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Limited Liability Partnership-Taxation Issues

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Abstract: **Limited Liability Partnership (LLP) and general partnership is being treated as equivalent (except for recovery purposes) in the Income-tax Act, 1961. As opposed to a corporate entity, distribution made by an LLP to its partners is tax exempt i.e. there is no dividend distribution tax on distribution to partners and further, an LLP is not subject to Minimum Alternate Tax. The Finance act, 2010 has proposed the much awaited provisions with respect to tax treatment on conversion of existing private companies and unlisted public companies into LLPs. And the finance act 2011 has introduced the application of AMT on LLPs by inserting new chapter-XII-BA consisting of four sections 115JC, 115JD, 115JE and 115JF in the income tax act 1961.**

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. There are specific provisions in income tax act for the tax implication on conversion of private company or unlisted public company into LLP.

1. INTRODUCTION

The "LLP Bill, 2008" was introduced in Rajya Sabha on 2 October, 2008. This Bill has been passed by the Rajya Sabha on 24 October, 2008.The LLP Bill, 2008 was passed by Lok Sabha on 12thDecember, 2008 and the LLP act got the assent of the President on 7 January 2009 and was notified in official gazette on 9 January 2009. The provisions of the LLP Act came into force on 31 March 2009(effective in parts). The Limited Liability Partnership Rules, 2009 have also been notified by the Central Government in phases since 1 April, 2009. But the act has skipped the question of taxation of LLPs. The issue of whether LLPs would be taxed like companies or like partnerships or in some other way was left for the finance ministry to decide separately.

LLP is a hybrid form of business having the colours of both, general partnership and company. It provides the benefit of limited liability but allows its members the flexibility of organising their internal structure as partnership based on mutually arrived agreement. As soon as the limited liability partnership act got the legal consent, the need for a clear cut tax regime in respect of the income of the LLP was essential to give certainty in all respects of conducting business via this mode of business.

Limited Liability Partnership (LLP) and general partnership is being treated as equivalent (except for recovery purposes) in the Income-tax Act, 1961. As opposed to a corporate entity, distribution made by an LLP to its partners is tax exempt i.e. there is no dividend distribution tax on distribution to partners and further, an LLP is not subject to Minimum Alternate Tax. The Finance act, 2010 has proposed the much awaited provisions with respect to tax treatment on conversion of existing private companies and unlisted public companies into LLPs. And the finance act 2011 has introduced the application of AMT on LLPs by inserting new chapter-XII-BA consisting of four sections 115JC, 115JD, 115JE and 115JF in the income tax act 1961.

Introduction of a tax regime will provide a road of certainty in relation to the tax cost associated with carrying the business via the LLP mode.

2. LITERATURE REVIEW

The ministry of corporate affairs has assured that as regards taxation, the matter being related to the ministry of finance will be taken care of by that ministry. Also, the Indian LLPs will in no way be put to any disadvantage and our LLPs will have a level playing field with other similar bodies outside the country. The ICAI has already made a representation to the

ministry of corporate affairs suggesting that the law should prescribe a reasonable taxation regime for limited liability partnership in consonance with the best global practices. In most of the countries, including U.K. and Singapore, the LLPs are treated in the same manner as the partnership firm under the tax laws.

On6 July, 2009 the road map for taxation of LLPs in India has been cleared by the Union Budget2009,whereby,the profits and losses of the LLP would be assessable in the hands of the LLP. The new provisions do not treat the LLP as a transparent entity but treat the same at par with the partnership firm under the Indian Partnership Act, 1932. Introduction of this long awaited tax regime shall surely provide a road of certainty in relation to tax costs associated with carrying the business via LLP mode.

