

Structuring and mergers using LLPs

High level concepts

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LLPs

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- Why LLP

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Background – Legislative history

Background – Legislative history

- Limited Liability Partnership Act, 2008 (LLP Act) published in the Official Gazette on 9-Jan-2009
- LLP Act - different dates of effectiveness for different provisions
 - Basic provisions -> 31-Mar-2009
 - Conversion of firm, private company and unlisted public company into LLP -> 31-May-2009
- Limited Liability Partnership Rules, 2009 (LLP Rules) issued
 - Basic provisions - 1-Apr-2009
 - Conversion of firm, private company and unlisted public company into LLP -> 31-May-2009

Why LLP

Why look for an alternate form of entity

- **Shortcomings of Partnership firm**
 - Unlimited liability of the partners
 - Maximum 20 partners (10 - in banking business)
 - Not found favor when it comes to foreign investments (not under automatic route)
 - No perpetual succession
- **Shortcomings of company**
 - Dividend Distribution Tax
 - Minimum Alternate Tax
 - Onerous compliance requirements

Why LLP

- **Blend of benefits of Partnership firm & company**
 - Limited liability of the partners
 - No limit on maximum partners
 - No Dividend Distribution Tax / Minimum Alternate Tax
 - Cost effective to incorporate
 - Few administrative compliance
 - Perpetual succession
- **LLP is aimed to**
 - provide a vehicle to SME and professional firms (CS, CA, CWS, Advocates, etc.) to conduct their business / profession efficiently with lesser administrative compliances
 - Boost growth of services sector

Tax considerations

Taxation of LLP

| Particulars | Implications |
|--|---|
| Tax status | <ul style="list-style-type: none"> • LLP to be treated at par with a partnership firm <ul style="list-style-type: none"> – Income liable to tax @ 30% • Not liable to DDT • Liable to Alternate Minimum Tax (“AMT”) on tax profits before considering deductions under Chapter VI-A and under Section 10AA • Option of presumptive taxation not available |
| Deduction for interest & remuneration to partners | <ul style="list-style-type: none"> • Maximum interest deduction ~ 12% simple interest p.a. • Remuneration payable to working partners deductible, subject to limits applicable to partnership firms |
| Losses | <ul style="list-style-type: none"> • Change in constitution of LLP due to death / retirement of a partner would disentitle the LLP to carry forward & set off proportionate unabsorbed losses (excluding unabsorbed depreciation) |
| Recovery of tax | <ul style="list-style-type: none"> • LLP liable to pay taxes • Where tax cannot be recovered from LLP, all partners jointly & severally liable for payment of tax, subject to certain exceptions |
| Share of LLP profit | <ul style="list-style-type: none"> • Exempt |
| Interest & remuneration from LLP | <ul style="list-style-type: none"> • Taxable as business income |
| Contribution of assets to LLP | <ul style="list-style-type: none"> • May be liable to capital gains tax |
| Recovery of tax liability of LLP | <ul style="list-style-type: none"> • Joint & several liability where tax cannot be recovered from the LLP, except where partner proves that non recovery of tax cannot be attributed to his gross neglect, misfeasance or breach of duty on his part |

Tax implications on conversion of company to LLP

Conversion of small private company / unlisted public company to be tax neutral subject to satisfaction of certain conditions

- Conditions at the time of conversion
 - Sales, turnover or gross receipts of business in any of the 3 preceding years not to exceed Rs. 6 million
 - All assets and liabilities to continue
 - All the shareholders to become partners
 - Capital contribution and profit sharing ratio to be in the same proportion as their shareholding in the company
 - No other consideration except by way of share of profit and capital contribution in the LLP
- Conditions having future implications
 - Aggregate profit sharing ratio of the shareholders to be a minimum of 50% for 5 years
 - No amount to be paid to any partner out of the balance of accumulated profit of the company for a period of 3 years
- Violation of conditions triggers tax for LLP in the year of violation
- Other implications
 - Continuity benefits available:
 - ✓ business loss and unabsorbed depreciation
 - ✓ cost of acquisition of capital assets
 - ✓ amortization of VRS expenditure
 - Depreciation allowance to be apportioned on the basis of actual number of days
 - MAT credit cannot be carried forward

