SHAREHOLDER FOUNDATIONS

THE FIRST EUROPEAN STUDY

Prophil
Beyond Philanthropy

IN COLLABORATION WITH

DELSOL AVOCATS
LA QUALITÉ DE LA RELATION

ESSEC BUSINESS SCHOOL
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OVERVIEW

A LACK OF AWARENESS OF THE SHAREHOLDER FOUNDATION MODEL

Although authorized by law, the shareholder foundation has not yet established itself in French mentality as a feasible model of governance: Two centuries of mistrust cannot be erased so easily!

In France, as elsewhere, the foundation is the act whereby one or more legal persons decide to irrevocably allocate assets, rights or resources to a non-profit entity – one that works in the interest of the common good. However, unlike many other democratic countries, a foundation cannot exist in France unless it is approved beforehand by public authorities. Only in France is there a public belief that the common good cannot be served by a private initiative, unless it is first validated by the state.

WHY ARE THERE SO FEW FOUNDATIONS?

Even though their numbers have grown considerably in recent years – we can count slightly more than 630 foundations that are recognized as "public utility" in France – the number remains very low compared to other countries (e.g. Switzerland and Denmark, even without compensating for the difference in population). If we include "sheltered" foundations (i.e. those under the aegis of a state approved foundation), corporate foundations or special purpose foundations such as hospitals, universities and scientific partnerships (see the following section on "alternative solutions"), this number still only reaches a paltry 2,200.

Certainly, the 2008 law recognizing endowments as a legal form – similar to that of foundations but requiring only a simple declaration – has helped to promote philanthropic and general interest initiatives; to date, there are almost 2,000 of these in France. This form has strong parallels with "declared" associations that do not require prior authorization to be established (based on a law from July 1st, 1901).

RECONCILING BUSINESS AND THE COMMON GOOD

In France, the sphere of the common good remains markedly distinct from economic and commercial spheres. Thus, even associations themselves have not recognized that over the past twenty years, they have had the option of creating a subsidiary firm, and exercising control over the majority of shares. Similarly, it was not until the passing of a law on August 5th, 2005 that this possibility was opened to "publicly recognized" foundations. For ten years, this law has only been applied to the Pierre Fabre Foundation, owner of the eponymous pharmaceutical laboratory, with few others taking advantage of the new regulation.

Excluding spin-off firms established by foundations to house their commercial activities, there is only one other foundation in France that holds a controlling ownership of a for-profit firm: The Marguerite and Alexander Varenne Foundation, established in 1988 and majority owner of the press group Centre France/La Montagne.

A POTENTIAL SOLUTION TO A VERY IMPORTANT ISSUE

Nevertheless, scientific studies on shareholder foundations demonstrate that firms held by foundations are strong performers, as much in social performance as in economic efficiency. In an era where the welfare state is weakening, and where 700,000 French family firms are poised to be transmitted over the next fifteen years, the shareholder foundation is undeniably a model that merits exploration and development.

KEY FIGURES OF FOUNDATIONS IN FRANCE

2 SHAREHOLDER FOUNDATIONS

AMONG **2,200** FOUNDATIONS

632 **RECOGNIZED PUBLIC UTILITY** FOUNDATIONS

359 **CORPORATE** FOUNDATIONS

1,200 **SHELTERED** FOUNDATIONS

AND

1,988 **ENDOWMENT FUNDS** INCLUDING 13% CREATED BY FIRMS

66 MILLION INHABITANTS

TOTAL ESTIMATED VALUE OF DONATIONS

€ 4 BILLION

INCLUDING € 2.2 BILLION FROM INDIVIDUAL DONORS, WITH THE REMAINING COMING FROM COMPANIES

GROWTH RATE IN THE NUMBER OF FOUNDATIONS BETWEEN 2001 AND 2013

80%

Source: ADMICAL-CSA 2014/ Reseach and Solidarity (Recherches & Solidarités); 2014 Francis Lefebvre Association Memo; 2014 Deloitte annual report on endowment funds.

THE LEGAL AND FISCAL CONTEXT

An under-utilized legislation

BY **XAVIER DELSOL**

DELSOL AVOCATS

Over the past ten years, French law has evolved considerably: Foundations can now act as majority owners of a commercial enterprise, regardless of the size of the firm. Yet the provisions for this kind of ownership remain largely unused. Are volunteers needed to put them in action?

