

TAXATION OF FRACTIONAL VACATION PROPERTY IN FRANCE OWNED BY NON-FRENCH RESIDENTS

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This article will provide an overview and summary of tax issues which should be considered by non-French purchasers of fractional interests in real estate located in France. I will begin by introducing certain key concepts of French real estate transactions, ownership entities used for real estate in France, real property taxation in France and the associated tax treaties, and fractional ownership. I will then discuss the nature and extent of taxation of fractional vacation properties located in France, with particular emphasis on the tax effects of various fractional ownership structures, allowance versus prohibition of rentals of the French property, and characterization of the fractional ownership arrangement as “commercial”.

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1. Executive Summary

Ownership of property in France, whether as an individual or as part of a fractional ownership group, will trigger liability for French taxes. The types of taxes likely to be payable, transfer tax, capital gains tax, income tax (if the property is rented), and inheritance tax, are similar to those associated with property ownership in most western democracies, and the tax rates tend to be only slightly higher than the average among these countries. Many nations have tax treaties with France, allowing residents to offset French capital gains, income and inheritance taxes against tax otherwise payable in their home country. Under current French law, no ownership structure, regardless of the type and number of intermediary offshore entities involved, will avoid or significantly diminish taxes owned in France, and some ownership structures may substantially increase French tax. Buyers who are uncomfortable with French real estate taxation should not buy property in France, fractionally or otherwise, regardless of ownership structure.

Fractional ownership and usage arrangements require a non-judicial enforcement mechanism which allows the co-owners to quickly resolve any disputes and, following a fair hearing and opportunity to cure any default, to foreclose upon the ownership interest of a non-paying or non-compliant co-owner. If the fractional ownership agreement can only be enforced through a long and expensive judicial process conducted in a foreign language in a faraway place, the fractional ownership may devolve into a source of constant frustration and endless dispute-related costs, and the owners may be unable to use, rent, or sell their property for periods of months or even years. Fractional owners of property located in a country where the owners do not reside also need to be able to sell, gift or inherit their fractional interests without enduring a long and expensive legal process in a foreign country.

Generally, the owner of a fractional interest in property located in France will be subject to the same types of French tax, and the same French tax rates, as she would if she owned the entire property herself. If the fractionally-owned property is never rented, the legal structure of the fractional ownership arrangement has no bearing on the tax treatment, and the best structure is the one that best serves the twin needs of efficient enforcement/foreclosure and quick and inexpensive

transferability. These typically involve a company formed in a country, like the U.S., with a highly developed and reliable non-judicial dispute resolution and foreclosure mechanism. This foreign company owns a French SCI (a type of French company described below) which, in turn, owns the French property. This is the most common fractional ownership structure currently used for France property by non-French fractional owners and developers.

If the fractional French property is used for vacation rentals, even occasionally, certain fractional ownership structures may trigger “commercial” characterization. Unfortunately, the only structure under which vacation rental will not risk “commercial” characterization is direct deeded ownership, and the enforcement/foreclosure and transferability problems associated with direct deeded ownership outweigh any potential tax advantages. The potential adverse tax consequences of allowing rental within more practical fractional ownership structures may be less likely if rental by the ownership association or company is prohibited, and rent pooling is avoided in favor of individual rentals by the fractional interest owners. But the only way to definitively eliminate the problem is to prohibit all rentals. In the end, purchasers of fractional interest must weight the economic benefits of rental income potential against the possible adverse tax consequences of “commercial” characterization and, based upon the outcome of this analysis, choose between projects that allow rental and projects that do not.

2. Key Aspects of Real Estate Transactions In France: *Notaire* and SCI

In general, each French real estate transaction must be facilitated by a *Notaire* whose job is to research the ownership history of the property, determine the validity of title, prepare transaction documents including the equivalent of deeds and mortgages, and ensure that governmental requirements are fulfilled and taxes paid. Real estate sales and other transfers handled by a *Notaire* typically take about 90 days, and the *Notaire* receives a percentage of the price or value of the property transferred.

Although France allows individuals to own real estate in their own names, many people form a *Société Civile Immobilière* (or “SCI”), which is a form of French entity specifically intended to hold title to real property. The most common reason to own as an SCI is to eliminate certain restrictions relating to inheritance and succession following death. A collateral benefit of SCI ownership is that shares of the entity can be transferred without a *Notaire*.

3. Commercial Characterization of French Property

As discussed below, the characterization of real estate ownership as “commercial” has a significant negative impact on real property taxation in France, including the imposition of additional tax, an increase in tax rate, and automatic depreciation to create an artificial profit on which tax is imposed. Generally speaking, where an individual or group owns real property directly (as opposed to through an SCI or other entity), they can rent the property furnished or unfurnished without triggering “commercial” characterization. Where ownership is held in an SCI, unfurnished rental can avoid “commercial” characterization, but furnished rental automatically causes the SCI to be deemed “commercial”.

