as temporary, following on from various assistance schemes introduced by successive ministers. Without these schemes, the returns would be derisory,

- ownership of commercial assets, privately or by a company, is only common practice if a shell real estate investment company, which is not liable for corporation tax, owns the property. It is set up for fiscal purposes. Depreciation of the value reduces the attractiveness of a subsequent sale. It is set up for fiscal purposes. Depreciation of the value reduces the attractiveness of a subsequent sale. The asset is then stagnating and it's worth capitalising a usufruct since the property has become practically off-market or heavily discounted should it leave this real estate investment company vehicle.

By contrast, investment property still enjoys a certain degree of popularity because of the fall in interest rates and despite the more moderate fall in the rates of return. The margin generated in this way enables returns that are clearly above those of numerous assets (stocks and bonds, etc.) to be obtained. In this case, real estate is a default investment.

## Is commercial real estate benefiting from a favourable environment?

Commercial rental income can be secured. Legislation on leases is still liberal despite the diminishing effects of the Loi Pinel (June 2014). On the whole, the outlook for three to five years hence remains favourable. Commercial real estate is the asset providing the greatest return over this period.

On the other hand, what will happen when interest rates inevitably rise? Values will fall mechanically because they cannot be financed at a low rate. In-fine capital repayment loans will then become expensive to service. Investment in real estate will no longer appear to be a long term winning investment, but a highly volatile temporary financial product, which is a paradox in this segment. This is the consequence of the excessive financialisation of real estate activities.

## How do you think the real estate market will evolve?

In order to successfully face the inevitable challenge of rising rates, it is better to anticipate and consider the attributes of location, structure and the tenant's signature – the BASICS.

Nevertheless, certain niches are lucrative in the long term, such as tourist (and even social) accommodation and nursing homes, as a result of the ageing population. Whatever the sector, property assets with integrated services provide both returns and sustainability. These are the most favoured assets.

A successful real estate market will include an element of risk for the operator. The distinction between premises and business assets will become blurred.

# Valuation of real estate companies and properties: valuation methods with significant fiscal issues

**The issue of valuing private individuals' or companies' real estate assets is still relevant in a period of crisis where real estate is a safe investment, even though the authorities are applying a great deal of pressure in terms of regards fiscal controls.**

In general, the valuation method that the taxpayer must use in order to fulfil his tax obligations must be based on research into the "market value" of properties, a concept for which, paradoxically, tax law does not provide a definition. It is therefore case law and administrative doctrine that have established the principle according to which the market value of a property equates to the price that could be achieved on the basis of supply and demand on an actual market, leaving aside any suitability value.

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Although the definition adopted in this manner contributes to an objective view of the market value (exchange value) and not a subjective view (suitability or usage value), it appears that the authorities and certain jurisdictions do not satisfactorily apply these principles, which is frequently a source of misunderstanding and uncertainty.

## General valuation principles

Traditionally, the preferred method adopted by case law for determining the market value of real estate consists of referring to the prices recorded for recent sales of intrinsically similar properties. Obviously, there is an abundance of

case law relating to the interpretation of what is meant by intrinsically similar properties, in particular where there are none of these. Hence, the Court of Cassation has ruled that if the actual market value of a property cannot be determined without comparisons being made with sales of intrinsically similar properties, this requirement does not necessarily mean that the real estate examined in this way should be strictly identical, in terms of time, environment and location (Cass. com. 12th January 1993 no. 25 P,

SCI du Chemin des Anes). Nevertheless, this comparison method has its limits in the case of properties generating revenue and, even more so, as regards real estate companies. As this relates to properties, there is a real difference between valuing a private asset, a primary or secondary residence, and valuing

valuing a property generating income, for which the income capitalisation method is most frequently used. Although this consists of determining the value of a property by capitalising its revenue, it still borrows from the comparison method in the sense that the capitalisation rate adopted is, in principle, that applied by the market and reflected by the most recent transactions. In doing so, there may be numerous sources of disagreement with the authorities when applying this method.

First and foremost, it is necessary to adopt the same definition of the property's revenue, i.e. gross rent, net rent and even triple A rent, for example.

