MAYER • BROWN

2016

How to Invest in Real Estate in France

This memorandum outlines some of the issues involved regarding investing real estate in France.

1. How are ownership rights organised?

Ownership rights are principally organised as follows:

1.1. FREEHOLD (*PLEINE PROPRIÉTÉ*)

Full ownership of real estate (freehold)[1] gives the owner[2] the possibility of using the property (*usus*), collecting any proceeds thereof (*fructus*) and disposing thereof as he/she sees fit (*abusus*).

Practically, it entitles the owner to sell the property, grant lease agreements, grant easements over it, mortgage it.

1.2. OWNERSHIP ORGANISED IN VOLUMES

The division in volumes of real estate is a legal technique which consists in dividing the ownership of a building into different fractions at different levels, which can be located above as well as below the natural ground. Every fraction is located within the volumes defined geometrically in three dimensions, in reference to plans and quotations, without any common ownership existing between the various volumes. In most cases, a specific entity known as an *ASL* or an *AFUL* governs the relationships between the various owners of lots.

The division in volumes is generally used for large real estate structures. It may also be used to deal with specific smaller structures, for example, where regulations need to apply both to public buildings (3.4) and private premises.

1.3. BUILDING LEASE (*BAIL À CONSTRUCTION*)

The building lease is a lease whereby the tenant has an obligation to build on the land, and to maintain/operate such construction. It grants the tenant a right *in rem* over the construction, which may be freely transferred or mortgaged. It is a long term contract (minimum 18-year term), which may not be tacitly renewed. Upon expiry of the lease the land as well as the building revert to the owner.

1.4. LONG TERM LEASE (*BAIL EMPHYTHÉOTIQUE*)

The long term lease is a lease relating to land or property whereby the tenant has the obligation to improve such land/property and pay an annual rent. The main difference with the building lease is that the tenant has no obligation to build but only the possibility to do so. As the building lease, it grants the lessee a right *in rem*, which may be freely transferred or mortgaged.

1.5. CO-OWNERSHIP (*COPROPRIÉTÉ*)

Co-ownership is the organisation of the ownership of a building consisting of lots owned by different persons.

Each co-owner is thus the owner of (i) a private element (such as an apartment) of the building, and (ii) a share of the common ownership over the common parts thereof (such as the roof, walls, staircases, etc.) such share being usually referred to as a percentage of ownership over the common parts of the building.

Any building whose ownership is organised as described above is subject to the co-ownership regime governed by the law dated July 10, 1965. Under this law, co-owners must appoint a manager (known as a syndic), whose rights and obligations are strictly regulated.

2. How to acquire real estate?

In France, to be binding on/enforceable against third parties, the sale of real estate must be registered at the Land Registry (*Service de Publicité Foncière*), and signed before a French *notaire* (notary).

2.1. THE PURPOSE OF THE NOTAIRE (NOTARY)

The notary is a public officer (*officier ministériel*) under the authority of the Minister of Justice (*Ministère de la Justice*) and is appointed by decree (*décret*).

The notary's role is to carry out searches on the property to be sold (e.g., with respect to zoning law, potential encumbrances including easements, mortgages, etc.), and on the ownership rights of the seller (to ensure the validity of such ownership over a 30-year period, which is the legal statute of limitations to acquire ownership over real estate by possession), before drafting the deed of sale.

1 Freehold rights cover what is beneath the ground and the space above it.
2 The person or the company whose interests in the property are fully owned. It is possible for various persons to own the same property. They are said to be "*en indivision*". Such situation often occurs as a result of succession/estate planning.

Every notary has the obligation to obtain professional civil liability insurance, to cover the financial costs necessary to make good any damage caused by a notary to his or her client.

2.2. ACQUISITION PROCESS

At the outset of negotiations and once the parties have agreed on the price and the subject matter of the sale, they generally enter into a preliminary agreement (2.3), which is usually subject to various conditions.

Under French law, this preliminary agreement is a binding sale and purchase agreement between the parties, unless the parties intend otherwise. For this reason, each party should be properly advised by legal counsel from the outset of any discussions.