LLP

Structuring options



Reorganization provisions in the LLP Act

- LLP Act has provisions dealing with the following:
 - Hiving off or separation (demerger) of undertaking, property or liabilities of LLP
 - Compromise, arrangement or reconstruction between LLP and creditors
 - Compromise, arrangement or reconstruction between LLP and its partners
 - Amalgamation of two LLPs
 - Voluntary, involuntary winding up of LLP

The Income tax Act, 1961 contains no specific provisions with respect to the above reorganizations

Option #1 - Amalgamation of LLPs

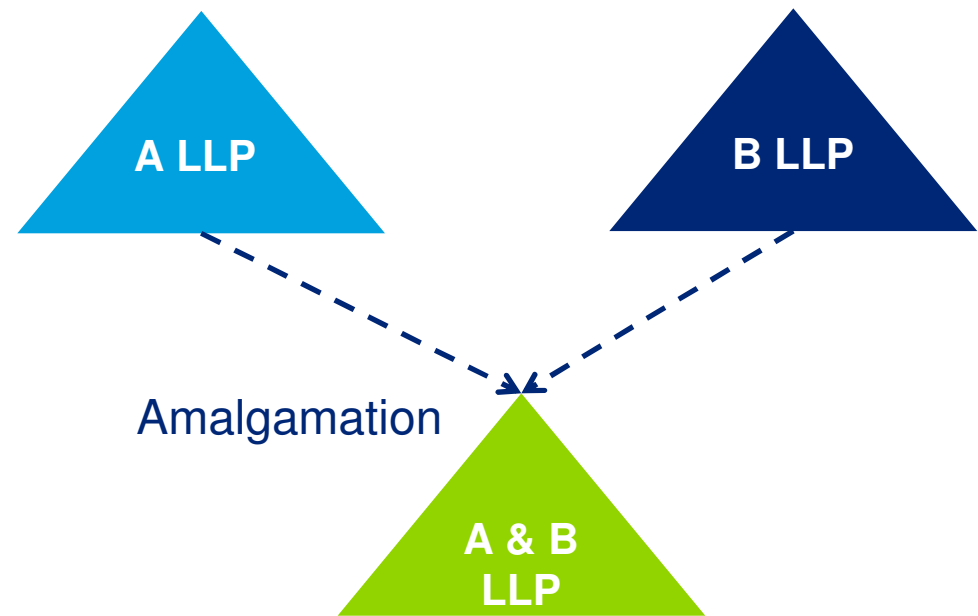
Option #1

Amalgamation of two LLPs

Scenario 1: Amalgamation of one LLP with another



Scenario 2: Two LLPs to merge together to form a new LLP



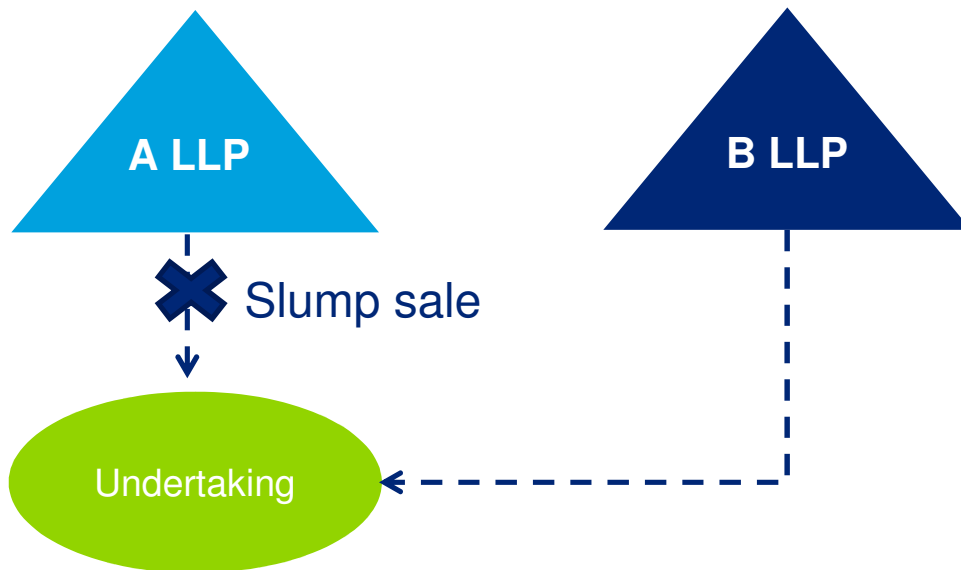
In absence of any specific provisions in the Income tax Act, 1961, there is no clarity on the tax implications that will arise in the above scenarios

Could the amalgamations be structured in a manner that will achieve the same objectives but with more clarity on the tax implications?

