

# *NewsAlert - Law Firms*

## *August 2011*



### *Alternative Structures of Law Firms: German Trade Tax Risk*

#### *New Law Firm Structures in the United Kingdom*

Since 31 March 2009 law firms in the UK are permitted to operate as "Legal Disciplinary Practices" (LDPs). LDPs provide legal services, but allow different kinds of lawyers with respect to ownership and management, and up to 25 per cent non-lawyers.

In addition, from October 2011 onwards "Alternative Business Structures" (ABSs) will be authorized in the United Kingdom. ABSs are firms which are allowed to form structures with non-lawyers in professional, management or ownership roles, and that provide legal services or legal services in combination with non-legal services. Moreover, partial or complete external ownership of the firm would be allowed, so that e.g. private equity or quoted institutional investors could hold interests in the law firm.

These new structures shall *"allow greater competition in service delivery and innovative ways of meeting consumer demand for legal services"*.

#### *New Structures Considered in the United States*

The existing system in the United States allows only lawyers to own law firms.

The American Bar Association however has formed a working group which is considering whether *"lawyers and law firms, in order to better serve their clients, should be able to structure themselves differently and to use Alternative Business Structures to those currently permitted under the Model Rules of Professional Conduct"*.

It is also interesting to note the current lawsuits by Jacoby & Meyers against the justices of New York's Appellate Division, the Connecticut Superior Court and the Supreme Court of New Jersey, challenging the current restrictions and attempting to permit firms to raise capital from non-lawyer investors, who in return would become "partners" of the law firm.

#### *German Trade Tax Issues for International Law Firms Operating in Germany*

If a law firm that operates in Germany through a branch decides to implement one of the above-mentioned structures it should be kept in mind that the new structure could result in a German trade tax liability.

German trade tax is a tax in addition to income tax and is imposed on the German income of the firm only. Law firms are generally exempt from German trade tax.

However, even a law firm can trigger German trade tax if it generates income that is not typical for a lawyer (i.e., unusual activity), or if the law firm has an unusual legal structure.

The trade tax rate depends on the municipality where the law firm resides - for example the Frankfurt trade tax rate currently amounts to approximately 16%. Although a part of the paid trade tax can be credited against the German resident and non-resident partners' German income tax, a considerable portion is normally not creditable and therefore, results in an effective tax burden in Germany.

The following structures of international law firms operating in Germany through one or more German branches would be regarded as problematic by the German fiscal courts and the German tax administration:

- **The law firm has equity partners who are "passive", i.e. do not render any legal services.**

This regulation (amongst others) is aimed at preventing law firms from having equity partners, who regard their interest in the firm as just a capital investment, and whose only interest lies in the "distributions" of the firm. Such an investment contradicts the idea that lawyers are first and foremost obliged to render legal services, and not to run a business enterprise which is aimed at maximizing its profits. Consequently, any "investor", whether a private equity house or institutional investors, would be problematic and thus lead to a German trade tax liability of the law firm with respect to the income of its German office. That means for a law firm which decides e.g. to implement a UK ABS structure that any partner who could be regarded as an "investor" could lead to negative German tax effects.

Furthermore, if there are partners who do not render any legal services (such as a full-time Managing Partner or retired partners who are still listed as partners), this could also be regarded as problematic.

Finally, if non-equity partners, freelancers or employed attorneys advise and take care of clients independently and without the involvement of an equity partner, the German tax authorities normally qualify this as problematic, given that the equity partners do not have a controlling position and do not act on their own responsibility with regard to these clients anymore.

- **A corporation holds shares in the law firm**

In such cases where a law firm has (under the ABS structure) an entity as a partner which qualifies a corporation from a German tax perspective (such as a US P.C., an S-Corp., a UK Limited etc.), this would also immediately lead to a trade tax liability.

- **The law firm has equity partners who are not (German or foreign) lawyers**

According to the German tax, legal and bar provisions German lawyers are, in principle, allowed to form a partnership together with other (foreign) lawyers.

However, if only one of the equity partners does not fulfill this requirement of being a lawyer, the participation of such a person in the firm would generally be deemed problematic and the whole income of the firm's German branch would be subject to German trade tax.

Consequently, verification is needed as to whether the appointment of non-lawyers as equity partners of the firm (which would be permitted under the LDP and ABS structures) would comply with the aforementioned preconditions or not.

### **Conclusion**

New law firm structures (such as LDPs or ABSs) could result in a German trade tax liability. Therefore, a review of the German tax implications should be thoroughly considered before implementing any new, proposed structure. We would be pleased to discuss the potential effects of new / alternative business structures with you and are ready to find solutions for your individual situation.

### **Your contact**

If you have any further queries or questions, please contact:

#### **Stefan Bernütz**

*PricewaterhouseCoopers AG WPG*

*Lise-Meitner-Str. 1*

*10589 Berlin*

*Tel.: +49 30 26 36-52 05*

*Fax: +49 69 95 85 - 9 - 18291*

*stefan.bernuetz@de.pwc.com*

Stefan Bernütz is the head of the "German Competence Center for International Law Firms" at PricewaterhouseCoopers, which specializes in providing tax advice to national and international law firms.

The Competence Center consists of tax advisors, tax lawyers, accountants, German certified public accountants and assistant tax consultants. All team members have extensive experience in advising on international tax law matters. Ongoing tax compliance services such as preparing tax returns for the firm or resident and non-resident partners as well as tax structuring and tax planning services are the main aspects of the team's activity in advising its more than 30 law firm clients.

Moreover, the German Competence Center is part of the global PwC-Network, which also specializes in providing international advice to law firms. For more information, see: [www.pwc.com/lfs](http://www.pwc.com/lfs).

### **Solicitation.**

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