LLP as a Corporate Business Vehicle

LLP PROPOSITIONS

TAXATION OF LLP

CONVERSION OF ENTITY INTO LLP

LLP

Constituent of Limited Liability Partnership

Limited Liability Partnership [LLP] as a business vehicle has been recognised worldwide. Internationally in countries like UK, France, USA, Singapore, Japan, China, Canada, Germany etc., LLP is preferred as a business medium especially for the service sector, realty sector, Joint Ventures / Special Purpose Vehicles etc.

In India, LLP, a body corporate (which is hybrid of a company and a partnership) has been introduced through Limited Liability Partnership Act, 2008 [LLP Act]. Subsequently, in respect of registration and operational aspects under the LLP Act, the Limited Liability Partnership Rules, 2009 [LLP Rules] were notified by the Government.

Due to its organisational flexibility coupled with limited liability, LLP is beneficial not just to entrepreneurs, professionals and enterprises providing services but for other propositions as well. Before delving into it further, we briefly understand the salient features of LLP.

Sr.	Incorporation Steps
1	Select Partners / Designated Partners
2	Obtain DPIN
3	Check Name Availability
4	Draft LLP Agreement
5	File Incorporation documents
6	Issue of Certificate of Registration

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SALIENT FEATURES OF LLP

- **Body Corporate** - LLP is a body corporate and a legal entity distinct from its partners and has perpetual succession. This is a distinct advantage of LLP over partnership firms since the latter do not enjoy a perpetual succession.
- **Flexible to Manage** - LLP is managed as per the LLP agreement. However, in the absence of such agreement, LLP would be governed by framework provided in Schedule I of the LLP Act.
- **Partners** - A minimum of two partners are required to form an LLP. There is no maximum limit on number of partners. An individual or a body corporate may be partner in the LLP. Partner may lend money to and transact other business with LLP. Due to this advantage of LLP, carrying on big venture with small contribution from large number of partners is possible in LLP.
- **Designated Partners** - LLP shall have atleast two individuals as designated partners and atleast one of whom shall be resident in India. The designated partner shall be responsible for all the compliances, rules and provision to be complied by the LLP.
- **Agency** - All partners shall act as the agent of the LLP but not of the other partners.
- **Contribution by Partners** - The contribution of a partner may consist of tangible, movable or immovable or intangible property or any other benefit to the LLP. However, as required for companies there is no minimum amount of contribution required.
- **Liability of Partners** - The liability of a partner is limited to the amount of the contribution. However, a partner is personally liable for his own wrongful act i.e. act which is not authorised by LLP or for fraud on his part.
- **Separate Property -** The LLP as legal entity is capable of owning its funds and other properties. The property of LLP is not the property of its partners.
- **Related party transactions -** No restriction on entering contracts with related parties.
- **Investment -** LLP can invest in shares of other Companies.
- **Compliances -** There are minimum compliance required under the LLP Act. Books of Accounts are to be maintained at the registered office for such period as may be prescribed. Statement of accounts and Solvency [SAS] are to be prepared within 6 months from end of the Financial Year [FY]. Accounts of LLP must be audited in case contribution/turnover exceeds 25 Lakh/40 Lakh in a FY. Annual Return must be filed with Registrar of Companies [ROC] within 60 days of end of the FY.
- **Raising Money -** The LLP being a regulated entity like company can attract finance.
- **Capacity to sue -** As a juristic legal person, the LLP can sue in its name and be sued by others.
- Provisions relating to transferability of Partner's interest in LLP, conversion of partnership firm, pvt. ltd. company and unlisted public companies exist. Also stipulations are laid down for Compromises, Arrangement or Reconstruction of LLP as also it's winding up and dissolution.

How popular are LLPs ?