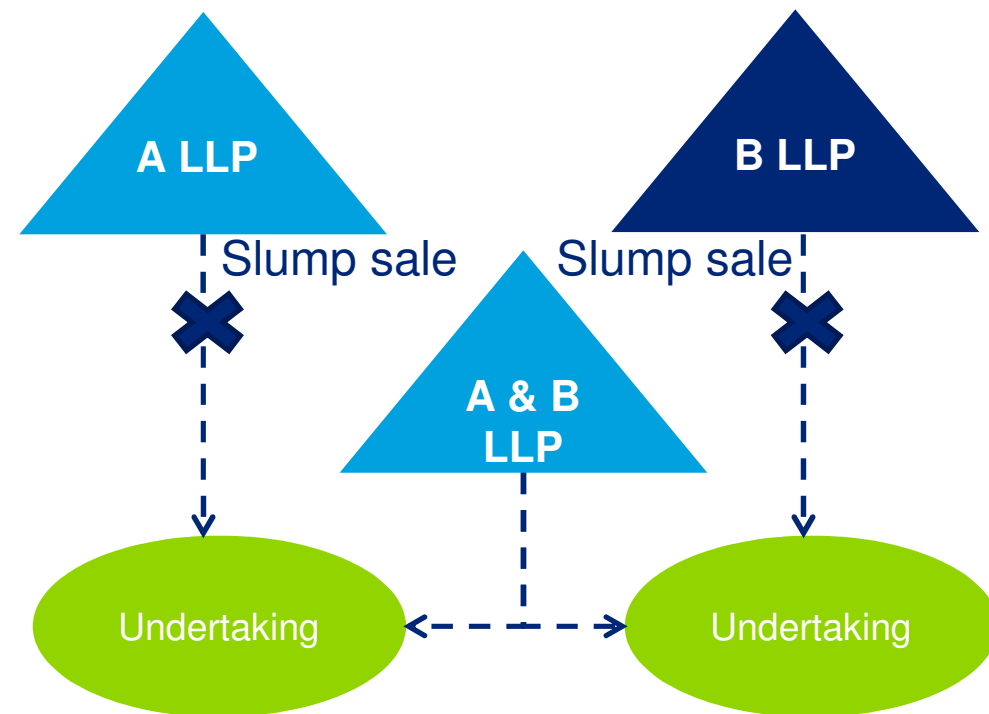
Option #1

Amalgamation of two LLPs

Slump sale of business undertaking from one
LLP to another



Slump sale of business undertaking by the two
LLPs to a new LLP



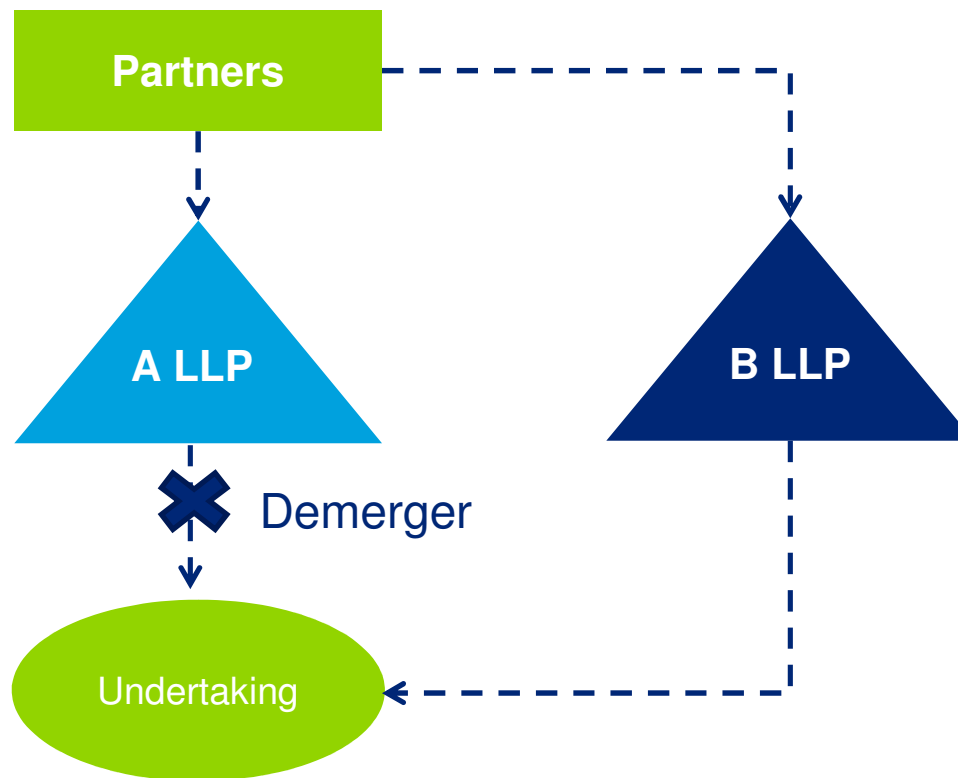
A slump sale at “net worth” (as defined in section 50B) of the undertakings could be explored to achieve the desired objectives in a tax neutral manner

Option #2 - Demerger

Option #2

Demerger of LLP

Demerger of business undertaking from one
LLP to another



What will be the implications from a tax perspective if the demerger is not as defined in section 2(19AA)?

Option #2

Demerger of LLP

- Will it be possible to argue that a demerger which is not as defined in section 2(19AA) is tax exempt for:
 - Demerging LLP on the ground that it is not receiving any “consideration” on demerger
 - Resulting LLP on the ground that it is not “transferring” any capital assets
 - Partners of LLP on the ground that it is not “transferring” any capital assets

Impact of non-compliant demerger on unabsorbed business loss and depreciation of demerging LLP?

Option #3 – Conversion (Mitigating DDT / MAT)

Option #3

Conversion of small Pvt. Co. / unlisted public Co.

Scenario 1: Operating company - Distributes PAT by declaring dividends

| Particulars | Company |
|--|---------|
| Profit after tax / distributable cash profit | 100.00 |
| Less: DDT @ 19.99% | 19.99 |
| Distributions to shareholders | 80.01 |

