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A first victory in our litigation against the French Trust tax regime

In 2011, France enacted a new legislation aimed at taxing to inheritance tax and wealth tax assets put in trust when either the assets, the settlor or one of the beneficiaries are located in France.

Although French law has failed to recognize the trust (France has not even ratified the Hague Convention of 1985 on the recognition of trust), civil cases law have long recognized that a trust regularly set up abroad could produce legal effects in France. In order to allow the taxation in France of assets put in trust to the ISF (and inheritance tax, but we will limit our remarks to the ISF), the 2011 amending Finance law (n ° 2011-900 of July 29th, 2011) provided for the following regulations:

- The settlor is subject to the ISF on the trust's assets;
- The same applies to the beneficiary deemed to be the settlor, that is to say the beneficiary of a trust when the settlor's death has not terminated the trust;
- If the settlor does not declare the property put in trust, he is liable, in addition to the ISF, to a *sui generis* levy equal to the maximum rate of the ISF from the first euro, without any possibility to be capped and with no applicable exemptions (art and business assets for instance);
- The beneficiaries shall be jointly liable for payment of the *sui generis* levy with the settlor and the trustee.

If the choice made by the French legislator may appear rationale when the trust is revocable because the owner of the assets put in the trust can decide to again become owner of the assets put in such trust, it seems to us much more questionable when the trust is irrevocable and discretionary since the transfer of

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the ownership of the assets is definitive.

In this particular situation not only the settlor is no longer the owner of the assets put in trust, but even if he is a beneficiary, he has no means to compel the trustee to pay him the sums necessary to pay off the ISF required by French law.

And if he refuses to declare the assets in trust, the French tax Administration will claim the *sui generis* levy which at best will double his tax burden without the possibility to take advantage of the cap rule. Since the beneficiary is jointly liable for payment of the *sui generis* levy, the tax administration will notify him of the proceedings even though he may not be aware of his status as beneficiary.

This situation raises several constitutional problems:

- Does it comply with the taxpayer's capacities to contribute principle when the tax is based on assets which he is not only the owner of and on which he will never again have any right?
- Is the *sui generis* levy a separate tax or a penalty added to the ISF?
- If it is a separate tax, does the non-application of the exemption and cap respect the contributory capacity of the settlor? And is not the 3% rate at which it accumulates with the ISF excessive given the current yield for non-risk assets?
- If it is a sanction, does it respect the principle of proportionality of penalties whereas the penalty rate to which it results will always exceed 100% of the ISF?
- Does the solidarity of payment also respect the contributory faculties of the beneficiary? And the settlor's right to privacy? And the individualization of penalties?

These questions must be answered. On June 30, 2017, our law firm filed claims before the French supreme administrative court (the "Conseil d'Etat") against the Administrative guidelines which commented on the 2011 law on behalf of several clients affected by these provisions, to which we attached several Priority Questions of Constitutionality ("QPC").

The *Conseil d'Etat* having three months to transmit our QPC to the Constitutional Council, which will also have three months to rule on, these interesting questions

should be answered by the end of the year.

Nevertheless, we already received some goods news.

Even though the Tax Administration was of the view that the *sui generis* levy (art 990 J CGI) and the ISF (art 885 G ter CGI) could be jointly applied. The Tax Administration abandoned several tax adjustments based on this same principle before the *Conseil d'Etat*.

It seems to us that it is important to explicit the arguments leading to this unexpected turn-around of the French tax Administration.

Many settlors of irrevocable and discretionary trusts have declared, through their ISF return, that the assets put in trust have no value since they cannot use or have them at their disposal.

However, the tax Administration considered that the settlors should have mentioned the market value of the assets without taking into account the irrevocable and discretionary character of the trusts. As they then considered that the settlors did not file a correct return, they claimed that the settlors were liable to the *sui generis* levy.

During the tax audit of the settlors, and to reply to our argumentation, the tax Administration considered that the ISF and the *sui generis* levy could be accumulated in the following terms:

"[…] Section 885 G ter and 990 J of the French Tax Code (CGI) allows simultaneous application of those sections on all assets put in trust except for when a settlor or beneficiary have declared regularly those assets in their ISF return.

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The taxation of assets for ISF purposes does not discharge the settlor of the sui generis levy *unless the return was filed regularly. So in case of a tax audit, the tax Administration have the right to ask for the* sui generis *levy for all assets put in trust and subjected to the ISF".*

This position was based on the letter of section 990 J, III paragraph 4 & 5 of the CGI:

"*However, the* sui generis *levy is not due at the rate of the assets, rights and proceeds capitalized when they were:*

1. *Included in the wealth of the settlor or the beneficiary, based on section 885 G ter of the CGI, and regularly declared as such by the taxpayer".*

Unless they were declared regularly on the ISF return, assets put in trust were not exonerated from the *sui generis* levy taking into account that a return mentioning a different amount than the fair market value is considered as irregular.