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By **Richard Foissac**, partner and tax specialist, dealing specifically with acquisitions and the restructuring of listed and unlisted real estate groups, as well as advising on their operations. A lecturer in tax law at the Universities of Paris I and Nice Sophia-Antipolis.  
[richard.foissac@cms-bfl.com](mailto:richard.foissac@cms-bfl.com)



and **Frédéric Gerner**, tax partner, providing advisory and litigation services for matters relating to direct taxation, in particular those involving intra-group restructuring and real estate.  
[frederic.gerner@cms-bfl.com](mailto:frederic.gerner@cms-bfl.com)

In addition, the quality of tenants as well as the nature and term of the lease agreed specifically influence the capitalisation rate used for rents. Finally, physical, geographic, legal and economic factors may also be taken into consideration. Therefore, this may be a question of the state repair of the property and work to be carried out, or a forthcoming change to the property's operating conditions (a change in the urban development environment or even the regulatory environment).

### Real estate companies

The issue of valuing private individuals' or companies' real estate assets also frequently arises in relation to property portfolios held via the intermediary of a dedicated company, which is liable for corporation tax or not, where the property generates rental income. In this case, the valuation exercise becomes somewhat more complex as it is a case of valuing a company, but one that largely comprises real estate. This specific aspect means, in general (we are not

talking here about listed or publicly traded companies) and except in certain special cases of recent transfers relating to other shares in the company, which could be used as a comparison value, that the classic financial methods for

determining the value of an unlisted company only have a minor influence when determining the value of shares in a real estate company, which is primarily undertaken using the restated net assets method, but with the exception of situations involving minority shareholdings where the capitalised value is no longer used. The restated net asset value method (ACV) consists of adding the unrealised gain determined for the real estate held to the company's net assets: in this case the valuation of real estate is undertaken as outlined above.

Therefore, by way of an example, the yield (VR) or discounting future cash flow (DCF) methods are seldom adopted when determining the value of shares and frequently only used within the framework of standard weighting ( $VMR \times 3 + VR \times 1 + VDFC \times 1$ )/5.

Various adjustments are made to the values determined in this manner, in order to take account of the absence of stock liquidity or

or a minority shareholding or even, in the case of partnerships, of the risk known as "liability", which justifies discounts of the same name.

We will subsequently mention two other tax-related types of adjustments to values, which continue to be discussed with the tax authorities and which, although established in practice, remain disputed, and which may result in theoretical market values that are higher than the values obtained by the taxpayer.

### The impact of transfer taxes

One of the true tax-related issues, which arises when determining the value of a real estate asset, is therefore associated with taking account of the cost of transfer taxes, the influence of which is far from negligible within the framework of transactions relating to the assets or shares of real estate companies.

From the point of view of investors or transferees, the price that they are prepared to pay to acquire the assets is generally formulated by taking account of the acquisition costs, foremost among which are registration fees where they are due on a transfer: in this case, the value that investors assign to an asset, equating to the price that they agree to pay, is known as "including transfer taxes". At the same time, from the point of view of property owners, the market value is frequently expressed as "excluding transfer taxes" and, in this case, equates to the net selling price that may hope to retain from the sale of their assets, taking account of the conditions imposed on them by the market and the purchasers. This value known as "excluding transfer taxes" or "net selling price" will form the basis for calculating their capital gain or loss; it is also the market value that will serve as the base for the applicable transfer taxes should the property be sold.

The question arises of the ability that the taxpayer has, as part of the valuation of shares in a real estate company, to retain a valuation approach excluding transfer taxes for shares, even though the value of the underlying asset has been determined excluding transfer taxes. Although this is common practice on the market and may have been confirmed by experts and professional bodies, it has been challenged by the tax authorities in various cases, on the grounds that it would result in a kind of "double discount" by taking account of an identical cost twice. The authorities believe that the taxpayer should only adopt the excluding transfer taxes valuation approach on a single level as the former is only transferring a single property. The authorities' rationale turns out to be entirely questionable since, justified or not, the offending method is in current

***"The yield or discounting future cash flow methods are seldom adopted when determining the value of shares and are frequently only used within the framework of weighting."***

use on the market for actual transactions. The Council of State should be called on to settle this matter soon.