Finance act 2009:

Finance act no.2 of 2009 carried out necessary amendment in the income tax act, 1961 to provide taxation of LLP on the same lines as firm. Finance act, 2009 substituted the definition of firm, partner and partnership given under section 2(23) of the income tax act as under:-

1. "firm" shall have the meaning assigned to it in the Indian partnership act, 1932(9 of 1932), and shall include a limited liability partnership as defined in the limited liability partnership act, 2008(6 of 2009);
2. "partner" shall have the meaning assigned to it the Indian partnership act, 1932(9 of 1932), and shall include-
   - any person who, being a minor, has been admitted to the benefits of partnership; and
   - a partner of a limited liability partnership as defined in the limited liability partnership act, 2008 (6 of 2009);
3. "partnership" shall have the meaning assigned to it in the Indian partnership act, 1932 (9 of 1932), and shall include a limited liability partnership as defined in the limited liability partnership act, 2008 (6 of 2009);

By the above amendments it was clarified it was clarified that LLP shall be taxed at par with general partnership i.e. taxation in the hands of the entity and exemption from tax in the hands of its partners. Accordingly, all the provision of the income-tax act, 1961 which are applicable on firm, partner and partnership shall also be applicable on LLP, partner of LLP and limited liability partnership unless otherwise provided in the act. Therefore, LLP shall pay tax @30.09 per cent (30% + 3% education cess) on its profit earned during any previous year. Since the LLPs have been treated at par with the general partnership, the provision of minimum alternate tax and dividend distribution tax will not be applicable for LLP.

Remuneration and interest to partners:

LLP shall be eligible to claim remuneration and interest paid to its partners up to the permissible limit given under section 40(b) subject to LLP agreement authorises such payment. Maximum rate of interest allowable is 12 per cent per annum. Section 40(b) was amended by the finance act, 2009 so as to provide uniform limit of remuneration for both professional and non professional firms for simplicity and administrative ease. The revised limits of remuneration are as under:

On the first RS 300,000 of book profit or in case of loss	RS 1,50,000 or 90 per cent of book profit whichever is more
On the balance of book profit	60 per cent

Taxation of partner:

Profit of LLP credited to the accounts of the partners shall be exempt to tax under section 10(2A) in the hands of partners to avoid double taxation. However, remuneration and interest paid by the LLP to its partners shall be taxable in the hands of the partners up to which deduction has been claimed by the LLP under section 40(b) under the head " profits and gains of business or profession". However, any amount exceeding the limit specified under section 40(b) paid by LLP to its partner shall be taxable in the hands of LLP and therefore, not chargeable to tax in the hands of partners.

Finance act 2010:

Finance Act of 2010 effected some more amendments to the IT Act to further integrate an LLP into the IT Act. The conversion of private limited company or unlisted public limited company into an LLP was facilitated by introducing Section 47(xiii) (b), by adding Section 47A (4), by inserting Section 115JAA (7).

Forms of business convertible into LLP:

Following forms of business can be converted into LLP:

Section 55 of the limited liability partnership act provides that an existing partnership firm (firm) can be converted into LLP by following the procedure laid down in the second schedule.

Section 56 of the limited liability partnership act provides that an existing private limited company registered under the companies act can convert itself into LLP by following the procedure stated in the third schedule.

Section 57 of the LLP act provides that an existing unlisted public company registered under the companies act, 1956 can convert itself into LLP by following the procedures stated in the fourth schedule.

Conversion of partnership into LLP: tax implication:

As per definition given under income tax, 1961 firm includes LLP. Therefore, conversion of firm into LLP will be conversion to itself i.e. no change (nothing happened) in the eyes of the income tax law, subject to

- Right and obligations of the partners remain the same after conversion.
- If there is no transfer of any assets or liability after conversion.

The explanatory memorandum attached to the finance (NO.2), bill, 2009, clarifies as follows:-

"As an LLP and a general partnership is being treated as equivalent in the act, the conversion from a general partnership firm to an LLP will have no tax implication if the rights and obligations of the partners remain the same after conversion and if there is no transfer of any assets or liability after conversion. If there is a violation of these conditions, the provision of section 45 shall apply."

Therefore there will be no capital gain on conversion of firm into LLP either in the hands of firm or in the hands of partners. All the provisions of the income-tax act, 1961 shall continue to apply on LLP as they would have applied on firms as if no conversion had taken place.