Generally, once the conditions precedent to the preliminary agreement are satisfied (if any), the parties complete the sale process by signing a deed of sale, which is witnessed by the notary (2.4) and subject to payment of acquisition costs (2.5).

2.3. PRELIMINARY AGREEMENT

The preliminary agreement may, under French law, take the form of a unilateral option to sell (*promesse unilatérale de vente*) or a bilateral agreement to sell and purchase (*promesse synallagmatique de vente et d'achat*). They often contain conditions precedent which should be satisfied before the transaction is completed.

2.3.1. The unilateral option to purchase

The seller undertakes to sell, and grants to the other party (i.e., the purchaser, if he decides to exercise his option to purchase) of that unilateral agreement an option to purchase the property within a specified period of time. The signing of this option usually triggers payment of a 10% down payment, based on the purchase price, which is consideration for keeping the property off the market and available to the purchaser during the option period (*indemnité d'immobilisation*). This deposit is credited against the purchase price but is not refundable to the purchaser in the event it fails to complete the sale (assuming the conditions precedent are met).

This unilateral option must be executed either before a notary or as a private agreement registered with the French tax authorities within 10 days from the date on which the option has been accepted by the beneficiary, failing which it automatically lapses.

2.3.2. The bilateral agreement to sell and purchase

The seller undertakes to sell and the purchaser undertakes to purchase the property. The signing of this agreement usually triggers the payment by the purchaser of a 10% down payment, based on the purchase price. There is no requirement to execute this agreement before a notary (although this is often the case) nor to register it with the French tax authorities.

Preliminary agreements are generally subject to conditions precedent or subsequent. The standard conditions are:

- The ability of the purchaser to obtain the necessary financing (if any);
- The provision by the seller of a mortgage registry abstract evidencing a clear and unencumbered title to the property;
- The expiration of the 2-month municipality pre-emption period:
  - The municipality, of the territory on which a property is located, may be entitled to exercise a pre-emption right in relation to the sale of said property (DPU). In such a case, the notary sends a declaration of intent to sell (DIA) to the municipality which has two months to inform the seller that it intends or not to exercise such pre-emption right. When the municipality exercises this right, the municipality becomes the purchaser.
- The obtaining of building permits (if necessary);
- The obtaining of certificates from the authorities confirming that the premises are properly zoned for the intended use.

2.4. DEED OF SALE

Once the conditions to the preliminary agreement are satisfied, the deed of sale, which is a reiteration of the preliminary agreement, is drawn up by a notary (in an authenticated form) and signed by the parties, at which time the balance of the purchase price is paid. The use of a notary and the registration of the deed of sale at the competent Land Registry make the sale of the property enforceable against third parties, as explained above.

2.5. ACQUISITION COSTS – NOTARY'S FEES / REGISTRATION DUTIES /VAT

2.5.1. Acquisition costs

The acquisition costs consist of a set of (i) taxes/ registration duties that the notary collects to cover administrative costs, (ii) disbursements incurred by the notary in relation to the acquisition process, and (iii) the notary's fees per se (*emoluments du notaire*).

The acquisition costs vary according to the type of acquisition (e.g., acquisition of land, or of a building, old or new, etc.).

More precisely the acquisition costs applying to the sale of a property are the following:

Nature of the applicable tax/cost	Basis	Rate
Registration tax	Price amount	5.09%
Salary of land registrar	Price amount	0.1%
Notaire's fees	Price amount	0.825% (excl. VAT)
VAT on Notaire's fees	Notaire's fees	20%
Disbursements	Fixed amount of €1,500 (approx.)	

2.5.2. Notary's fees

The notary's fees, which are included in the global acquisition costs mentioned above, are strictly regulated, and are proportional fees, the amount of which is determined by the public authorities[3].