### The impact of latent tax liabilities

However, the main discount applied to the value of shares in a real estate company is the discount for latent tax liabilities, which is based on the existence of unrealised tax liabilities deemed to be in existence on the date on which the shares are valued at the level of unrealised gains appearing in the company's real estate assets. Buyers actually believe that they will be required to bear the latent tax liabilities in question in the event of a subsequent transfer of the property by the company, even though they do not have the means to absorb the cost of the purchase of rights representing the real estate acquired, as these are company shares.

Therefore, the corresponding discount is liable to amount to the corporation tax on the unrealised gains calculated at a rate of 33.3%. Bear in mind that this discount relates,

in principle, to real estate companies liable for corporation tax, insofar as "Quémener" case law allows, under certain conditions, a company liable for corporation tax, which is acquiring shares in a partnership that is not liable for corporation tax, to

wind up the company it has acquired and to revalue its assets without bearing the fiscal cost of a gain that it has already paid in the share price.

While market practice has clearly confirmed the existence of this discount, with only the theoretical rate of corporation tax applied being liable to vary, because of negotiations between the parties, the tax authorities and departmental conciliation commissions (in this respect also Cass. com. of 12th June 2012, no. 11-30396) refuse to allow it to be taken into account, in practice, except for shares in estate agents, property developers and companies building and selling properties, on the grounds that, since the business of a real estate company is not to transfer all its assets, no discount to take account of a latent tax liability on assets deemed useful for operations and therefore intended to be retained, would be justified. Here again, it is possible to see the entirely questionable manner

in which the theoretical notion of market price may be applied where market practices and customs contribute differently to determining the value of such shares.

### The protection offered by case law for the need for a significant difference

It should ultimately be noted that the Council of State, called on to rule on the existence of liberality in the event of a lack of prices, requires the authorities to provide proof of the existence of a significant difference between the market value of a property and the transaction price and that, therefore, in a Hérail ruling of 3rd July 2009, the Supreme Court deemed that a difference of between 9% and 20% was not significant, with the public rapporteur in this case explaining that it "appears out of the question to view as significant a price that would not differ by less than 20% from the estimated market value". Apart from the fact that this ruling was issued in relation to the valuation of unlisted, non-real estate shares, recent developments in

administrative case law may imply a hardening.

Faced with an appeal against a judgment of 21st April 2011 by the Nantes Administrative Appeal Court, which ruled that a difference of 12% between the market value adopted by the authorities and

the transfer price of an apartment was sufficiently significant, the Council of State issued a decision to refuse to accept an appeal, with the public rapporteur stating that the judge of cassation should not exercise control over legal classifications relating to the significant nature of the difference but should leave this assessment to the sovereign power of trial judges.

***"The main discount applied to the value of shares in a real estate company is the discount for latent tax liabilities."***



# Valuation in relation to expropriation or pre-emptive rights

**Failing amicable agreement between a compulsory vendor and purchaser or between the vendor and the holder of a pre-emptive right, the judge of compulsory purchase will determine the market value of the property.**



By **Céline Cloché-Dubois**, associate, specialising in town planning and environmental law, providing advisory and litigation services to companies and public entities publiques. [celine.cloche-dubois@cms-bfl.com](mailto:celine.cloche-dubois@cms-bfl.com)



and **Alice Le Néel**, associate, assisting companies and public entities in relation to town planning and environmental law. [alice.leneel@cms-bfl.com](mailto:alice.leneel@cms-bfl.com)

## Expropriation/Compulsory purchase

The expropriation or compulsory purchase procedure comprises two phases: one is administrative (public inquiry, declaration of public utility and compulsory purchase order) and the other judicial (transfer of ownership of the property and compensation for the compulsory vendor). Failing amicable agreement between the parties, the value of the compensation paid by the compulsory purchaser to the compulsory vendor is determined by the judge of compulsory purchase.

This sum consists up of primary compensation equating to the market value of the property and additional compensation designed to redress losses suffered by the compulsory vendor (re-investment compensation, compensation for depreciation in the case of partial expropriation, etc.). The property is finally valued on the date of the first instance decision and its consistency – i.e. its component parts, quality, condition as well as its rental situation – is assessed on the date of the order enacting the transfer of ownership. In practice, except in a specific situation relating to the property, the market value of the expropriated property is assessed by comparison with data from the real estate market. This data is transmitted by the compulsory vendor and the government commissioner (France Domaine). Expropriated owners may request, free of charge, from the tax authorities, the transmission of information relating to property values declared at the time of transfers occurring within the past five years<sup>1</sup>.

