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THE 3 PERCENT TAX REGIME REFORM

Pursuant to sections 990 D to 990 H of the French tax code ("FTC"), all French and foreign legal entities that directly or indirectly own real property situated in France are subject to an annual tax equal to 3 percent of such properties' fair market value (as determined on January 1 of the relevant year) ("3% Tax").

The 3% Tax was initially aimed at ensuring effective fiscal supervision and preventing tax avoidance and evasion with respect to the French wealth and inheritance/gift taxes. The objective was to prevent the acquisition of French real estate assets by taxable individuals acting through intermediary entities located in foreign countries. Foreign legal entities established in a jurisdiction whose tax administration cooperated with the French tax authorities pursuant to an applicable tax treaty could, however, be exempt from the 3% Tax, provided that they disclosed the identity of their members to the French tax authorities.

The effect of this mechanism quickly became much broader than a mere tool in the fight against wealth tax avoidance, and it is used today by the French tax authorities to monitor all investment in French real estate. However, the inflexible nature of the 3% Tax regime began to be perceived as restricting foreign investment in French real estate. Further, the European Court of Justice ("ECJ") held that certain provisions of the 3% Tax did not comply with European Union ("EU") law.[1]

The Amended Finance Act for 2007, which is effective as from January 1, 2008, provides for a major reform of the 3% Tax regime aimed at extending its scope, modifying its exemptions, and conforming it to EU law.

1. ECJ, October 11, 2007, Elisa, case # 451/05.

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EXECUTIVE SUMMARY

The main features of the reform are:

- Any French assets held by any intermediary entity will be taken into account in order to determine whether the parent entity is predominantly invested in French real estate for the purposes of the 3% Tax.
- Taxpayers (except those located in a tax haven country) are exempt from the 3% Tax if their direct or indirect share in the fair market value of the real estate assets or rights is less than 100,000 € or 5 percent of the total market value of such real estate assets or rights.
- The disclosure obligations to be exempt from the 3% Tax are less burdensome: the identity of an investor holding less than 1 percent of the shares or rights in a taxpayer does not have to be disclosed.

FORMER 3% TAX REGIME

The 3% Tax applied until January 1, 2007, to legal persons whose French real properties (owned directly or indirectly) represented more than 50 percent of their total French assets ("50% Ratio"). Real properties used in a trade or business (other than passive real estate investments) were not taken into account for purposes of computing this ratio. Individuals were outside the scope of the 3% Tax.

Legal persons falling within the scope of the 3% Tax were nevertheless exempt from the tax in the following situations:

(i) either they met the following cumulative requirements[2]:

(a) their head office was located in France or in a jurisdiction that had concluded a treaty with France providing for mutual assistance and exchange of information in order to fight tax avoidance; and

(b) before May 15 of each year, they filed the tax return relating to the 3% Tax (#2746) that disclosed the following information to the French tax authorities:

- location, nature, and value of the property assets (owned directly or indirectly) as of January 1,
- identity and address of the entity's shareholders,
- and number of shares held by each shareholder;

(ii) or, alternatively, they met the following cumulative requirements[3]:

(a) their effective place of management was located in France or in a country that had concluded a treaty with France including an appropriate nondiscrimination clause; and

(b) either, within two months of the acquisition of the property interests, they undertook to disclose certain information (including evidence of the tax residence of their shareholders or investors) upon the French tax authorities' request, or they disclosed each year similar information by making the 2746 filing.

(iii) they were French real estate partnerships that filed an annual return #2072 or #2038 (including French pass-through *sociétés civiles immobilières* ("SCI"))[4]

(iv) they were publicly listed companies;

(v) they were international organizations, sovereign states and government-owned institutions;

(vi) they were pension funds (*caisses de retraites*) and other nonprofit organizations carrying out a charitable activity, and whose activity justified the ownership of French real estate assets;

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2. Article 990 E-2° of the FTC.

3. Article 990 E-3° of the FTC.

4. Revenue Ruling, 7Q-2112, #22 et 23, September 1, 1997.

(vii) they were SPICAV or real estate investment funds subject to an equivalent regulation in another country or territory with which France has a mutual assistance arrangement.

MAIN FEATURES OF THE REFORM

New Scope of the 3% Tax Regime. Although individuals are still outside the scope of the 3% Tax, the reform extends the scope of this tax to other entities that are not legal persons; this tax may now be applicable to any juridical persons, organisms, "*fiducies*," or any similar institutions.

In this regard, although it was clearly the intention of the legislator to require trusts to make 3% Tax filings, there is still some uncertainty with respect to the scope of the disclosure obligations in order to be exempt from the 3% Tax. For instance, the trustee might be liable for the 3% Tax if it could be considered as having the disposal of the real estate asset in trust (which might be the case in an irrevocable and discretionary trust). Given that all the "members" of an "entity" falling within the scope of the 3% Tax must now be disclosed, the question is to know whether or not the beneficiary or a settlor of a trust may be considered as a "member" covered by the disclosure obligations.

Determination of the 50% Ratio. Under the former 3% Tax regime, the 50% Ratio was determined by dividing (i) the aggregate fair market value of the entity's French real estate assets (owned *directly or indirectly*) (numerator), by (ii) the aggregate fair market value of the entity's total French assets held *directly*, excluding all non-French assets, (denominator). This rule gave rise to some strange results in complex group structures.