LLP was expected to be the next popular business vehicle after the Company. However, the number of LLPs formed are not very encouraging. Some notable reasons for the same are:

- **Lack of Privacy** - Incorporation document, details of partners, accounts, SAS and annual return filed with ROC would be available for public inspection.
- **No major tax advantage** - The introduction of Alternate Minimum Tax [AMT] has dented the tax advantage of LLP.
- **Binding Act of Partners** - Any act of partner without the other partner, may bind the LLP.
- **Extended liability of Partners** - In cases of fraud etc., the liabilities of partners are extended to their personal assets. Further, for loans even banks insist personal guarantee of partners.
- **Finance constraints** - LLP cannot raise money from public. Also, banks are hesitant to provide finance to LLPs since LLPs do not provide sufficient protection as that in a company viz. Provision of filing charge, restriction on withdrawal of capital, requirement of statutory audit, restriction on related party transactions etc.

Despite the above, LLP still remains a viable medium in the long run due to its inherent flexible structure. Further, as the cost of running LLP is lower, small businesses which can be carried on with own funding can convert into LLP.

More avenues for LLP than just for entrepreneurs, professionals and the service industry

LLP is a useful medium for the below propositions:

- **Investment vehicle -** LLP may hold the shareholding of family owned companies. Further, it may be easy to plan the affairs of the LLP as it is managed as per the LLP Agreement which also outlays the rights and duties of the partners.
- **Alternate to forming a Subsidiary company -** Incase of a business conglomerate, the flagship company may form an LLP for its ancillary businesses instead of a subsidiary company. LLP shall provide operational flexibility, lesser regulations to be complied as also save on the tax cost viz. Dividend Distribution Tax [DDT], deemed dividend provisions etc.
- **Suited vehicle for businesses with potential lawsuits** - As liability for repayment of debts and lawsuits incurred by the LLP lies on it and not on the partners, it provides an added layer of protection.
- **Key Employee Benefit Enterprise** - Business houses desiring to reward key employees, may entrust associated or ancillary business to employee constituted LLP. It will ensure efficient accomplishment of work and also some extra reward for employee groups.
- **Concept Sale -** LLP is suited where the promoter is desirous of setting up a business activity and after the activity gears up, selling it off. Change of hands become possible by making modifications in the LLP document without any need for other changes in registrations etc.
- **Project Business** - In a project where diverse skill sets are required, a typical need of entrusting the whole responsibility with one person gets addressed in the LLP mechanism.
- **Civil Construction -** LLP facilitates joining in by landlord for sharing in profits without accessing project risks.

Taxability of LLP

- An LLP formed and registered under the LLP Act shall be taxed as a 'firm' under the Income-tax Act, 1961 [IT Act].
- LLP being a 'firm' would be liable to pay tax at the rate of 30% (plus EC and SHEC).
- From Assessment Year [AY] 2013-14, AMT is applicable to LLPs only if it has claimed any deduction u/s. 10AA or any section (other than section 80P) included in Chapter VI-A of IT Act
- Some tax advantages to LLP compared to a company are as under:
  - Non-applicability of Dividend Distribution Tax;
  - Non-applicability of Wealth Tax;
  - Non-applicability of Deemed dividend provisions u/s. 2(22)(e) of the IT Act;
  - LLP can claim interest upto 12% on capital and borrowings from partners subject to conditions u/s. 40(b) of the IT Act, irrespective of profit or loss during the given year;
  - Working partners of LLP are eligible for remuneration subject to conditions u/s. 40(b) of the IT Act;
  - Immunity from Capital gain tax on conversion of private companies and unlisted public companies to LLP if the conditions u/s. 47(xiiib) are complied with.

Taxability in the hands of Partner of LLP

- **Share of total income**

- Post-tax profits profits distributed amongst partners of LLP (including company) are exempt from tax u/s. 10(2A) of the IT Act. Further, in case of a company such profit is also eligible to be excluded in computation of book profit u/s. 115JB for MAT purposes.

- **Realignment of Profit sharing ratio [PSR]**

- Realignment of PSR on admission of a new partner does not amount to 'transfer' u/s. 2(47) of the IT Act for capital gain purposes. This is because during the subsistence of partnership firm, partners do not have any defined share in the assets of the partnership.