Conversion of private or unlisted public company into LLP: tax implications:

Initially the income tax law was silent about tax implications, on conversion of private company or unlisted public company (hereinafter referred to as company) into LLP. But later, the finance act, 2010, has inserted a new clause (xiiib) in section 47 of the income tax act, 1961 and amended certain other sections granting limited exemption from taxation on conversion of a private or unlisted public company.

New section 47 (xiiib):

New section 47 (xiiib) has been inserted w.e.f. A.Y. 2011-12 which provides that when a private or public unlisted company is converted into LLP, exemption from capital gain on such conversion will be granted. Similarly, exemption from capital gains will also be granted to a shareholder when his capital account is credited on cancellation of shares held by him on conversion of the company into LLP. There are however, certain conditions for grant of such exemption. These conditions are as under.

a) All the assets and liabilities of the company immediately before the conversion become the assets and liabilities of the LLP.

b) 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 in the company on the date of conversion.

c) The shareholders of the company do 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) 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.

e) The total sales, turnover or gross receipt in business of the company in any of the three previous years preceding the previous year in which the conversion takes place does not exceed RS 60 lakh.

f) 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.

Above mentioned six conditions are cumulative and each one of them has to be satisfied to claim exemption. The first four conditions are on the same line as provided for conversion of firm/AOP/BOI into company in section 47(xiii).

Fifth condition seems to be added to discourage the big companies to be converted into LLP.

The reason behind sixth condition is dividend distribution tax, since there is a liability to pay dividend distribution tax @ 16.995 per cent for the company on declaration/payment of dividend out of its current or accumulated profit, therefore sixth condition restricts the partners of the LLP to distribute its accumulated profit standing on the date of conversion in the accounts of the company to avoid the conversion only for saving dividend distribution tax.

However the sixth condition is redundant because what the company can do is, "issuing bonus shares to equity shareholders is not dividend as per definition given under section 2(22) and thus out of the ambit of dividend distribution tax. Therefore, if before conversion, company issues bonus shares to its equity shareholders out of its accumulated profit by capitalising its whole profit and on the next day it converts itself into LLP, then, shareholders (prospective partners) shall get their part of accumulated profit to the credit of their capital account as contribution in LLP without any tax implication which is not the intention of law."

Hence sixth condition introduced by the finance act, 2010 needs reconsideration.

Withdrawal of exemption (section 47A (4)):

New sub section 4 to section 47A has been proposed to be inserted by the finance act, 2010 so as to provide that if any of the conditions laid down in proviso to section 47(xiiib) are not complied with, in any subsequent assessment year the consequences shall be as under:

The amount of profit or gains arising from the transfer of such capital assets or intangible assets not charged under section 45 by virtue of conditions laid down in the said proviso shall be deemed to be the profits and gains chargeable to tax of the successor limited liability partnership for the previous year in which the requirements of the said provison are not complied with.

The amount of profit and gains arising from the transfer of shares not charged under section 45 by virtue of conditions laid down in the said proviso shall be deemed to be the profits and gains chargeable to tax of the shareholder of the predecessor company for the previous year in which the requirement of the said proviso are not complied with.

Mat credit shall lapse:

A new sub section 7 to section 115JAA has been proposed to be inserted by the finance act, 2010 so as to provide that, if there is a conversion of a company into LLP irrespective of the fact it satisfies the six conditions laid down in the proviso to section 47(xiiib), MAT credit available to the predecessor company shall lapse and the LLP cannot enjoy the benefit of the same.

Finance act 2011:

The amendment by the finance act, 2011 has disturbed the applecart. The amendment removes one important advantage, i.e., NO MAT, from an LLP. Prior to Finance Act, 2011, Limited Liability Partnerships were considered as very tax effective business vehicle since it was not subject to Minimum Alternate Tax, Dividend Distribution Tax and Surcharge. The introduction of Alternate Minimum Tax has dented the attractiveness of Limited Liability Partnership but not to a large extent. The amendment will take effect from the Assessment Year 2012-2013, thereby giving businessmen a leeway of one year.

