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" PRACTICAL ISSUES IN TAXATION OF A PARTERSHIP WITH SPECIAL REFERENCE TO A LLP"

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Abs tract:- *A general partnership and a Limited Liability Partnership (LLP) both own separate governing laws. While a partnership firm is an unincorporated entity under the Indian Partnership Law, a LLP Firm is an incorporated entity having a separate legal existence from its partners under the Limited Liability Partnership Law As far as the Income Tax Law is concerned, it recognizes a partnership as a separate tax entity for charge of income tax on the income of the partnership firm. The Income Tax Law contains similar provisions for charge of income tax on the income of a partnership firm and a LLP. Taxable income is computed after allowing certain deductions from the profits on account of payment of remuneration and interest to its partners subject to certain conditions. However, there exist certain procedural differences in taxation of a LLP such as tax recovery procedure. Apart from this, there are certain unique tax advantages which a LLP firm enjoys over a company. These include non-applicability of certain provisions relating to dividend distribution tax, provisions relating to deemed dividends tax and so on. In view of the concept of LLP being new in India, certain issues pose challenge with regard to taxation of a LLP firm in India. This research article attempts to analyse the tax issues of a partnership with special reference to a LLP, the conversion of company into a LLP and the possible ways to tackle these tax issues.*

Keyw ords:Taxation of Partnership, LLP Taxation, Limited Liability Partnership, Conversion into LLP.

INTRODUCTION TO TAXATION OF PARTNERSHIPS:

Accordingly to the Indian Partnership Law, a partnership is the relationship between persons who have agreed to share the profits of a business carried on by all or any of them acting for all. The Income Tax Law1 in India recognizes a general partnership firm as a separate tax entity for charge of income tax on the income of the firm. A general partnership firm is eligible for deduction of payments to its partners which includes remuneration paid to its working partners based on book profits of the firm and interest paid to the partners on the amounts invested by them in the business of the firm subject to maximum specified limits. While calculating the taxable income of the individual partners, the amount of remuneration and interest so allowed as a deduction to the firm is taxable as income in the hands of the individual partners of firm.

According to the Limited Liability Partnership Act, 20082, a Limited Liability Partnership means a partnership formed and registered under this Act. The prime difference between a general partnership firm and a LLP firm is that while the former is an unincorporated entity the later is an incorporated entity having a separate legal entity distinct from its partners. As far as the income tax law is concerned a firm includes a LLP firm and there exists similar provisions for the computation of income and tax. Moreover, in case of LLP there exist certain procedural differences in some cases for example tax recovery procedures. For tax point of view there are certain unique advantages which an incorporated firm i.e. LLP enjoys over a company. These include the deduction of interest on money invested by the partners in the business of the firm known as partners capital upto 12% p.a., non-applicability of the provisions of profit or dividend distribution tax, provisions relating to deemed dividends and so on.

RESEARCH METHODOLOGY:

The present paper is based on both primary as well as secondary data collection. Regarding primary data, it has been collected from a sample survey of twenty small businesses operating under the general partnership form and LLP form of business in the State of Delhi and NCR. The primary data was collected by personal meeting with partners and key personnel of these firms with a small questionnaire to be filled by them regarding the tax issues faced by them while running business under partnership or LLP. As far as secondary data is concerned the official publications of the Government of India has been used for the sake of reliability. In view of the concept of LLP being new in India, many important issues originated from the primary data collected by us relating to taxation of a partnership and LLP in India. Secondary data has been used to find a practical solution to these tax issues.

General Tax issues in Taxation of LLPs:

Remuneration and interest payments by LLP to its partners: The remuneration paid only to working partners is allowable as a deduction subject to specified limits, so while drafting the LLP Agreement it is important to specifically name those partners as working partners who wish to look after the affairs of the LLP and claim remuneration for their services from the LLP. Interest on capital invested by the partners is allowable only upto 12% per annum and any interest beyond this percentage shall be disallowed while computing taxable income of the LLP. It is important to note here that the remuneration paid by the LLP to nominees of the company-partners is not eligible for deduction because the recipients are not partners of the LLP. Adequate contracts should be entered into for such payments so that such amounts are otherwise allowed under the income tax law as salary or fees etc.

Tax liability of partners of the LLP: The amount of remuneration which is allowed to the LLP is taxable in the hands of the individual partners as their business income. Similarly the amount of interest which is allowed to the LLP is taxable in the hand of the individual partners as their business income.

