

# **Western India Regional Council of ICAI**



## **DIRECT TAX REFRESHER COURSE**

**Tax issues in reorganization through LLP**

**Pinakin Desai**

**4 June 2016**

# Overview of LLP



# Indian LLP: Meaning and Features

---

- ▶ LLP means a partnership formed and registered under LLP Act, 2008

## Key attributes of an Indian LLP:

- ▶ Two or more persons associated for carrying on a lawful business with a view to earn profit
  - ▶ LLP and NBFC akin activities?
- ▶ Legal entity and personality distinct from that of its partners, having perpetual existence
- ▶ Change in partners not to affect existence, rights or liabilities of LLP
- ▶ Partners' liability limited to contribution except in the event of fraud, wrongful acts, etc.

# Indian LLP: A Snapshot

---

- ▶ Mutual rights and duties governed by LLP Agreement
  - ▶ Different asset sharing ratio and profit sharing ratio permissible?
  - ▶ Partner in profits only?

## Partner of an LLP

- ▶ Can be an Individual, Indian/foreign company or LLP
  - ▶ Minimum 2 partners
  - ▶ Can a Trust/HUF/Karta or Firm become a partner in LLP? (MCA Circular No. 2/2016 dtd 15 Jan 2016)

## Relationship of partner

- ▶ Is an agent of LLP for the purpose of business of LLP, but not of other partners
- ▶ Not personally liable for LLP obligation unless his own wrongful act or omission

# Indian LLP: A Snapshot

---

## Contribution by partner

- ▶ Can be tangible, movable or immovable or intangible property or other benefit to the LLP(e.g. know-how, development project)
- ▶ Can be contracts for services performed or to be performed
  - ▶ Eg. Partner bringing business/contracts for LLP as capital contribution
- ▶ If in kind, to be valued by a practicing CA or cost accountant or approved valuer (Rule 23(2) of the LLP regime)

# Indian LLP: A Snapshot

---

## Designated partner (DP)

- ▶ Requires minimum two 'individual' DP, one of whom has to be an Indian Resident
- ▶ Where LLP consists of only 'body corporate' partners, nominees of such bodies corporate shall act as DP

## A DP is responsible for:

- ▶ Compliance obligations including:
  - ▶ Filing of documents, return, statement and like
  - ▶ Verifying Statement of Account and Solvency, etc.
  - ▶ Additionally, matters specified in the LLP Agreement
- ▶ Tax return to be signed by DP (S. 140 of the IT Act)
- ▶ DP will be personally liable in case of fraudulent acts, subject thereto, limited liability

# Indian LLP: A Snapshot

---

- ▶ Partner's right to share profit and losses of LLP and to receive distributions can be transferred either wholly or in part
- ▶ Assignee not entitled to participate in management or conduct of the activities of LLP or access information relating to transactions of LLP

# Commercial advantages and disadvantages of LLP

---

## Commercial advantages

- ▶ Limited liability of partners
- ▶ Flexibility of organizing internal management by mutual agreement
- ▶ Fewer compliance requirements as compared to body corporate

## Commercial disadvantages

- ▶ LLP not able to get itself listed without further reorganization
- ▶ Unlike in case of a company, cross border merger of a foreign entity with an Indian LLP is not feasible



# Overview of FDI: Tax Analysis



---

# GOI Press Note 12 of 2015

---

- ▶ No specific government approval for FDI in LLPs engaged in automatic route sectors
- ▶ FDI in LLP is made subject to the compliance of the conditions of LLP Act, 2008
- ▶ LLPs with FDI now allowed to make downstream investment
- ▶ Also permitted to avail ECBs

# Tax Analysis – LLP in general



# LLP Taxation

---

- ▶ Definition of 'Firm', 'Partner' and 'Partnership' amended to incorporate LLP taxation
  - ▶ 'Firm' definition amended to include an LLP
  - ▶ 'Partner' definition now includes a partner of LLP
  - ▶ 'Partnership' includes LLP
- ▶ Definition not relevant to non-tax purposes: For example, Partnership Act

# LLP Taxation

---

- ▶ LLP taxed as a “general partnership” (firm)
  - ▶ Entity level taxation of LLP: partners not taxed again irrespective of their residential status and tax treaty residence
  - ▶ Company partner can claim share of profit exempt u/s.10(2A) [refer MAT exclusion]
  - ▶ Possibility of deduction for remuneration paid to “individual” working partner if authorised by LLP Agreement
  - ▶ Simple interest permitted upto 12% p.a. on capital contribution by firm if authorised by LLP Agreement
  - ▶ Ensure compliance with s.184/185 of ITA
- ▶ LLP resident in India even if part of the control and management is in India

# LLP Taxation

---

- ▶ Contribution to LLP may trigger capital gains in the hands of contributing partner with respect to value at which transfer is recorded [S.45(3)]
  - ▶ Interplay of s.56(2)(viiia) if contribution is in form of shares
- ▶ S.45(4) implications in case of distribution of property by LLP at the time of its dissolution
- ▶ Assignment of interest by a partner likely to trigger capital gains tax
  - ▶ Is cost of acquisition of transferred asset ascertainable ?
- ▶ Cessation of interest akin to retirement of partner not triggering tax implications?
- ▶ Revaluation of asset of LLP - a tax neutral event?

# Advantages of being assessed as a 'firm'

---

- ▶ No tax on cash distribution during the life of or on winding up of LLP
  - ▶ Indian company pays 20.36% tax as dividend distribution tax (DDT)

Particulars	Company	LLP
Profit before tax (Income > 1cr, but < 10cr)	100	100
Less: Tax @ 30% + applicable SC + cess	(33.06)	(34.61)
Profit after tax	66.94	65.39
Less: DDT @ 20.36%	(13.63)	-
Profit available for shareholders/ partners	<b>53.31</b>	<b>65.39</b>

- ▶ S. 56(2)(vii-a) limited in its application to shares of a company

# Advantages of being assessed as a 'firm'

---

- ▶ Loan to a partner or to the concerns in which partner holds beneficial interest do not trigger deemed dividend – Sec 2(22)(e)
- ▶ Deemed income provisions of Sec 2(24)(iv) does not apply in respect of transaction with partners
- ▶ Artifice of Sec 73 does not apply to convert delivery based share trading loss to speculation loss
- ▶ Impact of internal change in partners on carry forward of loss
  - ▶ Admission may not, but retirement does impact carry forward of loss component



