Taxation of Limited Liability Partnership

From the taxation point of view, an LLP has certain distinct advantages. Though the LLP is a body corporate, certain unfavourable provisions applicable to a company such as Dividend Distribution Tax, Deemed Dividend, Wealth Tax, etc. are not applicable to an LLP, thereby placing the LLP in a more advantageous position. An LLP also has a distinct advantage of claiming interest upto 12% on capital and borrowings from partners irrespective of profit or loss. Further, to encourage small companies (private & unlisted) to convert themselves into LLPs, there are provisions to give immunity from capital gains tax by not treating 'conversion' as 'transfer'. An attempt is made in this article to analyse the provisions applicable to LLPs in India.

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LLP – Introduction

A Limited Liability Partnership (LLP) is an entity which brings forth the dual advantages of limited liability (as in case of a company) coupled with the flexibility of internal management (as in case of a partnership).

An LLP, being a separate entity distinct from its partners, makes it more closely akin to a company than to a partnership except that its internal relations are governed by an agreement between partners known as the LLP Agreement.

An LLP formed and registered under the LLP Act, 2008 (Indian LLPs) in India shall be taxed as a 'firm' under the Income-tax Act, 1961 (Act). Accordingly, an LLP and a general partnership are treated as

equivalent for the purpose of taxation (except for recovery purposes).

From the taxation point of view, an LLP has certain distinct advantages. Though the LLP is a body corporate, certain unfavourable provisions applicable to a company such as Dividend Distribution Tax (DDT), Deemed Dividend, Wealth tax, etc., are not applicable to an LLP. An LLP also has a distinct advantage of claiming interest up to 12% on capital and borrowings from partners irrespective of profit or loss during the given year. Further, to encourage small companies (private & unlisted) to convert themselves into LLPs, provisions are made under the Act to give immunity from capital gains tax by not treating 'conversion' as 'transfer' u/s. 47(xiiib) of the Act.

LLPs to be Taxed as Firms:

The taxation scheme of LLPs under the Act is on the same lines as the taxation scheme prevalent for general partnerships, i.e., taxation in the hands of the entity and exemption in the hands of its partners.

As per the amendments made by the Finance (No. 2) Act, 2009, a 'partner' shall include within its meaning a partner of an LLP. Similarly, the word 'firm' shall include within its meaning an LLP and the word 'partnership' shall include a Limited Liability Partnership.

Some of the important issues relating to taxation of LLPs are as under:

Partners in LLP –

a. **Designated Partners** – Every LLP is required to have at least two Designated Partners who shall be individuals and at least one of them shall be a resident of India. In case of LLPs in which all or one or more partners are bodies corporate, at least two individuals who are partners of such LLPs or nominees of such bodies corporate shall act as designated partners.

   The Return of Income (ROI) of an LLP shall be signed by the Designated Partner. However, any other partner may sign the ROI where the designated partner is not able to sign for any unavoidable reasons.

b. **Minor Partners** – As per Section 2(23)(ii)(a) of the Act, 'partner' includes 'any person who, being a minor, has been admitted to the benefits of partnership'. From the above definition, one may interpret that if a minor can be a partner in an LLP or can be admitted to the benefits of partnership in an LLP under the LLP Act, such minor shall be a 'partner' within the meaning of Section 2(23) for income tax purposes also.

   As per Section 5 of the LLP Act "any individual or body corporate may be a partner in LLP provided…" The phrase 'any individual' has no limitations or qualifications and therefore it is possible to interpret that 'any individual' includes a minor also.

   However, unlike Section 30(1) of the Indian Partnership Act, 1932, which expressly provides that a minor can be admitted to the benefits of Partnership, there is no express provision under the LLP Act.

   Accordingly, it is possible to take a view that a minor can be a partner in an LLP.

The scheme of taxation of LLPs is based on single point taxation. In other words, post-tax profits distributed amongst the partners of LLPs are exempt from tax u/s. 10(2A) of the Act, in the hands of partners. Similarly, where a company is a partner in an LLP, the share of profit received by the company shall also be exempt u/s. 10(2)(A).

Contrary View:

However, the above view may cause certain practical difficulties. For example, Section 25(3)(c) of the LLP Act requires that notice of changes in partners to be filed with ROC should contain a statement signed by the incoming partner that he consents to become a member. Since a minor is incompetent to contract under the Indian Contract Act, 1872, he is incompetent to give Notice of Consent which needs to be signed by him in terms of Section 25(3)(c).

Residential Status and Tax Rates Applicable -

An LLP formed and registered in India is a 'resident' in India in any previous year except where during that year the control or its management is situated wholly outside India [Section 6(2)]. Therefore, even where the management of an LLP is partly outside India, such an LLP shall be entitled for the status as a 'resident' in India.

