Considerations when expanding your law firm overseas

Expanding your law firm into a new geography comes with risks, stresses and unknowns. Will your firm attract clients in the new marketplace similar to your current market? Are there talented, qualified and motivated individuals in the local area to help grow the new office? How will your presence in the new geography affect the firm's current clients?

These are concerns you would have expanding operations in the U.S. – *let alone expanding into a foreign country!* What are the cultural differences that your firm will have to adapt? What are the business, financial and tax hurdles of operating overseas? Will it be financially lucrative for the firm to expand into a new country?

Law firms are looking for expansion opportunities across both the Pacific and Atlantic for several reasons. The ability to market the firm as an international law firm appeals to existing U.S. clients and prospects because an international law firm can offer more resources to their clients. Foreign clients and prospects looking to do business in the U.S. want to work with law firms with both a local in-country and U.S. presence.

Inevitably, the foreign and U.S. offices will refer each other work and rely upon each other's expertise for local customs and laws. The experiential learning that occurs when working with other cultures develops your U.S. attorneys' abilities and can make them think differently and more creatively about how they approach their clients. From a competitive standpoint, midsize to large law firms know their competitors are exploring opportunities overseas, and if a firm wants to remain competitive and grow, they have to be open to operating in a foreign market.

All of these are great reasons why a firm would look internationally – the question becomes what are the considerations when deciding to expand? There are various business and tax factors when determining what is appropriate for your firm. This article highlights some of the considerations that law firms face when contemplating an international expansion.

Branch versus separate legal entity

One of the most important decisions when opening a foreign office is the choice of entity structure. For tax purposes, a branch is treated as an extension of the U.S. home office, whereas a separate legal entity operates independently of the U.S. firm.

Since foreign branches have a similar structure to a second office, their flexibility and ease make them a popular choice for U.S. law firms. U.S. management can still have direct oversight and control over the day-to-day operations. If the branch is not profitable, especially in the early business development years, the losses are combined with the U.S. office's income statement, reducing the firm's overall taxable income. As the branch becomes profitable and pays tax in the foreign country, the U.S. partners may be able to claim a foreign tax credit based on either the taxes paid or accrued during their tax year.

Contrarily, U.S. partners may have a foreign nonresident filing obligation, potentially requiring them to find a personal tax advisor in the foreign country. Some foreign countries will allow the firm to file a nonresident group return to relieve the U.S. partners of their individual filing obligations.

Structuring as a separate legal entity could protect the U.S. firm's partners and/or shareholders from any adverse legal actions overseas. Since the separate legal entity would be considered a domestic business in the country which it is domiciled, the annual tax filings generally are less stringent on the U.S. partners. If the foreign office generates losses though, the U.S. office cannot utilize the losses to directly offset U.S. profits.

In an effort to capture advantages from both structures, depending on the particular facts and circumstances, U.S. firms may be able to create a legal corporation in the foreign country and make the "check-the-box" election to treat the entity as a branch for U.S. tax purposes. This option will provide the

U.S. firm with liability protection overseas. If the foreign entity is not profitable, it allows the overseas losses to flow-up to the U.S. office. In profitable years, the foreign corporation would pay the corporate tax and pass-up this tax to the U.S. partners in the form of a foreign tax credit. Also, this option likely eliminates the need for U.S. partners to file foreign tax returns. The one caveat to consider is there may be withholding taxes on the earnings and profits distributions from the foreign corporation in the foreign jurisdiction.

Regardless of the structure, transfer pricing considerations need to be factored. In particular, how are costs shared across offices for overhead and management? Documenting a transfer pricing methodology is *highly recommended*. One item to consider, once a methodology has been adopted, it can be difficult to revise. A discussion with a transfer pricing specialist and the papering of a transfer pricing study is highly advisable at the early onset of your overseas operations.

Per se foreign corporations

If the overseas entity is structured as a per se corporation, then U.S. taxpayers cannot “check-the-box” to become a branch in the U.S. The U.S. classification will be a corporation. A comprehensive list of countries and foreign entity structures that must be treated as corporations for U.S. tax purposes can be found at Treasury Regulation §301.7701-2(b)(8)(i).

