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France: Treatment of capital gains on sale of securities – retroactive application of new rules

France has enacted its tax legislation for 2014 recently that retroactively changes the capital gains tax rules, bringing gains from sale of securities held by individuals, even a year ago, taxable under the new rules. The saving grace here is that these new rules are, in most cases, more favourable than the previous tax rules.

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I. Introduction

Following the vicissitudes of French tax legislation can be confusing. The French government has recently enacted its revenue legislation for 2014 which – as concerns capital gains taxes realised by individuals - deals retroactively with legislation that first became law in November 2012 but was never implemented until now.

This means that sales of securities made as early as January 1, 2013 will be taxed under rules that are significantly different than those that were actually in effect on the date of the sale.

The good news is that, in most cases, the treatment under the new law is more favourable than it would have been had the November 2012 legislation been implemented in the form originally adopted.

The new tax regime is summarised as follows:

- any capital gain on securities realised by individuals is subject to the progressive income tax scale, meaning that statutory exceptions, whether it be exemptions or a flat 19 percent taxation rate, are no longer applicable;

- the standard tax allowance depending upon the holding period is increased; and

- two derogatory tax allowances are provided.

II. Capital gains on securities now subject to progressive income tax scale

The 2014 Finance Bill introduces the principle that any and all capital gains on securities are subject to progressive income tax scale. The more favourable regimes that had previously been in effect are no longer applicable.

In particular:

- the 19 percent fixed rate which was previously applicable to certain managers or employees is cancelled retroactively as of January 1st, 2013. As this regime was only introduced by the Finance Bill for 2013, it has been abrogated before it ever came into effect;

- for sales since January 1, 2014, capital gain exemptions provided respectively in favour of companies having the status of "jeune entreprise innovante" (JEI) – young innovative companies -[1] and for intra-family sales[2] are no longer applicable;

- similarly, for sales realised since January 1, 2014, the specific capital gains tax allowance for managers of small and medium sized companies ("SMEs") who sell their shares upon retirement is no longer applicable. This regime enabled a total exemption of capital gains from personal income tax when the shares sold were held for more than eight years (but not from the 15.5 percent social security contributions which were always assessed on the total capital gain).

• finally, the new law also does away with rules permitting the deferral and in some cases exemption of taxation on gains reinvested in an entity subject to corporate income tax.

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[1] Article 150-0 A, III-7 of the French Tax Code.

[2] Article 150-0 A, I-3 of the French Tax Code

Capital gains realised before December 31, 2013, which benefited from the deferred taxation, will continue to benefit from this specific regime.

Applying the progressive personal income tax scale to all capital gains on securities could have been a way to simplify the French tax regime. Unfortunately, this is not the case, as the computation of the taxable capital gain is required to be made by factoring in various allowances at different rates depending on the sale in question and also because none of the allowances applies to social security contributions.

III. Increased standard allowance based on the holding period of securities is favourable to sellers

As a reminder, the standard allowance that was dependant on the holding period, which was introduced by the 2013 Finance Bill, was capped at 40 percent[3] . This meant that the overall tax rate[4] applicable to capital gains on securities realised by individuals who are subject to the top marginal rate of personal income tax of 45 percent and to the Exceptional Contribution on High Income (ECHI) at the rate of 4 percent could, in the most favourable scenario, be reduced from 64.5 percent[5] to 46.5 percent[6] if the securities were held more than six years.

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[3] 20 percent allow ance for shares held for more than tw o years and less than four years, 30 percent allow ance for shares held for more than four years and less than six years, 40 percent for shares held since more than six years.

[4] The partial tax deductibility of the Contribution Sociale Généralisée, CSG (reduced from 5.8 percent to 5.1 percent betw een 2012 and 2013).

[5] Personal income tax of 45 percent + ECHI 4 percent + social security contributions 15.5 percent.

[6] Personal income tax 27 percent (45 percent x 0,60) + ECHI 4 percent + social security contributions 15.5 percent.

The 2014 Finance Bill simplifies and improves the standard tax regime by introducing two different rates for the standard deduction:

• 50 percent for shares held for more than two years but less than eight years; and

• 65 percent for shares held for more than eight years.

IV. Holding period – starting date

As for the previous regime, the starting point of the holding period taken into account to determine the applicable allowance is, as a matter of principle, the date on which the shares were subscribed or acquired. However, there are some exceptions that apply in the specific situations listed below:

Specific situations	Starting point of the holding period
The shares sold are held by an interposed entity such as a personal holding company	Subscription date or acquisition date of the shares by the interposed entity
The shares sold were received as a result of an exchange of securities on which tax is deferred	Subscription date or acquisition date of the shares transferred as part of the exchange

