BREATHING A NEW LIFE INTO INVESTMENT TAXATION

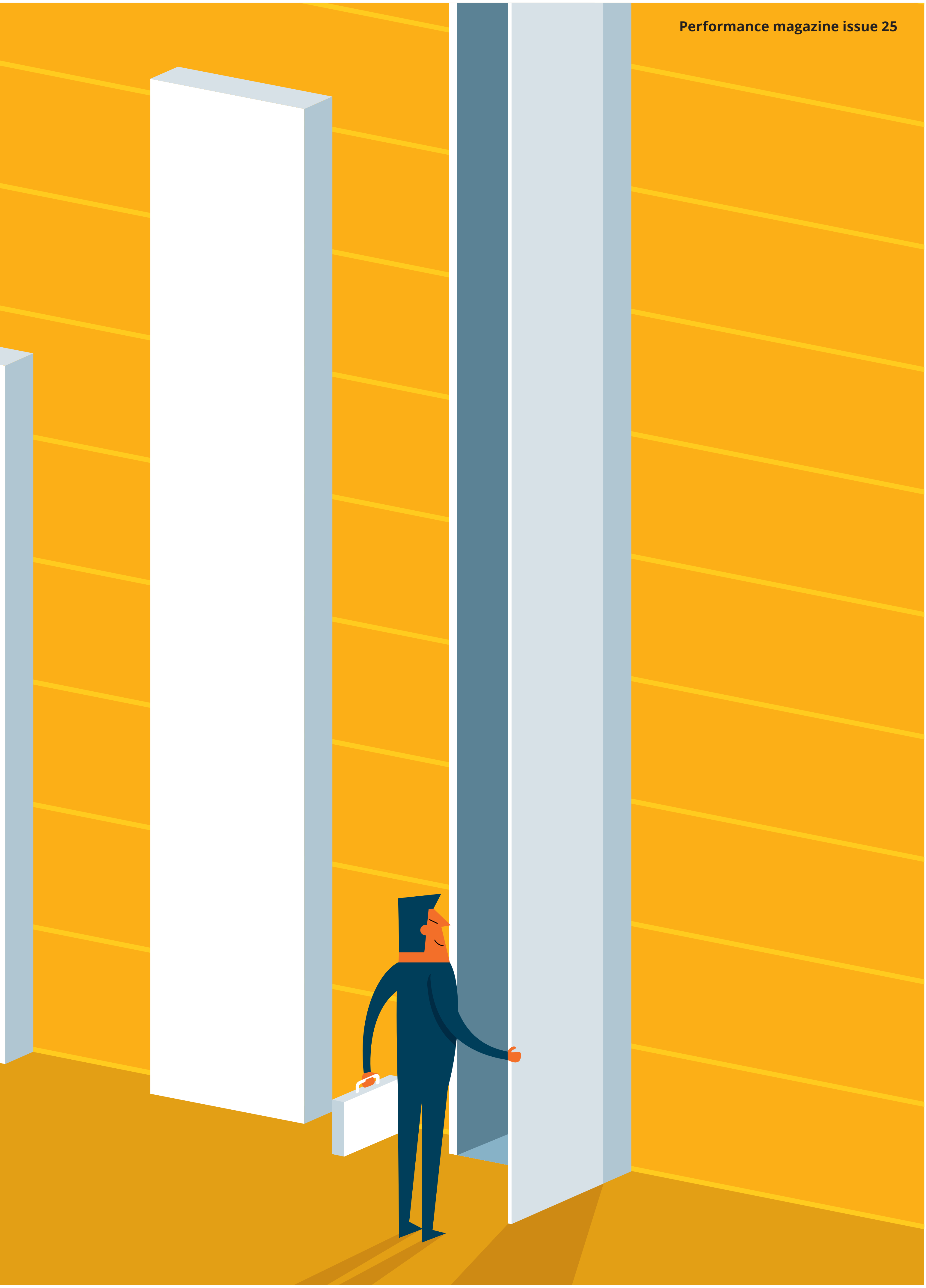
The French Finance Bill 2018

Helene Alston
Partner
Taj

Alexis Fillinger
Partner
Taj

Caroline Wiesener
Manager
Taj

On 21 November 2017, the lower house of the French parliament (*Assemblée Nationale*) adopted the draft finance bill for 2018 (*Projet de Loi de Finances pour 2018 or "PLF 2018"*) at the first reading.



