International

French Income Tax on Discretionary Trust Income

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Some continental jurisdictions, lacking a history of trust law and practice, are still in a learning curve when it comes to taxing income arising in a discretionary trust. This article deals with France and a number of decisions which have been made by the courts there in order to fill something of a vacuum in the domestic tax legislation.

In the most recent decision n° 19PA00458 of 24 June 2020 the Administrative Court of Appeal (CAA) of Paris has confirmed that the beneficiary of a discretionary trust does not hold an "interest in an entity" in the sense of art.123 *bis* of the Code Général des Impôts (CGI) and therefore should not be subject to income tax unless an actual distribution has been made to them.

The decision is welcomed with enthusiasm by trust and estate practitioners. It may however not be the end of the troublesome relationship between the French revenue and trusts or trust-like structures.

Taxation of distributed income

Until the coming into force of art.14 of the supplementary budget for 2011 ("LFR 900-2011"),[1] the taxation of trusts was essentially governed by case law and thus resulted in a great deal of uncertainty. LFR 900-2011 introduced a definition of trusts into the CGI and also a specific tax and compliance regime.

Article 120.9 CGI

Generally, under art.120.9 of the CGI income distributed by a trust to a French resident is subject to tax as "foreign movable capital income."

Since 2018 the beneficiary may opt for a fixed 30% Prélèvement Forfaitaire Unique (PFU) or be taxed under the following sliding scale:

Up to €10,064	0%
From €10,065 to €27,794	11%
From €27,795 to €74,517	30%
From €74,518 to €156,806	41%
Above €156,806	45%

A 17.2 % social security contribution may apply in addition to the above.

[1] *Loi n° 2011-900 du 29 juillet 2011 de Finances Rectificative pour 2011, art.14.*

Finally, a high income tax may apply as follows (married couple) :

From €500,000 to €1,000,000	3%
Above €1,000,000	4%

Accumulated income is not taxable except where art.123 *bis* of CGI applies.

Article 123 *bis* of the CGI

Article 123 *bis* results from art.101 of the loi 98-1266 of 30 December 1998 (Budget 1999), aimed at "defeating international tax evasion".[2]

Wherever a French resident individual holds a minimum of 10% of the "shares, financial rights or voting rights of a corporate, fiduciary or other entity established or constituted outside France and subject to a fiscally privileged tax regime," art.123 *bis* creates an irrefutable presumption of income which is then subject to tax and social security contributions.

A "fiscally privileged" regime is defined by reference to art.238A of the CGI as one which is subject to "less than half of the tax that would apply if the entity was established in France." This would include not only all offshore jurisdictions but also to some EU jurisdictions, including Luxembourg.

CAA Nancy 22 August 2008

Article 123 *bis* was ruled in breach of European freedom of movement by the CAA of Nancy on 22 August 2008 in a case precisely involving Luxembourg.[3]

Budget 2010

Consequently the 2010 budget, or law of 30 December 2009, introduced a "safeguard clause" setting aside the irrefutable presumption of art.123 *bis* wherever the entity is situated in a Member State of the European Union.

This law introduced a new irrefutable presumption : the 10% minimum share is deemed to be satisfied where the individual has transferred his assets or interests to a legal entity situated in a non-cooperative state or jurisdiction. The list of non-cooperative states or jurisdictions is permanently updated but currently is : Anguilla, Bahamas, Fiji, Guam, British Virgin Islands, US Virgin Islands, Oman, Panama, American Samoa, Samoa, Seychelles, Trinidad & Tobago and Vanuatu.

In practice, wherever the French Revenue can identify a transfer to an entity in such a non-cooperative state or jurisdiction they do not have to establish that the individual holds a minimum of 10% in the entity and the French Revenue are entitled to tax the whole entity.

2016-614 QPC

Art.123 *bis* was eventually taken before the Conseil Constitutionnel on the grounds of a breach of the Declaration of the Rights of Man and of the Citizen (DRMC) and the principle of Equal Distribution of Contributions contained in art. XIII of DRMC.