SCI owners sometimes try to escape “commercial” characterization by leasing the property to an intermediary unfurnished, then having the intermediary provide the furnishings and sublease the now furnished apartment to the occupant. An alternative variation has the SCI leasing the property to the tenant without furniture, and another entity leasing the furniture to the same tenant. Special care must be taken with either of these structures to ensure that (i) none of the furnishings are owned by an SCI shareholder or a related entity or person, (ii) the tenant signs one rental agreement for the unfurnished apartment and a separate rental agreement for the furniture, and then pays rent separately under each rental agreement each month, and (iii) most importantly, that the SCI owners are not benefiting economically from the presence of the furnishings in the property.

4. France Real Estate Ownership By Offshore or Foreign Companies

Entities formed outside France may own French real estate directly or through an SCI. France recognizes a distinction between *sociétés de personnes*, which are transparent, or “pass-through”, entities for tax purposes, and companies which have a tax identity separate from their owners. Entities which are not *sociétés de personnes* are always deemed “commercial” with all of the resulting negative tax effects, and also pay corporate tax in addition to tax on funds distributed to the shareholders. Entities which are *sociétés de personnes* can be either “commercial” or “non-commercial” depending on the content of their governing documents and their activity.

When considering or discussing French taxation, it is potentially confusing to describe all entities formed outside France as “offshore companies”. Within France, this phrase is generally understood to apply only to entities formed in a country that does not have a tax treaty with France. The distinction between treaty-country entities and non-treaty-country entities is significant because a long history of tax avoidance schemes involving non-treaty-country entities has created a high degree of suspicion of such entities among French tax authorities. This suspicion may make it more difficult for such an entity to achieve *sociétés de personnes* treatment and/or trigger automatic characterization of the non-treaty-country entity as “commercial”. It is best to use the term “offshore company” only in connection with entities formed in non-treaty countries.

Some authors have opined that ownership of an SCI by an entity formed outside France will automatically trigger “commercial” characterization of the SCI. I have been unable to locate any legal authority to support this opinion. Rather, it appears that the “commercial” characterization of the SCI cited by these authors is attributable either to the rental activities of the owner, or to the failure of the foreign entity to qualify as a *sociétés de personnes*.

5. Real Estate and Real Estate Company Taxation in France and Associated Tax Treaties

French real property taxation can be grouped into four categories: (i) transfer/registration tax; (ii) income tax, including tax on capital gains; (iii) inheritance tax; (iv) value added tax, or TVA, payable in some cases if a real estate holding is characterized as a “commercial” enterprise; and (v) the annual 3% tax on properties owned by entities. In an effort to end various tax avoidance schemes, many French tax laws and treaties, including those related to transfer/registration tax, capital gains tax, and inheritance tax, have recently been expanded to include the concept of the “Real Estate Company” which is considered, for tax purposes, exactly the same as real estate. Although the definition of Real Estate Company varies somewhat by context, in general a “Real Estate Company” is an entity with at least 50% of its assets in either (i) real estate in France, and/or (ii) one or more other Real Estate Companies. In practice, this means that a company formed to hold title to real estate in France, or formed to hold shares of another company formed to hold title to real estate in France, will be deemed a Real Estate Company, and the transfer of its ownership or shares will be treated for tax purposes exactly like the transfer of the underlying real estate.

For an owner who lives in a country that has a tax treaty with France, some of these taxes may be offset against tax otherwise due in the country of residence. This means that when French tax exceeds what is owed in the residence country, the taxpayer will pay only the French tax; when French tax is less than what is owed in the residence country, the taxpayer will pay the French tax plus the amount by which the residence country tax exceeds the French tax. In other words, for treaty-country residents, the total payable on tax within the scope of the treaty will always be the greater of the tax owed in either France or the residence country. Treaty countries include the United States and virtually all of Europe.

5.1 France Transfer/Registration Tax

France real estate transfer/registration tax is approximately 5% of the value of the property, and is payable each time French real estate, SCI shares, or Real Estate Company shares, are transferred. The inclusion of Real Estate Companies within the transfer/registration tax regime means France’s real estate transfer/registration tax is due on sale of shares in a foreign entity which owns an SCI.

While it may be difficult for French tax authorities to discover such a share transfer, it is prudent to report transfers and pay the associated French transfer/registration tax voluntarily. Transfer/registration tax is not due when an individual or group transfers property from their own name to an SCI owned by them in identical proportions. French transfer/registration tax is payable at the same rate regardless of whether the ownership is characterized as “commercial”, and generally cannot be offset against tax otherwise due in a treaty country.