Foreign tax credit

U.S. taxpayers, both corporations and individuals, can benefit from foreign taxes being paid overseas in the form of a foreign tax credit (FTC). FTCs can be used to offset U.S. tax liabilities, determined by the amount of foreign-source income and foreign taxes paid on such income. This helps limit double taxation on taxpayers. As briefly mentioned earlier, U.S. taxpayers may be able to claim a FTC based on either the taxes paid or accrued during their tax year. The foreign country’s tax year, as well as the timing of when tax liabilities are paid, both play key factors in determining whether the paid or accrued method is the better approach.

Two examples that illustrate the complications of which methodology might be best is the United Kingdom and Germany. The United Kingdom’s tax year runs from April 6, 20XX to April 5, 20XY. The crossover of calendar years, which most U.S. taxpayers follow a calendar tax year, creates the need for diligent record keeping and reporting to make sure an accurate FTC is calculated for the U.S. firm. Germany requires businesses and individuals to file tax returns the year after the close of the tax year. The tax liability is determined based off the filed tax returns, where then Germany sends the taxpayer an assessment. The taxpayer then has an additional few months to remit the tax liability. Therefore, in Germany, the tax remittance could potentially be two years after the conclusion of a tax year. This creates the potential for a mismatch in foreign source income and foreign taxes paid if the taxpayer follows the paid method for the FTC.

Due to these types of nuances, U.S. taxpayers have the option to either report their FTC under a paid or accrued methodology. The firm’s circumstances and the particular foreign country will help dictate which option is the most advantageous.

Registrations and filings requirements

Business registrations and tax filing requirements vary between countries and localities. Regardless of the structure, the firm will have similar start-up activities overseas as it would when opening a new office in the U.S.

Generally, the firm will need to register in the new country and potentially a locality and obtain an identification number similar to a U.S. employer identification number.

There will also be foreign payroll, property, and income tax filings that need to be considered. In the U.S., depending on the structuring, there are additional filings that may have to be included with the firm’s U.S.

income tax returns as well as potentially the individual shareholders and partners. At the firm and individual levels, there is a requirement to report foreign bank and financial account information. The U.S. firm would report the ownership, and any individuals that have signatory authority or a significant enough indirect ownership over the foreign account(s) would also have to file their own foreign bank and financial account report. Keep in mind that the Chief Operating Officer and Chief Financial Officer, even if they are not partners or shareholders, may have signatory authority over the financial account(s) and would be required to file a foreign bank and financial account report at their individual level.

Impacts from tax reform

The Tax Cuts and Jobs Act (TCJA) passed by Congress and signed into law on December 22, 2017, brought major tax provisions and implications for U.S. individuals and businesses. The TCJA also included legislation that effects U.S. law firms doing business overseas.

Law firms structured as foreign corporations need to consider the new global intangible low-taxed income (GILTI) rules. Generally speaking, these provisions annually subject income earned overseas by a controlled foreign corporation (CFC) to a U.S. tax. These rules and the subsequent calculations are complex for both U.S. corporations and partnerships that own a CFC. At a high-level, a U.S. partnership and/or U.S. corporation annually may have a "GILTI inclusion" that needs to be incorporated with its U.S. tax filings because of the CFC's activities. Transfer pricing policies could affect your GILTI inclusion, too.

The Internal Revenue Code §199A deduction may allow a law firm partner, subject to income limitations, a twenty percent deduction on the lesser of (a) the partner's share of U.S. source qualified business income from the firm; or (b) the partner's taxable income in excess of the sum of the their net capital gains and any qualified cooperative dividends. The firm's qualified business income cannot include foreign income and losses. Therefore, Box 20Z on the partner's Schedule K-1 which reports §199A income cannot include the income and/or loss of the firm's foreign operations.

As previously discussed, U.S. law firms have historically been able to utilize FTCs to offset U.S. tax liabilities. Under the TCJA, this is still allowed – however, the calculation has changed. Income from foreign branches now fall under their own computational "basket", and the ability to take FTCs if multiple overseas operations exist could be limited if one foreign branch is profitable and the other is not.

This article is intended to serve as an overview of various business, financial and tax considerations of opening and operating an international law firm office. Conducting business overseas continues to be an attractive option to growing law firms, but careful planning and guidance is essential to meeting your law firm's objectives. We recommend consulting with a tax advisor who can properly assist with your particular circumstances.

For more information on this topic, or to learn how Baker Tilly professional services specialists can help, contact our team.