The securities were acquired in a so-called PEA savings plan (Plan d'Epargne en Actions) and sold after its termination or its eight year	Date of the PEA termination or date of withdrawal of the sale proceeds from the PEA
The securities sold were received in consideration for a contribution in kind which benefitted from a deferred capital gain taxation	Date on which the contributor initiated its/his/her commercial, industrial, artisanal, independent or agricultural activity
Distribution of assets by a FCPR -French private equity limited partnership- and capital gains distributions by a SCR -French venture capital investment company- in favour of its holders who do not benefit from the personal income tax exemption for managers or members of the management team (i.e., those who benefit from rules applicable to « carried interest”)	Acquisition or subscription date of the shares by the FCPR or the SCR
The securities sold are part of a larger shareholding interest, which were acquired or subscribed on different dates	The sale is deemed made in priority on the first shares acquired or subscribed (FIFO rule « First in, First out”)

The allowance, which will be calculated based on the applicable holding period, applies to all of the following types of transactions:

• all gains or losses realised from the sale of securities (which for such purpose is defined very broadly to include usufruct and bare-title interests as well as other equity-like interests such as interests in mutual funds and investment partnerships);.

• portions of sale proceeds paid as earn-outs over time;

• distributions of assets by a FCPR, including distributions made to employees or managers benefiting from carried interest;

• capital gains distributions by a SCR, including distributions made to employees and managers benefiting from a share of carried interest;

• capital gains resulting from the sales of securities distributed by a FPI (Real Estate Investments Funds); and

• capital gains distributions by mutual funds.

IV. Specific allowances applicable to certain sales

A. Exceptional allowances introduced

Two exceptional allowances are introduced by the new legislation:

A super allowance, intended to favour entrepreneurial risk and the creation and financing of SMEs is applicable to capital gains realised since January 1, 2013 (as an exception, the super allowance is applicable to family sales only on or after January 1, 2014).

The super allowance is equal to:

• 50 percent if the shares sold were held for more than one year and less than four years,

• 65 percent if the shares sold were held for more than four years and less than eight years; and

• 85 percent if the shares sold were held for more than eight years.

The super allowance, which is not applicable to investments through mutual funds[7], is applicable in the three following situations:

[7] Gains resulting from the sale of shares of an OPCVM or of other collective investment vehicles or non-French entities having the same nature or from the w inding up of such , vehicles or entities or from distributions of a portion of FCPR assets, of capital gains recorded by OPCVM or SCR are excluded from the scope of the super allow ance.

B. Sales of shares issued by SMEs of less than 10 years

Irrespective of the nature of the seller (manager, employee or ordinary shareholder …) and the level of his/her shareholding, the capital gain realised is eligible for the super allowance if:

• on the subscription or acquisition date of the shares sold, the issuing company qualified as a SME business under applicable EU definitions[8], was incorporated for less than 10 years at the time of the sale of securities, and was not incorporated as part of a business combination or restructuring exercise; and

• at all times since its incorporation, the issuing company satisfied the following four conditions:

• it only granted to subscribers rights resulting from their status as partners or shareholders with a risk of loss on their investment;

• it was subject to corporate income tax;

• its registered office was situated in a State within the European Economic Space; and

• it carried out a commercial, industrial, artisanal, independent or agricultural activity, other than merely managing its own real estate or investment assets;

[8] Under the EU definition, a company having less than 250 employees and w ith a turnover less than EUR 50 millions or w ith a total balance sheet value less than EUR 43 millions in assets qualifies as a SME business.

Capital gains on shares of an active holding (i.e. a holding company that is actively involved in the management of its subsidiaries, as opposed to a passive holding company) can also benefit from the super allowance if the above conditions are satisfied by the holding itself, as well as by each of its subsidiaries.

1. Intra-family sales

The super allowance is also applicable to sales of shares issued by a company subject to corporate income tax or to a similar tax and having its registered office within the European Economic Area if the following three conditions are met

• the seller, his/her spouse, their ancestors and descendants, as well as their siblings jointly held, directly or indirectly, more than 25 percent of the rights to receive the company profits at any time during the five years preceding the sale; and

• the sale of shares, whatever the level of the shareholding sold, is made to a member of the family group as defined above; and

• the purchaser does not resell any of the acquired shares within five years as from their acquisition.

2. Sales by managers of SMEs with a view to retire:

Capital gains on shares realised by managers selling their shares upon retirement benefit from the super allowance subject to compliance with following conditions:

a. Conditions related to the issuing company:

The issuing company must:

• have its registered office within the European Economic Area;[9]

• be liable for corporate income tax or equivalent;

• qualify as a PME under the EU definition; (see footnote 8)

• have 75 percent of its share capital or voting rights held by individuals or by one or several SMEs that also complying with these conditions; and

• carry out continuously an industrial, commercial, artisanal, agricultural, independent or financial activity during the five years preceding the sale.

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[9] The EEA is comprised of the member states of the European Union, as w ell as Norw ay, Lichtenstein and Iceland.