Price	Percentage applicable to determine the notary's fees
€0 to €6,500	4% (excl. VAT)
Over €6,500 up to €17,000	1.65% (excl. VAT)
Over €17,000 up to €60,000	1.10% (excl. VAT)
Over €60000	0.825% (excl. VAT)

Note:

- The amount of notary's fees is generally known as being 0,825% (excl. VAT) as such rate applies to almost all the price (i.e., to the portion of the price exceeding €60,000);
- The VAT amount applying to the notary's fees is 20,00%.

2.5.3. Salary of the land registar (*Conservateur*)

Acquisition costs will also entail the payment of the "*salary of the Conservateur*", i.e. 0.10% of the purchase price.

2.5.4. Registration duties

The registration duties (*droits de mutation*) due when acquiring an "old" building (i.e. built more than five years ago) are of 5.09% of the purchase price.

2.5.5. VAT

As regards the acquisition of a "new" building (i.e., *inter alia* completed less than five years ago), since the price already includes the VAT (at the rate of 20,00%) payable by the purchaser, only the reduced rate of registration tax (*taxe de publicité foncière*) of 0.715% of the price, VAT excluded, will apply and be payable by the purchaser.

VAT also applies to the purchase of development land when the purchaser undertakes to build on the land within a five-year period. In such a case, there will be a full exemption of registration tax and only a fixed rate of €125.00 will apply.

2.6. OTHER ACQUISITION TECHNIQUES

2.6.1. SALE OF REAL ESTATE IN THE COURSE OF CONSTRUCTION (VEFA)

The sale of real estate in the course of construction is a mechanism whereby the purchaser progressively becomes the owner of real estate which is being developed, as said real estate is being built. Usually, the purchaser pays for and acquires the bare land, and then, following an agreed schedule of payments, makes stage payments as the building works progress.

It is often used in urban zones to build housing premises, and in that case (i.e., housing premises), mandatory rules apply, which aim at protecting the purchasers.

3 See the Decree (décret) No. 78-262 dated March 8, 1978, as amended inter alia on February 20, 2011.

2.6.2. Finance lease

A finance lease[4] is an agreement whereby the owner of real property grants the use thereof, for business purposes, to an operating company that has an option to acquire it at the end of an irrevocable lease term, in consideration of a fixed price agreed at the time the agreement is made and that takes into consideration the rent applicable during the lease term. The lease term theoretically reflects the useful life of the asset for tax depreciation purposes.

Upon expiration of the lease term, the operating company will have three options:

- Buy the asset for its agreed residual value;
- Surrender it to the finance lessor;
- With the finance lessor's agreement, begin a new lease term (through a normal lease agreement).

This is a method frequently used to finance a real estate acquisition at a higher level of leverage than may otherwise be available through normal mortgage financing.

A finance lease may also be used in a "sale and lease-back" transaction, under which a company sells a property to a financial leasing company, which then immediately leases it back to the user under a finance lease. The purpose, from the user company's point of view, is to obtain liquidity whilst retaining the use of the asset.

2.6.3. Sale of shares of a company owning real estate

The advantages of the acquisition of shares of a company owning real estate are the following:

- The sale process does not require the intervention of a notary.
- The absence of the pre-emption right for the municipality, except in the case of a civil real estate company (SCI) where the municipality has voted the extension of its pre-emption right.
- Lower registration fees, 3% of the purchase price of the shares (the indebtedness and the working capital can be deducted from the enterprise value and thus allowing a lower tax basis) capped at €5,000 for the sale of shares of an SA or SAS but 5% of the purchase price when the target company is a real estate company (i.e. more than 50% in value of its assets are real estate assets).

The drawbacks of such technique:

- The purchaser will inherit all the liabilities of the target company and therefore should carry out an in-depth due diligence.
- If the company has more than 50 employees, no sale can be agreed without the receipt of an opinion (positive or negative) of the works council.

3. What environmental and safety issues may arise?

3.1. SOIL POLLUTION

The risk of soil being polluted may arise in acquisitions of industrial sites on which a potentially polluting activity is carried out.

Hence, when contemplating the purchase of such a site and even though the seller has the obligation to inform the purchaser on the environmental history/issues of the site, it is advisable that the purchaser carries out its own environmental due diligence to ensure the site is not polluted, and if it is, to help determine (i) its potential obligation to remove said pollution from the site, and (ii) the costs and potential financial impact of such removal.