In one of our cases, a reassessment notice, based on the reasoning above-mentioned, was addressed to the settlor, beneficiaries and trustee according to the solidarity of payment established by section 990 J of the CGI for the *sui generis* levy.

In this particular context, we have challenged before the Conseil d'Etat the constitutionality of the possibility for a taxpayer to be subject for the same year to the ISF and the sui generis levy, and also the solidarity of payment of the sui generis levy.

As regard the accumulation of the *sui generis levy* and the ISF, our law firm based its position on the parliamentary reports. According to those reports, the

legislator had the intention to set up the *sui generis* levy in case some assets put in trust were not declared regularly. In other words, the legislator had no intention to add the *sui generis* levy to the ISF already involving late-payment interests and tax penalties.

Consequently, we pointed out the contradiction between the legislator's intention and the letter of section 990 J of the CGI which considers that it is possible to accumulate the *sui generis* levy and the ISF.

Moreover, we also stressed out that the preamble of the 2011 tax bill on trusts and the parliamentary reports related to tax audits both mentioned this particular levy by using different terms like "levy", "taxation", or even "tax". But what was also indicated about the *sui generis* levy is that its first main purpose was to substitute the ISF by imposing sanctions in case assets put in trust were not mentioned within the ISF return.

However, since section 990 J, III paragraph 4 and 5 of the CGI provides for the accumulation of the ISF and the *sui generis* levy, it seemed to us that it did not respect the Constitution principles whatever the qualification given (tax or sanction).

If the levy is considered as a wealth tax, it would be against the principle of equality toward public charges insofar as there is no cap rule to prevent it from exceeding the taxpayer's incomes on the one hand, and to the extent that the overall rate may reach 3% (1.5% for the highest bracket of the ISF and 1.5% for *sui generis* levy).

If the levy is qualified as a sanction, it would be against the principle of proportionality: a failure in the return of the ISF related to assets put in trust might trigger both the sanctions provided by articles 1728 and 1729 of the CGI that could reach 80% of the tax reassessment and a *sui generis* levy would apply

to a larger tax basis than ISF since no relief is available (ie. art or professional assets).

We have finally been heard by the tax Administration: they indicated in their statements of defense in several cases before the *Conseil d'Etat* that any tax adjustment based on section 990 J of the CGI was an incorrect interpretation made by the tax auditors and would not be recovered.

As a matter of principle, the tax Administration also indicated that the administrative regulation commenting the *sui generis* levy was in accordance with section 990 J of the CGI and does only transpose the legislator's intention. In other words, the *sui generis* levy should only substitute to the ISF when there are assets or rights put in trusts which are not declared regularly. The *sui generis* levy is then not supposed to be added to the ISF.

As this interpretation of the letter of section 990 J does not lead directly to that result of non-accumulation, the tax Administration have a restrictive interpretation of article 990 J of the CGI but in accordance with the legislator's intention.

Hence what are the consequences of the tax Administration's turn-around.

In our cases, the settlors had declared their trust's assets on their ISF return. However, they declared that their trust's assets had no value. As a result of the position now taken by the tax administration, should we conclude that the *sui generis* levy would only be applicable in the absence of any ISF return?

In case of an undeclared trust for ISF purposes, the reassessment can legally be operated either on the ISF or on the *sui generis* levy but not on both of them.

On which legal basis should the tax inspector decide? In absence of clear

guidelines, they would be able to pick up the legal ground that would be the more favorable for them: either the *sui generis* levy if the taxpayer may take advantage of the cap rule or of tax exemptions (arts or professional assets for instance) or the ISF if they can apply tax penalties for intentional negligence.

It seems to us that such a solution would be against the principle of equality before the law since it is perfectly possible to have two taxpayers neglecting their ISF obligations and not getting reassessed on the same legal basis (which would be exclusively decided discretionarily by the tax Administration).

Anyway, since the argument concerning the tax adjustment based on the *sui generis* levy has been won, it seems very likely the Constitutional Court will not have to decide on the solidarity of payment instructed for the payment of this tax. It is unfortunate since those questions might have interested other measures of solidarity.

Nevertheless, winning a battle does not mean the war is over. Even if we are expecting answers for our arguments concerning the ISF sometime before the end of the year, other legal measures should be contested, especially the application for inheritance tax in the event of death of the settlor even if no distribution occurs to the beneficiaries, provided by section 792-0 bis of the CGI. And we are currently working on it.

Cette note d'information générale ne saurait s'assimiler ou se substituer à une consultation juridique. Elle ne saurait remplacer un entretien privé avec un avocat qui, après étude des circonstances de fait et de droit propres à chaque dossier individuel, sera en mesure d'apporter une solution précise et adaptée à chaque dossier compte tenu de ses spécificités.