Taxation of Limited Liability Partnership (LLP)

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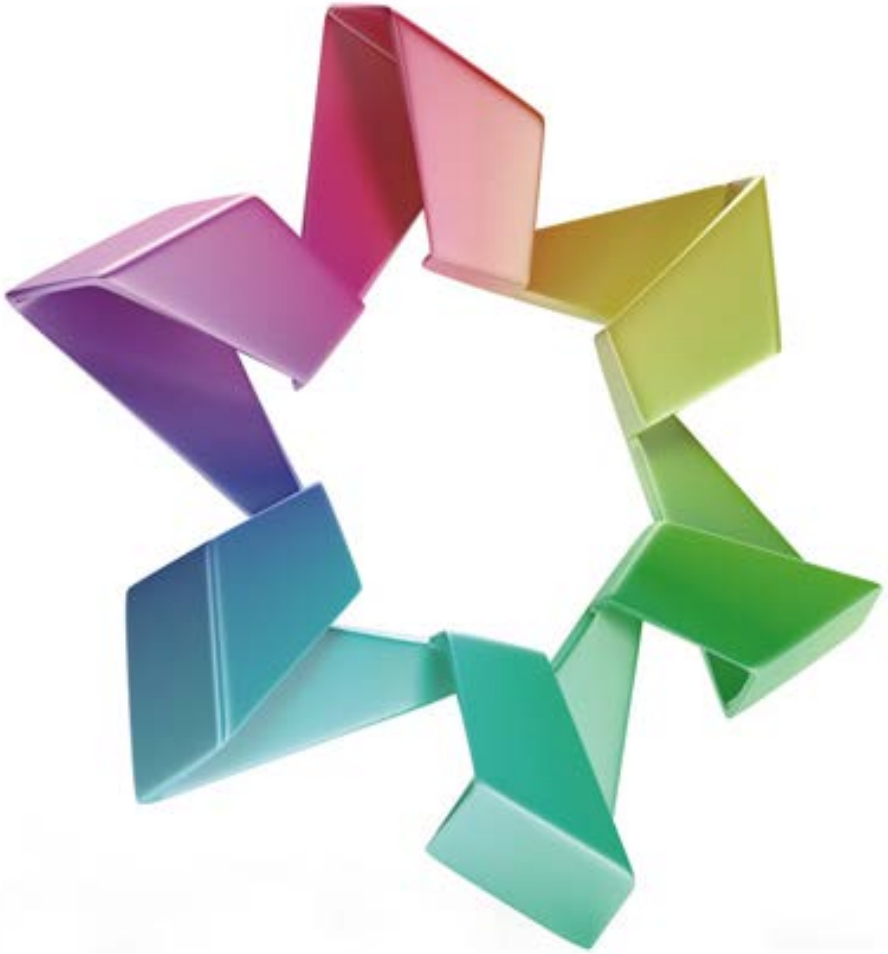

Introduction

- Limited Liability Partnership Act, 2008 (LLP Act) notified on 7th January, 2009:
  - Majority of the provisions came into effect on 31st March, 2009
  - Initially no clarity under the ITA
  - Finance (No. 2) Act, 2009 made LLPs at Par with the Partnership Firms under the ITA w.e.f. 1.4.2010 [i.e. A.Y. 2010-11]
- The definition of Terms "Firm", "Partner" and "Partnership" contained in Section 2 (23) of ITA amended to include LLPs as defined under the LLP Act
  - No change in the definition of the "working partner" and no reference to the concept of "designated partners"
  - S. 2 (1)(j) of LLP Act read with S. 7, does not require a designated partner to be a "working partner" defined under Explanation 4 to S 40 (b)

Characteristics of LLP

- S. 3 of the LLP Act provide that LLP :
  - Shall be a Body Corporate, *formed and incorporated* [Simple Partnership is not a body corporate and its existence is not separate from the partners]
  - It shall have a perpetual succession
- S 14 of the LLP Act provide that an LLP shall by its name capable of :
  - Suing and being sued
  - Acquiring, owning, etc. of property (movable, immovable, tangible or intangible)
  - Having common seal (not obligatory)
  - Doing all such acts and suffering such acts and things as a body corporate may lawfully do and suffer
- S 28 provides for Limited Liability of Partners [S. 30 an exception in case of fraud]
- No agency relationship between partners inter se (S 26 specifically provides that one partner will not be agent of another but will be gent of LLP)
- Only minimum partners (two) defined under S. 6 of the LLP Act. No maximum limit