5.2 France Capital Gains and Income Tax

France capital gains tax is payable whenever French real estate or SCI shares are sold. Under most French tax treaties, including the U.S. treaty, French capital gains tax is also payable upon a sale of shares in a Real Estate Company. This means French capital gains tax is due on sale of shares in a foreign entity which owns an SCI. Here again, while it may be difficult for French tax authorities to discover such a share transfer, it is prudent to report transfers and pay the associated French capital gains tax voluntarily.

France’s capital gains tax is payable on the difference between the cost basis and the sale proceeds of the property or shares. The tax rate begins at 33 1/3% for non-EU residents, and 16% for (non-French) EU residents. For property not characterized as “commercial”, the “taper rule” reduces the rate 10% per year beginning after five years of ownership, meaning that no capital gains tax is payable upon sale of property held fifteen years or more.

Property characterized as “commercial” fares considerably worse from a capital gains tax perspective. First, the “taper rule” does not apply, meaning that the same tax rate is payable regardless of how long the property or shares have been owned. Second, a corporate rate (higher than those described in the preceding paragraph) will apply if an entity which is not a *sociétés de personnes* is involved in the ownership. Finally, the cost basis of the property will be reduced 2% for each year of ownership based upon presumed depreciation, resulting in a higher capital gain on which tax is due.

Separate from capital gains tax payable on sale, income tax is payable on net rental income regardless of whether a property is characterized as “commercial” and regardless of the way ownership or title is held. Where the property is owned directly or by a *sociétés de personnes* (including an SCI), the income tax rate is based on the taxpayer’s taxable income from French sources. Where the property is owned by a non-transparent company, rental income tax is paid by the company at the corporate rate and again by the shareholders to the extent profits are distributed. Non-transparent companies owe tax on rental income which could have been derived from the property even if it is rented only occasionally or not at all, but the negative effect of presumed rental income is mitigated somewhat by the ability of non-transparent companies to take depreciation deductions and to carry all expense deductions forward indefinitely.

Capital gains tax and income tax can generally be offset against tax otherwise due in a treaty country. For U.S. taxpayers owning non-“commercial” properties, French capital gains tax will generally be greater than U.S. capital gains tax on a sale during the first 8-10 years (depending on the taxpayers U.S. state of residence), and less than U.S. capital gains tax on a sale that occurs later.

5.3 France Inheritance Tax

France inheritance tax is payable when a death causes succession of ownership of real estate or SCI shares. Most French tax treaties, including the U.S. treaty, also make this tax payable on succession of shares in a Real Estate Company. France’s inheritance tax rates range from 20-60% of the value of the real estate or shares, and these taxes can generally be offset against tax otherwise due in a treaty country.

5.4 France Value Added Tax (TVA)

France value added tax (TVA) at the rate of 19.6%, is generally payable on gross rental income if the property is characterized as “commercial” regardless of whether the property is owned by an individual or a company, and regardless of whether a company is or is not a *sociétés de personnes*. TVA generally cannot be offset against tax otherwise due in a treaty country, but may be deductible against operating income or gain on sale in the country of residence.

5.5 France Annual 3% Tax on Properties Owned By Entities

France imposes an annual tax of 3% of the value of real estate owned, directly or indirectly, by most foreign companies (regardless of type or transparency), unless the entity is hosted by a treaty country and a form is filed annually providing information about each of the natural persons who ultimately own and control the company. This tax is intended to discourage the use of foreign companies to launder money. Assuming the form is filed annually, the 3% tax is not payable. Note that the annual filing will effectively inform at least one government agency when shares in the company have been sold, gifted, inherited or otherwise transferred. It remains unclear how broadly this information is disseminated among French tax authorities, but it is prudent to assume that transfer of shares in a foreign entity owning French real estate (directly or through an SCI) will be evident to such authorities, and to pay tax due on such transfers.

6. Key Aspects of Fractional Ownership: Efficient Enforcement and Transferability

In any arrangement involving shared ownership and use of real estate, detailed agreements are essential to ensure fairness and avoid disputes. Each owner must be sure that she will have the usage opportunities and/or income she expects, that the property will be properly managed and maintained, and that the other co-owners will contribute their respective shares of operating costs. In addition to being thorough, detailed and well-organized, agreements for fractional ownership and usage arrangements must be enforceable in a relatively predictable, inexpensive and rapid manner.

In most countries, including France, Britain and the U.S., enforcement through the judicial system will not satisfy a fractional ownership group's needs because it will take too long and be too expensive. Fractional ownership and usage arrangements require a non-judicial enforcement mechanism which allows the co-owners to obtain final resolution of any disputes through mediation or binding arbitration and, following a full and fair hearing and opportunity to cure any default, to foreclose upon or otherwise force sale of the ownership interest of a non-paying or non-compliant co-owner. The U.S. has by far the most developed and reliable non-judicial dispute resolution and foreclosure mechanism, and this feature makes the U.S. an ideal place in which to locate the legal structure and enforcement system of a fractional ownership arrangement, regardless of where the shared property is located and regardless of whether some of the fractional owners reside outside the U.S. If the fractional ownership agreement can be enforced only through a long and expensive judicial process conducted in a foreign language in a faraway place, the co-ownership may devolve into a source of constant frustration and endless dispute-related costs, and the owners may be unable to use, rent, or sell their property for periods of months or even years.