Alternate minimum tax (AMT):

Apart from its inherent advantages on limited liability, perpetual succession and flexibility in operation, an LLP enjoyed immunity from corporate surcharge, dividend distribution tax and minimum alternate tax (MAT). Positive effect of the aforesaid amendment (finance act 9 &10) was beginning to be felt and businessmen were beginning to feel that an LLP would be a viable option considering tax advantages associated with an LLP.

But the amendment by the finance act, 2011 has disturbed the applecart. The amendment removes one important advantage, i.e., NO MAT, from an LLP.

The new chapter-XII-BA consisting of four sections 115JC, 115JD, 115JE and 115JF is proposed to be inserted. The chapter titled "special provisions relating to certain LLP" is proposed to be inserted with effect from 01-04-2012 so as to be applicable for the assessment year 2012-2013 onwards.

Section 115JC(1) provides for comparison between regular income tax(RIT) and alternate minimum tax (AMT) and provides that if AMT is more than RIT, adjusted total income (ATI) shall be deemed to be the total income which shall suffer tax at 18.5 per cent.

Section 115JC(2) provides for computation of ATI by adding back chapter-VIA-C deductions (section 80HH to section 80TT) and deduction claimed under section 10AA to the total income of an LLP.

Section 115JC (3) provides for obtaining an accountant's report certifying the correctness of the computation of ATI and AMT and filling the same with the department.

Section 115JD provides carry forward and set off of AMT paid in one year against RIT in another year.

However, as per section 115JD (2) the eligible credit is restricted to excess AMT over RIT (AMT-RIT).

Further as per section 115JD (5), the carry forward amount can be set off against excess of RIT over AMT (RIT-AMT).

Section 115JD (4) provides for such carry forward for ten following assessment years.

No interest is allowed on AMT credit as provided in section 115JD (3).

Section 115JD(6) provides for variation of tax credit consequent to reduction or increase of RIT or AMT as a result of any order passed under the IT act.

Section 115JE provides for application of all other provisions of the IT act to LLP liable to pay AMT.

Section 115JF defines various terms like accountant, AMT, LLP and RIT.

Justification for levy of AMT:

The memorandum explaining clauses justifies levy of AMT so as to preserve tax base vis-a-vis (in relation to) profit linked deductions. The memorandum identifies three distinct advantages of LLP on being treated as a firm, i.e. being non-liable to MAT, DDT and surcharge.

The proposed amendment with the objective of preserving the tax base vis-a-vis profit linked deduction will make an LLP no more a firm simpliciter. LLP is now placed between a firm and a company. Out of three distinct advantages associated with an LLP, only two will remain. Introduction of AMT will discourage the LLP format for those enterprises who are eligible for the chapter VI-A-C deductions as well as those in SEZ business, whether as developer or as entrepreneurs. Such enterprises may prefer to remain as conventional partnership firms. Thus, a significant segment of business may stay out of LLP option of business format.

Applicability of AMT to various LLPS:

For purpose of the chapter XII-BA, section 115JF(c) defines an LLP as having the meaning assigned to it as per section 2(1) (n) of the LLP act, 2008. As per section 2(1) (n) of the act, "LLP" means partnership formed and registered under the act. As a foreign LLP firm is not registered under the LLP act, the same cannot be regarded as an LLP for the purpose of chapter-XII-BA.

However, if such foreign LLP is a body corporate formed outside India, it may become a company under section 2(17), which defines "company" as including any body corporate incorporated by or under the laws of a country outside India. Therefore, such a foreign LLP may become a company under section 2(17) and may become a foreign company under section 2(23A). If such an LLP is having permanent establishment in India, although it may not be liable to AMT, it may be liable to pay MAT under section 115JB.

Extension of AMT to non-corporate sectors other than LLPs:

The AMT provisions are extended to non-corporate sector (these already stand extended to LLPs). The objective behind such extension as mentioned in the explanatory memorandum to the finance act, 2012 is to "widen the tax base vis-a-vis

profit linked deductions". For this purpose, "it is proposed to amend provisions regarding AMT contained in chapter XII-BA in the income-tax act to provide that a person other than a company, who has claimed deduction under any section (other than section 80P) included in chapter VI-A under the heading "C-deductions in respect of certain incomes" or under section 10AA, shall be liable to pay AMT".