LLP Vs. Company – ITA – Broad Points

Advantages	Disadvantages
• No DDT • No MAT (AMT Applicable) • No Applicability of 2 (22)(e) • Remuneration to Partners • Speculative Income presumption – Expl to S. 73	• No Deduction U/s.s 35 D, 35DD, 35(2AB), S. 80-IA(4)(i) • No Dedn U/s. 80 IB (infra-structure Projects) [Residual period] • Tax neutrality for mergers and demergers not provided for

ITA and LLP / Firm

- S. 184 and 185
  - Filing of instrument of partnership
    - Certified true copy signed by all the partners [Formation / Change]
    - Take case of a LLP with 100 partners [There is no limit on number of partners]
    - Need to Re-look at this provision
  - Individual Share of Partners specified *in the instrument* [contingent, incentive, variable, etc. not permitted]
  - Filing being procedural requirement, can be done at any time during the course of assessment [New Ajanta Roadlines – 254 ITR (AT) 85 (Jab)]
  - Failure to comply will disentitle the Firm for getting deduction U/s. 40 (b) for interest and remuneration to the Partners [Not taxable in hands of Partners also]
- S 167 C enable the recovery of tax due from partner unless such partner proves that such non-recovery is due to any gross neglect, misfeasance or breach of duty on his part
  - S 188 A - Each Partner is jointly and severally responsible for the taxes of the firm

Capital Contribution by Partner

- S 32 of LLP Act provides that contribution of a Partner
  - Can be in cash or in kind
  - Monetary value to be accounted for
  - S 14 of the IPA, 1932 [In absence of such provision under LLP Act, whether separate document and stamp duty required?]
- Rule 23(2) - Contribution in kind to be valued by a CA / Cost Accountant / approved valuer
  - Does not provide that the value so assessed to be taken
  - Section 32 (2) provides that the monetary value shall be disclosed.
- Section 45 (3) apply to the contribution made to the Partnership
  - S 32 (2) r.w.r 23 (2) provide for “accounted for and disclosed in the accounts”
  - S 45 (3) of the ITA “amount recorded in the books of account of the firm, as the value of the capital asset”

Contribution of intangibles

- The Concept of Sweat Equity Shares / Sweat Equity
  - Where intangibles in the form of “knowledge” is brought in without the same being classified as a Capital Asset
  - Where agreement to work as “working partner” is regarded as intangible contribution and the amount is credited to Capital Account
- Capital Contribution and other Provisions
  - Applicability of Section 45 (3) & 50 C [If capital asset contributed]
  - Applicability of Section 43 CA for partner, if asset other than capital asset is contributed
  - Applicability of Section 56 (2)(viia) applies to the firm
    - LLP Act mandates valuation and accounting for as per the valuation
    - 56 (2)(viia) provides that if less than book value than the difference chargeable to tax in the hands of the firm
    - What happens when the fair market value under LLP Act is less than the book value?

Partner in LLP

- Eligibility :
  - Individual,
  - Company,
  - another LLP (including Foreign Company/ LLP)
- Not Eligible ;
  - persons not competent to contract - Unsound mind, Undischarged insolvent, where application for adjudication for insolvency is pending
  - HUF cannot be a Partner (even through a Karta - General Circular No.13/2013 dated 29th July 2013 issued by MCA)
  - Minor cannot be admitted (even to the benefits of the Partnership in absence of provisions similar to S. 30 of the IPA
- Whether assignment U/s. 42 in favour of Minor / HUF permissible?