Beyond a detailed agreement and an efficient enforcement and foreclosure mechanism, fractional owners need to be able to sell, gift or inherit their ownership interests relatively quickly and inexpensively. Situations often change in unexpected ways, and owners who did not expect to transfer their co-ownership interests in the foreseeable future sometimes find that they no longer use the property as planned, prefer a different location, need to liquidate to generate funds, get married or divorced, become ill, or even die. If these situations trigger a long and expensive legal process in a foreign country, the affected co-owner or her heirs will be frustrated.

All fractional ownership structures involving property located in a country where the fractional owner does not reside must meet the twin needs of efficient enforcement/foreclosure and quick and inexpensive transferability. Unfortunately, structures meeting these needs can sometimes result in less desirable tax consequences than structures that do not. When structural goals conflict with tax

goals, it is important to carefully weigh the likelihood and consequences of adverse tax treatment against the likelihood and consequences of the inability to use, rent or sell the property due to a protracted co-owner dispute, or the cost and inconvenience of a long and complex transfer or inheritance process. In the vast majority of cases, the potential adverse tax consequences are minor in comparison.

7. Tax Consequences of Fractional Ownership in France

7.1 Tax Consequences of Direct Deeded Fractional Ownership in France

In a direct deeded fractional ownership arrangement, each fractional owner will be listed on the deed as the owner of a specified percentage interest in the property, and will sign a co-ownership agreement detailing her rights and duties in relation to the other co-owners. The tax treatment and enforcement/transfer consequences of this type of fractional ownership arrangement are as follows.

7.1.1 Transfer Tax: Transfer tax will be payable at the rate of 5% of the value of the fractional interest each time a fractional interest is transferred. Transfer tax generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.1.2 Capital Gains Tax: Capital gains tax will be payable following each sale of a fractional interest, based on the difference between the cost basis and net sale price of the fractional interest sold. The capital gains tax rate begins at 33 1/3% for non-EU residents, and 16% for (non-French) EU residents, but the "taper rule" reduces the rate 10% per year beginning after five years of ownership, and no capital gains tax is payable upon sale of property held fifteen years or more. The "taper rule" will not apply if the fractional ownership is characterized as "commercial", but such characterization is unlikely with direct deeded ownership even if the property is periodically rented furnished when not being used by the fractional owners. Capital gains tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.1.3 Income Tax: Each fractional owner will pay French income tax on any net rental income he/she receives, at the tax rate applicable based on the recipients total income from French sources. Residents of non-treaty countries may be subject to an income tax based on three times the rental value of the property. Income tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.1.4 Inheritance Tax: France inheritance tax will be payable upon the death of a fractional interest owner, at the rate of 20-60% of the value of the deceased's fractional interest. Inheritance tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.1.5 Value Added Tax (TVA): France value added tax (TVA), at the rate of 19.6%, is generally payable on gross rental income only if the property is characterized as "commercial", but such characterization is unlikely with direct deeded ownership even if the property is periodically rented furnished when not being used by the fractional owners. TVA generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.1.6 Annual 3% Tax: Direct deeded fractional owners are not subject to France's annual 3% tax on properties owned by entities.

7.1.7 Fractional Ownership Agreement Enforcement/Foreclosure: With direct deeded fractional ownership, the fractional ownership agreement must be enforced in France. This means it must be written in compliance with French law, and enforced by French lawyers using the French judicial system. Fractional owners will need to be willing to travel to France repeatedly to propel the enforcement procedure, and to participate in an enforcement process conducted in French. Non-judicial dispute resolution and foreclosure is generally inefficient

and/or unavailable in France, meaning that enforcement is likely to take years and legal costs are likely to be high.

7.1.8 Transfer of Fractional Interests: Sale, gift and inheritance of direct deeded fractional ownership interests will require the services of a *Notaire* and payment of *Notaire* fees. Sale and gift processing through a *Notaire* typically takes a minimum of 90 days, and inheritance often takes much longer. French law dictates who can inherit real estate even when the deceased owner is not a French resident, and this law may prevent an owner from controlling who will inherit her share following death. Inheritance may also involve procedures in the deceased owner's country of residence.

7.1.9 Summary of Advantages and Disadvantages of Direct Deeded Fractional Ownership in France: Direct deeded fractional ownership offers more advantageous tax consequences than any other form of fractional ownership of property located in France, but the difficulties of enforcing the fractional owner's agreement are formidable. Transfer of a direct deeded fractional interest is time-consuming and expensive, and French inheritance law dictates who can inherit the fractional interest.

