SCI
SELLING A PROPERTY & CAPITAL GAINS TAX (CGT) IMPLICATIONS. VOLUNTARY DISSOLUTION OR NOT?

More frequently than not, when an SCI sells its property, once the French CGT (Plus-Values) has been paid, the residual sales proceeds tend to be paid into the SCI bank account by the *notaire*. If there is no intent for the SCI to buy a replacement then these proceeds tend to be withdrawn and shared between the SCI shareholders (*associés*) according to their proportionate interest in the SCI (represented by their parts). If accounts (*bilans*) have been maintained – which in our experience is rarely the case – then the allocation of the withdrawal may also take into account the balance of any loans made to the SCI and agreed between the *associés*.

This process is then completed in France with the SCI French bank account being closed down and the shareholders assuming that, with the SCI no longer having any assets, it has naturally expired – thereby having no further obligation in France.

If the shareholder is UK tax resident then they may recognise that they have a UK tax liability in some shape or form as a result of the French house sale and so – perhaps with the help of their UK accountant – will complete a UK CGT self assessment return with the CGT computation being based on a proportion of the house sold which reflects their share in the SCI, claiming credit against UK tax for the French CGT already paid.

There are a range of problems with this approach, however, which if not addressed will eventually lead to financial difficulties down the line, either for the ex shareholder or for their estate.

1. The SCI still exists!
2. The above described UK CGT computation would be fine if the SCI was a partnership, however HMRC currently take the view that an SCI is a company!

What are the implications?

1) The Continuing Existence of the SCI

The fact that the SCI no longer holds any property assets doesn't lead to its automatic termination. It remains on the *Registre du Commerce et des Societes (RCS)* until either action is taken to dissolve the SCI and strike it off the RCS or until it naturally expires on the 99th anniversary of its registration.

Because – **for French resident shareholders -** the costs in dissolving the SCI and formally allocating proceeds, terminating the joint and several relationship which otherwise continues to exist between the ex-shareholders might be between 3% and 4% of the net share value and because it is perfectly legal for the SCI to allocate **-** without tax impact **-** the net sales proceeds to shareholders as a loan, the *notaire* responsible for the sale will tend not to propose completing the house sale by also administering the dissolution of the SCI. Instead, the SCI lies (informally) dormant as a shell company, with neither tangible property nor cash at bank but nonetheless holding implicit assets in the form of loans to the shareholders, albeit in the absence of any formal set of accounts laid out and approved by the shareholders to provide documented evidence that this is the case.

For better or worse this tends to be standard practice amongst *notaires* in France and also seems to be acceptable (either through ignorance or explicit consent) to French resident shareholders.

But when the shareholders are all UK (or non-French) tax resident, the main stamp duties associated with the dissolution – the agreement allocating the proceeds between the ex-shareholders – can easily be avoided, reducing the costs to perhaps 1-1.5% of the net share value, most of which comprise the professional fees for drawing up the necessary balance sheet, administering the dissolution and formalising the allocation of proceeds.

Apart from the practical issues surrounding the fact that as far as the administration is concerned, (*Tax office*, *Greffe*), the SCI's centre of management is still at the registered address which has now been sold, (e.g. irate new owner receiving correspondence to the SCI, not knowing where to forward it and taking action to enforce dissolution), there are other practical consequences of such an approach.

Once the SCI reaches the end of its natural life on its 99th anniversary, the SCI is automatically dissolved and shares cancelled with any assets existing over and above the share capital at that point being deemed held jointly and severally between the shareholders or their inheritors indefinitely, or until such time as these loan assets are formally allocated on an individual basis via a share allocation order known as an "*Acte de Partage*".

But are there any such assets if there is no property or cash deposits in the name of the SCI?

Well it depends on each SCI case, but if French CGT was paid and SCI *bilans* were not properly maintained to account for shareholder inputs to the SCI during the property ownership period, then the answer will be ***YES!***

Remember the withdrawal and allocation of the net cash proceeds from the sale? Well ***these sale proceeds still belong to the SCI***. It is important to understand here that an SCI is a separate legal entity to its *associés*: SCI assets (property / cash) do not belong to the *associés*, they belong to the SCI. Only the shares belong to the *associés* and their value can only be realised / encashed by a disposal (sale or gift) or ***cancellation*** (*dissolution*). Without any such action then, **the allocation of the sales proceeds (an asset of the SCI) *can be nothing other than a loan from the SCI*** to its *associés*.

The loan needs either to be repaid by returning the proceeds to the SCI or cancelled out as a liability on the *associés* via SCI dissolution and cancellation (encashment) of the shares – either on expiry of the natural life of the SCI (up to 99 years from incorporation), or earlier if this is actioned by the *associés* voluntarily.

It is only on dissolution that the SCI is struck off from *the Registre du Commerce et des sociétés* and no longer exists. Only at this point do the sales proceeds truly belong to the *associés*.

But there is more:

Unless formal allocation of the share encashment proceeds takes place (via an "*Acte de Partage*") any excess value in those sales proceeds over and above the actual share capital paid is deemed owned jointly and severally by the (now ex) *associés*. Such continued joint ownership of the proceeds has unsatisfactory implications – notably potential exposure of the full net proceeds to recovery by a creditor of another *ex-associé* where the debt arises by reference to the SCI.

The formal *Partage* sorts such problems out and is the final hurdle to jump in order to ensure that the proceeds are allocated as intended (normally reflecting proportionate ownership of the share capital) and free from potential recovery by creditors of other *associés*.

In our view, if the shareholder allocation agreement is drawn up and signed off in the UK it will be free of any need for registration and related stamp duties in France. This would save duties otherwise payable, amounting to 2.5% of the increase in share value arising from the sale.