The "recognized public utility foundation"[1] is an act by which one or more legal persons decide to irrevocably allocate assets, rights or resources towards a non-profit initiative, one that is oriented towards the common good. Such a foundation is given legal capacity after the Council of State (*Conseil d'Etat*) publicizes a decree recognizing its public utility[2] – although this process can sometimes be lengthy (more than 18 months on average). The foundation is especially subject to the rules established by the Council of State, whether it relates to adoption of by-laws (including an imposed mode of governance), prohibition of founders acting as controlling managers in decision-making bodies, etc.

Furthermore, in order to preserve the longevity of the foundation, the Council requires founders to make a significant endowment (generally in the area of € 1.5 to € 2 million, whether in cash, real estate, or shares).

A mandatory adherence to the "principle of specialization"

The recognition as being "public utility" prevents a foundation from pursuing a mission of asset protection solely for private interests. More specifically, a foundation cannot hold shares of a company with the sole purpose of preserving family assets.

However, since 2005 it has been acknowledged that, *"in the area of firm succession or transmission, a public utility foundation can – without limits or thresholds – receive shares in a firm having industrial or commercial activity, in addition to voting rights, as long as it respects the principle of specialization."*[3] Taken in the strictest sense, this adherence to the principle of specialization implies that the foundation can only possess a minority share in a given firm, in order to prevent the foundation from diluting its original purpose. The only exception is when the firm's activities are demonstrably linked to the foundation's mission (for example, a hospital foundation owning a private clinic)[4]; in such cases, majority shareholding is permitted.

This interpretation remains an entrenched doctrine for foundations. Yet in our view, it is mistaken; such a perspective hampers the income options for a foundation which should, in principle, be based mainly on returns on endowment investments. Although this possibility of majority ownership has been open since the law of August 2nd 2005, only the Pierre Fabre Foundation has fully benefited from it[5].

No direct management of the firm by a foundation

A foundation must not involve itself directly in the management of a company, but rather exercise a role of oversight – even if it owns preferred shares.

Thus, two outcomes are possible: First, an intermediary holding company can be established, one that is completely controlled and managed by the foundation (as is the case with Pierre Fabre). In this situation, the foundation would only be allowed preferred shares, i.e. it would have priority in receiving dividends, but would have zero – or severely restricted – voting rights. The second solution is illustrated by the framework of the Avril Foundation and the group formerly known as Sofiprotéol. It consists of transforming a firm into a private limited company (or the creation of an intermediary with this form), which makes a distinction between "sleeping" partners (*commanditaire*) and active partners (*commandité*). In this case, the foundation acts as the sleeping partner – although it needs to have at least three representatives. The foundation cannot interfere in the management of the company, but can benefits from dividends. The active partners, on the other hand, fully assume control of the company, including any related risks[6].

It is permissible, however, for a foundation to entrust or transfer the management of its economic functions (especially if they are taxed) to a subsidiary firm, whether civil or commercial – as long as the foundation is a majority owner. This must be done in accordance with its by-laws, notably with respect to the intended goals, as well as the maintenance of the economic independence of the foundation.

Public supervision over foundations regarding their mission

A foundation that is recognized as public utility has to submit to oversight by the Interior ministry and the Council of State. This is done in order to ensure that the social mission and charter of the foundation are followed; this also provides re-assurance for the founders that their wishes will be respected in the future. However, the ministry and the Council do not involve themselves in the operational management of the foundation.

In certain cases, a foundation can be subject to an audit or inspection – as with any other non-profit organization – depending on the nature of its activities or resources (for example, by the Court of Auditors if the foundation receives subsidies, or by the Inspector General of Social Affairs if it receives private donations through a public fundraising campaign).

Tax advantages as a key benefit

A foundation may freely accept donations that are granted to it (notably donations and bequests of company shares) but it must first declare them to the prefecture, which has the power to object[7]. These donations are exempt from transfer taxes[8].

Without exception, the foundation is exempt from corporate taxes, and benefits from a reduced rate on income from assets: e.g. securities, rent from real estate, agricultural and forest property[9]. These benefits also extend to revenue derived from ownership of subsidiaries; in this way, the foundation avoids restrictions on dividends when they come from managed investments. However, the titles to the firms – those that the foundation actively controls – must be placed in a completely separate (and taxable) accounting area.

Moreover, the foundation can pursue both profit and non-profit activities. These latter activities should be managed in a separate accounting area if their annual income exceeds €60,540 (in 2015)[10].

Little or no taxation on income from shares

In principle, a foundation is exempt from all taxes coming from share dividends, as long as they are: 1) from inherited investments, or 2) on the holdings of firms in which the foundation is a passive or minority shareholder. Any eventual capital gains on the resale of these holdings are similarly tax-exempt[11].