7.2 Tax Consequences of Direct SCI Fractional Ownership in France

In a direct SCI fractional ownership arrangement, the property is owned by an SCI and each fractional owner purchases a share of the SCI. The SCI *statut*, or bylaws, specify the rights and duties of the fractional owners. The tax treatment and enforcement/transfer consequences of this type of fractional ownership arrangement are as follows.

7.2.1 Transfer Tax: Transfer tax will be payable at the rate of 5% of the value of the fractional SCI interest each time an SCI share is transferred. Transfer tax generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.2.2 Capital Gains Tax: Capital gains tax will be payable following each sale of an SCI share, based on the difference between the cost basis and net sale price of the SCI share sold. The capital gains tax rate begins at 33 1/3% for non-EU residents, and 16% for (non-French) EU residents, but the "taper rule" may reduce the rate 10% per year beginning after five years of ownership in which case no capital gains tax is payable upon sale of property held fifteen years or more. If the SCI is characterized as "commercial", the "taper rule" will not apply (resulting in a higher tax rate), and the cost basis of the property will be reduced 2% for each year of ownership (resulting in a higher gain amount subject to tax). "Commercial" characterization is automatic if the SCI rents the property furnished. SCIs sometimes try to escape "commercial" characterization by leasing the property unfurnished and having another person or entity provide the furnishings, but this approach is unlikely to be successful in a fractional ownership situation (see discussion above). It may be possible to avoid "commercial" characterization if the SCI itself is prohibited by its *statut* from renting the property, and the only rental permitted is individual fractional interest owners renting out their own allotted usage and retaining all rental income (net of any rental agency fees). This approach is inconsistent with rental income "pooling", where rental income is commingled and shared by the fractional interest owners according to an allocation formula. The ability of the individual rental approach to avoid "commercial" characterization is unknown, and the only way to definitively avoid the adverse tax consequences of "commercial" characterization is to prohibit rental of the property. Capital gains tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.2.3 Income Tax: Each fractional owner will pay French income tax on any net rental income he/she receives, at the tax rate applicable based on the recipients total income from French sources, regardless of whether the SCI is characterized as "commercial". Income tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.2.4 Inheritance Tax: France's inheritance tax will be payable upon the death of a fractional interest owner, at the rate of 20-60% of the value of the deceased's SCI interest. Inheritance tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.2.5 Value Added Tax (TVA): France's value added tax (TVA), at the rate of 19.6%, may be payable on gross rental income if the SCI is characterized as "commercial". TVA generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.2.6 Annual 3% Tax: SCI owners are not subject to France's annual 3% tax on properties owned by foreign entities.

7.2.7 Fractional Ownership Agreement Enforcement/Foreclosure: With direct SCI fractional ownership, the SCI *statut* must be enforced in France. This means it must be written in compliance with French law, and enforced by French lawyers using the French judicial system. Fractional owners will need to be willing to travel to France repeatedly to propel the enforcement procedure, and to participate in an enforcement process conducted in French. Non-judicial dispute resolution and foreclosure is generally inefficient and/or unavailable in France, meaning that enforcement may take years and legal costs are likely to be high, although the process should be slightly more streamlined with direct SCI ownership than with direct deeded ownership.

7.2.8 Transfer of Fractional Interests: Sale or gift of SCI interests does not require the services of a *Notaire*, but does require recording of a notarized deed of conveyance. Accomplishing this without a French attorney or *Notaire* is very difficult. Inheritance of SCI interests requires a French attorney or *Notaire*, and may also involve procedures in the deceased owner's country of residence. The cost and delay associated with selling or gifting SCI shares is likely to be about the same as that of direct deeded fractional interests, but the cost and delay associated with inheritance of SCI shares should be less than that of direct deeded fractional interests. French law does not dictate who can inherit SCI shares, and this is one of the principal advantages of this form of ownership as compared with direct deeded ownership.

7.2.9 Summary of Advantages and Disadvantages of Direct SCI Fractional Ownership in France: Where rental of the fractional property is absolutely prohibited, direct SCI fractional ownership offers tax consequences as beneficial as those of direct deeded fractional ownership. But where rental of the fractional property is permitted, either explicitly or through lack of direct prohibition, "commercial" characterization is possible and would create significant adverse tax consequences. These adverse consequences may be less likely if rent pooling is avoided in favor of individual rentals by the fractional interest owners. Direct SCI fractional ownership has the same formidable enforcement difficulties as direct deeded fractional ownership. Transfer of SCI shares is less time-consuming and expensive than transfer of direct deeded fractional interests, but much more time-consuming and expensive than transfer of shares in most foreign entities used in indirect SCI fractional ownership arrangements.