No tax on distributed profit & deemed dividend: A company liable to profit or dividend distribution tax on profit paid by the company to its shareholders. On the other hand, a LLP is not liable to such provisions. Similarly the provisions of deemed dividend are not applicable to a LLP and a LLP can freely extend loan and advances to its partners without any tax implications.

Issues relating to a minor[3] as a partner in LLP: As per the LLP Act any individual can become a partner in a LLP and there is nothing to stop a minor individual to be admitted as a partner in LLP. However there are practical difficulties for instance as per the LLP Act an incoming partner has to sign his consent to become a partner in the LLP, is a minor is admitted as a partner in LLP there is practical difficulty in signing such consent for the simple reason that a minor is not capable of entering into a valid contact.

Relief from clubbing of minor's share of profits in LLP: The share of profit received by a partner from the LLP is exempt under the Income Tax Law. In effect minor's share of profits in the LLP is not liable for clubbing in the hands of his parents.

Immunity from Wealth Tax: A[4]lthough a LLP is an incorporated entity, it is not liable to any Wealth Tax under the Wealth Tax Act, 1957.

Tax rates applicable to a LLP: A LLP is charged to tax at rates similar to that of a general partnership firm that is 30% plus Education Cess and Secondary and Higher Education Cess of 3%. No surcharge is applicable to a partnership firm or a LLP. The effective rates of tax are generally equal and even less as compared to a company because a company is also liable to surcharge where the taxable income exceeds specified limits.

Tax issues on conversion of a company into LLP:

The Income Tax Law provides exemption from capital gains on the conversion of a company other than a listed company into a Limited Liability Firm (LLP) by inserting section 47(xiiib) in the Income Tax Act, 1961. The provisions have been made effective from assessment years starting from 1st April 2011. The exemptions provided by these provisions are subjects to various conditions as imposed in these provisions, a company failing to satisfy any of the conditions shall be denied the benefits of available exemptions. The conversion should take place as per section 56 and section 57 of the Limited Liability Partnership Act, 2008 and following conditions must be satisfied on such conversion;

Pre-conversion conditions: Company is eligible to take exemption benefit only if the total sales, turnover or gross receipts in the business of the company in any of last three previous years preceding the year of conversion does not exceed 60 lakh rupees.

At-conversion conditions: (a) All the properties, assets and liabilities of the company just prior to conversion become the assets and liabilities of the LLP. (b) All the shareholders of the company just before conversion become the partners of the LLP with their capital contribution and profit sharing ratio in the LLP to be in the same proportion as their shareholding in the company at the time of conversion. (c) The shareholders of the company shall not receive any consideration or benefit in any form other than by way of share in profit and capital contribution in the LLP.

Post-conversion conditions: (a) The aggregate of the profit sharing ratio of the shareholders of the company in the LLP shall not be less than 50% at any time during the period of five years from the date of conversion. (b) Three years lock-in period for the balance of accumulated profit standing in the accounts of the company on the date of conversion and no amount is paid, either directly or indirectly, to any partner out of such balance.

If all the following conditions are satisfied, there shall not be any capital gain on conversion of the company into LLP. In effect the company shall be exempt from capital gains arising on transfer of its business to the LLP. Further the shareholders of the company shall be exempted from capital gain on transfer of their share shares in the company. Further any unabsorbed business loss or unabsorbed depreciation of the company shall be allowed to be carried forward by the LLP in the same way as the predecessor company would have allowed under the income tax law. The exemption is liable to be withdrawn if default is made by the LLP in the fulfillment of any of the post conversions conditions mentioned above. That is to say non-maintenance of aggregate of 50% profit sharing ratio upto a period of five years and lock-in period of three years for use of balance of accumulated profit of the predecessor company shall lead to charge of tax on the capital gains exempted earlier at the time of conversion in the year of default.

Tax issues in pre-conversion conditions: The pre-conversion condition or the eligibility condition itself says that the company is eligible to take exemption benefit only if the total sales, turnover or gross receipts in the business of the company in any of last three previous years preceding the year of conversion does not exceed 60 lakh rupees. "Gross receipts are the amount received from the clients for the contract and will not include the value of material supplied by the client.5" Considering the general size of business of a company restricting the eligibility to total sales, turnover or gross receipts only rupees 60 lakh is too low. This eligibility quantum must be of a reasonable amount to extend the tax benefit to more companies to be raised at least to rupees one crore commensurate with the provisions of presumptive taxation under section 44AD of the Income Tax Act, 1961 where an entity with upto rupees one crore turnover is treated as a small business entity. It is also important to understand the meaning of gross sales, turnover or gross receipts for the purpose for which reference can be made to the Guidance Note6 issued by the Institute of Chartered Accountants of India for this purpose.