# Disadvantages of being assessed as a 'firm'

---

- ▶ May not qualify for tax holiday/ incentive provisions when restricted to company (E.g. S. 80-IA)
  - ▶ Impact may get diluted on withdrawal of profit linked incentives
  - ▶ Lower corporate tax rate benefit of 25% may not be available (s.115BA)
- ▶ Certain presumptive tax provisions available only to foreign company (E.g. S. 44BBB)
- ▶ Certain deductions available only to company – e.g.
  - ▶ Section 35(2AB) of IT Act - Weighted deduction for scientific research
  - ▶ Section 35D of IT Act- Deduction for preliminary / pre-operative expenses
- ▶ Tax neutrality for merger /demerger apply only when companies are parties to the reorganization

# Comparison: MAT(Company) and AMT(LLP)

---

MAT	AMT
<ul style="list-style-type: none"><li>▶ Linked to 'Book Profit' as modified for specified downward / upward adjustments</li><li>▶ Depreciation as per books</li><li>▶ STT paid LTCG subject to MAT despite exemption u/s 10(38)</li><li>▶ Restrictive set off of book losses of earlier years – lower of brought forward loss or unabsorbed depreciation as per books</li></ul>	<ul style="list-style-type: none"><li>▶ Linked to total income as adjusted for deductions u/s 10AA, 35AD and under Ch. VI-A</li><li>▶ Full depreciation as per IT Act</li><li>▶ Incomes exempt u/s 10 beyond purview of AMT</li><li>▶ Quantum of set off of carried forward losses restricted to total income</li></ul>

# Impact Analysis: MAT and AMT

---

Particulars	Company (MAT)	Particulars	LLP (AMT)
Book profit	100	Profit before tax	100
Less: Depreciation as per books	(10)	Less: Depreciation as per Act – 100%	(50)
Less: LTCG exempt u/s 10(38)	-	Less: LTCG exempt u/s 10(38)	(20)
<b>Taxable profits</b>	<b>90</b>	<b>Taxable profits</b>	<b>30</b>

# Presumptive taxation and LLP [S.44ADA]

---

- ▶ Presumptive scheme for professionals u/s 44ADA applicable to all assesseees including firms/ LLPs provided total gross receipts do not exceed INR 50 lacs
- ▶ Explanatory memorandum to the Finance Bill 2016 indicates that the scheme is not available to LLP
- ▶ Whether partner of LLP covered by presumptive scheme?
- ▶ No deduction u/s 30 – 38; WDV of assets deemed to be reworked with depreciation allowance
- ▶ Not entitled to claim separate deduction of interest/remuneration paid to partners in absence of specific provisions – deemed to be allowed
  - ▶ May result into taxation in the hands of partners u/s 28(v)
  - ▶ Preferably, partnership deed be amended to avoid taxation of interest and remuneration in the hands of partners

# Tax Analysis - Conversion of Firm into LLP



# Conversion of firm into LLP



- ▶ Pre-conditions for conversion
  - ▶ Firm as defined in Indian Partnership Act may convert
  - ▶ Partners of LLP into which the firm is to be converted should comprise of all the partners of the firm and no one else
- ▶ In terms of s.58(4) of the LLP Act:
  - ▶ LLP comes into being from the date of registration
  - ▶ Transfer of assets to LLP
  - ▶ Firm shall be deemed to be dissolved and removed from the records of the ROF
- ▶ No tax implications on conversion of firm into LLP since firm and LLP are treated as equivalent under the IT Act – CBDT Circular 5/2010
- ▶ No specific tax exemption in s.47 of the IT Act for conversion of firm into LLP
- ▶ Unabsorbed AMT credit may be admissible

# Tax Analysis - Conversion of Company into LLP



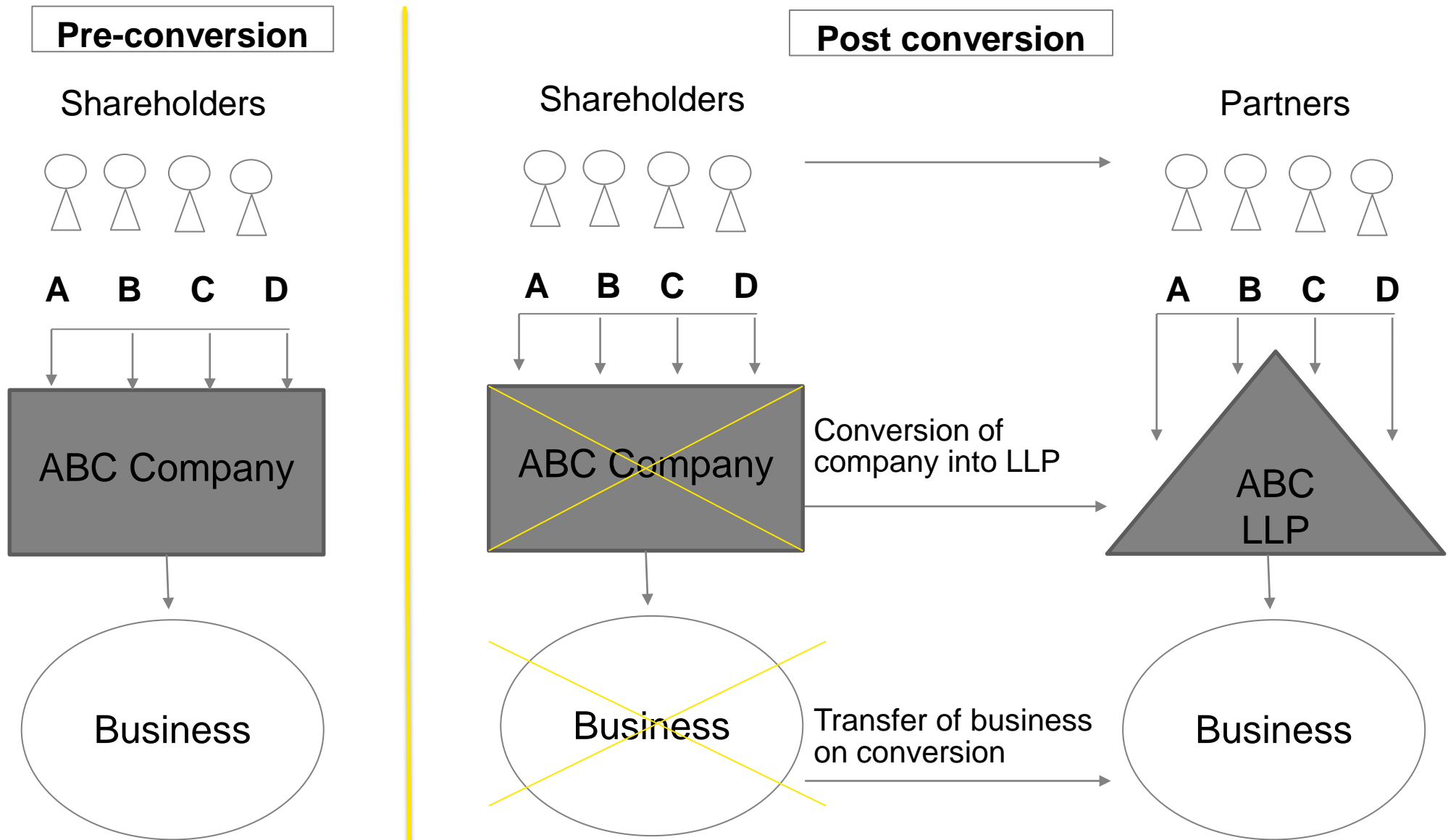
# Why to convert company into LLP?