The judge makes a visit to the premises and hears the parties<sup>2</sup>. Should he/she encounter specific problems with valuation, he/she may appoint an expert or be accompanied, when

visiting the premises, by a solicitor/notary<sup>3</sup>. The judge must rule within the limits of the parties' conclusions and those of the government commissioner<sup>4</sup>. He/she must take account of amicable agreements between the compulsory purchaser and the various holders of rights within the scope of operations forming the subject of a declaration of public utility<sup>5</sup>. The value of the primary compensation may not exceed the valuation produced by France Domaine where a

previous transfer, less than five years before the date of the decision enacting the transfer of ownership, resulted in either an administrative valuation or a tax return for a sum below this valuation. Nevertheless, the compulsory vendor may demonstrate that the authorities' valuation does not properly take account of

changes in the real estate market or that the property has, since its transfer, undergone changes to its material or legal consistency, its condition or its occupancy situation<sup>6</sup>.

## Urban pre-emptive rights

An owner wishing to dispose of a property that is subject to a pre-emptive right must issue a declaration of intent to dispose of property (DIA)<sup>7</sup>. The DIA details the price and conditions for the proposed disposal (in particular payment terms). Should the holder of the pre-emptive right decide to acquire the property within a period of two months following receipt of the DIA and failing agreement on the price, it is up to him to take the case to the judge of compulsory purchase.

The price is determined in accordance with the applicable procedure for compulsory purchase<sup>8</sup>. It excludes all additional compensation, unlike the compulsory purchase procedure. Should there be a lack of amicable transactions providing sufficient references to value the property in the same area, account may be taken of transfers occurring for similar properties located in comparable areas.

***“The market value of an expropriated property is assessed by comparison with data from the real estate market.”***

1. Art. L. 322-10 C. Exp.

2. Art. R. 311-14 C. Exp.

3. Art. R. 322-1 C. Exp.

4. Art. R. 311-22 C. Exp.

5. Art. L. 322-8 C. Exp.

6. Art. L. 322-9 C. Exp.

7. Art. L. 211-1 - L. 213-18 C. Urb.

8. Art. R213-11 C. Urb.

# The impact of the contractual clauses of commercial leases on rental value

Rental value is the cornerstone of the status of commercial leases. In effect, renewal of a lease is based around this notion. Therefore, when renewing a lease, the landlord's entire aim consists of returning to the rental value in order to have his rent revalued. In order to do so, he must prove that the base line data contributing to the formation of the rental value has been modified during the course of the lease. On the other hand, for his part, a tenant wishing to obstruct this return will invoke the rent capping rule and demonstrate that nothing has changed. This value will be determined by the courts, which have sovereign power in this respect. In this regard, they must nevertheless take account of the provisions of the lease forming the subject of renewal, as certain contractual clauses will actually have an impact on the rental value assessment. Pursuant to the terms of article R. 145-8 paragraph 1 of Commercial Code: "From the point of view of the parties' respective obligations, restrictions on the use of premises and the obligations normally incumbent on the landlord, which would be passed on to the tenant, without consideration, represent a factor that reduces the rental value. The same applies to obligations imposed on the tenant beyond those resulting from the law or common practice."

Therefore, in order to assess the rental value, account should be taken of restrictions on the use of premises, on the one hand, and the transfer of obligations and costs to the tenant, on the other.

## **Clauses affecting the use of premises**

Where a lease imposes specific constraints on the tenant, such as the obligation to repay the landlord 25% of the price should there be a transfer of his right to lease (CA Paris 5, Chamber A, 27th June 2007, Administrer nov. 2007 p. 32) or a prohibition on affixing a sign or plaque (CA Paris Division 5, 3rd Chamber, 15th Sept. 2010 Jurisdata no. 2010-018352), the rental value will

be subject to a reduction to take account of these constraints.