Tax issues in post-conversion conditions: Shareholders here includes both the equity shareholders as well as the preference shareholders. If any of the shareholders are not certain whether they shall continue to be a partner in the new LLP in the near future, the conversion should be planned accordingly and the company may choose to buy back shares of any such shareholders before the conversion to the company. Nevertheless the transaction shall be liable to buy back tax of 20% in view of the introduction of buy back tax by the Finance Act, 2013. Further there may be cases of partners leaving the LLP for natural reasons or reasons which are beyond their control but unfortunately no recognition of such situations has been given. The balance of accumulated profits must be retained for a period of three years but there will be practical difficulties in the separate identification of such balance particularly where new partners enter the LLP and old partners leave. The non-fulfillment of post-conversion condition can also lead to denial of carry forward of unabsorbed losses and unabsorbed depreciation of the predecessor company.

MISCELLANEOUS TAX MATTERS:

Issues relating to unexpired Minimum Alternate Tax (MAT) credit: MAT credit provisions are applicable to a company but not to a LLP. So any unexpired MAT credit in the books of the company shall expire in the hands of the LLP after conversion. So it is advisable to see the merits and demerits of conversions in such cases particularly where the company is having substantial amounts of unexpired MAT credit.

Issues relating to books of accounts and tax audit: Being an incorporated entity a LLP is nevertheless under obligation to prepare books of accounts. As far as tax audit of the books is concerned it is applicable only where the turnover, gross sales or gross receipts exceed the specified limits. Tax audit is also mandatory where the capital contribution of the partners of LLP is more than the specified limits irrespective of the quantum of its business transactions.

Issues relating to return of income: In case of a LLP covered by tax audit provisions, it is required to file its return of income by the 30th September from the end of a financial year. Other LLP may file by 31st July. The return of the LLP has to be signed by a Designated Partner7 only. However in the event of inability of a designated partner to sign the return for any unavoidable reasons, a non-designated partner may also sign the return of income of the LLP.

Power of the Tax Department to recover dues of the LLP from its partners (Sec. 167C of the Income Tax Act, 1961): If any tax due from the LLP for any previous year or from any other person in respect of any income of any previous year during which such other person was a LLP cannot be recovered, every person who was a partner of the LLP at any time during the relevant previous year, shall be jointly and severally liable for the payment of such tax due. He can be granted immunity from payment of tax due if he proves that he is not liable to any gross neglect, misfeasance or breach of duty on his part in the affairs of LLP. The power is not limited to recovery of tax but it extends to all sums which may be payable under the Income Tax Act and includes penalty and interest.

CONCLUSION:

A LLP firm enjoys dual benefits of being an incorporate entity with limited liability as well as being taxed in a similar way as a general partnership firm. A large number of tax exemption benefits are also provided by the Income Tax Law on conversion of small companies into LLP design so that they can get rid of the cumbersome compliances which are applicable in case of a company design. Moreover LLP design has also thrown new area of opportunity for practicing professionals with more challenges to face in the future.

END NOTES AND REFERENCES:

1Official website of the Income Tax Department – Income Tax Act, 1961 – www.incometaxindia.gov.in
2The Gazette of India, Extraordinary Part II-Section I, New Delhi, 9th January, 2009, Ministry of Law and Justice, The Limited Liability Partnership Act, 2008.
3Minor is a person, male or female, who has not completed the age of 18 years [According to the Indian Majority Act, 1875]
4Wealth tax is a tax in respect of the net wealth as on the valuation date of individual, Hindu undivided family and company at the rate of 1% under the Indian Wealth Tax Act, 1957 in excess of specified limit of rupees 30 lakh.
5Central Board of Direct Taxes Circular No. 684 dated 10th June, 1994
6"The Guidance Note of the ICAI on Tax Audit, 2013 for calculation of gross sales, turnover or gross receipts."
7Designated partner in reference to Limited Liability Partnership means any partner designated as such pursuant to section 7 of Limited Liability Partnership Act 2008. Every limited liability partnership shall have at least two designated partners who are individuals and at least one of them shall be

a resident in India. The role of Designated Partners in case of LLP is similar to that of directors in case of a company.

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