Dividends entails DDT at an effective tax rate of 19.99% resulting in lower distributions to the shareholders

Scenario 2: Holding company - Pays MAT on book profits

| Particulars | Company |
|--|---------|
| Taxable profits | Nil |
| Exempt LTCG on sale of listed equity share | 100.00 |
| MAT @ 20.961 | 20.96 |

MAT at 20.96% is payable on book profits even though there are no taxable profits

Could structuring these companies as LLPs assist in mitigating the DDT / MAT cost?

Option #3

Conversion of small Pvt. Co. / unlisted public Co.

Scenario 1: Operating company: Distributes PAT by declaring dividends

| Particulars | Company | LLP |
|--|---------|--------|
| Profit after tax / distributable cash profit | 100.00 | 100.00 |
| Less: DDT @ 19.99% | 19.99 | NA |
| Distributions to shareholders / partners | 80.01 | 100.00 |

**No DDT on LLP,
effectively resulting
in approx. 20%
higher distributions**

Scenario 2: Holding company: Pays MAT on book profits

| Particulars | Company | LLP |
|--|---------|--------|
| Taxable profits | Nil | Nil |
| Exempt LTCG on sale of listed equity share | 100.00 | 100.00 |
| MAT @ 20.961 | 20.96 | NA |

**No MAT on LLP,
effectively resulting
in savings of
approx. 20%**

**LLP appears to be a more tax efficient form of doing business vis-à-vis a company
(subject to analyzing specific facts of each case)**

Option #4 – Conversion (Sales exceed Rs. 6 mn)

Option #4

Conversion of small Pvt. Co. / unlisted public Co.