---

- ▶ Lesser compliances as compared to company
  - ▶ Eg. ROC, FEMA
- ▶ Benefits of limited liability within the fold of partnership format
- ▶ Flexibility of internal organisation and management
- ▶ Beneficial for companies with lower asset base and low turnover
  - ▶ Tax neutral transaction subject to fulfillment of conditions u/s 47(xiiib)
- ▶ Tax mitigation opportunity, subject to compliance



# What happens on conversion?



# Conversion of Private/ Unlisted company to LLP

---

## Conditions for tax neutral conversion of company into LLP

- ▶ All assets and liabilities of company to become that of LLP
- ▶ All shareholders to become partners in LLP with capital contribution and profit sharing ratio in the proportion of shareholding
- ▶ Shareholders not to receive any consideration or benefit, directly/indirectly, in any form except by way of share in profit and capital contribution in LLP
- ▶ Aggregate of profit sharing ratio of the shareholders of company in LLP > 50% for a period of 5 years
- ▶ Sales, turnover or gross receipts in business of company in any of preceding 3 years < INR 6 million
- ▶ Total value of assets as appearing in the books of accounts in any of preceding 3 years < INR 5 crores (*inserted by FA 2016*)
- ▶ No direct / indirect payment to any partner out of accumulated profits of company for a period of 3 years post conversion date

# Conversion of company to LLP

---

- ▶ All assets and liabilities of company immediately before conversion to become that of LLP
  - ▶ Wholesale conversion; akin to amalgamation
  - ▶ Suppose, some asset is not to be taken over?
  - ▶ Constraint of transition of unabsorbed MAT credit
- ▶ All the shareholders to become partners of LLP with their capital contribution and profit sharing ratio in the proportion of shareholding as on the date of conversion
  - ▶ Capital as also profit sharing ratio in LLP to be aligned to shareholding ratio
  - ▶ Position of minor shareholders?
  - ▶ Treatment of preference shareholders?
  - ▶ Reorganization amongst the shareholders prior to the date of conversion, subject to impact of S. 79

# Conversion of company to LLP

---

- ▶ Shareholders not to receive any consideration or benefit, directly/indirectly, in any form except by way of share in profit and capital contribution in LLP
  - ▶ Consideration or benefit in the capacity as shareholder, in lieu of transfer, at the time of conversion or later.
  - ▶ Avoid diversion in form of loan to partners
  - ▶ Payment of remuneration or interest after the date of conversion?

# Conversion of company to LLP

---

- ▶ Aggregate profit sharing ratio of the shareholders of the company in LLP > 50% for a period of 5 years
  - ▶ Involuntary transfers beyond the control of the assessee (such as death etc.) arguably not covered
  - ▶ No lock in for the period upto which erstwhile shareholder continues to be a partner, so long as condition of aggregate of 50% of profit sharing ratio fulfilled
  - ▶ Condition to be tested on aggregate basis; internal change permissible
  - ▶ Admission of new partners upto 50% is permissible
- ▶ Total value of assets *as appearing in the books of accounts* in any of preceding 3 years < INR 5 crores
  - ▶ Reference is to book value or market value of the assets?
  - ▶ Whether deferred revenue expenditure, P&L debit balance, MAT credit to be included?

# Conversion of company to LLP

---

- ▶ No direct / indirect payment to any partner out of accumulated profits of company for a period of 3 years post conversion date
  - ▶ No bar on payment from current profits of the LLP (e.g. normal business profit or gain from sale of acquired assets)
  - ▶ Avoid loans given to related parties – an attempt to divert accumulated profits
  - ▶ What constitutes accumulated profits? (Refer next slide)