Subject to amendments, noteworthy provisions of the finance bill 2018 will include:

- The introduction of a 30 percent flat tax on investment income.
- A new real estate wealth tax.

Although the level of taxation would remain relatively substantial, asset managers and investors have high expectations for this proposed regime.

The new 30 percent flat tax on investment income

Under the proposed tax legislation, a 30 percent flat tax would replace most current tax regimes for investment income and capital gains on securities.

The 30 percent flat tax would apply, provided that there are no stipulations to the contrary, where the operative event ("*fait générateur*") occurs on or after 1 January 2018. The rate would be composite, including a 12.8 percent flat income tax and a 17.2 percent flat social income surtax.

The flat tax would most notably apply to the following:

- **Dividends** (qualified and non-qualified)
- **Interest**
- **Capital gains**
- **Gains on life insurance policies** (under certain conditions)

The flat tax would also apply to capital gains and distributions of funds.
There should be no distinction between retail and closed funds, or European (UCITS/AIF) and non-European funds.

However, it is still beneficial to use a PEA ("*Plan d'épargne en Actions*"—investment savings account in shares) to invest in shares because, after a five-year holding period, there should still be an income tax exemption. This means that only the social security taxes would be due, i.e., taxation would be limited to 17.2 percent instead of 30 percent.

The reporting, withholding, and remittance of the flat tax on the 15th day of the month following the payment of the investment income would be the responsibility of the "paying agent" ("*établissement payeur*").

The paying agent is the entity paying the income to the beneficiary (e.g. company, bank, insurer, etc.). The paying agent is either:

- An entity located in France, to which French tax law is applicable and mandatory.
- An entity located in the European Economic Area (EEA), were:
  - The entity has voluntarily entered into an agreement with the French tax authorities for the purpose of withholding tax on its behalf.
  - The beneficiary has voluntarily mandated the entity to withhold tax and remit it to the French tax authorities.

This represents a significant improvement compared to current tax legislation in which, unless there are stipulations to the contrary, investment income is subject to[1]:

- Social income surtax[2] of 15.5 percent.
- Income tax of up to 45 percent.

1. Excluding the 3 percent or 4 percent tax on high income (Contribution sur les hauts revenus or CHR).
2. The current rate is 15.5 percent. Under the latest draft of the social security finance bill 2018, the 1.7-point increase in social income surtax would be applicable to some investment income arising in 2017.

However, in-depth analysis shows that a series of different rates and regimes apply:

- **Qualifying dividends**[3] are taxed at 42.5 percent, after deduction of a 40 percent[4] allowance on the sole income tax base for "qualified dividends".
- **Non-qualifying interest**[5] is taxed at up to 60.5 percent.
- **Qualifying capital gains**, after tapered relief of 50 percent, 65 percent (after eight years), or 85 percent is applied, depending on the holding period, are taxed at either 60.5 percent, 31.25 percent or 22.25 percent (additional fixed-sum allowances may apply).
- **Non-qualifying capital gains** are taxed at up to 60.5 percent.
- **Gains on life insurance policies** are taxed at the point of partial or full surrender, depending on the length of time that has elapsed since the life insurance policy was taken out, at 60.5 percent, 50.5 percent, 30.5 percent[6], or 23 percent after eight years.

The taxation of capital gains and distributions from funds depends on whether or not they fall under a specific regime. Where this is not the case, funds are subject to a tax rate of up to 60.5 percent.

The specific case of gains on life insurance policies

The application of the new flat tax to life insurance products is one of the more controversial elements of the tax reform. Under the provisions of the draft finance bill 2018, the following would apply:

- A decrease in the taxation of gains on life insurance policies taken out less than eight years before surrender.
- An increase in the taxation of the fraction in excess of €150,000 of the gains on life insurance policies taken out more than eight years before surrender (30 percent vs. 24.7 percent).

The taxation of capital gains and distributions from funds depends on whether or not they fall under a specific regime.

3. Dividends are also currently subject to a non-final 21 percent withholding tax, which can then be offset against income tax.
4. The 40 percent allowance on "qualified dividends" is subject to the following conditions: (1) the company paying dividends is established in the European Union or in a state which has entered into a tax treaty with France; (2) the company is liable to pay corporate tax in France, or if incorporated in a state with which France has a double tax treaty with a clause on administrative assistance, a tax equivalent to corporate tax; (3) the distributed income must be eligible (dividends and similar); (4) the distribution has been decided in accordance with applicable laws (e.g., shareholders meeting resolution).
5. Interest is also currently subject to a non-final 24 percent withholding tax, which can then be offset against income tax.
6. Including a 15.5 percent social income surtax, in addition to the 45 percent, 35 percent, 15 percent and 7.5 percent income tax.