7.3 Tax Consequences of Direct Foreign Company Ownership in France

In a direct foreign company fractional ownership arrangement, the property is owned by an entity formed in a treaty country (the "Host Country") and recognized under French law as a *sociétés de personnes* (meaning transparent or "pass-through" for income tax purposes). Each fractional owner purchases a share of the foreign company, and the bylaws of the entity specify the rights and duties of the fractional owners. The difference between direct and indirect foreign company fractional ownership is that, in the direct arrangement, the foreign company holds title to the French property, whereas with the indirect arrangement, the foreign company owns shares in an SCI which holds title to the French property. The tax treatment and enforcement/transfer consequences of this type of fractional ownership arrangement are as follows.

7.3.1 Transfer Tax: Transfer tax will be payable at the rate of 5% of the value of the interest each time a foreign company share is transferred. Transfer tax generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.3.2 Capital Gains Tax: Capital gains tax will be payable following each sale of a foreign company share, based on the difference between the cost basis and net sale price of the share sold. The capital gains tax rate begins at 33 1/3% for non-EU residents, and 16% for (non-French) EU residents, but the "taper rule" may reduce the rate 10% per year beginning after five years of ownership in which case no capital gains tax is payable upon sale of property held fifteen years or more. If the foreign company is characterized as "commercial", the "taper rule" will not apply (resulting in a higher tax rate), and the cost basis of the property will be reduced 2% for each year of ownership resulting (resulting in a higher gain amount subject to tax). "Commercial" characterization is automatic if the foreign company rents the property furnished. It may be possible to avoid "commercial" characterization if the foreign company itself is prohibited by its bylaws from renting the property, and the only rental permitted is individual fractional interest owners renting out their own allotted usage and retaining all of the rental income (net of any rental agency fees). This approach is inconsistent with rental income "pooling", where rental income is commingled and shared by the fractional interest owners according to an allocation formula. Qualification of the foreign company as a nonprofit entity should provide still greater protection from "commercial" characterization, because such qualification will generally necessitate a prohibition of all commercial activities, including rentals, by the foreign company. Significantly, for projects being marketed in the U.S., prohibiting rentals by the foreign company and rent pooling, and qualifying the foreign company as a nonprofit entity, will also avoid characterization of the fractional ownership interests as "securities" requiring special governmental approvals and sales licenses. But the extent to which these measures avoid "commercial" characterization in France is unknown, and the only way to definitively avoid the adverse tax consequences of "commercial" characterization is to prohibit rental of the property. Capital gains tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.3.3 Income Tax: Each fractional owner will pay French income tax on any net rental income he/she receives, at the tax rate applicable based on the recipients total income from French sources, regardless of whether the foreign company is characterized as "commercial". Income tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.3.4 Inheritance Tax: France's inheritance tax will be payable upon the death of a fractional interest owner, at the rate of 20-60% of the value of the deceased's foreign company interest. Inheritance tax generally can be offset against tax in the co-owner's country of residence if that country has a French tax treaty.

7.3.5 Value Added Tax (TVA): France's value added tax (TVA), at the rate of 19.6%, may be payable on gross rental income if the foreign company is characterized as "commercial". TVA generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.3.6 Annual 3% Tax: Foreign company owners will be subject to France's annual 3% tax on properties owned by entities unless the entity is hosted by a treaty country and a form is filed annually providing information about each of the natural persons who ultimately own and control the entity. The tax generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.3.7 Fractional Ownership Agreement Enforcement/Foreclosure: With direct foreign company fractional ownership, the fractional ownership agreement can be enforced in the Host Country. This is a significant advantage if the Host Country is one, like the U.S., with a highly developed and reliable non-judicial dispute resolution and foreclosure mechanism,

7.3.8 Transfer of Fractional Interests: Sale, gift or inheritance of direct foreign company fractional ownership interests involves procedures in both the Host Country and France, and

may also involve procedures in the deceased owner's country of residence. The actual transfer of shares occurs in the Host Country, and may or may not require the assistance of an attorney (depending on the country). A notarized deed of conveyance must also be recorded in France, and accomplishing this without a French attorney or *Notaire* is very difficult. The cost and delay associated with selling or gifting shares in a foreign company which holds direct title to French real estate is likely to be greater than the cost and delay associated with selling or gifting of SCI shares or direct deeded fractional interests. The cost and delay associated with inheritance of shares in a foreign company which holds direct title to French real estate is likely to be about the same as the cost and delay associated with inheritance of SCI shares but much lower than that of direct deeded fractional interests. French law does not dictate who can inherit shares in a foreign company which holds direct title to French real estate.