Designated Partner

- S 7 of the LLP Act require At least 2 designated partners
  - Have to be individuals
  - one of the DP should be Resident of India
    - defined separately and requires physical presence of not less than 182 days during the immediately preceding year.
    - Condition to be satisfied on annual basis (use of the word “shall have”)
- Nominee of a body corporate who is a partner can be a DP. [Therefore a DP need not be a Partner]
- S 8, call upon DP to be responsible for compliances under the LLP Act and be liable for penalty in case of non-compliance;
  - LLP Agreement may provide for additional (including absolute) powers, roles and responsibilities of DP and restrictions on powers of the partners other than DP.
- Designated partner v/s Working partner
  - A DP need not be working partner U/s. 40 (b) and a working partner U/s. 40 (b) need not be a DP.

Remuneration to DP

- A “working partner” is defined in Section 40(b) – Explanation 4 of Income tax Act, 1961
  - Needs to be an individual
  - One who is actively involved in conduct of affairs of the LLP
- Individual who is partner and DP can be a working partner
- Individual who is nominee of a body corporate and works as DP and is actively involved in conduct of affairs of the LLP:
  - Whether Section 40 (b) will apply?
  - Whether remuneration allowable, if meets the reasonable test or the tests U/s. 37 (1)
- Remuneration to a working partner allowable, even when he / she may not be a DP. Similarly merely because a person is designated as DP, the remuneration may not be allowable

Transfer of Partner Rights

- This is covered under Section 42 of the LLP Act
- Transfer can be made via assignment/transfer of partners interest
  - To share profits and losses;
  - To receive distribution in accordance with LLP Agreement
  - The above two can be separately assigned in part or in whole
- Such a transfer does not, *by itself*, cause the disassociation of the partner
- Does not result in dissolution of LLP
- Assignee / Transferee
  - does not, by itself, become partner
  - does not get right of management in the LLP

Assignment U/s. 42

- Section 42 Assignment is not same as assignment of rights of the Partner in a wholesome manner:
  - A partner may cease to be a Partner U/s. 24 of the LLP Act
  - A partner may cease to have the share of profit / distribution U/s. 42
- An Assignment U/s. 42 may also have characteristics of cessation of being partner U/s. 24 and new person admitted to the partnership
  - Procedure U/s. 24 and U/s. 22 read with the LLP Agreement to be followed for admission and retirement
  - The provisions of section 45 (4) will apply to the retirement or dissolution
- Assignment of share U/s. 42 without ceasing to be a Partner
  - Whether gives rise to capital gains? – Cost of Acquisition
  - Section 50 D – Only applies to determination of full value of consideration.

Retirement of Partner

- Surplus received from firm on pure retirement cases
  - Mohanbhai Pamabhai – 165 ITR 166 (SC), where it was held that the surplus is not taxable – Whether applicable?
  - Fundamental difference between relationship of a partner of a normal firm and partner of an LLP
  - A Firm has no legal existence and the property of the firm vests in all the partners. In case of an LLP, the property vests with the LLP (S. 14) and it cannot be said that the partner has undivided interests in the assets of the LLP
- Surplus received on Assignment of share of partnership (including admission and retirement from partnership)
  - Assignment of rights is taxable as capital gains
  - N. A. Mody – 162 ITR 420 (Bom)

Change in Constitution

- S 78 applies on retirement or death of a partner
  - Loss proportionate to the share of the deceased or retired partner not allowed to be carried forward
  - The proportion to be seen in respect of the previous year – i.e. the year in which such person retires
  - Applies only to loss (including loss under the head capital gains, speculative losses, etc.) but not to unabsorbed depreciation or other allowances
- Only on cessation on being partner and not for change in PSR
- Unlike Section 79, no provision for protection of losses in case of inheritance
  - However, no loss of 100 % of carried forward losses even when change is only 51 %
  - No concept of beneficial ownership [Case of a company being a partner]

Alternate Minimum Tax (AMT)

- Introduced with only being applicable to LLPs. Thereafter extended to other non-company persons.
- Chapter XII-BA
  - Section 115JC to Section 115JF
- Rate of 20.9605 % (with surcharge) or 19.055% (without surcharge) on adjusted total income
- Adjusted Total Income = Net Taxable Income + Deduction under part C of Chap VIA + deduction u/s. 10AA (SEZ Units) + deduction u/s 35AD (net of notional depreciation otherwise allowed)
- There is no concept of book profits unlike MAT
- This Chapter will be applicable to LLPs and Firms even if adjusted total income is below 20 lakh rupees
  - Section 115JEE(2)