Conversely, benefits accorded to the lessee will justify an increase in the rental value. The same applies where the lease includes an authorisation to sublet, to freely transfer the right to lease and even the stipulation of a particularly broad destination clause. It is considered that a building permit, the lack of a deposit<sup>1</sup> and even the benefit of a "right to a terrace" for the tenant<sup>2</sup> will result in an increase in the rental value of premises.

## **Clauses enacting a transfer of obligations or costs to the lessee**

It is necessary to ask questions about the obligations and costs that the landlord should bear in principle. If they are underestimated in comparison to what they should have been, the rent for the renewed lease must take account of this. It is mainly in the area of work and repairs and in terms of the tax burden that this idea will be applied. In terms of work and repairs, the

landlord's and the lessee's obligations are defined by Civil Code. The principle is that the tenant is only liable for tenant's repairs and maintenance. Where the lease requires the tenant to pay for all work, including

major repairs covered by article 606 of Civil Code (which applied prior to the Loi Pinel), a reduction is applied when determining the rent for the renewed lease (CA Paris 16, Ch. B, 20th Dec. 2007: Jurisdata no. 2007-354694). As regards taxes and duties, there will be a transfer of costs every time the landlord requires the lessee to pay taxes and duties, for which it is legally liable. The most frequent example is one where the lease requires the tenant to pay real estate tax. It is therefore deemed that "a reduction factor of 10% must be adopted, where a proportion of real estate tax must be paid by the tenant<sup>3</sup>".

In practice, account may be taken of transfers of costs by:



By **Philippe Riglet**, partner, specialising in real estate law and providing repeated advice to large retail chains, hotel groups and investment funds, more specifically in the fields of commercial leases and real estate transactions. He is also the co-author of the Francis Lefebvre "Commercial leases" handbook. philippe.riglet@cms-bfl.com



and **Sandra Kabla**, associate, specialising in real estate law and specifically in commercial leases. She provides both advisory and litigation services and lectures at the University of Paris I. sandra.kabla@cms-bfl.com

1. CA Paris, Division 5 chamber 3, n°. 1213/023 of 21<sup>st</sup> May 2014.

2. CA Versailles 17<sup>th</sup> June 2014 no. 13/05583.

3. CA Rennes, Chamber 5, 22nd October 2014, no. 351, 13/03823

- a direct deduction of their value from the gross rental value;
- by applying a discount measured as a percentage of this value;
- by adjusting the basic unit price. As a result, the rental value must be adjusted to take account of the possible existence of overriding clauses of common law, whether they have an upward or downward effect. As the case may be, these clauses may therefore represent factors that reduce or increase the rental value.

However, reducing factors risk being mitigated by Loi Pinel 2014-626 of 18th June 2014 (art. L. 145-40-2 C. com.) and its implementing decree no. 2014-1317 of 3rd November 2014 (art. R. 145-35 C. com.), which lists the costs which, by their very nature, cannot be passed on to the lessee. Where a cost is deemed to be recoverable from the tenant pursuant to article L. 145-40-2 of Commercial Code, insofar as it does not appear on the list outlined in article R. 145-35 of Commercial Code, the question must be asked whether it could represent an overriding clause of common law pursuant to article R. 145-8 and give rise to a reduction in the rental value. The same applies, for example, to real estate tax, which, to date, has given rise to a reduction.

Finally, as regards the division of work between the landlord and the tenant, the Loi Pinel states that "costs that cannot be charged to the tenant include: 1. expenditure relating to major repairs outlined in article 606 of Civil Code" (C. com art R. 145-35). It is no longer possible to pass on major repairs to the lessee. This factor reducing the rental value is therefore scheduled to disappear.

Irrespective of article R. 145-8 of Commercial Code, there is a clause that has a particularly significant impact on the assessment of rental value: the accession clause. This clause organises the transfer of ownership of structures, work and improvements carried out by the tenant, to the landlord.

Depending on whether accession takes place at the "end of the lease" or the "end of use", the results are completely different.

Accession at the end of the lease means that work carried out by the lessee becomes the property of the landlord on expiry of the lease and must, therefore, be included in the assessment of rental value.

Conversely, if the lease states that accession to work will take place at the end of use or when the lessee departs, this work cannot be taken into account when setting the rental value.

