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The change in the method of allocation of profits between the shareholders provided for in the company's by-laws does not constitute a gift

The change in the method of allocation of profits between the shareholders provided for in the company's by-laws does not constitute a gift insofar as (i) such change can only be made pursuant to a decision of a corporate body, and (ii) the profits earned by the company are considered as having the nature of income only at the time they are allocated to shareholders in the form of dividends which have no legal existence until the competent corporate body acknowledges the existence of sums available for distribution and determines the amount to be allocated to each shareholder.

In the commented decision^[1], the capital of a family-owned company was allocated between the two parents and the children. Each of them was the full and unrestricted owner of a fraction of the shares making up the capital. In addition the parents are the usufructuaries of the majority of the shares and, as such, taken together they receive 95 % of the distributed profits.

During an extraordinary meeting of shareholders, the shareholders unanimously resolved to amend the method of allocation of the dividends for the next five years as follows: 17 % of the distributable profits to each

of the parents, i.e. taken together 34% instead of 95%, and 30.5% to each of the children.

Claiming that such a waiver by the parents constituted an indirect gift, the French tax authorities applied the gift tax to the dividends distributed to the children.

After having received the notice of assessment, one of the children filed an objection with the tax authorities. This objection was dismissed and the child decided to initiate proceedings before the competent Court of First Instance to request the cancellation of this tax.

The Court of Appeals of Douai^[12] ruled in favor of the tax authorities. It considered that the decision to change the dividend allocation was made unanimously by the shareholders and inferred therefrom that it necessarily came from the parents, donors, who, as usufructuaries, owned the majority of the voting rights during meetings of shareholders.

The *Cour de Cassation* (French Supreme Court) rejected this analysis on the basis of Articles 894 and 1842 of the French Civil Code^[13] and recalled that:

- A change in the method of allocation of dividends within a company may only be made pursuant to a collective decision of the shareholders. By participating in this decision, **adopted by a corporate body**, the parents have not personally consented to make a gift of one of their assets/properties. Stating the contrary would in fact be a **denial of the company's legal personality**;
- Profits earned by a company are considered as having the nature of income only at the time they are allocated to shareholders in the form of dividends which have no legal existence until the competent corporate body acknowledges the existence of sums available for distribution and determines the amount to be allocated to each shareholder^[14], which means that the parents, **who had no right - even suspensive - on the dividends allocated to their children**, could not possibly have made a gift of such dividends.

There are few judicial precedents concerning indirect gifts^[15] between shareholders. In practice, they concern cases where the articles of incorporation granted to one of the shareholders a number of shares higher than what would have been justified in light of such shareholder's contribution^[16].

Preferred shares, as defined in Article L.228-11 of the French Commercial Code, are shares with or without voting rights^[17], that carry specific rights of any nature whatsoever, whether pecuniary or non-pecuniary, allocated on a permanent or temporary basis.

The commented decision provides the opportunity to recall that a careful attention should be paid to the creation of such shares, irrespective of how they are created (issuance of new shares or conversion of existing shares), notably by making sure that such a transaction is not likely to be considered as an indirect gift.

[1] Commercial chamber of the *Cour de Cassation*, December 18, 2012, n°11-27.741

[2] Court of Appeals of Douai, September 5, 2011.

[3] Article 894 of the French Civil Code: *"A gift inter vivos is a transaction by which the donor divests himself/herself now and irrevocably of the donated thing in favor of the donee who accepts it."*

Article 1842 of the French civil Code: *"Companies, other than partnerships referred to in chapter III, enjoy legal personality as from the date of their incorporation. Until incorporation, the relationships between members/shareholders are governed by the articles of association and by the general principles of law governing contacts and obligations".*

[4] Concerning the legal status of dividends and the existence of dividends, please see Decision of the Commercial Chamber of the *Cour de Cassation* dated November 28, 2006.

[5] An indirect gift should not be confused with a disguised gift. Indeed, an indirect gift is not based on an apparently totally fictitious instrument.

[6] See notably Decision of the 3rd Civil Chamber of the *Cour de Cassation*, April 7, 1976 and Decision of the 2nd Civil Chamber of the *Cour de Cassation*, December 2, 1981.

[7] The issuance of shares without voting right is subject to a number of conditions: cf. Article L.228-11§3 of the French Commercial Code.

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