7.3.9 Summary of Advantages and Disadvantages of Direct Foreign Company Fractional Ownership in France: From a tax standpoint, properly structured and reported direct foreign company fractional ownership offers consequences similar to direct SCI fractional ownership. Where rental of the fractional property is absolutely prohibited, tax consequences are the same as those of direct deeded fractional ownership, but where rental is permitted, either explicitly or through lack of direct prohibition, "commercial" characterization can create significant adverse tax consequences. These adverse consequences may be made less likely if rent pooling is avoided in favor of individual rentals by the fractional interest owners, and if the foreign company is formed as a nonprofit entity. From an enforcement standpoint, direct foreign company fractional ownership is significantly superior to both direct SCI fractional ownership and direct deeded fractional ownership because it allows the fractional interest owners to avail themselves of the non-judicial dispute resolution and foreclosure mechanism of the Host Country. But from a transfer standpoint, direct foreign company fractional ownership combines many of the cost and delay disadvantages of both SCI fractional ownership and direct deeded fractional ownership, and is therefore generally less desirable than indirect foreign company fractional ownership (discussed below).

7.4 Tax Consequences of Indirect Foreign Company Ownership in France

In an indirect foreign company fractional ownership arrangement, an company is formed in a treaty country (the "Host Country") and recognized under French law as a *sociétés de personnes* (meaning transparent or "pass-through" for income tax purposes), but the foreign company does not hold title to the property in France. Rather, the transparent foreign company owns the shares of an SCI, which, in turns, holds title to the French property. Each fractional owner purchases a share of the foreign company, and the bylaws of the entity specify the rights and duties of the fractional owners. When fractional owners transfer shares of the foreign company through sale, gift or inheritance, there is no change in the ownership of the SCI shares or the property. The tax treatment and enforcement/transfer consequences of this type of fractional ownership arrangement are as follows.

7.4.1 Transfer Tax: Transfer tax will be payable at the rate of 5% of the value of the interest each time a foreign company share is transferred. Transfer tax generally cannot be offset against tax in the co-owner's country of residence, even if that country has a French tax treaty.

7.4.2 Capital Gains Tax: Capital gains tax will be payable following each sale of a foreign company share, based on the difference between the cost basis and net sale price of the share sold. The capital gains tax rate begins at 33 1/3% for non-EU residents, and 16% for (non-French) EU residents, but the "taper rule" may reduce the rate 10% per year beginning after five years of ownership in which case no capital gains tax is payable upon sale of property held fifteen years or more. If the foreign company is characterized as "commercial", the "taper rule" will not apply (resulting in a higher tax rate), and the cost basis of the property will be reduced 2% for each year of ownership resulting (resulting in a higher gain amount subject to tax). "Commercial" characterization is automatic if the foreign company or its SCI rents the property furnished. It may be possible to avoid "commercial" characterization if both the foreign company and its SCI are prohibited by their respective bylaws from renting the property, and the only rental permitted is individual fractional interest owners renting out their own allotted

usage and retaining all of the rental income (net of any rental agency fees). This approach is inconsistent with rental income “pooling”, where rental income is commingled and shared by the fractional interest owners according to an allocation formula. Qualification of the foreign company as a nonprofit entity should provide still greater protection from “commercial” characterization, because such qualification will generally necessitate a prohibition of all commercial activities, including rentals, by the foreign company. Significantly, for projects being marketed in the U.S., prohibiting rentals by the entities and rent pooling, and qualifying the foreign company as a nonprofit entity, will also avoid characterization of the fractional ownership interests as “securities” requiring special governmental approvals and sales licenses. But the extent to which these measures avoid “commercial” characterization is unknown, and the only way to definitively avoid the adverse tax consequences of “commercial” characterization is to prohibit rental of the property. Capital gains tax generally can be offset against tax in the co-owner’s country of residence if that country has a French tax treaty.

7.4.3 Income Tax: Each fractional owner will pay French income tax on any net rental income he/she receives, at the tax rate applicable based on the recipients total income from French sources, regardless of whether the foreign company is characterized as “commercial”. Income tax generally can be offset against tax in the co-owner’s country of residence if that country has a French tax treaty.

7.4.4 Inheritance Tax: France’s inheritance tax will be payable upon the death of a fractional interest owner, at the rate of 20-60% of the value of the deceased’s foreign company interest. Inheritance tax generally can be offset against tax in the co-owner’s country of residence if that country has a French tax treaty.

7.4.5 Value Added Tax (TVA): France’s value added tax (TVA), at the rate of 19.6%, may be payable on gross rental income if either the foreign company or its SCI is characterized as “commercial”. TVA generally cannot be offset against tax in the co-owner’s country of residence, even if that country has a French tax treaty.

7.4.6 Annual 3% Tax: Foreign company owners will be subject to France’s annual 3% tax on properties owned by entities unless the entity is hosted by a treaty country and a form is filed annually providing information about each of the natural persons who ultimately own and control the entity. The tax generally cannot be offset against tax in the co-owner’s country of residence, even if that country has a French tax treaty.