Restructuring of LLPs

- Detailed framework for compromise or arrangements of LLPs under LLP Act
- Forms of Restructuring
  - Change of Partners [Discussed earlier]
  - Conversion into or from LLPs
    - Firm to LLP and LLP to Firm
    - Company to LLP and LLP to Company
  - Merger of two or more LLPs
  - Demerger of an undertaking to another LLP
- Presently the CA 2013 or LLP does not provide for inter form restructuring i.e. merger of LLP and a Company or demerger from LLP to a Company

Firm to LLP

- Firm and LLP are different entities under regular law. However, for tax purpose both are treated in the same manner.
  - Section 55 of the LLP Act read with Second Schedule provide for conversion of a partnership into LLP
  - S 58 (4) of the LLP Act provides that upon registration:
    - All tangible and intangible assets of the firm and liabilities of the firm shall be transferred to and vest in the LLP without further assurance, act or deed;
    - The Firm shall stand dissolved
- Can Section 45(4) be invoked? – Distribution of Asset on dissolution / otherwise
  - Texspin Engg. & Mfg.Works – 263 ITR 345 (Bom)
    - Dealing with Part IX conversion of a firm to a company
    - Statutory vesting is not distribution u/s 45(4)
    - Transfer *inter vivos* involve existence of 2 persons at one time.
    - No consideration accruing to the transferor firm even is there is a transfer
- Valuation of Stock-in-trade
  - ALA Firm [1991] 189 ITR 285 (SC)
    - Since business is continued, no need to value stock at market value

Firm to LLP (Contd.)

- Tax benefits u/s. 80IA , 80IB, 80IC, 10A etc. should continue for unexpired period
  - *Chetak Enterprises (P) Ltd 325 ITR 405 (Rajasthan HC)*
  - *Tech Books Electronics Services P Ltd. 100 ITD 125 (Del)*
  - *Kumaran Systems (P) Ltd 106 TTJ 484 (Chennai)*
- Good case for getting credit for the unavailed AMT – Refer to Jindal Exports Ltd., [2009] 314 ITR 137 (Del.) in context of MAT to amalgamated company
- Explanatory Notes to Finance (No. 2) Act, 2009 [Circular No. 5/2010 dated 3rd June, 2010] – provided as under:
  - Conversion from General Partnership to LLP shall have no tax implication if rights and obligations of the partners remain same after conversion; and
  - If there is no transfer of any asset or liability after conversion
  - If there is any violation, section 45 will apply

Firm to LLP – Stamp Duty

- In case of conversion of Firm to LLP
  - Fairly similar to the conversion of a firm into a company under Part IX of the CA 1956
  - Valli Pattabhi Rao vs Ramanuja Ginning and Rice Factory (P) Ltd. 60 Comp Cases 568 (AP) – held no stamp duty payable
    - Referred to provisions of CA 1956, Indian Stamp Act and relevant Stamp act and held that MoA and AoA, read with CA 1956 there is statutory vesting
    - No Need to execute separate documents and stamp duty on MoU and AoA defined separately
  - LLP Act, the provisions are slightly different
    - Though there is statutory vesting
    - Rule 8 of 2nd Schedule provide for taking appropriate steps, as required by relevant authority, to notify the authority of the conversion, etc.
    - Whether this can be a requirement for execution of deeds of conveyance, etc. and therefore above ratios may not apply ????