As far as rates of tax are concerned, an LLP being a 'firm' would be liable to pay tax at the rate of 30% (plus EC & SHEC) like in the case of a partnership firm. Further, an LLP is not liable for Surcharge.

Share of Total Income Exempt in Partners' Hands:
The scheme of taxation of LLPs is based on single-point taxation. In other words, post-tax profits distributed amongst the partners of LLP are exempt from tax u/s. 10(2A) of the Act, in the hands of partners.

Similarly, where a company is a partner in an LLP, the share of profit received by the company shall also be exempt u/s. 10(2)(A). Further, such profit is also eligible to be excluded in computation of book profit u/s. 115JB for MAT purposes in terms of Clause (ii) of the Expl. to Section 115JB(1).

A minor admitted to the benefits of LLP also being a partner, his share in total income of LLP is exempt in his hands and shall not be clubbed in the hands of parent u/s. 64.

An incidental issue is whether any expenditure incurred by a partner in relation to the share of profit from an LLP is hit by the provisions of Section 14A. Since a partner incurs expenditure in relation to both taxable income (such as remuneration, interest on capital) and exempt income (share of profit), a reasonable view could be that *pro-rata* expenditure attributable to exempt income is disallowable u/s. 14A. [*DJ Mehta (2007) 104 ITD 527 ITAT (Mum)* and *Sudhir Dattaram Patil vs. DCIT (2005) 2SOT 678 (Mum)]*

Deduction of Interest & Remuneration Paid to Partners:
Simple interest not exceeding 12% paid by an LLP to a partner, (whether working partner or not) on capital or borrowings from a partner shall be allowed as deduction to the LLP subject to conditions u/s. 40(b) irrespective of profit or loss.

Section 8 of the LLP Act implies that designated partners shall be 'working partners'.

Working Partners of an LLP are eligible for remuneration. A working partner is defined to be an individual who is actively engaged *in* conducting affairs of business or profession of the firm in which he is a partner. While drafting the LLP agreement, one must ensure that names of working partners are specified in the Deed of LLP to comply with the requirements of Section 40(b). This is because remuneration paid only to a 'working partner' named in the Deed is allowable.

It should be borne in mind that where remuneration is paid to nominees of bodies corporate who are partners of an LLP, such remuneration is not allowed u/s. 40(b) as the nominees are not partners of the LLP. In such cases, it is advisable to have contracts of service with these nominees and pay them salaries instead of partners' remuneration.

The remuneration received by a partner of an LLP shall be taxed in the partner's hands as 'Profits and Gains from business or profession' u/s. 28(v) to the extent the same has been allowed as deduction in the hands of the LLP.

Any capital asset brought in by a person into an LLP in which he becomes a partner would be liable for tax in the hands of such incoming partner in terms of Sec. 45(3) of the Act. The amount at which such capital asset is to be credited in the books is governed by Rule 23 of the LLP Act. The said Rule provides that the capital asset shall be valued by a practicing Chartered Accountant/Cost Accountant/Approved Valuer.

Transfer of Partner's Interest in LLP :
A partner of an LLP enjoys two basic rights - 'Right to share in profits & losses' and 'Right to receive distribution of assets' as per LLP Agreement (Section 42 of the LLP Act). Both these rights are capable of being transferred/assigned. However, the transferee/assignee, not being a partner, is not entitled to the benefits u/s. 10(2A).

Further, even if such a right is transferred to a non-relative, it cannot be treated as a gift since the list of specified gifts u/s. 56(2)(vii) does not include 'interest in LLP'.

Admission of new partners by LLPs:

Realignment of PSR –
Realignment of PSR on admission of new partners does not amount to 'transfer' u/s. 2(47) for capital gains purposes. On admission of a new partner there is realignment of PSR *inter-se* between the partners only to the extent of sharing of profits or losses. Thus, when the PSR undergoes a change, it does not amount to 'transfer' u/s. 2(47), as there is no change in the ownership of assets held by the firm. During the subsistence of a partnership firm, partners do not have any defined share in the assets of partnership. Therefore, on realignment of PSR on admission of a new partner, there is no relinquishment of any non-existent share in the partnership assets.

Such an arrangement is also not covered u/s. 45(4), which covers the case of dissolution of an LLP. Accordingly, no capital gain arises on such relinquishment of PSR in LLP.

Introduction of Capital Assets by a partner:
Any capital asset brought in by a person into an LLP in which he becomes a partner would be liable for tax in the hands of such incoming partner in terms of Section 45(3) of the Act. The amount at which such capital asset is to be credited in the books is governed by Rule 23 of the LLP Act. The said Rule provides that the capital asset shall be valued by a practicing Chartered Accountant/Cost Accountant/Approved Valuer.