3.2. ASBESTOS

Real estate owners have an obligation to carry out asbestos searches to confirm the absence of asbestos in their premises, or on the contrary to identify the location and condition of any asbestos in their premises, in order to later ensure the monitoring or removal of said asbestos, depending on its location and condition.

Hence, before any investment, and even though the seller has the obligation to inform the purchaser on the presence of asbestos on the site, it is advisable that the purchaser carries out its own technical survey with respect to asbestos, as the removal of asbestos (in particular) can be quite costly.

4 Finance leases were recognized by Law n° 66-455 dated 2 July 1966, codified in Articles L.313-7 et seq. of the Monetary and Financial Code (« MFC ») (*Code Monétaire et financier*). These provisions were supplemented by Decree-Law (*Ordonnance*) 67-837 dated 28 September 1967 and Articles R.313-3 to R.313-14 of the MFC.

3.3. OTHER RISKS / INFORMATION

Depending on the nature of the premises, their use, and the date they were built, certain risks and information shall be provided to the purchaser.

These risks and information may relate, amongst other things to:

- The presence of lead.
- The location of the premises in a zone where the potential presence of termites has been identified.
- The energetic performance diagnosis (DPE).
- The compliance of the gas and electric appliances.
- The presence of radon.
- The presence of legionella.

3.4. BUILDINGS INTENDED TO RECEIVE THE PUBLIC

Every building intended to receive the public (*ERP*) must comply with the applicable fire-fighting safety standards.

Such buildings include, for example, hotels, retirement homes, boarding schools and summer camps.

Prior to their opening to the public, the competent safety commission will visit the premises and either (i) deliver a favorable recommendation for opening the premises to the public, or (ii) provide a list of requirements to comply with in order to proceed with opening to the public.

4. How can ownership rights be affected?

4.1. MORTGAGE

A mortgage (*hypothèque*) is a property-based charge whose aim is to secure the payment of a debt. It may, under French law, result either from a contract (*hypothèque conventionnelle*), a legal provision (*hypothèque légale*) or a judicial decision (*hypothèque judiciaire*).

As with the deed of sale, a mortgage must, to be binding on third parties, be published at the land registry. The rank applying to different mortgages burdening a property generally derives from their date of publication taken chronologically.

4.2. LENDER'S LIEN

A lender's lien (*privilège de prêteur de deniers*) is a legal lien to the benefit of the bank which grants the purchaser a loan for the purpose of acquiring real estate.

4.3. SELLER'S LIEN

A seller's lien is a legal lien to benefit the seller to secure all or part of the price which remains to be paid.

4.4. EASEMENTS

A number of easements (*servitudes*) may exist in France in relation to real estate. They may result from the law, regulations or contractual agreements.

The purchaser's notary should therefore collect information on the potential existence of such easements by *inter alia* contacting the Land Registry and the local administrative authorities.

5. How do commercial leases work?

French law provides for a specific set of rules[5] with respect to leases relating to commercial premises. The French commercial leases regime is tenant-friendly in that it aims to protect the stability of on-going businesses (*fonds de commerce*) by giving the tenant the right to renewal of its lease, which, if it is refused, will give rise to an obligation on the landlord to pay an indemnity to the tenant to compensate for the harm suffered by the tenant.

5.1. TERM

The minimum term of a commercial lease is nine years; it may consequently be entered into for longer terms (10, 12 years, etc.).

The French Commercial code provides that the tenant is entitled to terminate the lease every three years[6]. The parties remain nevertheless free to provide otherwise, e.g., by providing for a fixed term (i.e., a nine-year fixed term, or a nine-year lease with a six-year fixed term) for leases entered into for a term greater than nine years, leases for premises used for a single purpose (hotel, cinemas, etc.), leases for premises to be used exclusively as offices and premises to be used for storage purposes/as warehouses.

5 French law on commercial leases is governed by the decree (décret) dated September 30, 1953, which has been codified as part of the French Commercial code (code de commerce), at articles L. 145-1 et seq.