As a result of the reform, the 50% Ratio is now determined by dividing (i) the aggregate fair market value of the entity's French real estate assets (owned *directly or indirectly*), excluding the real estate assets used in a trade or business by the entity or any related entity (numerator), by (ii) the aggregate fair market value of the entity's total French assets held *directly or indirectly* whatever the 3% tax position of the intermediary entity (denominator). Accordingly, any French assets held by any intermediary entity will be included in the parent company's denominator for the computation of the 50% Ratio.

French Administrative Tolerance: Loncle Ministerial Answer. If a taxpayer had in good faith failed to comply with the exemption requirements (*i.e.*, filing tax return (#2746) or making the undertaking), it could file the undertaking or tax return (#2746) spontaneously at any time after the deadline without forfeiting the 3% Tax exemption or incurring any penalties on the basis of a ministerial answer.[5] This tolerance was applicable once per taxpayer.

The new section 990 E of the FTC clearly states that the entity falling within the scope of the 3% Tax as of January 1, 2008, must file the undertaking by May 15, 2008. Although the exact effect of this new provision is debated, it appears likely from this new deadline that the above-mentioned ministerial answer can no longer be used by entities that have failed to comply with the exemption requirements. **Therefore, unless the French tax authorities confirm in the coming months that the Loncle ministerial answer is maintained, all entities falling within the scope of the 3% Tax and that have failed to comply with their filing requirements so far should regularize their 3% Tax position by May 15, 2008.**

Scope of the Exemptions.

EU Entity. Under the former 3% Tax regime, EU entities benefited from the undertaking or the filing exemptions only if they could benefit from the provisions of a treaty concluded with France providing for mutual assistance or nondiscrimination. Accordingly, some EU entities that do not enjoy treaties (*e.g.*, Luxembourg 1929 Holding companies), could not benefit from these exemptions. This situation was held to be discriminatory by the ECJ.[6]

5. RM Loncle, AN, March 13, 2000, # 39372, p. 1638.

6. ECJ, October 11, 2007, Elisa, case # 451/05.

As a result of the reform, EU entities will now benefit from the same exemptions as French entities without having to also enjoy tax treaties.

Filing Requirements. As described above, previously a distinction had to be drawn between foreign entities according to the country in which the entities were located: If the entity enjoyed a treaty that included a mutual assistance provision, the foreign entity could file the tax return (#2746). However, if the entity enjoyed a treaty that included a nondiscrimination provision, the foreign entity could file the undertaking or the tax return.

As a result of the reform, any entities located in France, an EU member state, or a country that has concluded a tax treaty with France providing for either mutual assistance or nondiscrimination can obtain an exemption from the 3% Tax either by filing an undertaking or a return.

In addition, the filing requirements are less burdensome under the new 3% Tax regime:

- Entities are exempt from the 3% Tax without having to comply with any filing requirements if their direct or indirect share of the fair market value of the French real estate assets or rights is less than 100,000 euros or 5 percent of the market value of such real estate assets or rights.

- The disclosure obligations relating to the undertaking or the tax return do not include the members of a taxpayer who hold less than 1 percent of the shares or rights.

- Evidence of the tax residency of the entity's members is no longer required when filing an undertaking.

Note, however, that whereas previously SCIs and SNCs that filed their income tax returns were not obliged to file 3% Tax forms (the information contained in the income tax returns sufficed), it seems likely that the new filing requirement will put an end to this tolerance.

Pension Funds. Pursuant to the former 3% Tax regime, pension funds (*caisses de retraites*) and other nonprofit organizations (even those located in a tax haven country) could be exempt from the 3% Tax provided that they did not carry out a profit-making activity, to the extent their activity justified the ownership of French real estate assets.

As a result of the reform, any entity established in France, an EU member state, or a country that has concluded a tax treaty with France providing for mutual assistance or nondiscrimination can be exempt from the 3% Tax if the entity:

- manages pension funds

- is a public-interest organization

- is a nonprofit organization whose activity or financing justify the ownership of the real estate assets or rights.

The reform is therefore double-edged: On the one hand, any entity located in a tax haven country can no longer benefit from this exemption, but on the other, the scope of this exemption has been extended since pension funds are no longer required to be not-for-profit organizations.

Tax haven entities, the assets of which were mainly composed of real estate properties for the purposes of the 3% Tax, may only be exempt from the 3% Tax if they are listed.

Listed Entities and their 100 Percent Subsidiaries. The listed entity exemption has been reinforced and extended; henceforth, listed entities are only exempt if their shares are subject to significant and regular negotiations on a regulated market. The exemption applicable to listed entities is no longer an objective exemption but requires a subjective interpretation. Thus, entities listed on a foreign regulated market, where the shares are not subject, in practice, to any trading, will not be exempt. The expression "*significant and regular negotiations*" is expected to be further defined by the French tax authorities in the statement of practice dealing with the reform. In particular, they are expected to set out whether minimum float conditions will be required for a taxpayer to be eligible for this exemption. However, as a counterpoint to this restriction, the new regime provides that any 100 percent owned subsidiary of a qualifying listed entity is also exempt from the 3% Tax.

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