Revaluation of Assets:
Revaluation of assets by an LLP and credit of the revalued amount to the capital account of partners does not entail any 'transfer' u/s. 2(47) and so does not give rise to taxable capital gains. *[ITO vs. Smt. Paru D. Dave () 88 ITD 524 (Chd.)*] On the contrary, such increased capital balances can be considered for calculating interest admissible u/s. 40(b).

Conversion of Firms & Companies into LLP

Sections 55, 56 and 57 of the LLP Act, read with Schedule II, II and IV respectively provide for conversion of a partnership firm, a private company or an unlisted public company (not listed company) into an LLP.

Conversion of General Partnership firm to LLP:
A general partnership firm can be converted into an LLP

a. if partners of the LLP into which the firm is to be converted comprises all partners of the general partnership firm and no one else.
b. by transfer of all property, assets, interests, rights, privileges, liabilities, obligations and undertaking of the general partnership firm to the LLP in accordance with Schedule II.

If the above conditions are satisfied the conversion shall not be regarded as transfer and consequently the provisions relating to transfer of capital asset are not triggered.

Conversion of a Private/Unlisted Company to an LLP:
Conversion of a private/unlisted company (company) into an LLP, technically involves transfer of assets from the company to the LLP. However, to encourage certain companies to operate in the LLP format, the Finance Act 2010 has inserted Section 47(xiiib) to exempt the conversion from any tax implications subject to certain conditions.

MAT credit of predecessor company shall not be available to successor LLP. Thus, it may make sense for the company to first avail MAT credit before converting to an LLP. The provisions of Sec. 115JAA(7) shall apply regardless of whether conversion is in compliance with the conditions specified u/s. 47(xiiib) or not.

These conditions are summarised in the table below:

I	Eligibility Criteria	(i)	Average annual total sales/ turnover/gross receipts of the company does not exceed ₹60 lakh in any 3 preceding previous years.
II	Conditions at Conversion stage	(ii)	All shareholders of the company before conversion become partners of the LLP & Capital/Profit Sharing Ratio in the LLP should be in same proportion as their shareholding in the company.
		(iii)	Shareholders of the company receive no consideration, other than share in contribution & PSR in the LLP.
		(iv)	All Assets/Liabilities of the company are transferred to the LLP.
III	Conditions after Conversion	(v)	Erstwhile shareholders of the company to retain at least 50% PSR for 5 years from date of conversion.
		(vi)	No distribution of Accumulated Profits of the company as on the date of conversion for 3 years from date of conversion.

Following issues be considered in relation to the conditions specified above:

a. **Condition (i)** - Total Sales/Turnover/Gross Receipts not to exceed ₹60 lakh-
   - Turnover of preceding 3 FYs (excluding the year of conversion) be considered. Therefore,

the turnover for the year in which the conversion takes place is immaterial and therefore could be even more than ₹60 lakh.

- The turnover of each of the preceding 3 FYs be reckoned *qua business*. In other words, if the company has more than one business, so long as the average annual turnover of each business does not exceed ₹60 lakh, the company is eligible for conversion. (*CIT vs. K Satish Shetty [2010] 108 Taxmann 32*)
- Where the company is in the construction business, gross receipts will not include value of material supplied by the client. (*CBDT Circular No. 684 dated 10.06.1994*)
- One may refer to the ICAI Guidance Note on Tax Audit (Revised Edition-2013) in determining 'turnover/sales/gross receipts'.

b. **Condition (ii)** - All shareholders of the company should become partners of the LLP.
   - In case any shareholder is not willing to become a partner of the LLP, it is advisable to buy back/transfer his shares before conversion. This is also important from the point of view of the related condition that the aggregate of PSR of shareholders of company in an LLP should not fall below 50% at any time during a period of 5 years from the date of conversion. The *inter-se* PSR should be the same as the proportion of their shareholding on the date of conversion as per condition (ii).
   - 'All the shareholders' would include preference shareholders as well.

c. **Condition (iii)** - The shareholders of the company shall not receive any consideration or benefit, directly or indirectly, in any form or manner, other than by way of share in profit and capital contribution in the LLP.

d. **Condition (iv)** - Aggregate PSR of shareholders to remain at least 50% for a period of 5 years-
   - The object of this condition is to prohibit dilution of ownership of erstwhile shareholders of the company who are partners in the LLP, which is understandable and purposeful. However, if as a result of death of one or more of the partners at any time during five years from the date of conversion, the PSR of shareholders in the LLP may fall below 50%. Whether in such cases this condition would be treated as violated and the LLP would be liable to pay capital gains tax? As on date, there is no express provision under law or clarification from CBDT.

e. **Condition (v)** – All assets and liabilities of the company immediately before conversion should become assets and liabilities of LLP.
   - No partial transfer of assets and liabilities is permitted. Accordingly, no transfer to any erstwhile shareholder who becomes a partner of LLP is permitted; else Condition (iii) will be violated and the transaction would be liable to capital gains tax.