LLP to Firm

- No specific provision under LLP Act for reverse conversion
- May Result in Dissolution of the LLP
  - Whether Section 45(4) of ITA applicable
  - Though there is dissolution, there is no distribution
  - There is no consideration passing from the transferor to the transferee
- Since there would not be any statutory vesting of the property, in absence of the provisions, it needs to be seen the implication on the stamp duty laws
  - The LLP owns the property in its own name
  - The Firm owns the property through its partners [Good case for stamp duty implications]

Company to LLP

- A Company is converted to a LLP by virtue of Section 56 or 57 of LLP Act, 2008.
- Tax Neutral Conversions : [Section 47 (xiiib)]
  1. All assets and liabilities of the Company before conversion become assets and liabilities of LLP.
  2. All shareholders before conversion become partners in their inter se shareholding ratio
  3. Shareholders do not receive any consideration / benefit directly or indirectly other than by way of share of profit and capital contribution
  4. Aggregate PSR of shareholders shall not reduce to less than 50% at any time during 5 years from date of conversion.
  5. Total sales, turnover & gross receipts shouldn't exceed 60 Lacs in 3 preceding PYs.
  6. No direct or indirect payments to partner out of Accumulated Profits for 3 years from date of conversion

Certain Points in Section 47(xiiib)

- Aggregate PSR of shareholders shall remain at least 50 % for 5 years
  - PSR on aggregate basis or individual basis and then aggregated
  - No exceptions like in S. 79
- Sales, turnover, gross receipts
  - Only the amounts that are taxable under the head “profits and gains” are included
    - Exempt Income, Income from other Sources, Capital Gains, Rental Income, etc. are excluded.
  - Otherwise, principles U/s. 44AB shall apply
  - What happens in cases of merger prior to the conversion?
- No payment out of Accumulated Profits for 3 Years
  - AP as per books of accounts
  - What if the land which is appreciated significantly appreciated is sold after conversion and the profits are distributed leaving the original value of the Company

Certain Tax issues in 47(xiiib)

- Carry forwards of loss under Section 72A(6A) of ITA.
  - Can be carried forward for further 8 years
- MAT credit cannot be carried forward by LLP u/s 115JAA(7).
  - AMT and MAT are different levies and are not interchangeable
  - Principles applicable for merger of companies or firm to LLP not applicable here
- Depreciation on WDV as per Explanation (2C) to Section 43(6).
- If conditions are violated - 47A(4)
  - Profit not charged to tax U/s. 45 shall be charged as CG in the hands of LLP in the year in which the conditions are violated
  - Similar exemption to the shareholder will be liable to be taxed in the hands of the Shareholder in the year of breach
  - Nature of the gain will retain its character (Long Term Vs. Short Term)

Non-Exempt Conversion

- In case of conversion of Company into LLP not covered by exemption (say turnover in excess of Rs. 60.00 lacs):
  - Transfer of Assets by the Company to LLP
  - Transfer of Shares by Shareholder in lieu of share of profit and capital contribution
- Transfer of Assets by the Company
  - Principles of Part IX Conversion from a firm to Company whether applicable
  - There is no *inter vivos* transfer
  - No consideration passes from the transferee to the Transferor (Credit in the capital account of the partner, would be consideration from the transferee but not to the transferor
- Transfer of Shares by the Shareholders [Extinguishment]
  - Conversion leads to extinguishment of shares and amounts to transfer Grace Collis 248 ITR 323 – [SC]- Hence Transfer u/s 2(47)
  - Sunil Sidharthbhai - 156 ITR 509 (SC) - consideration credited to partners capital cannot be considered to be full value of consideration received
  - Section 45 (3) applies only when there is a transfer by a person of a capital asset to the firm.
  - Implication of Section 50 D - ????

Conversion from LLP to Company

- Section 47 (xiii) deals with the conversion from LLP to Company and accordingly, so long as the conditions specified in Section 47 (xiii) are satisfied, the transaction will be tax neutral.
  - Conversion by sale as a going concern of the entire business
  - Part IX Conversion [For Stamp Duty Point of view]
- Part IX of the CA 1956 is *pari materia* with Part I of Chapter XXI of the CA 2013 *[These provisions of CA 2013 are already notified]*
  - Section 366 of CA 213 specifically allows LLP to register
  - The case laws and discussions relating to the registration of a firm as a Company under Part IX will be applicable