Transitional provisions have been issued regarding gains on life insurance policies in order to maintain the tax rates that were applicable at the time the policyholder paid the premiums (i.e., gains on premiums paid before 27 September 2017).

It should be noted that the implementation of the aforementioned changes to the taxation of gains on life insurance policies is likely to prove challenging for insurers. Indeed, their IT systems will have to be able to determine the applicable tax regime for each fraction of the gain depending on: the date on which the life insurance policy was taken out, the date on which the premiums were paid, whether additional, even older, tax regimes apply, etc.

Finally, the inheritance tax advantages of life insurance would continue to apply, including tax allowances of between €30,500 and €152,000.

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The safeguard clause mechanism
As the introduction of the flat tax is also intended to simplify the existing structure, none of the current proportional allowances would apply.

However, the taxpayer may opt to retain the current tax regime through a "safeguard clause" mechanism ("clause de sauvegarde") (e.g., if the taxpayer’s effective tax rate is below 30 percent). In that case, the 40 percent dividend allowance would apply; and, for shares acquired before 1 January 2018, the proportional allowances on capital gains (up to 65 percent only) would also apply.

It should be noted that this option is global for the taxpayer, meaning that the option would apply to all types of income otherwise subject to the 30 percent flat tax, rather than just one particular income stream or type of income.

The paying agent is responsible for correct withholding and could incur heavy penalties when paying investment income if the withholding is not correctly applied.

The new real estate wealth tax

In an effort to incentivize investment, the French government has decided to exempt non-real estate assets (such as equities, securities, bonds, life insurance, etc.) from wealth tax.

Under the proposed tax legislation, the wealth tax would be repealed and replaced with a real estate wealth tax ("*Impôt sur la Fortune Immobilière*" or IFI), meaning that tax households would then

only be subject to tax on the net value of their sole private real estate wealth.

Real estate wealth tax would need to be paid on the following assets:

- For individuals who have been tax residents of France for five years or more: real estate located in France or outside of France.
- For non-tax residents of France, and for individuals who have been tax residents of France for under five years: real estate located in France only.

Real estate assets should be reported at fair market value (FMV) on 1 January of the year in question.

Under current tax legislation, tax households (individual, spouse, minor children and other dependents) are taxed on the overall net value of all their private assets, including the value of their life insurance policies, but excluding business assets. Tax households are only taxable if the overall net value of their private assets exceeds €1.3 million on 1 January of the year in question.

The inclusion of real estate assets held through entities
Real estate held indirectly through one or more legal entities (partnerships, companies, trusts, etc.) is included in the real estate wealth tax base[7], except:

- Rights in UCITS, investment funds, securitization funds (subject to conditions), (OPCI—real estate collective investment schemes would be included in the tax base).
- Shares, rights or similar in operational entities (subject to conditions).
- Real estate assets held by an operational entity and used in the course of its business activities (e.g., a factory held by a manufacturing company).

The cap on deductible debt
The real estate wealth tax base is the net overall value of the private real estate assets of the tax household, which means that debts relating to chargeable real estate assets, such as mortgages, may be offset against the gross value of chargeable real estate assets.

However, as an anti-abuse measure, subject to conditions, the ratio of deductible to chargeable assets would be capped.

Rates would remain unchanged.

The deductions for donations and investment in SMEs
Additionally, 75 percent of amounts donated to eligible entities (charities, research foundations, etc.) would continue to be deductible from the amount of real estate wealth tax, up to €50,000.

However, direct investments in SMEs, which are currently eligible for a 50 percent deduction under the wealth tax, would no longer be deductible under the real estate wealth tax.

To the point:

- The new investment income tax regime, along with the introduction of a flat tax and wealth tax reforms are a welcome change and a step in the right direction for most financial industry players and investors.
- Asset managers and insurers for all financial intermediaries will now have to adapt in order to offer tax attractive products and ensure beneficial treatment for their investors, particularly as regards life insurance products.

[7] Technically, the taxpayer's shares, rights or similar, in the legal entity would be included in the real estate wealth tax base, in proportion to the value of real estate held by the legal entity relative to all of its assets.