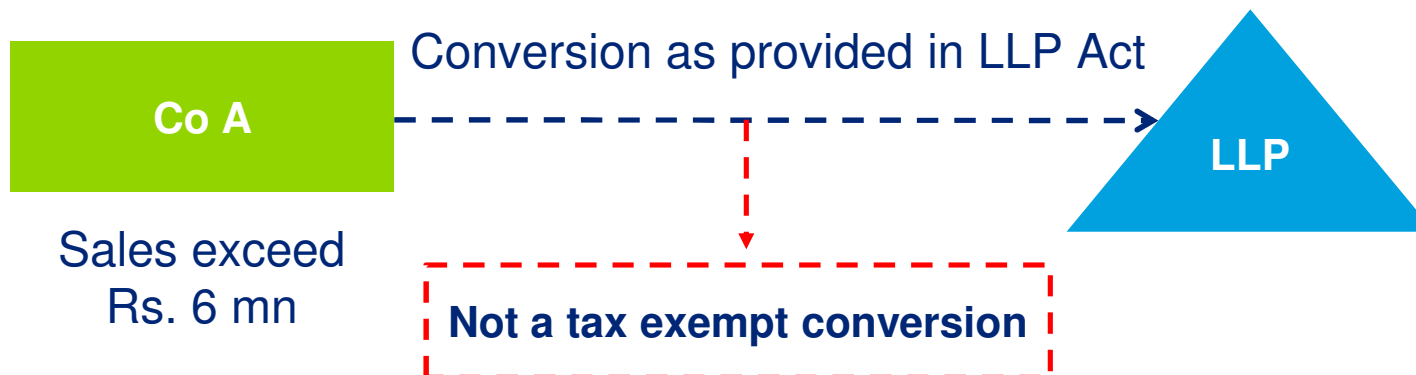
One of the critical condition for a Co. for tax neutrality on conversion to LLP is

Sales, turnover or gross receipts of business in any of the 3 preceding years not to exceed Rs. 6 mn