Appraisal of the new provision (AMT):

The grounds given for bringing new provisions concerning AMT in the income tax act, it is said with utmost respect are, prima facie, uncalled for. No study has been done regarding the extent the tax base would be widened and in regard to the extent of revenue gain because of AMT concerning non-corporate taxpayers. It looks ironical that on one hand the coverage of tax incentive provisions (referred to as tax preference in later discussion) is being extended year-after-year and consequently revenue loss because of these is getting increased for various years and then to retrieve the loss because of these new provisions like AMT are being brought in the IT law to lessen the impact of loss of revenue because of tax preference. In this process, the income –tax act is getting long and complicated.

The government since the year 2006-07 is placing before the parliament, a tax expenditure statement which shows loss of revenue consequent to tax preferences, namely, exemption, deduction and tax subsidy benefits to preferred taxpayers. Such taxpayers are corporations, firms, association of persons (AOPs), body of individuals (BOIs) and individuals. Because of these, the effective rate of tax gets reduced.

The issue then is whether it would be more appropriate to reduce the number of tax preferences instead of finding new measures (AMT) to bring back the loss of revenue consequent to these.

3. OBJECTIVES OF THE STUDY

- To highlight a reasonable taxation regime for limited liability partnership in consonance with the best global practices.
- To analyse the tax implication regarding conversion of partnership into LLP.
- To analyse the tax implication regarding conversion of private or unlisted public company into LLP
- To study the implication of new provision (alternate minimum tax) on limited liability partnership.
- To analyse justification regarding the introduction of AMT in income tax law

4. AREAS FOR FURTHER RESEARCH

Section 115JAA (7) provides that MAT credit is not allowed to the successor LLP formed by conversion of PLC or UPLC. Even in the absence of this specific provision, the successor LLP would not have got the benefit of carry forward and set off of MAT credit by predecessor company, as the successor LLP could not have paid normal tax in excess of MAT in terms of section 115JAA(5).

As LLP is now liable to pay AMT, the need may be felt for facilitating the successor LLP to carry forward MAT credit of the predecessor company. For this purpose, it is necessary that the express prohibition of section 115JAA (7) is not only removed, but necessary amendment is also carried in section 115JAA (5).

Similarly, when an LLP is reconverted into a company, although there is no express prohibition on similar lines as section 115JAA (7) in chapter XII-BA, successor company may not be eligible to use AMT credit of predecessor LLP. The setting of section 115JD (5) does not permit such set off. Therefore, it is necessary to make appropriate amendment, to section 115JD (5) so as to enable successor company to set off AMT credit available with the predecessor LLP.[Section115JD (5), the carried forward amount can be set off against excess of RIT over AMT (RIT-AMT).]

5. CONCLUSION

As far as taxation scheme for LLP is concerned, it has been prescribed on the same lines as currently applicable for partnership firms (except for recovery purposes), and all the provisions of the income tax act applicable to firm apply to LLP also unless otherwise provided in the act. There are specific provisions in income tax act for the tax implication on conversion of private company or unlisted public company into LLP.

Limited Liability Partnerships are now subject to Alternate Minimum Tax @18.5%, in line with Minimum Alternate Tax in case of companies. However, the tax base in the case of Limited Liability Partnerships would be the Adjusted Total Income computed under Section 115JC(2) and not Book Profit as in the case of companies. Prior to Finance Act, 2011, Limited Liability Partnerships were considered as very tax effective business vehicle since it was not subject to Minimum Alternate Tax, Dividend Distribution Tax and Surcharge. The introduction of Alternate Minimum Tax has dented the attractiveness of Limited Liability Partnership but not to a large extent.

Levy of AMT on LLP takes away one of the important benefits associated with an LLP format of business. Considering that the LLP format of business organisation should be popularised to facilitate carrying on of business in a more efficient but in a much simpler manner, levy of AMT at this stage may not be appropriate.

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