A notable exception: If the foundation is actively involved in the management of its subsidiary, its holdings must be placed in a separate (and taxable) area[12]. As a result of this stipulation, a separate entity will usually be created to house the business management activities related to the foundation (e.g., a foundation having a majority stake in a publishing house, with economic ties between the two, or even common senior managers).

Theoretically, dividends received by the foundation are subject to the ordinary tax rate (33.3%). However, the foundation can benefit from a "parent-subsidiary" regime to avoid double-taxation (i.e. corporate taxation before distribution, then again on dividends). With this regime, only 5% of dividends are taxed at the ordinary rate, corresponding to an effective tax rate of 1.67%. In contrast, any eventual capital gains generated by the sale of a holding are taxable according to common law.

Inheritance law: An obstacle to the creation of shareholder foundations?

French civil law states that a person's wealth be at least partially reserved for heirs (a concept that is not found in Anglo-Saxon law). The deceased must leave at least half of his wealth to the heir if he has only one child; two-thirds if he has two children; three quarters if he has three children, and so on[13]. He can assign the remaining wealth to a beneficiary of his choosing (for example, a foundation).

In the case of a significant *inter vivos* donation (and also a bequest) – for example, company shares possessed by the donor (or the deceased) – it is mandatory to verify in advance that this act does not impinge upon the share of inheritance reserved for heirs.

Since 2006 though, Article 929 of the civil code[14] has permitted presumed heirs to re-assign all or part of their inheritance in advance, towards one or more others (such as a foundation). They cannot subsequently revoke this reassignment except in exceptional circumstances (for example: if the heir renounces his inheritance in a state of need, he can recover it if his situation subsequently improves). However, it becomes necessary to introduce an act for the heirs, in order to prevent the risk that they reclaim their inheritance during the succession process.

[1] Law No. 87-571 of 23 July 1987, Article 18. They are to be distinguished from: i) "Commercial foundations", created by one or more firms, for as long a duration as necessary to complete the initiative of general interest (Article 19 of the Law of 23 July 1987); ii) "Sheltered foundations" that are unincorporated organizations, without legal personality, sheltered within a recognized public utility foundation (Article 20 of the Law of 23 July 1987); iii) Other special categories that do not fall within the scope of this study (university foundations, partnerships, hospitals, etc.). See box below for "Alternative solutions".
– [2] Law No. 87-571 of 23 July 1987, Article 18, paragraph 2.
– [3] Articles 18-3 and 19-3 of Law n° 87-571 of 23 July 1987 on the development of sponsorship, added by Act No. 2005-882 of 2 August 2005.
– [4] This might paradoxically result in significant tax consequences, if the tax authorities consider that this proximity demonstrates the existence of "special relationships with a for-profit sector of the business," thus constituting feasible grounds for commercial taxation on the foundation (cf tax instruction of 18 December 2006, resumption to BOFiP: IS-CHAMP-10-50-10-30, § 10 et seq.).
– [5] The other shareholder foundations (Fondation Mérieux, which holds 28% of shares in the SAS Compagnie Mérieux Alliance or the Avril Foundation) have, at most, a blocking minority ownership.
– [6] Article L.226-1, paragraph 1 of the Commercial Code.
– [7] Article 910, paragraph 3 of the Civil Code.
– [8] Article 795, 2° and 4° of the General Tax Code.
– [9] Article 206, 5 ° of the General Tax Code.
– [10] Article 206.1 bis of the General Tax Code.
– [11] BOFiP, No. IS-BOI-CHAMP-10-50-20-10, § 670.
– [12] BOFiP, No. IS-BOI-CHAMP-10-50-50-10, § 560 et seq.
– [13] Articles 912 and 913 of the Civil Code.
– [14] Relatively recent, from the law of 24 June 2006.

Alternative solutions to the recognized public utility foundation

With fewer constraints and more flexibility in management, there are alternative governance forms available that permit partial or complete holding of a firm. However, these forms demonstrate their limitations over the long-term.

The association law of 1901: a fragile owner

The association law of 1901 is the most widespread non-profit form in France, with approximately 1.5 million organizations actively operating under it. In contrast to the recognized public utility foundation, it can be created by a simple declaration by the founder at the prefecture, along with publication in the official registry; it is henceforth prohibited from distributing profit and shares to its members. However, nothing prevents it from holding a firm, either as part of its purpose (if provided for in its by-laws – see below for the case of Leroux Development) or as a means of operating (if, for example, it pertains to outsourcing commercial activities to a subsidiary that the association itself does not want to manage).