# Conversion of company to LLP

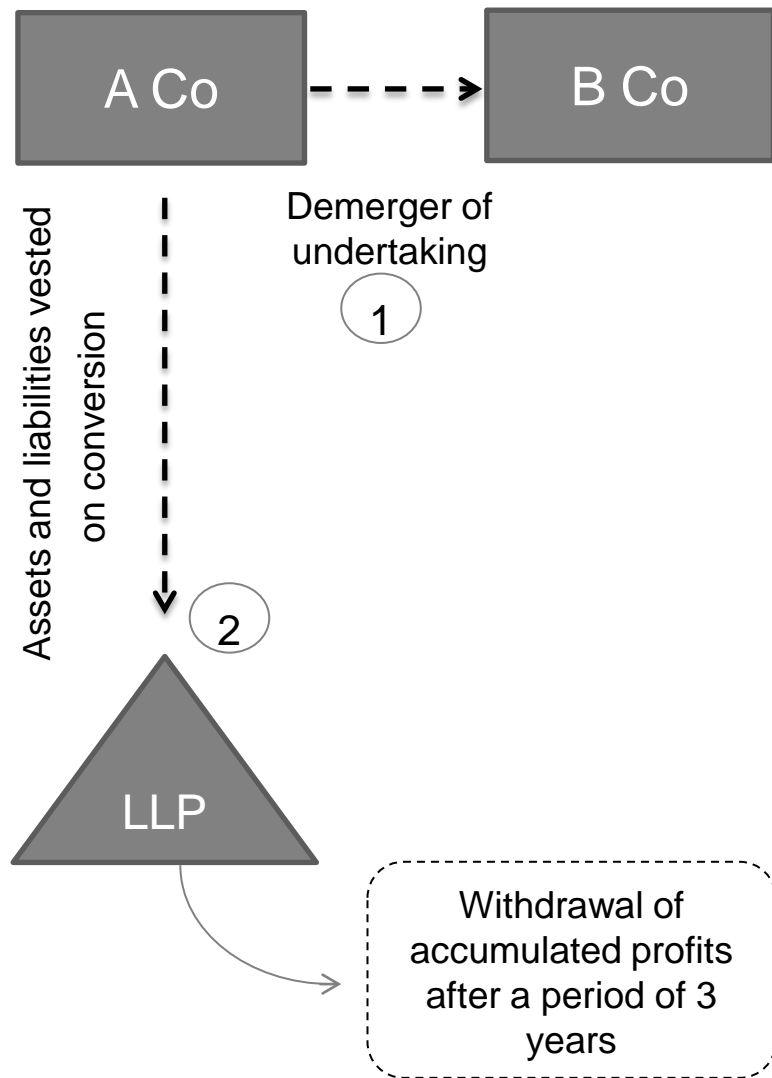
Balance sheet of company

Liabilities	INR	Assets	INR
Share capital	1000	Fixed Assets	3000
Bonus shares	500	Sundry Assets	1000
<u>Reserves &amp; Surplus</u>			
Amalgamation reserve	200		
Securities Premium	500		
Revaluation reserve	200		
CRR	100		
P&L A/c	1500		
<b>Total</b>	<b>4000</b>	<b>Total</b>	<b>4000</b>

Balance sheet of LLP post conversion

Liabilities	INR	Assets	INR
Capital contribution	100	Fixed Assets	3000
Reserves & Surplus carried forward from company	2500	Sundry Assets	1000
Share capital not converted into capital contribution	1400		
<b>Total</b>	<b>4000</b>	<b>Total</b>	<b>4000</b>

# Law Compliant Conversion of company to LLP



## Facts

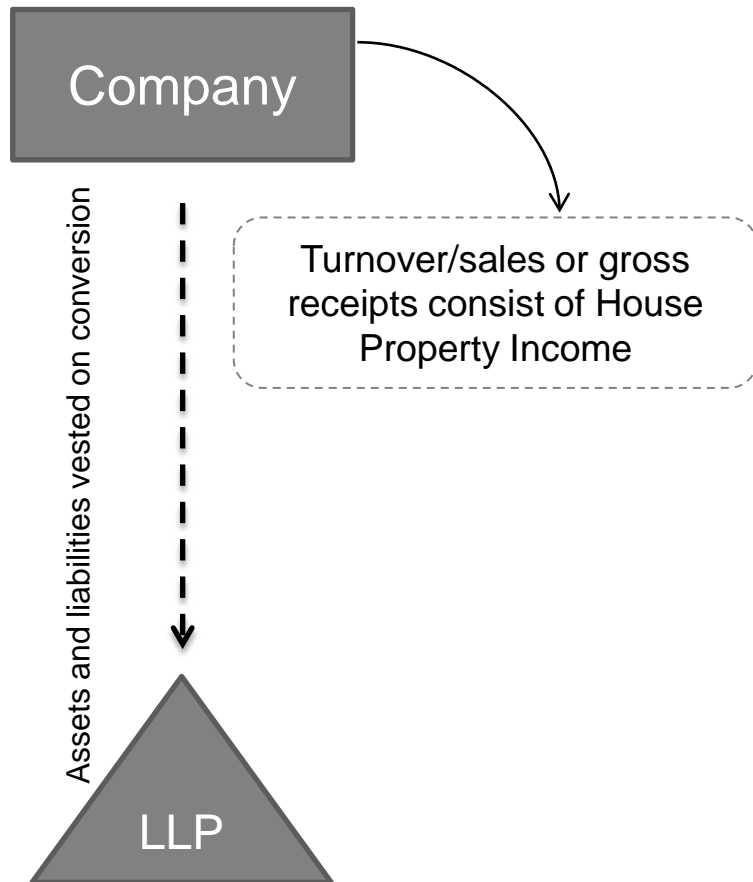
- ▶ A Co's turnover exceeds Rs. 60 lakhs in preceding 3 years
- ▶ A Co holds huge reserves
- ▶ A Co demerges its business undertaking in B Co., a newly formed entity
- ▶ A Co converts into LLP after a period of 3 years, turnover less than 60 lakhs in preceding 3 years
- ▶ Partners withdraw out of accumulated profits of A Co. post 3 years of conversion

## Issue

- ▶ Is conversion of A Co into LLP S. 47(xiiib) compliant?



# Conversion of company to LLP: Turnover



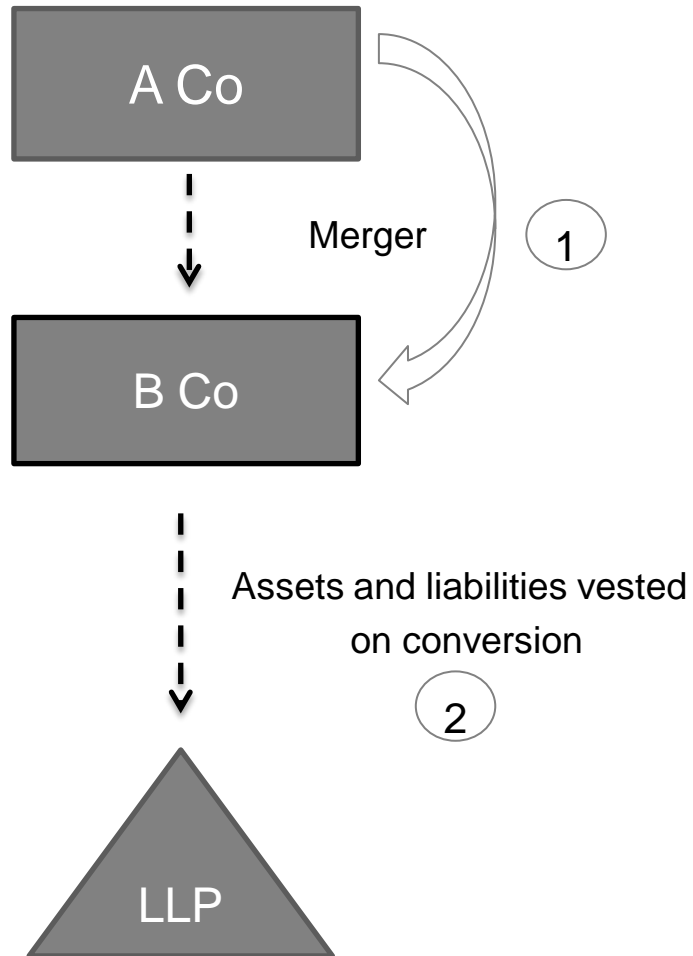
## Facts

- ▶ Company is engaged in the business of acquiring and holding and letting out properties
- ▶ Turnover for the preceding 3 years is:
  - ▶ House Property Income: 75 lakhs

## Issues

- ▶ In terms of S. 47(xiiib), what shall be construed as 'turnover' for the purposes of computing 60 lakhs limit? (Refer Circular No. 1/2011)
- ▶ Refer SC ruling in the case of Chennai Properties and Investments Ltd. (Civil Appeal No. 4494/2004)

# Conversion of company to LLP



## Facts

- ▶ A Co's turnover exceeds Rs. 60 lakhs in preceding 3 years
- ▶ A Co merges with B Co., a newly formed entity whose turnover is less than Rs. 60 lakhs
- ▶ Post merger, B Co. immediately converts into LLP

## Issue

- ▶ Is conversion of B Co into LLP S. 47(xiiib) compliant?

