

Taxation of Limited Liability Partnership

WIRC SEMINAR ON LLP

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Key features of LLP

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- LLP is governed by Limited Liability Partnership, Act 2008
- Features of LLP are a mix of features of a general partnership firm and a company
- LLP is a legal entity separate from that of its partners
- LLP has perpetual succession
- The liability of partners of LLP is limited
- Generally, no restriction on the business activity that can be carried on by an LLP (except for FDI rules)
- Minimum 2 partners; no limit on the number of partners

General scheme of taxation of LLP

General scheme of taxation of LLP

- Taxation of LLP was introduced by Finance Act, 2009
- Scheme of taxation of LLP was incorporated on the same lines as prevailing for general partnerships
 - Taxation in the hands of the partnership firm / LLP
 - Exemption from tax for the partners of the partnership firm / LLP
- Definitions of partner, firm and partnership under section 2(23) of the Income-tax Act amended to include relevant references to LLP
 - Definition of a “partner” shall include a partner of an LLP
 - Definition of a “firm” shall include an LLP
 - Definition of “partnership” shall include an LLP

Residential status of LLP

Residential status of LLP

- As per section 6 of the Income-tax Act, a firm is said to be resident in India in any previous year in every case except where during that year the control and management of its affairs is situated wholly outside India
- Meaning of the term 'control and management'
 - The expression 'control and management' signifies controlling and directive power, 'the head and brain' as it is sometimes called. [CIT v. Nandlal Gandlal (1960) 40 ITR 1 (SC)]
 - The word 'affair' must mean affairs which are relevant for the purpose of the Income-tax Act and which have some relation to income [V.VR.N.M. Subbayya Chettiar v. CIT (1951) 19 ITR 168]
 - While the word 'situated' involves an idea of some sort of permanency, it also involves an idea of the present existence, that is, effective existence of such control in the relevant year [B.R.Naik v. CIT (1945) 13 ITR 124 (Bom.)]

Taxation of LLP

Remuneration to partners (1/2)

- As per section 40(b) of the Act, following amounts shall not be deducted in computing income chargeable under the head “Profits and gains of business or profession”
 - Any payment of salary, bonus, commission or remuneration to any partner who is not a working partner
 - Any payment of remuneration to working partner which is not in accordance with the deed
 - Any payment of remuneration to working partner which relates to any period falling prior to the date of the deed
 - Any payment of remuneration to a working partner exceeding the aggregate amount computed as under:

On the first Rs. 300,000 of the book profit or in case of loss	Rs. 150,000 or at the rate of 90% of the book profit, whichever is more
On the balance of the book profit	At the rate of 60%

Remuneration to partners (2/2)

- Book profit
 - Computed in the manner laid down under Chapter IV-D of Income-tax Act under the head Income from business or profession
 - Depreciation claim to be mandatorily reduced in computing book profits – it isn't optional
 - Income under no other head to be considered
- Working partner
 - an individual who is actively engaged in conducting the affairs of the business or profession of the firm / LLP of which he is a partner

Interest to partners

- As per section 40(b) of the Act, following amounts shall not be deducted in computing income chargeable under the head “Profits and gains of business or profession”
 - Any payment of interest to any partner which is not in accordance with the deed
 - Any payment of interest to any partner, which relates to any period falling prior to the date of the deed
 - Any payment of interest exceeding the amount calculated @ 12% simple interest p.a.

Partnership profits

- Partnership profits
 - Taxable in the hands of the LLP
 - Exempt in the hands of the partners
- Alternate Minimum Tax (AMT) provisions are applicable to LLP
- Dividend distribution Tax (DDT) provisions **not** applicable to LLP

Capital gains

- Capital gains on contribution of assets by partner to firm
 - Section 45(3) of Income-tax Act
 - Taxable in the hands of the partner in the year in which the transfer takes place
 - Full value consideration is the amount recorded in the books of accounts of the firm
- Capital gains on distribution of assets on dissolution or otherwise
 - Section 45(4) of Income-tax Act
 - Taxable in the hands of the firm in the year in which the transfer takes place (not in the year of dissolution)
 - Full value consideration is the fair market value of asset on date of transfer
 - “dissolution or otherwise” – does it include retirement? A. M. Naik Associates (Bom HC)

Carry forward of loss

- As per section 78 of the Act, where there is a change in the constitution of a firm, the losses proportionate to the share of the retired / deceased partner as exceeds his share of profits shall not be entitled to carry forward and set off
- Further, where the business is succeeded in such capacity by another person otherwise than by inheritance, no losses shall be entitled to be carried forward to any person other than the person incurring the losses
- Whether the above provisions would also be applicable to an LLP, especially when LLP has separate distinct legal entity and has perpetual succession

Key points regarding assessment of LLP

- As per section 184 of Income-tax Act, LLP is assessed as a “firm” if:
 - Partnership is evidenced by an instrument
 - Individual shares of partners are mentioned in the instrument
- As per section 185 of Income-tax Act, in case of non-compliance with section 184:
 - LLP assessed as AOP
 - No deduction of remuneration / interest paid to partners
 - For partner, remuneration / interest remains to be not taxable subject to limits
- If LLP is assessed under section 144 of Income-tax Act:
 - No deduction of remuneration / interest paid to partners
 - For partner, remuneration / interest remains to be not taxable subject to limits

Conversion of company to LLP

Conversion of company to LLP

- Specific provisions of the Limited Liability Partnership Act, 2008 permit conversion of a closely held company into LLP
- No capital gains tax on conversion of company to LLP if conditions prescribed under section 47(xiii b) of Income-tax Act are met – discussed on next slide
- If the conditions prescribed under section 47(xiii b) of Income-tax Act are not met, section 47A(4) of Income-tax Act provides for taxability of capital gains in the hands of LLP
- Supported by judicial precedents, is it possible to adopt a position that the conversion is tax exempt for both the shareholders and the company using the following arguments:
 - Conversion being a statutory vesting of properties in the LLP, it may not qualify as transfer under the Income-tax Act
 - Value of the business of the company and LLP remaining the same, no capital gains would arise in the hands of the shareholders
- Impact of general anti avoidance rule (GAAR), which has come to force from 1 April 2017, also needs to be considered

Conversion of company to LLP – key eligibility criteria for tax neutral conversion

1 **All the assets and liabilities** of the company immediately before the conversion become the assets and liabilities **of the LLP**

2 **All the shareholders** of the company immediately before the conversion become the **partners** of the LLP and their capital contribution and profit sharing ratio in the LLP are in the **same proportion** as their shareholding

3 **No consideration** or benefit in any manner (other than by way of share in profit and capital contribution) received by **shareholders**

4 The **aggregate of the profit sharing ratio** of the shareholders of the company in the LLP shall **not be less than 50 per cent**, at any time during the period of **five years** from the date of conversion

5 The **total sales / turnover / gross receipts** in business of the company in any of the **3 previous years preceding** the previous year in which the conversion takes place **does not exceed INR 6 million**

6 **No amount is paid**, either directly or indirectly, to any partner out of balance of **accumulated profit** standing in the accounts of the company on the date of conversion for a **period of three years from the date of conversion**

7 The total **value of the assets** as appearing in the books of account of the company in any of the 3 previous years preceding the previous year in which the conversion takes place does not exceed **INR 50 million**

Cumulative conditions

Tax neutral conversion of company to LLP

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Thank you