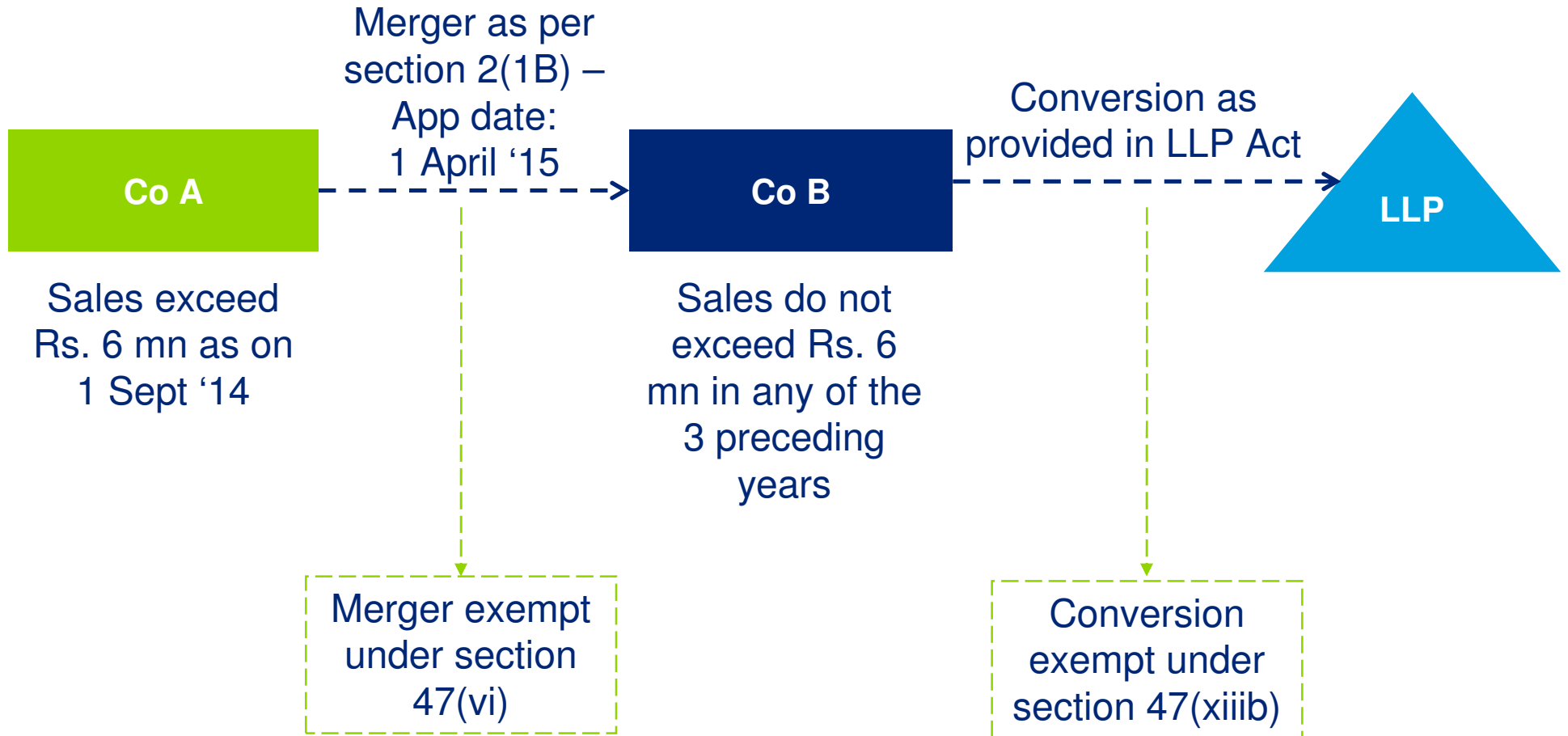
Query

If the aforesaid condition is not met by a company, can a tax neutral conversion to an LLP be achieved?



Option #4

Conversion of small Pvt. Co. / unlisted public Co.



Can the Tax Authorities deny exemption to a genuine merger between two companies followed by a conversion to an LLP?

Option #5 – Funding LLP

Background

- LLP Act enacted in 2009
- Created substantial anxiety and enthusiasm in the business community due to its advantages over corporate form
- Lack of clarity on FDI in LLP hampered its growth
- FDI in LLPs approved by the Cabinet Committee on Economic Affairs of the Government of India on 11 May 2011
- FDI policy amended vide Press Note No. 1 (2011 Series) issued by the Department of Industrial Policy & Promotion, Ministry of Commerce & Industry, Government of India
- FDI in LLPs allowed under the Government approval route and subject to satisfaction of certain conditions

Amendments in brief

- FDI in LLP allowed subject to following conditions
 - FDI in LLP allowed only through the Government approval route
 - FDI in LLP allowed only in sectors/activities where 100% FDI is allowed under automatic route and there are no FDI-linked performance related conditions
 - LLPs with FDI not allowed to operate in agricultural/plantation activity, print media or real estate business
 - Indian company with FDI permitted to make downstream investment in an LLP only if the company and LLP both are operating in sectors/activities where 100% FDI is allowed under automatic route and there are no FDI-linked performance related conditions
 - LLPs with FDI not allowed to make downstream investments
 - Foreign Capital participation in LLPs allowed only by way of cash consideration received by inward remittance through normal banking channels or by debit to NRE/FCNR account of the person concerned

Amendments in brief

- Conditions (contd..)
 - FIIIs and FVCIs not permitted to invest in LLPs
 - LLPs not permitted to avail ECBs
 - Body corporate acting as (or nominating an individual to act as) designated partner of the LLP having FDI should only be a company registered in India
 - Designated partner “resident in India” (as defined under the LLP Act, 2008) of an LLP having FDI to satisfy the definition of “person resident in India” under the Exchange Control Regulations as well
 - Designated partners to be responsible for compliance with above conditions and for penalties for their contravention
 - Conversion of a company with FDI into an LLP allowed subject to prior approval of FIPB/Government and fulfillment of above conditions

| Year | No. of approvals | Amt of FDI (Rs. cr) |
|------|------------------|---------------------|
| 2013 | 15 | 228.85 |
| 2014 | 16 | 87.81 |

