

LiFITS memo* Ruling signals change in French tax treatment of UK LLP distribution

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Summary

Earlier this year, the French authorities signalled that a welcome change in the tax treatment of distributions from UK limited liability partnerships (LLPs) in France was imminent. This article discusses the scope of the recent ruling that initiated the change and its ramifications for UK firms considering an LLP conversion, or those already in or contemplating alliances with French firms.

Law firms with an interest in France or planning to enter the French market should consider the implications of the ruling. It provides encouragement to those firms considering conversion to a UK LLP and also provides planning opportunities to those firms that have implemented arrangements to navigate the previous double taxation issue.

Background

Until very recently, there was no equivalent entity to an LLP under the French tax system, and this created uncertainty about the appropriate tax treatment of partner distributions under French tax law. Under French law, the key issue was whether income flowing to a partner should be treated as flow-through income or whether it should be deemed a dividend and taxed at the entity level. In the UK and US, such distributions are considered flow-through income that is reported by and taxable to the partner directly. This treatment avoids double taxation and is seen as a key benefit of the LLP structure.

Growth in the number of international mergers in the law firm market has increased the presence of UK firms in the French market. As of 2007, nearly all the leading French firms formed alliances with international firms, with UK firms claiming the lion's share. A recent change in the UK tax law makes the LLP structure more beneficial to international firms and, accordingly, clarification on the taxation of distributions becomes a pressing issue. If French law were to consider such distributions a dividend, this would have negative tax ramifications on all partners in the firm by

subjecting them to double taxation on the French source income. This could put a strain on existing mergers and leave some firms pondering if the tax disadvantage is worth accepting in return for having a presence in one of the world's largest economies.

Because the French authorities did not recognize the flow-through nature of the LLP structure, one way to limit the negative impact on the French partners was to have their status changed from partner to either independent contractor or employee. However, this solution meant that the French partners would lose their voting rights, so it was often deemed an unacceptable solution.

Recent changes

In April, the French authorities issued a favorable ruling that French partners in a UK LLP should not be subject to double taxation. As reported by the media, the ruling came about partly as a result of the lobbying efforts of UK firms Linklaters, Lovells, Freshfields and Ashursts to gain clarification on the matter. While this ruling is a positive step, it is important to note that the ruling issued bears a resemblance to a US Private Letter Ruling and, accordingly, is client specific and cannot be relied upon as precedent.

At this stage, the publishing of a broader ruling is not thought to be imminent, and firms with similar fact patterns may wish to seek similar private rulings on their situations. Law firms with a classic UK LLP arrangement should be able to obtain the same ruling. In terms of timing, a private ruling should take four to six months, depending on the time of year that the ruling is submitted. It is also a good idea for the firm's representative to stay in close contact with the French authorities while the ruling is in progress to keep the process moving. The original ruling took two and a half years, but such a delay is unlikely to hinder subsequent rulings.

Once in possession of a favorable ruling, firms may consider claiming a refund at the entity level for the distributions previously taxed as dividends. The original ruling suggests that no philosophical objection remains to the principle of flow-through treatment. This should bring some relief to the entities already established in the French market.

Additionally, on May 15, 2007, French authorities issued a decree allowing French lawyers to create "legal associations with individual unlimited liability," the first step towards the French equivalent of an LLP.

A look ahead

The election of Nicolas Sarkozy as French president in May is expected to bring greater liberalization to the French market, and this should spill over into the legal field. Nonetheless, we still expect significant delays before a new UK-France Tax Treaty, initially signed in 2004, is ratified. This treaty, unlike the old treaty, addresses the issue of partnerships and LLPs and should help entrench the concept of limited liability, as applied to foreign partnerships, into French law.

For more information, please contact Stanley Kolodziejczak at 646-471-3160, Michael Jaffe at 33 1 56574042 or Rachel Bentley at 646-471-7824.

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Law Firm Services national contacts

National Tax Leaders

Stanley Kolodziejczak

Tax Partner

phone: 646-471-3160

fax: 813-329-6448

stanley.kolodziejczak@us.pwc.com

Joseph A. Bailey, Jr.

Tax Partner

phone: 646-471-0860

fax: 813-329-8747

joseph.a.bailey@us.pwc.com

Gregg Sincoff

Tax Managing Director

phone: 646-471-1335

fax: 813-329-7863

gregg.sincoff@us.pwc.com

National Assurance Leader

David E. Gaulin

Assurance Partner

phone: 646-471-1810

fax: 813-286-9427

david.gaulin@us.pwc.com

*connectedthinking

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