- **Introduction of Capital Assets by a Partner**

- Any capital asset brought in by a partner would be liable to tax in his hands in terms of section 45(3) of the IT Act. The amount at which such capital asset is to be credited in books is governed by Rule 23 of the LLP Rules. 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 LLP and credit of the revalued amount to the capital account of the partners does not entail to transfer u/s. 2(47) and so does not give rise to taxable capital gains. Further, such increased capital balances can be considered for calculating interest u/s. 40(b).

Conversion of Partnership Firm into LLP

Section 55 read with Schedule II provide for conversion of a partnership firm into LLP. A partnership firm can be converted into LLP:

a) if the 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) All property, assets, interests, rights, privileges, liabilities, obligations and undertaking of the general partnership firm are transferred to LLP in accordance with Schedule II.

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

Speed Breakers on conversion of a general partnership firm into LLP

Though LLP enjoys the benefits of limited liability over general partnership firm, yet one must consider the below speed breakers before deciding on conversion of a firm into LLP:

- For tax purposes, no special benefit is given to LLP compared to a Firm;
- LLP has more disclosure requirements and compliances as compared to a Firm;
- Annual Statement of accounts and Solvency and Annual Return is required to be filed with the Registrar of LLP every year;
- Cost of formation/conversion of LLP is higher;
- Heavy penalties suffered by LLP incase of delayed filings;
- More Government intervention as compared to a firm;
- Applicability of stamp duty on conversion of a Firm to LLP is prone to litigation;
- Difficult to dissolve or wind-up as compared to a partnership firm.

Conversion of private/unlisted Co. into LLP

Section 56 and 57 of the LLP Act read with Schedule III and IV provide for conversion of a private limited company and an unlisted public company respectively into LLP.

As per Schedule III and IV of the LLP Act, a private company and an unlisted public company may be converted into an LLP if the below conditions are fulfilled:

a) there is no security interest subsisting on the assets of the company at the time of application of conversion;

b) The partners of the LLP to which it converts consists of the shareholders of the company and no one else.

Further, to encourage certain companies to operate in LLP format section 47(xiiib) of the IT Act exempts the conversion subject to fulfilment of below mentioned conditions:

a) **Eligibility criteria -** Average annual total sales / turnover / gross receipts of the company does not exceed Rs. 60 lakhs in any 3 preceding previous years;

b) **Conditions at Conversion stage** -

1. All shareholders of the company before conversion become partners of the LLP and Capital/ Profit Sharing ratio in the LLP should be in same proportion as their shareholding in the company;
2. Shareholders of the company receive no consideration, other than share in contribution and PSR in LLP;
3. All Assets / Liabilities of the Company are transferred to the LLP.

c) **Conditions after Conversion -**

1. Erstwhile shareholders of the Company to retain atleast 50% PSR for 5 years from date of conversion;
2. No distribution of accumulated profits of the Company as on the date of conversion for 3 years from date of conversion.

If the above 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 condition is violated.

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

As per section 72A(6A) of the IT 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 he successor LLP if all the conditions u/s. 47(xiiib) are satisfied.

- **MAT credit u/s. 115JAA not available to successor LLP**

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

Speed breakers on conversion of a company into LLP

Though LLP enjoys the benefits of operational flexibility, lesser compliance and tax cost, yet one must consider the below speed breakers before deciding on conversion of a company into LLP:

- Raising money through public is not possible;
- Lesser creditworthiness as compared to a company;
- Heavy penalties suffered by LLP incase of delayed filings;
- Applicability of stamp duty on conversion of a Company to LLP is prone to litigation;
- No provision relating to redressal in case of oppression and mismanagement.

Conclusion:

The LLP form of business vehicle is gaining popularity as it is well addressing the issues of risk and succession for small businesses. However, Taxation of LLPs is an important issue to be considered both while forming new LLP or converting existing firms / private or unlisted companies into LLP especially in light of the conditions to be complied with over a period of 5 years.

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