If such holdings are purely asset based, the distributed dividends are subject to a reduced tax rate of 15% (after payment of common corporate taxes – usually 33.33% – within the company before distribution). If, however, this ownership entails active management of the subsidiary, it becomes necessary to establish a distinct accounting system for the firm, subjecting the latter to corporate taxes. Nonetheless, there is the option of using the "parent-subsidiary" regime where only 5% of dividends received are subject to common tax (resulting in an effective tax rate of 1.67%). Any eventual capital gains from the resale of holdings, on the other hand, are fully subject to the common tax rate.

Endowment funds: easy to create, but what about after?

Emerging as the result of the law from August 5th, 2008 (article 140), endowment funds feature both the flexibility of an association as well as certain benefits associated with recognized public utility foundations. As with an association, a simple public declaration at the prefecture is sufficient for creation. Similarly, the operations are not constrained, given that their by-laws are very open. The only stipulation is the initial endowment, which should be at least € 15,000 in cash.

As with a foundation, these funds must have a general interest goal; holding onto the title of a firm would not be a sufficient purpose in and of itself. However, a fund could possess shares of commercial firms as part of an initial or augmented endowment, as long as they corresponded to the allowed investments in Article R. 931-10-21 of the social security code. The list is nonetheless very broad and does not exclude much except for risky investments. In principle, the revenues from assets are tax-exempt, including dividends and capital gains. However, if the by-laws state that the endowment can be consumed – without needing to invest it solely in order to live off its revenues – then the dividends are taxable at the same 15% rate as associations. Similarly, in the case of active management of a subsidiary – and presuming that the endowment represents majority ownership and is no longer a simple asset investment – the fund must establish a separate accounting system that is subject to common tax treatments. However, in this case, it appears necessary for the fund to primarily exercise activities towards the general interest in order to maintain its status; otherwise it must act as a re-distributor of its revenues to other general interest organizations.

Out of the almost 2,000 endowment funds present today, very few are majority owners of a firm. As is the case with associations, founders fear that in holding a business entity, their successors will not fully respect the goal for which the fund was created. This paradoxically implies a great deal of confidence in the heirs or successors that will be appointed as the next administrators.

The corporate foundation: a form that cannot control a company

The third solution is the corporate foundation, emerging after the law of July 4th, 1990 and supplementing the law of July 23rd, 1987 (article 19 and following). This is also a form of foundation established to pursue a general interest mission, but by a legal "person" (whether it be a civil or commercial company, an industrial or commercial establishment, a cooperative, a mutual, etc.) for a limited duration (which may not be less than five years but is renewable) and with a limited capacity. This foundation cannot engage in public fundraising, except among employees and shareholders from the founding company, and also cannot own investment properties. The commercial foundation may certainly hold securities in enterprises (including investment funds in multi-year action programs), but the holding should be at least five years, with a total amount of no less than € 150,000.

However, if it holds shares of the parent company, it cannot exercise any associated voting rights (article 19-3 of the same law of July 23rd, 1987). This stipulation is intended to avoid incentivizing companies to create a foundation as a means to control itself; however, given the limited life of such foundations, this ends up being an unlikely possibility. Given the limitation on voting rights, a corporate foundation is naturally unable to be the sole or even majority owner of a company. Tax-wise, these foundations are subject to a similar regime as associations, particularly with respect to the treatment of holdings, dividends, and any eventual capital gains from resale.

The sheltered foundation: a limited independence

The fourth solution, the sheltered foundation, appeared from the same law of July 23rd, 1987 (Article 20). It is defined as *"the irrevocable assignment, towards a work of general interest and with a non-profit goal, of goods, rights and resources to a recognized public utility foundation, one which allows such holdings in its by-laws"*. It is thus an internal entity within a recognized public utility foundation, without legal personhood but sufficiently autonomous according to the agreement between the founders and the public utility foundation. There are currently 50 umbrella foundations in France that house 700 sheltered foundations.

The major advantage of this form is that it permits founders to create their own foundation quickly and easily, and without the large endowment required by a recognized public utility foundation. Management constraints are handled at the level of the umbrella foundation, while the sheltered entity is endowed with decision-making autonomy (and using the name "*foundation 'Y', under the aegis of the recognized public utility foundation 'X'*"). The umbrella organization bestows upon the sheltered foundation – the latter of which is devoid of legal personality – all benefits, tax or otherwise, of a recognized public utility foundation. The sheltered form can thus legitimately possess (in an analytically distinct account) majority or full ownership of a firm as long as the umbrella foundation accepts it, and as long as it is under the same investment constraints and tax regime.