6 By delivering by process server or registered letter a six-month prior notice.

As for the landlord, apart from very limited and specific cases listed in the French Commercial code[7], it may only terminate the lease in case of contractual breach by the tenant (enforcement of the forfeiture clause - "*clause résolutoire*").

5.2. RENT

The parties to a commercial lease agreement may determine the rent freely, which for example can be a fixed rent, or a rent with two components[8], i.e., a fixed component (guaranteed minimum rent) and a variable component consisting of a percentage of the tenant's turnover.

The lease agreement may include an "indexation clause" whereby the fixed component of the rent shall be annually adjusted according to the evolution of the specific indexes set forth by the Law.

In addition, the rent can be revised upwards or downwards in case of legal revision *inter alia* in the following cases:

- Either party (whether the agreement provides for this possibility or not) has the right to request, every three years from the effective date of the lease, a revision of the rent to be set at the market rental value, being however capped by the evolution of the applicable index.

  In this framework, either party is entitled to request that the rent be set at the market value should the local commercial factors entail a change resulting in an increase of the market value by 10% (the above mentioned cap rule not being applicable);

- Either party is entitled to request that the rent be set at the market value, if, in the presence of an indexation clause, as a result of the application of such clause, the rent is increased or decreased by more than 25% of the rent as previously determined (i.e., contractually or following a judicial decision) (the above mentioned cap rule not being applicable).

However, in the aforementioned cases, in the event that the rent is fixed at market value, the variation in rent as a result may not lead to an increase greater than 10% per year of the rent paid during the previous year ("smoothing mechanism" over several years of the said increase).

5.3. RENEWAL

As mentioned above, the French commercial leases regime grants the tenant a right of renewal of its lease. Should the landlord refuse to grant the tenant such right, the landlord shall pay an eviction indemnity compensating for the harm suffered and costs incurred by the tenant as a result of having to relocate its on-going business.

The lease, once its renewal has been accepted by the landlord, shall be renewed on the same terms and conditions, except for the rent.

Indeed, the rent of the renewed lease shall be set at the market rental value, subject to the above mentioned cap rule and "smoothing mechanism" (which shall also apply).

Some exemptions to the cap rule or smoothing mechanism exist, among which some relating to:

- The term of the lease (e.g., if the lease subject to renewal was entered into for a term exceeding nine years, or if, as a result of a tacit extension, the lease term was extended to exceed 12 years, then, depending on the case, the cap rule or the "smoothing mechanism" shall not apply), or
- The type of rented premises (e.g., the rent of a renewed lease relating to premises with an exclusive use (office, hotel, etc.) shall not be subject to the cap rule/smoothing mechanism).

5.4. ASSIGNMENT / SUB-LETTING

5.4.1. Assignment

Assignment of the lease by the tenant may be forbidden by the landlord, but the tenant in any case remains entitled to assign the lease within the framework of the transfer of its on-going business.

Generally, the lease agreements provide for the tenant to remain the guarantor of its assignee for the remaining term of the lease[9].

5.4.2. Sub-letting

Sub-letting is only possible if it is specifically provided for in the lease agreement.

7 Article L. 145-4, al. 2 of the French Commercial code.

8 This type of two-component rent is frequently used for premises located in commercial centres.

9 Please note that since 18 June 2015, the law provides that the assignor may only remain liable with the assignee for a period of three years as of the transfer - the courts have not yet made a decision on the public order character of this provision.

5.5. RENTAL CHARGES/TAXES/REPAIRS

Usually, lease agreements provide for the tenant to bear the rental charges relating to the rented premises. As for the taxes payable by the landlord, although they are to be borne by the landlord, it can be contractually agreed that they will be reimbursed by the tenant.

The same applies with regards to repair works.