Source: FIPB

Option #5

Funding LLP

FDI in LLP allowed subject to following conditions (relevant extracts only)

- FDI in LLP allowed only through the Government approval route
- FDI in LLP allowed only in sectors/activities where 100% FDI is allowed under automatic route and there are no FDI-linked performance related conditions
- Indian company with FDI permitted to make downstream investment in an LLP only if the company and LLP both are operating in sectors/activities where 100% FDI is allowed under automatic route and there are no FDI-linked performance related conditions
- FIIs and FVCIs not permitted to invest in LLPs
- LLPs not permitted to avail ECBs



Query

Considering the restrictions with respect to FDI investments in LLP as well as ECBs, is there any option to source funds for an LLP from outside India?

Option #6 – Project specific SPVs

Option #6

Project Specific SPVs

Facts of the case

- Co VLF is engaged in real estate development
- It proposes to enter into an agreement with certain individuals who owns land parcels for development of a residential project
- As per the agreement, Co VLF will provide its development expertise and the individuals will contribute the land parcels to the joint venture
- Sale of the developed residential units will be undertaken to independent third parties
- Profits from the sale of residential plots will be shared in the ratio as agreed between the JV partners, viz Co VLF and the group of individuals
- Post distribution of profits, the partners will exit from the project or may decide to jointly commence a new project
- In case of exit, the joint venture partners desire to have the maximum flexibility in appropriately utilizing / up streaming the funds

Considering the facts of the case, ascertain whether a joint venture company or LLP should be formed for such project specific SPVs?