[2] Exposé des motifs Art.101.
[3] CAA Nancy 22 août 2008, *Rifaut n° 07-783*

It is on the basis of art.XIII that the Conseil Constitutionel had, previously, repeatedly ruled against taxation based on irrefutable presumptions introduced in statute :

(1) 2010-70 QPC of 26 November 2010 : on art.155A of the CGI (taxation of services invoiced from abroad on a deemed basis).

(2) 2010-88 QPC of 21 January 2011 : on art.168 of the CGI (taxation of a deemed income according to lifestyle).

(3) 2012-661 DC of 29 December 2012 : on art.68 of the CGI (taxation of the beneficiary of a lifetime gift on a deemed underlying profit).

(4) 2016-598 QPC of 25 November 2016 : on art.187 of the CGI (fixed 75% tax for distributions to an entity located in a non-cooperative jurisdiction).

In 2016-614 QPC the Conseil Constitutionnel ruled that "Article 123 *bis* is aimed at tax evasion through the use of tax privileged jurisdictions which is in itself in accordance with the Constitution."

However, by introducing an exemption applicable only to European entities in 2009, the legislation maintained an irrefutable presumption for all other jurisdictions in breach of the principle of Equal Distribution of Contributions of art. XIII of the DRMC.

2016-614 QPC therefore extended the European "safeguard clause" to all jurisdictions, and the individual should always be in a position to provide evidence of his actual interest in the entity and level of income.

CAA de Paris, 2ème chambre, 24/06/2020, 19PA00458

This was an appeal to the CAA of Paris from a decision of the Tribunal administratif of Paris on 28 November 2018. The case involves the French resident beneficiary of three Bermudian trusts subject to tax under art.123 *bis* as confirmed by the Tribunal administratif.

The beneficiary here claimed that since the trust was irrevocable and discretionary, he should not be regarded as holding a 10% share in a fiduciary entity and article 123 *bis* should not apply.

The CAA confirmed the first decision of the Tribunal administratif by reference to the parliamentary debates of Budget 1999 (above), concluding that "corporate, fiduciary or other entit[ies]" established or constituted outside France and subject to a fiscally privileged tax regime should include "trusts" in the sense of "Anglo-Saxon law" (sic).

However, it overruled the Tribunal on art.123 *bis* and stated that, the Bermudian trusts being discretionary trusts, their beneficiaries should not be regarded as holding a share or an interest in the entities, as the decision to make distributions belonged to the trustees, a "distinct corporate structure entity" over which the beneficiaries exerted no control.

The decision was in line with a decision of the Tribunal de Grande Instance (TGI) of Nanterre on 4 May 2004,[4] which had ruled in similar terms that property held in a discretionary trust over which the settlor had no rights no longer formed part of his estate for wealth tax purposes.

[4] TGI Nanterre 4 mai 2004 n° 03-9350, 2e Ch., Poillot.

The end of Article 123 *bis*?

So is this the end of taxation of offshore trusts under art.123 *bis*? This is unlikely.

Ruling on art.885G *ter* of CGI, which submitted trust assets to the Impôt de Solidarité sur la Fortune (ISF, a French wealth tax now abolished) as deemed to form part of the settlor's wealth, the Conseil Constitutionel in 2017-679 QPC confirmed that—

> ". . . the settlor (or deemed-settlor) must have the possibility of demonstrating that the assets, rights and products in trust do not confer on it any capacity to contribute, resulting in particular from the direct or indirect benefits that it derives from these assets, rights or products."

The proof however cannot result solely from the irrevocable nature of the trust and the discretionary management power of the trustee.

In other words, an irrevocable trust is not necessarily irrevocable. The French Revenue may see it otherwise when considering the circumstances. The fact that the very notion of a trust is by definition foreign to the French legal system, which in practice can rely only on translated documents, is certainly not reassuring in this respect. The onus will be on the taxpayer to demonstrate the position, which may prove long, costly and with very uncertain results.

It should be noted that the French Revenue did not appeal the Nanterre decision anticipating a likely confirmation by the CAA which would then have created a precedent.

Similarly the CAA of Paris is unlikely to be subject to appeal to the Conseil d'Etat (Supreme Administrative Court), which would be expected to confirm that decision.

Tax lawyers and courts may well be busy again.