However, the following shall not be borne by/cannot be "transferred" to the tenant:

- Costs relating to major repairs together with, as the case may be, all fees relating to the carrying out of such works.
- Costs relating to works aimed at repairing the wear and tear or making the premises conform with regulation relating to the rented premises or the building in which the premises are located, if such works are considered as being major works.
- Taxes, and in particular the local Economic Contribution Tax (*Contribution Economique Territoriale*) and royalties which the Landlord is legally responsible for; the real estate tax can nonetheless be borne by the tenant together with all taxes and royalties relating to the use of the building or services which the tenant directly or indirectly benefits from.
- The Landlord's fees relating to the management of the rent of the building.

5.6. MANDATORY SCHEDULE ON NATURAL OR TECHNOLOGICAL RISKS

When the premises are located in a zone where the existence of natural or technological risks has been identified, the landlord has the obligation to provide a document known as *ERNT*, which, based on the information made available by the public authorities, describes the existing risks.

Such *ERNT* shall be attached to the lease agreement, failing which the tenant shall be entitled either to terminate the lease or to request a decrease of the rent.

6. How is the 3% tax applied?

6.1. CONCERNED ENTITIES

French and foreign entities (corporate bodies, organisations, trusts and comparable institutions), which, on January 1 of each year, own directly or indirectly one or more real estate properties located in France, or holding rights *in rem* (*droits réels*) real estate properties and right *in rem* ("Taxable Assets") relating to such properties must pay a 3% annual tax computed on the market value of such properties or rights[10]. Individuals are outside the scope of the tax.

This tax is payable in relation to Taxable Assets owned on January 1 of the year of taxation.

Legal entities liable to the 3% tax must file a return at the latest by May 15 of each year indicating the location, composition and market value of the Taxable Assets owned as of January 1 of the year of taxation. The return must be accompanied by the tax payment.

When French real estate property is owned through a chain of entities, the first legal entity in the chain of ownership (from the entity owning the property to the entity owning the entity which is the owner of that property) that does not benefit from an exemption (see below) or that does not comply with certain filing requirements necessary to be exempt is liable for the 3% tax. Each entity interposed in the chain between the real property and the person subject to tax is jointly and severally liable for the possible payment of the 3% tax due by that person.

6.2. EXEMPTIONS

Legal entities may be exempted from the tax under certain conditions, among which are[11]:

- International organisations, sovereign States and their political and territorial subdivisions;
- Listed entities;

10 Article 990 D of the French General tax code (*Code général des impôts*).
11 Article 990 E, 1°, 2°, 3° of the French General tax code.

- Entities whose French assets are not predominantly real estate assets (i.e., an entity holding directly or indirectly French real estate assets is exempt from the 3% tax if the fair market value of its real estate assets located in France held directly or indirectly represents less than 50% of its French assets. For the computation of the 50% threshold, French real properties that are used by a company in order to carry out its own business activity (other than real estate business) are not taken into account); or
- To the extent that the entity is located in France, or in the European Union, or in a country that has signed with France a tax treaty containing an administrative assistance clause, or in a country that has signed with France a tax treaty containing a no-discrimination clause, the following exemptions are also available:
- Entities holding real properties with a limited value (entities whose share in French real properties is lower than €100,000 or represents less than 5% of the market value of such properties);
- Entities (including trusts and comparable arrangements) that are established in order to manage retirement and pension plans and non-profit entities or entities recognised as providing a community service, provided their activity or their financing justifies the ownership of real property;
- Certain collective investment vehicles allowed to invest in real estate properties (e.g., French «*Fonds de Placement Immobilier*»);
- Entities which satisfy certain filing requirements. These entities must either:
  - File an annual 2746 tax return with the French tax authorities, or
  - Take a commitment (within two months of the purchase of the real property) to provide, upon request from the French tax authorities, such a 2746 return.

The information to be disclosed on such return is as follows: location, nature and fair market value of their French real properties held on January 1, identity and address of their shareholders which own more than 1% of the shares or units of the entity, and number of shares or units held by each such shareholders.

Note: It should be noted that some French real estate companies have to file specific tax returns (e.g., form 2072 or form 2038), in which the above-mentioned information is already disclosed. As a consequence, these companies do not have to file a 2746 return or to take the above-mentioned commitment in order to benefit from the 3% exemption.

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