Option #6

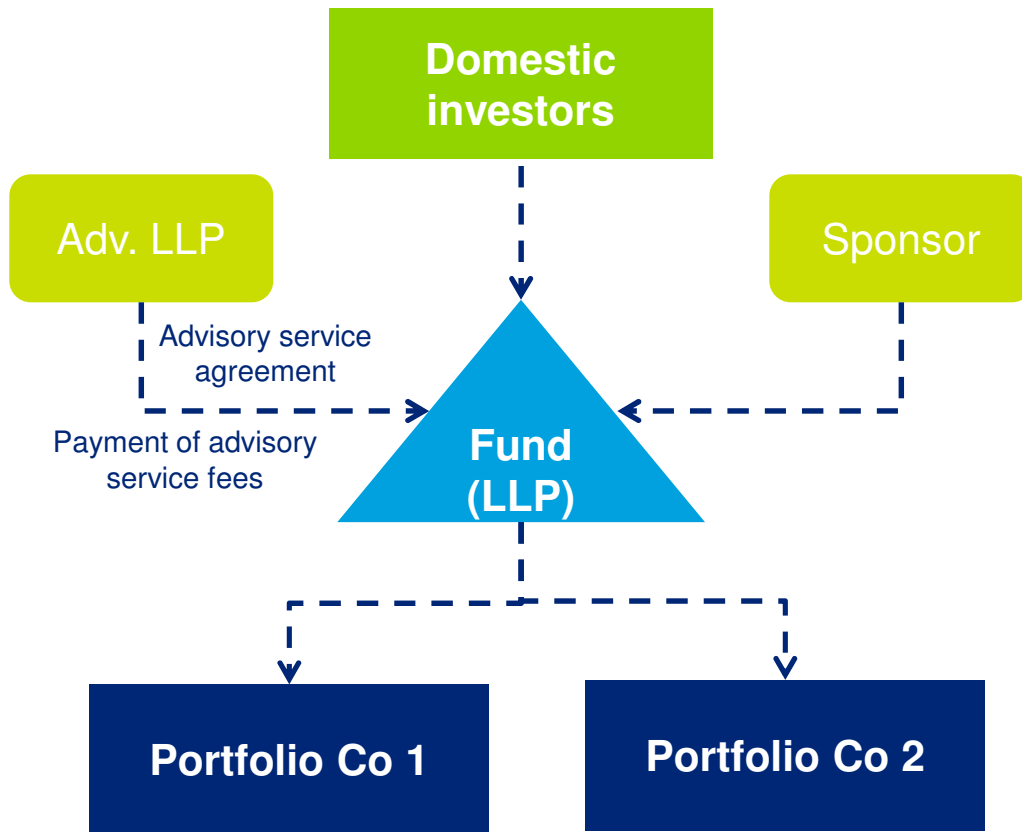
Project Specific SPVs

| Joint Venture Company | LLP |
|---|---|
| 1. Any distribution of profits during the operational stage of the project will entail DDT | 1. No DDT cost. Up streaming of profits is relatively easier |
| 2. Grant of loans / advances to any group companies could trigger deemed dividend provisions | 2. Deemed dividend provisions are not applicable to LLPs |
| 3. Stringent requirements under corporate law to be met for any loans / advances to group companies | 3. Corporate law requirements not applicable to LLPs |
| 4. At the end of the project, due to the above constraints, funds could get locked in the joint venture company | 4. LLPs provide greater flexibility to utilize funds |
| 5. Merger, a court approval process, with parent / group company may have to be undertaken to effectively close the company | 5. Dissolution and winding of LLPs could be relatively easier |

Option #7 – Fund structuring

Option #7

Fund structuring



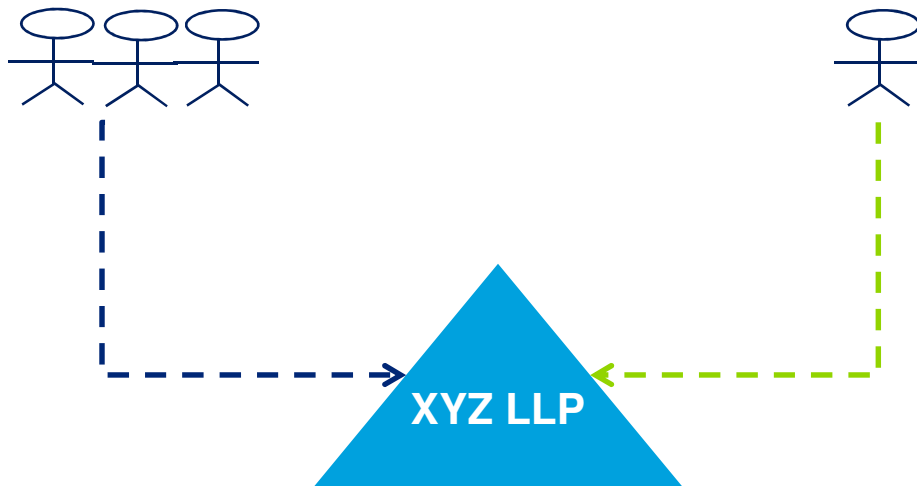
- Fund would be set up as a LLP
- Sponsors would act as designated partners
 - Other domestic investors in the LLP would act as limited partners
- Fund would enter into advisory service agreement with the Fund Manager (Adv. LLP)
 - Role of the Adv. LLP – Identify and advice on various investment opportunities
- Income earned by Fund would be distributed to the investors as per the distribution waterfall
- Fund set up as a LLP can be wound up subject to certain conditions

LLPs could be structured as a tax efficient fund pooling vehicle as well as advisor to the fund

Option #8 – Exiting LLP

Option #8

Exiting LLP



- Individuals A B C are partners in XYZ LLP
- XYZ LLP is a profit making LLP since its incorporation in 2011
- Individual A now wishes to transfer his partnership rights in XYZ LLP to Individual D
 - Transfer to be in accordance with the LLP agreement
- Tax authorities are likely to contend that Individual A should pay capital gains tax on such transfer of partnership rights

Can Individual A have a tax efficient exit from the LLP?

Option #8

Exiting LLP

- Individual A could consider ceasing to be a partner in XYZ LLP and withdrawing the following amounts from XYZ LLP:
 - His original capital contribution; and
 - His share in the profits of the LLP
- Withdrawal of the aforesaid amounts from XYZ LLP should not trigger any tax consequences for Individual A or XYZ LLP
- Individual D, the new partner, to contribute an amount equivalent to the amount withdrawn by Individual A to XYZ LLP for a partnership interest equivalent to Individual A's earlier interest
- Capital contribution by Individual D should not trigger any tax consequences for Individual D or XYZ LLP

Questions?

Thank you