The format of this agreement can be a simple statement ("*Sous-Seing Privé*"), confirming shareholder agreement to the allocation, the separate, individual and absolute entitlement to the corresponding funds and a termination of any joint and several liability regarding any debts or obligations carried over from the SCI which may otherwise have such a claim on the proceeds.

2) HMRC Tax Position in the UK

On a stand alone basis the French consequences of a failure to complete the task of SCI dissolution and *partage* is usually not disastrous – perhaps being more of a potential long term inconvenience when sorting out succession to the shareholder's estate on their eventual death and again for inheritors of the shares when the SCI reaches the end of its natural life and there are perhaps little or no records remaining to show the state of affairs following the sale of the property many years or decades before.

It is for this reason that *notaires* form the habit of leaving the SCI in limbo after the sale.

When the shareholders are UK tax resident and domiciled, however, the HMRC interpretation of an SCI introduces more severe potential problems which provide their own, more urgent incentives, to ensure the SCI is dissolved, struck off and proceeds formally allocated via the *partage* sooner rather than later.

So what is HMRC's position?[1]

Their view is that an SCI is a company entity which would be subject to Corporation tax treatment if it was resident in the UK.

With this interpretation it is important to understand and recognise that the assets of the SCI (the French property in the main) are not the assets of the shareholders. Rather, the shareholder's interests are in the shares.

[1] See HMRC response to CHFS 27/08/2014

As far as HMRC is concerned, ***only if the SCI is UK resident*** would it be assessable to tax in the UK on the sale. In this case the gain would be assessed under UK corporation tax rules and UK corporation tax payable albeit with a credit for the French income tax paid by the shareholders.

In practice however, ***at the point of the sale the SCI is normally assumed to be French tax resident***. Consequently, from the HMRC perspective, the **actual sale of the property itself is not taxable in the UK** since we have a French resident entity selling a French property.

It is only when the SCI is subsequently sold or – more likely – dissolved that there is a UK capital gains tax assessment; this time on the shareholders in respect to the gains made on the disposal or cancellation of the shares.

If the sales proceeds were to be retained indefinitely within the SCI this wouldn't be a problem; indeed it could represent a tax advantage since any latent UK CGT liability resting on the appreciation in share value resulting from the gains attached to the sale of the property would be wiped out if the shares are inherited on the shareholder's death.

However the usual practice is for the sales proceeds to be withdrawn within a short time of them being made available by the *notaire* and this causes UK tax problems.

In these circumstances, as described in section 1 above, such payment cannot be treated as a payment in return for cancellation of shares since the SCI has not been dissolved.

Nor can it entirely be treated as monies belonging to the shareholders because the sales proceeds belong to the SCI not the shareholders. In this latter context only so much of the proceeds as represent repayment of loans from the shareholders to the SCI, made to enable the purchase and/or carry out capital works such as improvements or extensions, could be paid out without any consequences.

If the amount in excess of shareholder loan capital cannot be treated as payment in return for cancellation of shares it must therefore take the characteristic of either a dividend or a loan from the SCI. Since the French nature of the SCI means the payment of a dividend is not possible, the excess must therefore represent a loan from the SCI, as is the conclusion arrived at in section 1 above when looking at the French perspective.

HMRC tax treatment of the loan.

There are no rules to prevent the funds being treated as a loan: being a construct of French law, the ability for the SCI to lend to its shareholders is a matter of French not UK law. In any event UK legislation[2] allows a company to lend to its directors with the approval of the shareholders.

However, if the loan is not repaid within 9 months of the funds being distributed by the SCI, HMRC may look to charge the SCI a temporary tax[3] at the rate of 32.5%[4] on the amount of the loan, refunding it only once the loan is repaid (such as on dissolution of the SCI and cancellation of the shares).

[2] Companies Act 2006
[3] By reference to section 455 of Corporation Taxes Act 2010
[4] This rate was 25% up until 31/03/2016

Technically, HMRC could only do this if the SCI is UK tax resident, however with the SCI now only having a nominal or fictitious address in France (there is no longer any scope for board / shareholder meetings to take place at the French property), it would be pretty straightforward to argue that the effective management and control of the SCI now takes place in the UK, thus rendering it within scope of UK tax.

Furthermore, if the loan equates to more than £10,000 then HMRC could look to treat it as a taxable benefit in kind, chargeable to income tax (and potentially class 1 NIC) on the interest free benefit being received, (3% at April 2016), for as long as the loan persisted.

On this basis then, at the current official interest rate, a 40% taxpayer would be liable to an income tax charge of £600 a year on an SCI loan of £50,000 as well as having to find £16,250 to cover the tax charge on the (now deemed UK resident) SCI which is only then repayable following dissolution of the SCI or repayment of the loan back to the SCI bank account.

All these costs are likely to outweigh both the cost of dissolution and the latent UK CGT sitting with the shares.

To avoid all risk of this happening it therefore makes absolute sense to insist on the SCI being dissolved and proceeds allocated via an *Acte de Partage* as soon as is practicable following the sale of the property by the SCI if here is no intent to keep funds within the SCI's bank account to purchase a replacement property[5].

It is also important to maintain SCI annual balance sheets and all documentation to justify the amounts and purposes of funds paid by the shareholders into the SCI bank account or on its behalf.

For details of Charles Hamer's services provided to establish the costs to dissolve the SCI and formally allocate the proceeds, oversee the appropriate dissolution and establish the UK Capital gains tax computation and declaration on the cancellation of the shares, please contact Emilie Mengin via: info@charleshamer.co.uk or by phone on 0033 231 978 072

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[5] The latent UK CGT liability on the shares will fluctuate with the exchange rate: if £ follows its long term trend of general depreciation against foreign currencies including the € then the UK tax chargeable on the shares will rise relative to the situation immediately following the sale.

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