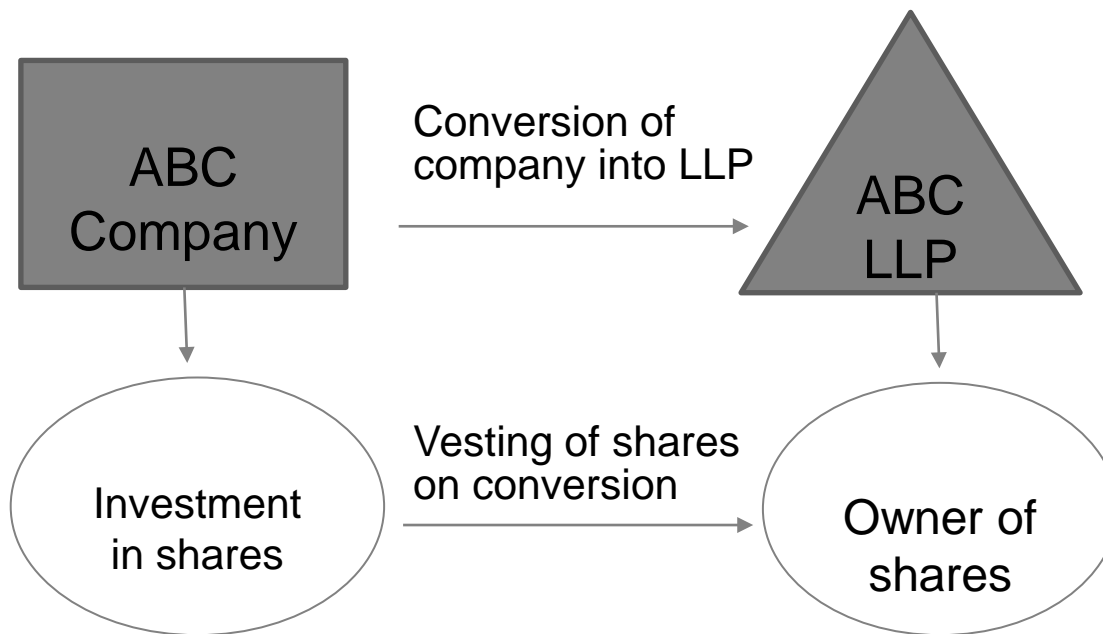
**Beware of GAAR**

# Conversion of company to LLP: Other tax implications

---

- ▶ DDT:
  - ▶ S. 2(22)(a): Any distribution by company to shareholders?
  - ▶ S. 2(22)(c): Any distribution by company to shareholders?
- ▶ S.2(24)(iv): Implications for shareholders: Any benefit passed on by the company?
- ▶ S. 56(2)(viiia): Company transfers its investment in shares to LLP upon conversion

# Impact of s.56(2)(viiia)



## Facts

- ▶ ABC Company, having investment in shares, converts into LLP
- ▶ On conversion, it may be contended that LLP has “received” shares from the company

## Issue

- ▶ Can s.56(2)(viiia) be triggered in the hands of LLP?

# Conversion of company to LLP: Other tax implications

---

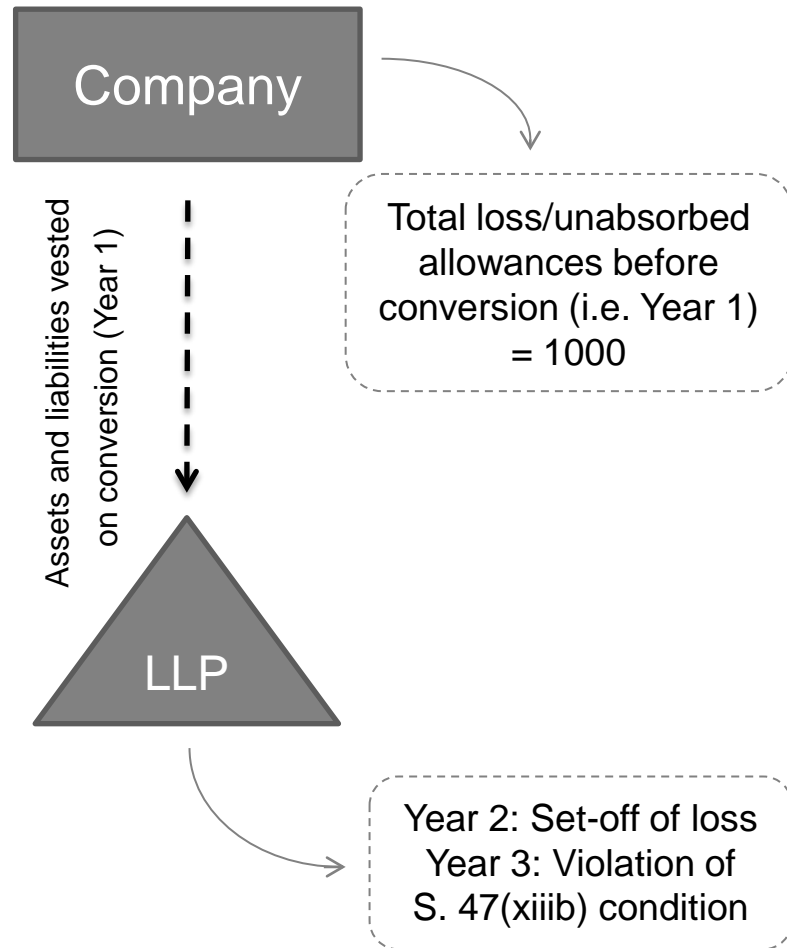
- ▶ Company and LLP are separate persons;
  - ▶ Company to file return of income upto the date of conversion
  - ▶ LLP to file return for the period from date of conversion till year end
- ▶ Separate Permanent Account Number (PAN) and Tax deduction Account Number (TAN)
- ▶ No specific amendment made to permit continuation of tax holiday or incentives in the name of LLP
- ▶ Predecessor to be assessed in the name of successor