f. **Condition (vi)** - No payment is made to any partner out of accumulated profits standing in the account of the company as on the date of conversion for a period of 3 years-
   - This condition is specified to avoid companies having reserves resorting to conversion into LLP and then distributing the accumulated profits resulting in evasion of DDT or to circumvent the provisions of Section 2(22)(e).
   - This condition requires retention of identity of accumulated profits in the LLP's books. Though this would not serve any useful purpose, it might create disputes with the new partners in the LLP as to whether even they have a claim on such accumulated profits. To simplify this issue, it would be prudent to issue bonus shares by utilising such accumulated reserves before conversion of the company into an LLP.

If these conditions are not satisfied then the provisions of Section 47A(4) will apply and there will be capital gains tax in the hands of successor LLP/shareholder of predecessor company in the year in which any of the conditions is violated.

Accumulated losses/unabsorbed depreciation of the erstwhile company available for set-off to successor LLP -

As per Section 72A (6A) of the Act, the accumulated business loss and unabsorbed depreciation of the predecessor company as on the date of conversion shall be allowed to c/f and set off by the successor LLP if all the conditions u/s. 47(xiiib) are satisfied.

If those conditions are violated, the benefit availed by the company shall be deemed to be

the profits of the successor LLP and shall be taxable in the previous year in which the conditions are violated.

MAT Credit u/s 115JAA not available to Successor LLP –

MAT credit of predecessor company shall not be available to successor LLP. Thus, it may make sense for the company to first avail MAT credit before converting to an LLP. The provisions of Section 115JAA(7) shall apply regardless of whether conversion is in compliance with the conditions specified u/s. 47(xiiib) or not.

Deductions u/s. 35DDA –

Where a company converts itself into an LLP fulfilling the conditions laid down u/s. 47(xiiib), the benefit of amortisation of Voluntary Retirement Scheme (VRS) payments shall apply to successor LLP as they would have applied to the said company. [Section (35DDA)(4)]. However, no amendment is made to Section 10(10C) to provide corresponding exemption to employees of LLP in respect of VRS payments received from employer LLP. Therefore, it would be advisable for companies to first avail full benefit of amortisation before converting to LLP so that employees can avail benefit u/s. 10(10C).

Advantages of LLPs over Companies in Matters of Taxation

An LLP is not liable to pay DDT on profits credited/paid by it to partners. Partners of LLP can be paid interest on capital whether there is profit or not, unlike dividends which depend on profits. Interest to partners on their capital/loan is deductible expense u/s. 36(1)(iii) read with Section 40(b)(v) of the Act.

There is no tax implication in respect of loans/advances given by LLP to its partners unlike in the case of company where such loans/advances trigger the provisions of deemed dividend u/s. 2(22)(e).

Wealth tax is applicable only to individuals, HUFs and Companies. [Section 3(2) of the Wealth Tax Act, 1957]. An LLP being a 'firm' within the meaning of Section 2(23) of the Act, Wealth Tax is not applicable to LLPs.

Other Issues

Presumptive Taxation of LLPs – LLP is not an 'eligible assessee' for the purpose of presumptive taxation u/s. 44AD. Accordingly, an LLP cannot offer its profits under the said section. Needless to

mention that maintenance of books of accounts is compulsory for an LLP under the LLP Act.

Audit of Accounts of LLPs – Audit of LLP under the LLP Act is mandatory if its turnover exceeds ₹40 lakh in any financial year or its capital contribution exceeds ₹25 lakh. [Rule 24(8)]

Return of Income (ROI) – The due date for furnishing ROI for LLP is:

- 30th September: If accounts of LLP are required to be audited under the LLP Act.
- 31st July: If the accounts are not required to be audited under the LLP Act.

Recovery of Tax u/s. 167C of the I-T Act – Though liability of the partners in an LLP is limited to the extent of their contribution, special provisions are made in respect of recovery of income tax due from LLP. Section 167C of the Act provides that where any tax due from an LLP in respect of any income of any previous year cannot be recovered, *every person who was a partner of the LLP* at any time during the relevant previous year shall, jointly and severally be liable for payment of such tax. However, a partner can claim immunity from the said section if he proves that non-recovery cannot be attributed to any gross neglect, misfeasance or breach of duty on his part in relation to the affairs of the LLP.

Conclusion:

The LLP format of business organisation is gaining popularity in India. Taxation of LLPs is one of the most important issues to be considered both while forming new LLPs or converting existing firms/private or unlisted companies into LLPs. Taxation issues relating to conversions throw up more challenges since LLPs are required to meticulously follow the conditions of law over a period of 5 years from the date of conversion. Taxation of LLPs has opened up a new area of professional practice for CAs and tax professionals. ■