To be noted: Capital gains realised on shares issued by holding companies are eligible irrespective of whether the holding company is actively involved in its subsidiaries management or not.

b. Conditions related to the seller

The seller must exercise an eligible function[10] with the issuing company during the five years preceding the sale and must satisfy the four following conditions:

• he/she must have held personally or through his/her family group at least 25 percent of the company's voting or financial rights directly or indirectly through an interposed company);

• he/she must sell all his/her shareholding (a partial sale is possible only if it represents more than 50 percent of the company's voting rights);

• he/she must cease any management role in the company upon the sale; and

• he/she must claim retirement benefits within two years before or after the sale of the shares.

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[10] Such as Executive Manager of a Limited company (Gérant of a SARL or of a société en commandite par actions) or President/Chief Executive Officer of a société par actions.

There is no specific order in which these three events must happen (sale of the shares, termination of a management role, and retirement) but there must not be more than 24 months between the first and the last of these three events.

To be noted:

• the seller may sell his/her shares in several installments, so long as all sales are realised within the 24 month-period;

• it is not clear whether the spouse of the retiring manager and the co- founding partners of the company will benefit from the favourable tax regime applicable to the retiring manager as was the case under the previous tax regime.

c. A fixed EUR 500.000 deduction applies to retiring managers

In addition to the super allowance, capital gains realised by managers retiring on or after January 1, 2014 will benefit from a fixed EUR 500,000 deduction subject the same conditions.

This lump-sum deduction applies on the net capital gain realised on the sale of all the shares of a given entity owned by a given seller, before being reduced by the super allowance (and not to each sale). Thus, in the case of installment sales, the seller benefits only once from the EUR 500,000 allowance. For instance, if an individual realises a capital gain of an amount of EUR 1,200,000 from the sale of shares held for more than eight years, such a gain will first be reduced by the lump sum EUR 500.000 allowance from EUR 1,200,000 to EUR 700,000, and then the EUR 700,000 remaining capital gain will be reduced by 85 percent to EUR 105,000.

As shown in the chart below, the 2014 Finance Bill results, in most cases, in a reduction of the effective rate of taxation of capital gains on securities (compared to the effective taxation rate introduced by the 2013 Finance Bill.

This improvement must however be viewed against the backdrop of the French regime of social contributions, which remain due on the total capital gains (i.e., without taking into account any of the standard deductions discussed above) without the benefit of all the prior exemptions.

<table>
<tr><th rowspan="3">Holding period of the shares sold</th><th colspan="2" rowspan="2">2013 Finance Bill</th><th colspan="8">2014 Finance Bill</th></tr>
<tr><th colspan="4">Standard allowance (Article 150-0 D, 1 ter)</th><th colspan="4">Super allowance (Article 150-0 D, 1 quater)</th></tr>
<tr><th>Allow-ance</th><th>Global taxation</th><th>Allowance for Personal income tax</th><th>Effective taxation rate for personal income tax</th><th>CSG, CRDS and ECHI on the total capital gain</th><th>Global taxation</th><th>Allowance for Personal income tax</th><th>Effective taxation rate for personal income tax</th><th>CSG, CRDS and ECHI on the total capital gain</th><th>Global taxation</th></tr>
<tr><td>Less than 1 year</td><td rowspan="2">0%</td><td rowspan="2">64.50%</td><td rowspan="2">0%</td><td rowspan="2">45%</td><td rowspan="2">19.5%</td><td rowspan="2">64.50%</td><td>0%</td><td>45%</td><td>19.50%</td><td>64.50%</td></tr>
<tr><td>Less than 2 years</td><td rowspan="2">50%</td><td rowspan="2">22.50%</td><td rowspan="2">19.50%</td><td rowspan="2">42%</td></tr>
<tr><td>From 2 to 4 years</td><td>20%</td><td>55.50%</td><td rowspan="3">50%</td><td rowspan="3">22.50%</td><td rowspan="3">19.50%</td><td rowspan="3">42%</td></tr>
<tr><td>From 4 to 6 years</td><td>30%</td><td>51.50%</td><td rowspan="2">65%</td><td rowspan="2">15.75%</td><td rowspan="2">19.50%</td><td rowspan="2">35.25%</td></tr>
<tr><td>From 6 to 8 years</td><td rowspan="2">40%</td><td rowspan="2">46.50%</td></tr>
<tr><td>More than 8 years</td><td>65%</td><td>15.75%</td><td>19.50%</td><td>35.25%</td><td>85%</td><td>6.75%</td><td>19.50%</td><td>26.25%</td></tr>
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At any rate, the overall taxation is, at best, reduced from 46.5 percent to 35.25 percent if the shares sold were held for more than eight years (or even to 26.25 percent if the sale benefits from the super allowance).

It is therefore likely that contribution-sales transactions (contribution of sales to a new company subject to corporate income tax followed by the sale of the contributed shares by the new company) will remain tax efficient subject to compliance with the holding period, and, as the case may be, with the reinvestment obligations. Similarly, the opportunity to grant a gift of shares prior to the sale will need to be considered.

For More Information

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