# S. 47(xiiib) compliant conversion: Back up provisions

---

Section	Brief Particulars
5th proviso to Section 32	In the year of conversion, aggregate of depreciation to LLP and company not to exceed depreciation as would have been allowable to the company without such conversion
Explanation 2C to section 43(6)	WDV of block of assets of company to be WDV of LLP
Section 32AD	Where new asset is transferred by the company to LLP, condition of retaining the new asset for a period of 5 years from the date of its installation shall apply to LLP
Section 35DDA(4)	Amortisation in respect of residual VRS payment by company available to LLP
Explanation 13 to Section 43(1)	Actual cost of capital asset for which investment linked deduction is granted u/s. 35AD to the company to be NIL in the hands of LLP
Section 49(1)(iii)(e)	Actual cost of capital asset of company to be the actual cost to LLP

# S. 72A(6A) – Carry forward of loss



## Facts

- ▶ Company has various losses/ unabsorbed allowances as under:

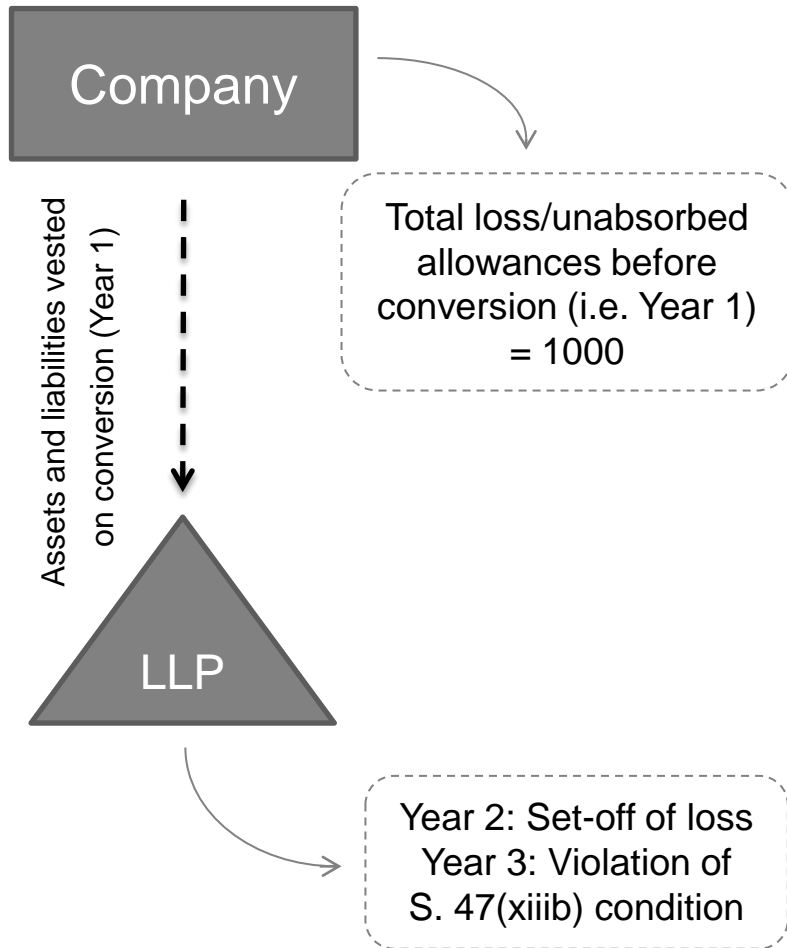
Particulars	Rs.
Business loss	400
Speculation loss	100
Capital loss	100
Unabsorbed depreciation	50
Unabsorbed expenditure on scientific research	150
Loss incurred in S. 35AD activity	200
<b>Total</b>	<b>1000</b>

- ▶ Company converted into LLP (say Year 1)

## Issue

- ▶ What shall be included to calculate accumulated loss and unabsorbed depreciation available for carry forward and set off in the hands of LLP u/s 72A(6A)?

# S. 72A(6A) – Carry forward of loss



## Facts

- ▶ In Year 1, there is conversion
- ▶ In Year 2, LLP claimed set off of loss carried forward from company
- ▶ Violation of S. 47(xiiib) condition in Year 3.

## Issue

- ▶ Will violation of S. 47(xiiib) condition in Year 3 lead to reversal of loss which is set off in Year 2?
- ▶ Tax liability to be discharged by partners in the year of reversal.