In practice, the Courts will apply a reduction to the rental value (depending on the scale and value of the work) in order to offset the work carried out by the lessee.

It therefore appears that although the contract establishes the rules for the parties and even though renewal of the lease should take place with the same clauses and conditions, the commercial rent panel judge has the discretionary power to re-balance the contract by reducing or increasing the rental

value under the overriding clauses of common law, which reflect the latest developments in the reform of contract law.

***"The rental value must be adjusted to take account of the possible existence of overriding clauses of common law, whether they have an upward or downward effect."***



# Real estate valuation in terms of local taxation, a long-awaited review has begun

According to the Court of Auditors, the “overly complex” process for the establishment of cadastral databases by the tax authorities “produces an outdated and unfair situation” and the judges at the Court stated that the Tax Commission was already concerned about the obsolescence of databases and their disconnection from the economic reality... in a report published in 1989.

It is obvious that this problem has now been compounded to such an extent that the overhaul heralded by the revision of rental values for non-industrial business premises, which was initiated in 2010 – the first assessment of which would result in significant transfers of costs between taxpayers – is proving hard to implement.

We could wager that the same will apply to the revision of rental values for residential premises, which is scheduled to come into force in 2018.

In fact, only the method for valuing industrial premises does not form the subject of reform, insofar as it is based on a mathematical calculation and adapts mechanically to changes in market prices.

The methods for assessing rental value are even more important given that this theoretical rental value is used to determine real estate tax, charges for the removal of household waste, corporate real estate tax and local residence tax.

## Assessment of the rental value for industrial premises

It should be stated at the outset that the notion of industrial premises naturally covers premises in which processing and manufacturing activities, strictly speaking, are carried out, as well as certain premises in which handling activities or

the provision of services take place, where the technical facilities, equipment and tools used are significant and play a prominent role in the business. Without opening a debate on the content of the notion of industrial premises and the scope of case law criteria, the reader will appreciate learning that the majority of logistics warehouses, to some extent mechanised and equipped with cold stores, are now classified as industrial premises by administrative jurisdictions.

The application of this valuation method, known as the accounting method, consists of determining the rental value of the property based on the cost

price of recording fixed assets liable for real estate tax in the assets (land, structures and fixtures and fittings) recorded in the owner's or the operator's balance sheet.

The rental value of properties liable for real estate tax is determined by applying a rate of 8% for land and, for structures, a rate of 9% or 8% depending on whether they have been purchased or created before or after the 1st January 1976. This rental value forms the subject of an annual update based on a coefficient

adopted by parliament.

## The assessment of rental value for non-industrial business premises and residential premises in accordance with current rules

Article 1498 of General Tax Code (CGI) outlines three assessment methods for the rental value of commercial premises, the reference date for which is 1<sup>st</sup> January 1970.

The method known as the “lease method” almost no longer applies as it relates to premises that were leased in 1970.

On the other hand, the method known as the “comparative method” is the most commonly



By **Cathy Goarant-Moraglia**, avocat associé en fiscalité. Elle intervient dans le cadre de la gestion des impôts locaux grevant les programmes immobiliers ainsi que dans le cadre de restructurations lourdes ou de commercialisations. Elle mène également des missions d'audit, d'assistance, de conseil technique et de défense des entreprises dans tous les secteurs d'activité.  
[cathy.goarant@cms-bfl.com](mailto:cathy.goarant@cms-bfl.com)



and **David Barreau**, avocat en fiscalité. Il intervient plus particulièrement dans les dossiers de conseil et de contentieux en matière de fiscalité locale.  
[david.barreau@cms-bfl.com](mailto:david.barreau@cms-bfl.com)

used and consists of assigning a given property or a portion of a property a rental value that is proportional to that which has been adopted, in the municipality's records of revision operations, for other properties of the same kind used as typical or standard for comparison on 1<sup>st</sup> January 1970.

Finally, where these first two methods are not applicable, the rental value is determined using the method known as "direct assessment", which consists of determining the estimated market value of the property on the reference date of 1<sup>st</sup> January 1970, adjusted using a specific reduction, to which an interest rate is applied, in order to obtain the rental value.

The aforementioned rental value is subsequently updated using various coefficients.