7.4.7 Fractional Ownership Agreement Enforcement/Foreclosure: Fractional Ownership Agreement Enforcement/Foreclosure: With indirect foreign company fractional ownership, the fractional ownership agreement can be enforced in the Host Country. This is a significant advantage if the Host Country is one, like the U.S., with a highly developed and reliable non-judicial dispute resolution and foreclosure mechanism,

7.4.8 Transfer of Fractional Interests: Sale or gift of indirect foreign company fractional ownership interests occurs entirely in the Host Country; inheritance also occurs in the Host Country, but may involve procedures in the deceased owner’s country of residence. The actual transfer of shares may or may not require the assistance of an attorney in the Host Country (depending on the country). Significantly, transfers of indirect foreign company fractional ownership interests by sale, gift or inheritance do not involve any procedure in France except the filing of required tax declarations and the payment of associated tax. Consequently, the cost and delay associated with selling, gifting or inheriting shares in a foreign company which owns an SCI is likely to be much lower than the cost and delay associated with selling, gifting or inheriting France property fractional ownership interests held in any other structure. French law does not dictate who can inherit shares in a foreign company which owns an SCI.

7.4.9 Summary of Advantages and Disadvantages of Indirect Foreign Company Fractional Ownership in France: From a tax standpoint, properly structured and reported indirect foreign company fractional ownership offers consequences identical to direct foreign company fractional ownership and direct SCI fractional ownership. Where rental of the fractional property is absolutely prohibited, tax consequences are the same as those of direct

deeded fractional ownership, but where rental is permitted, either explicitly or through lack of direct prohibition, "commercial" characterization can create significant adverse tax consequences. These adverse consequences may be made less likely if rent pooling is avoided in favor of individual rentals by the fractional interest owners, and if the foreign company is formed as a nonprofit entity. From an enforcement standpoint, indirect foreign company fractional ownership is significantly superior to both direct SCI fractional ownership and direct deeded fractional ownership because it allows the fractional interest owners to avail themselves of the non-judicial dispute resolution and foreclosure mechanism of the Host Country. From a transfer standpoint, indirect foreign company fractional ownership is superior to all the other French property fractional ownership structures discussed in this article because all transfers occur entirely outside of France, and only tax declarations and payment need occur there.

8. Conclusion

France imposes somewhat greater tax burdens than other countries on non-resident real estate owners, but the owner of a fractional interest fares no worse than if she owned the entire property. Owners who are uncomfortable with French real estate taxation should not buy property in France, fractionally or otherwise, regardless of ownership structure.

If the property is never rented, the legal structure of the fractional ownership arrangement has no bearing on the tax treatment, and the best structure is the one that best serves the twin needs of efficient enforcement/foreclosure and quick and inexpensive transferability. These typically involve a foreign company formed in a country, like the U.S., with highly developed and reliable non-judicial dispute resolution and foreclosure mechanism. This foreign company owns a French SCI which, in turn, owns the shared property.

If the fractional French property is used for vacation rentals, even occasionally, certain fractional ownership structures may trigger "commercial" characterization. Unfortunately, the only structure under which vacation rental will not risk "commercial" characterization is direct deeded ownership, and the enforcement/foreclosure and transferability problems associated with direct deeded ownership outweigh any potential tax advantages. The potential adverse tax consequences of allowing rental within more practical fractional ownership structures may be less likely if rental by the ownership association or company is prohibited, and rent pooling is avoided in favor of individual rentals by the fractional interest owners. But the only way to definitively eliminate the problem is to prohibit all rentals. In the end, purchasers of fractional interest must weight the economic benefits of rental income potential against the possible adverse tax consequences of "commercial" characterization and, based upon the outcome of this analysis, choose between projects that allow rental and projects that do not.

9. About the Author

D. Andrew Sirkin is a recognized expert in fractional ownership and other real estate co-ownership arrangements including TICs, equity sharing, and legal subdivisions such as condominiums. Mr. Sirkin has specialized in fractional ownership 1985, and has prepared fractional ownership documents for over 6000 clients. His practice areas include vacation fractional ownership planning and structures, offering materials, governing documents for fractional projects, entity formations, regulatory approvals, fractional lending and mediation. Mr. Sirkin regularly works on fractional ownership projects located throughout the United States, and in France, Italy, Argentina, Nicaragua, Dominican Republic, Panama, Costa Rica, Belize and Mexico. He is an accredited instructor with the California Department of Real Estate, and the co-author of *The Condominium Bluebook*, published annually by Piedmont Press, and *The Equity Sharing Manual*, first published by John Wiley and Sons in November 1994 (download the current edition in PDF). He has written numerous articles on related topics, all of which are available at www.andysirkin.com. He is now in the process of compiling a resource to feature a quick research summary plus the full text of all the laws, regulations and requirements (including filing requirements) for fractional and timeshare real estate sales and projects for all 50 U.S. states, to be offered for publication in March 2007. He can be contacted via email at DASirkin@earthlink.net, or by telephone at 1-415-738-8545 (U.S.) or 33-(0)8-72-90-76-34 (France).