# S. 47(xiiib) compliant conversion: Back up provisions

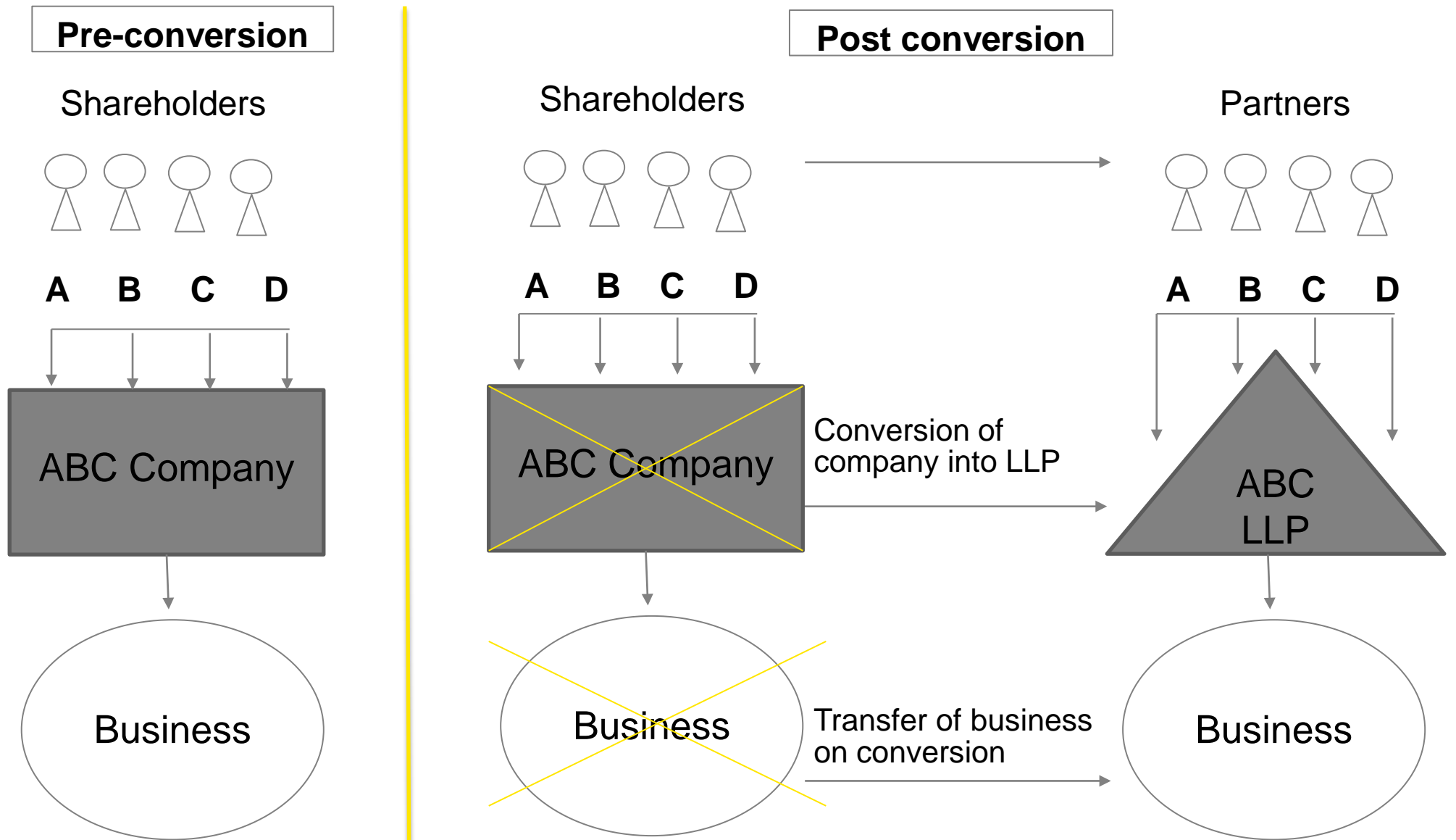
---

Section	Brief Particulars
Section 49(2AAA)	Cost of shares in company would represent cost of LLP interest for partner
Section 72A(6A)	LLP can carry forward unabsorbed business losses / unabsorbed depreciation of the company [Arguably, fresh lease of time period available] (Refer next slide)
Section 115JAA(7)	No carry forward of MAT credit to LLP (Refer next slide)
Section 47A(4) and Section 72A(6A)]	Also, S. 47(xiiib) breach leads to LLP paying tax in the year of violation on: <ul style="list-style-type: none"><li>▶ Capital Gains exempted in the hands of company and the shareholders</li><li>▶ Forfeiture of loss claimed by LLP [Proviso to section 72A(6A)]</li></ul>

# Taxation of LLP: Non-compliant conversion



# What happens on conversion?



# Non-compliant conversion: Implications for company

---

- ▶ Incorrect to suggest; absent S.47(xiiib) exemption, charge is, per se, attracted
- ▶ No consideration accruing to the company; company is statutorily dissolved
  - ▶ Principle, as equally relevant to stock-in-trade
- ▶ Akin to case of amalgamating company transferring assets to amalgamated company

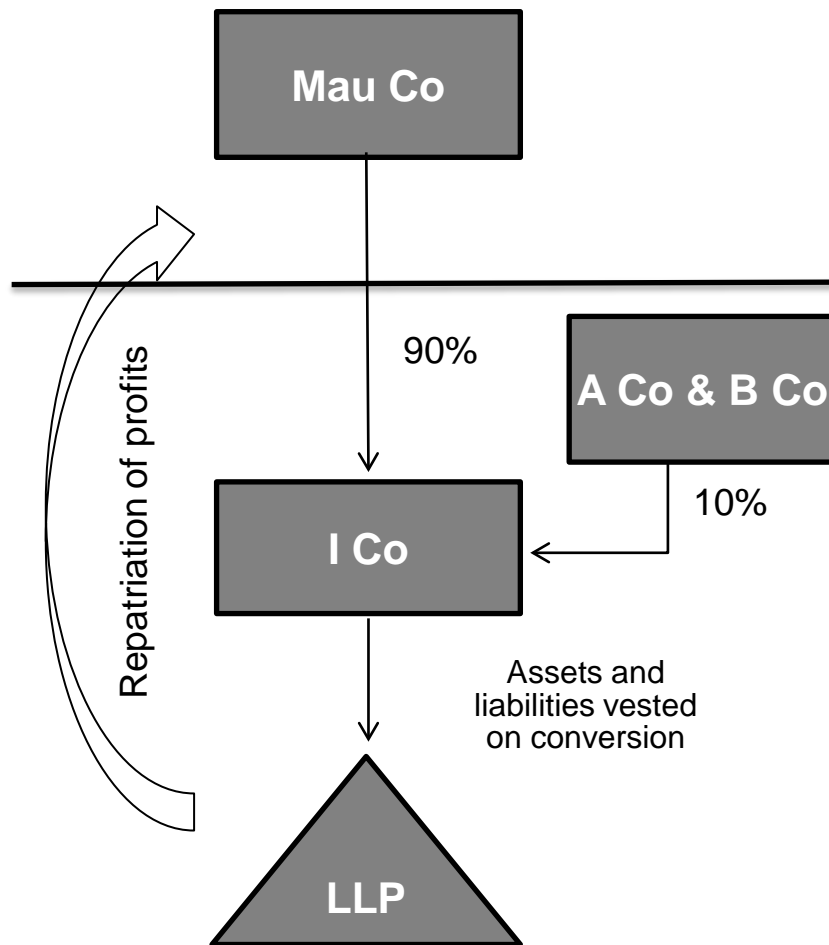
Upgrade unabsorbed depreciation in computation of  
WDV of assets of LLP?

# Non-compliant conversion: Implications for shareholders: Litigation Prone

---

- ▶ Exemption provision is not, in itself, indicator of an effective charge
- ▶ Extinguishment of shares against receipt of LLP interest
- ▶ In terms of s.58(4) of LLP Act, the sequence of steps is:
  - ▶ Registration of LLP
  - ▶ Vesting of assets
  - ▶ Dissolution of company
- ▶ No consideration becomes due as a result of extinguishment
- ▶ Cases of vesting do not envisage any enrichment
- ▶ No real income capable of attracting charge to tax?