***"Although the financial impacts of the revision of rental values for non-industrial business premises cannot yet be assessed, it appears that it will result in significant transfers of costs between the various taxpayers, to such an extent as to justify another deferral of the entry into force of the reform, which is now expected in 2017 at the earliest."***

As regards residential premises, article 1496 of General Tax Code provides for application of the comparative method as described above for commercial premises, but with different adjustments and weightings.

### **The main focuses of the revision of rental values for non-industrial business premises and residential premises**

As regards non-industrial business premises, the reform specifies two valuation methods: the general method known as the "pricing method" and the residual method known as direct assessment. The pricing method consists of applying a price that is representative of the rental market, and not a price for comparable typical premises, to the weighted area of the premises to be assessed (possibly adjusted using a location coefficient). The prices will be determined on the basis of rents recorded in each valuation sector with a uniform rental market for each property category on 1<sup>st</sup> January 2013. The data used to set these prices originates from information declared by the owners of non-industrial business premises in the 6660-REV forms filed during the 1<sup>st</sup> six

months of 2013. These prices will be updated by the tax authorities in line with changes in rents recorded each year (by means of information declared by those liable for corporate real estate tax in the DECLUYER form).

Should it not be possible to apply the pricing method, the residual method consists of applying a uniform interest rate of 8% to the market value of the property recorded on 1<sup>st</sup> January 2013 or on 1<sup>st</sup> January of the year of its construction, if this is later than 2013. This market value will be reduced by 50% for properties assigned partially or entirely to a public service or one identified as of general interest. The law outlines two accompanying measures for the rental value revision procedure:

- a neutralisation coefficient designed to maintain the respective weight of commercial and industrial premises in the databases for real estate tax, charges for the removal of household waste and corporate real estate tax, and which should lead to the reform being undertaken with consistent revenue for local authorities,

- a smoothing mechanism for five years of upwards and downwards variations in the databases for business premises, for which the revision of rental values will result in an increase of more than 10% and 200 euros in the contribution due. As regards residential premises, the revision of rental values, announced for 2018, is being trialled in five French departments with the reference date of 1<sup>st</sup> January 2015. The results are expected next autumn.

Although the financial impacts of the revision of rental values for non-industrial business premises cannot yet be assessed, it appears that it will result in significant transfers of costs between the various taxpayers, to such an extent as to justify another deferral of the entry into force of the reform, which is now expected in 2017 at the earliest.

Likewise, it will be necessary to monitor the financial impact of the revision of rental values for residential premises, to which all those liable for real estate tax and/or local residence tax – and therefore voters – should be sensitive.

# Real estate valuation in Europe

It is interesting to examine valuation practices beyond France's borders. We have therefore asked four lawyers specialising in real estate at firms, which are members of CMS, to provide brief answers to the following questions relating to the valuation of properties within their respective jurisdictions (the United Kingdom, Italy, Spain and Germany): is there a compulsory valuation method or one preferred by the tax authorities in your country? If this is not the case, what is the method generally adopted by practitioners? Are there any differences depending on the taxes in question?

In each of the countries examined, there is no general rule applicable to all taxes, which would be compulsory for determining the value of a property.

In the United Kingdom, the market value is defined as the price that the vendor may reasonably expect in the event of a sale on the market.

This definition applies to corporation tax, to capital gains tax for private individuals and to registration fees. As a general rule, the British tax authorities will agree to view the price applied between independent parties as a market price. The British Royal Institution of Chartered Surveyors ("RICS") regularly publishes a "Red Book" on the valuation of properties, covering the different principles for valuing immovable assets, which, although it is in no way compulsory, is commonly used. In addition, the English tax authorities may request advice from a government agency specialising in property valuation (Valuation Office Agency).

In Italy, for the purpose of income tax, the general rule also consists of referring to the market value of the property. This value is determined by applying the comparable price method on the open market (or "CUP" method). It is customary to refer to a database managed by the Italian tax authorities, which includes, for each type of property (residential, offices, commercial, industrial), for each period (six months) and for each sphere (district, area) the minimum and maximum prices applied within the

framework of property sales (all declared to the Italian tax authorities). It is general practice to adopt a mean value but the condition of the property (new, old, renovated), as well as its specific features, may lead to it moving closer to the minimum or maximum price. As regards registration fees, taxes on gifts, inheritance taxes and local taxes, the situation is different as taxation is not established on the basis of the market value but of the cadastral value, with the latter value being determined by capitalising a theoretical income over a certain number of years.