Merger / Demerger of LLP

- Sections 60 to 62 deal with the compromise, arrangement or reconstruction of LLPs which are similar to the provisions of Section 391, 392 and 394 of the CA 56.
- Accordingly, under these provisions an amalgamation of two LLPs and demerger of an undertaking of LLP into another LLP is permissible.
- Merger of two LLPs
  - All assets and liabilities of the transferor LLP get transferred to and vest in the transferee on amalgamation
    - Whether it would amount to transfer and if it is a transfer whether it would be chargeable to capital gains
      - Inter Vivos transfer and consideration not flowing from transferee to transferor.
  - Share of Profit of Partners in the Transferor Company gets extinguished and in turn these Partners will get share in the Transferee Company
    - Grace Collis 248 ITR 323 – [SC] held that extinguishment of rights in an asset will include extinguishment of asset itself

Classification of Indian LLP under DTAA

- Under LLP Act, LLP is a body corporate
  - DTAA generally defines the “Company” means any body corporate or any entity which is treated as a company or body corporate for tax purposes;
  - Therefore, distribution of income by the LLP may classify as dividend in the hands of the recipient
  - Indo-US Treaty, may make the US entity eligible for the underlying tax credits
    - No withholding taxes and getting the benefit of the underlying tax credits
    - It may also be considered as return of capital
- Only in cases where the definition of company is that if it is treated as a company under the tax laws of the contracting state [e.g. Belgian Treaty]

Global Scenario

- The existing ITA does not treat LLP as a transparent entity.
  - Profits and losses of the LLP would be assessable in the hands of the LLP.
- All the provisions relating to the firm incorporated apply mutatis mutandis to LLP.
- In the globalised scenario, issues have arisen as foreign LLPs do not per se fall within the traditional definition of partnership / company.
  - Entity Characterization is very important
- Different countries have different tax treatment and registration / incorporation regime for the Limited Liability Partnerships

Classification of Foreign LLP

- Can be classified as company or partnership under Indian Law / DTAA
  - Provisions dealing with registration / incorporation in the host country
  - Tax provisions dealing with it
- If it is tax transparent, then question of applicability of DTAA will arise
  - The treaty generally applies to a person who is resident (as per the definition in the DTAA) of one of the contracting states
  - The definition of “Resident” generally provide for “any person who, under the laws of that State, is *liable to tax therein* by reason of his domicile …..”
  - If LLP is treated as a tax transparent entity, then it is not liable to tax in that state and therefore may not qualify to be a resident and therefore not entitled to treaty benefit
  - Some DTAA therefore provide exceptions for this [US Treaty / UK Treaty amended w.e.f. 27.12.2013]

Applicability of Tax Treaty

- Article 4 of any tax treaty defines -“person” - to whom the provisions of the treaty may apply.
- OECD Model Convention-“person”-individual, a company and any other body of persons.
- Official Commentary
  - *“where a State disregards a **partnership** for tax purposes and treats it **as fiscally transparent**, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that State. In such a case, since the **income of the partnership “flows through” to the partners** under the domestic law of that State, the **partners** are the persons who **are liable to tax** on that income and **are thus** the **appropriate persons to claim the benefits of the conventions** concluded by the States of which they are residents. This latter result will be achieved even if, under the domestic law of the State of source, the income is attributed to a partnership which is treated as a separate taxable entity.”*
- *In the above context, applicability is to be determined.*

Applicability based on Status

- Apply to “persons” resident of one or both the countries
- In UK, a partnership is a tax transparent entity..
- Under the India-UK tax treaty-“person”
  - *”individual, a company, a body of persons and any other entity which is treated as a taxable unit under the taxation laws in force in the respective Contracting States”*
  - Partnerships(including foreign partnerships), LLPs taxable under IT Act-eligible for treaty benefits.
- Earlier partnerships (except Partnership taxable under IT Act) specifically excluded, but now eligibility based on transparency.
- Article 25 of the Indo-UK treaty stands omitted.

Classification of Foreign LLP as Company

- LLP as Company
  - Wide definition under Section 2(17) of IT Act.
  - It includes any body corporate by or under the laws of a country outside India
  - A foreign LLP if it is treated as body corporate, then it will classify as Company and provisions may apply accordingly
  - DTAA provide for definition of Company
  - It can have wide implications in India like Deemed Dividends

Thank You

Questions ????

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