# Non-compliant conversion: Implications for shareholders



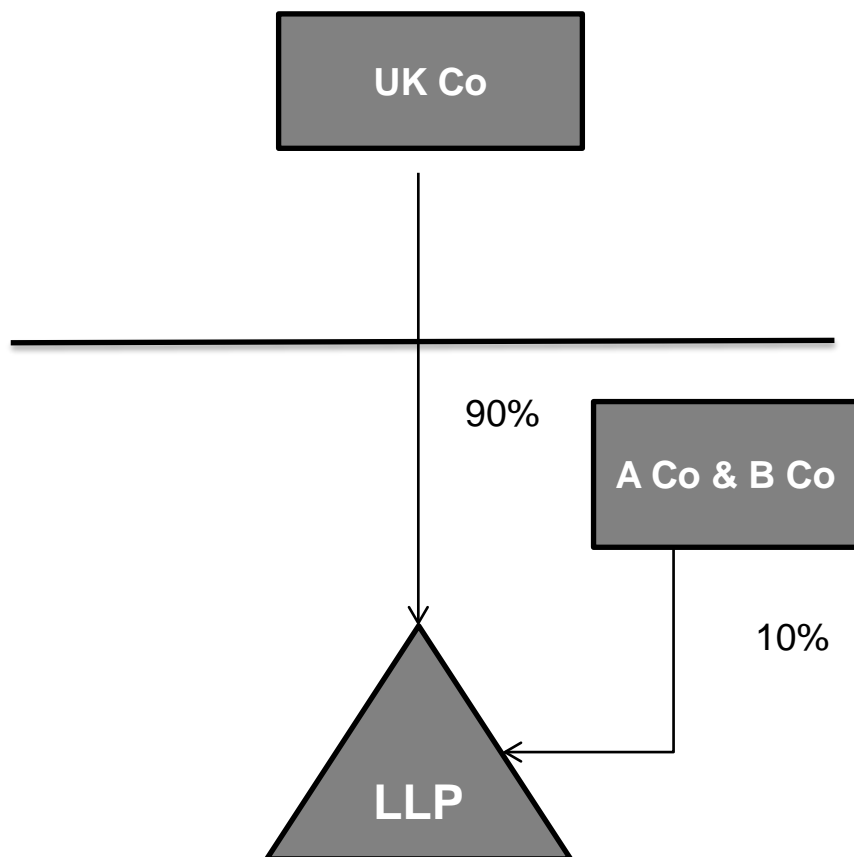
## Facts

- ▶ I Co's shareholding pattern is as under:
  - ▶ Mau Co. 90%
  - ▶ A Co. & B Co. 10%(Indian promoters)
- ▶ I Co proposes to convert itself into LLP; turnover for preceding 3 years exceeds 60 lakhs
- ▶ Post conversion, profits of LLP are repatriated to Mau Co

## Issue

- ▶ Tax implications in the hands of Mau Co?

# PE exposure



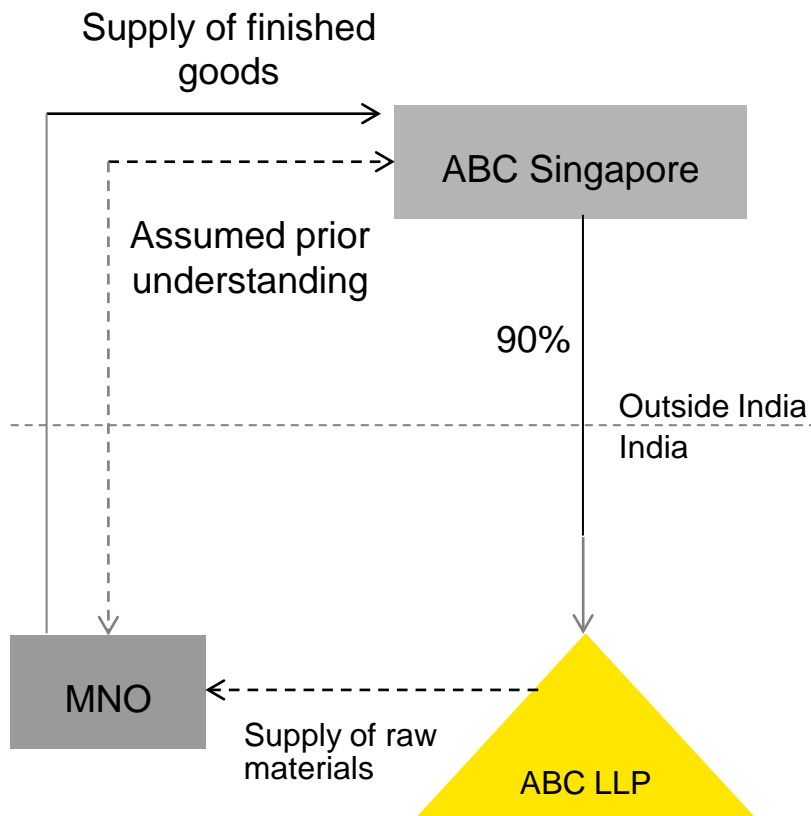
## Facts

- ▶ Capital as also profit sharing ratio in LLP is as under:
  - ▶ UK Co. 90%
  - ▶ A Co. & B Co. 10%
- ▶ UK Co. actively participates in the business of LLP
- ▶ LLP pays interest on capital to partners

## Issue

- ▶ Whether payment by LLP could be characterized as interest income under India-UK DTAA or is it PE connected profit of UK Co, or none?

# Deemed international transaction [S.92B(2)]



## Facts

- ▶ Capital as well as profit sharing ratio of ABC Singapore in ABC LLP is 90%
- ▶ ABC LLP supplies raw materials to MNO, an Indian company
- ▶ Subsequently, MNO supplies finished goods to ABC Singapore on cost plus basis
- ▶ There exists a prior understanding between MNO and ABC Singapore for the transaction

## Issue

- ▶ Issue arises as to whether the provisions of S. 92B(2) would apply to MNO as well as ABC LLP?



# Thank You

“This Presentation is intended to provide certain general information existing as at the time of production. This Presentation does not purport to identify all the issues or developments. This presentation should neither be regarded as comprehensive nor sufficient for the purposes of decision-making. The presenter does not take any responsibility for accuracy of contents. The presenter does not undertake any legal liability for any of the contents in this presentation. The information provided is not, nor is it intended to be an advice on any matter and should not be relied on as such. Professional advice should be sought before taking action on any of the information contained in it. Without prior permission of the presenter, this document may not be quoted in whole or in part or otherwise.”