In Spain, it is generally necessary to refer to the market value, which is usually determined by an expert. Nevertheless, certain local taxes on the transfer of land are determined on the basis of the

the cadastral value and the period of ownership. In addition, for registration fees, the tax authorities in the different autonomous regions publish property valuations. However, if the parties are able to justify a different market value, this last value is generally accepted. Finally, in Germany, reference is also made to the market value for income tax. As regards

registration fees, a specific fiscal value equal to 12.5 times the net annual rent (minus reductions depending on the age of the property) is used in the absence of the payment of a price. A standard value based on valuations from 1964 is also used for real estate tax.

***"In each of the countries examined, there is no general rule applicable to all taxes, which would be compulsory for determining the value of a property."***

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By **Julien Saiac**, international tax partner, dealing specifically with matters relating to international restructuring and real estate investments.  
[julien.saiac@cms-bfl.com](mailto:julien.saiac@cms-bfl.com)

# VAT and lease termination payments: a welcome explanation



By **Armelle Reyes**, tax associate, specialising in VAT, providing advisory and litigation services, in particular for VAT related issues involving real estate.  
armelle.reyes@cms-bfl.com

Determining the applicable VAT system for termination payments is the source of numerous adjustments by the tax authorities. In this area, the latter deals with both losses suffered by the tenant and services rendered by the latter. The Council of State has recently provided helpful clarification on VAT related processing of early termination payments for commercial leases (27th February 2015, 9th sub-section, *SCI Catleya*). On purchasing commercial premises, the real estate investment company – the landlord – concluded an agreement with the lessee, under the terms of which the current lease was terminated early, in return for the payment of compensation. At the same time, the real estate investment company – the landlord – signed a new lease with another company under more favourable market conditions. The authorities questioned the deduction of VAT applied to this compensation on the grounds

that its sole purpose was to redress the loss suffered by the lessee, which was caused by early termination of the commercial lease. The Council of State, hearing the case, ruled that vacating the premises as the result of early termination of the lease must be seen as a clearly isolated service, which was reflected by the opportunity offered to the landlord to conclude a new lease under more favourable market conditions. The direct link therefore appears obvious where the landlord needs to have early and unrestricted use of the property, where the latter's aim is to relet the property or to carry out work on it, and where termination takes place, or not, on expiry of the three-year term (contrary to the position that may have been adopted by the authorities in the past). The hope is that this ruling will provide legal certainty for operators, although there is still some uncertainty in this area.

## C'M/S/ Bureau Francis Lefebvre

2 rue Ancelle  
92522 Neuilly-sur-Seine Cedex  
Tél. 01 47 38 55 00

If you would like to contact the authors of this newsletter, please write to the editorial team, which will pass on your comments to the relevant people. You can also contact:

**M<sup>e</sup> Céline Cloché-Dubois**, [celine.cloche-dubois@cms-bfl.com](mailto:celine.cloche-dubois@cms-bfl.com)

**M<sup>e</sup> Richard Foissac**, [richard.foissac@cms-bfl.com](mailto:richard.foissac@cms-bfl.com)

**M<sup>e</sup> Frédéric Gerner**, [frederic.gerner@cms-bfl.com](mailto:frederic.gerner@cms-bfl.com)

**M<sup>e</sup> Cathy Goarant-Moraglia**, [cathy.goarant@cms-bfl.com](mailto:cathy.goarant@cms-bfl.com)

**M<sup>e</sup> Sandra Kabla**, [sandra.kabla@cms-bfl.com](mailto:sandra.kabla@cms-bfl.com)

**M<sup>e</sup> Armelle Reyes**, [armelle.reyes@cms-bfl.com](mailto:armelle.reyes@cms-bfl.com)

**M<sup>e</sup> Philippe Riglet**, [philippe.riglet@cms-bfl.com](mailto:philippe.riglet@cms-bfl.com)

**M<sup>e</sup> Julien Saiac**, [julien.saiac@cms-bfl.com](mailto:julien.saiac@cms-bfl.com)