

## LLP TAXATION

Limited Liability Partnership is becoming very popular amongst professionals especially advocates, architects, accountants and company secretaries. LLP is a good hybrid of partnership and company form of organization. Partnership form of business has unlimited liability so it seems to be very risky to bear unlimited liability. LLP removes defects of unlimited liability under partnership and rigidity of provisions as prevalent under Company Law. LLP has limited liability and perpetual succession. Incorporation of LLP in Indian legislation is being viewed as a path-breaking reform initiative to foster growth of professional services, small and medium enterprises and enables professionals and entrepreneurs to extend their operations to foreign countries, create a level playing field for both foreign and Indian firms and hence increasing their global competitiveness. But there has been some dispute on the taxation of LLPs. LLP will be taxed the same way as a partnership. The exception is that a partner of partnership firm is liable personally for income tax liability of firm. In case of LLP, all partners are jointly and severally liable for income tax liability, but a partner can escape the liability if he proves that non-recovery cannot be attributed to any gross neglect, misfeasance or breach of any duty on his part. The following discussion will through light upon the taxation part of LLPs.

### Income Tax Of LLP-

LLP incorporated in India will be assessed as if it is a partnership firm. Section 10(23) of Income Tax Act states that 'firm' shall include LLP, 'partner' shall include partner of LLP and 'partnership' shall include LLP. Share of profit of LLP at the hands of partners will be exempt [section 10(2A) of Income Tax Act]. LLPs incorporated outside India (foreign LLPs) shall be taxed as 'company'.

### Remuneration To Partners –

Remuneration paid to partners is deductible at the hands of LLP within limits prescribed under section 40(b) of Income Tax Act, if requirements of section 184 are satisfied. As per section 185 of Income Tax Act, if the requirements of section 184 are not satisfied,

firm will be assessed as firm but shall not be eligible for deduction of remuneration or interest to partner.

As per section 40(b) of Income Tax Act, maximum amount deductible in respect of remuneration to partner of LLP is as follows –

- If book profit is negative or less than Rs 1,66,667– Rs 1,50,000
- If book profit is Rs 1,66,667 or more – On first 3 lakhs 90% and on balance 60%.

The amount deductible from income of LLP will be the amount given above or amount actually debited to profit and loss account of LLP, whichever is lower. Remuneration paid/credited to partner will be allowable as deduction to LLP and it will be taxed at the hands of partner of LLP.

**Conditions for allowing deduction of remuneration –**

The conditions for allowing deduction of remuneration are as follows:

- Remuneration should be paid only to working partner
- Remuneration must be authorised by the partnership deed and should be in accordance with terms of partnership deed
- Remuneration should not pertain to period prior to partnership deed and
- Remuneration should not exceed the permissible limit.

**Book profit** means the net profit as shown in the profit and loss account for the relevant previous year, computed in accordance with chapter IV-D of Income Tax Act, as increased by the aggregate amount remuneration paid or payable to all partners of the firm, if such amount has been deducted while computing net profit of LLP [Explanation 3 to section 40(b) of Income Tax Act]

**‘Working partner’** means an individual who is actively engaged in conducting the affairs of the business or profession of the firm of which he is a partner [Explanation 4 to section 40(b) of Income Tax Act].

It should be noted that there is no requirement that he should provide full time for business of LLP. Thus, if a partner is engaged in establishing business policies of LLP, remuneration paid to him would be eligible even if does not participate in its implementation and other routine jobs.

**Requirements of LLP agreement for allowing deduction** - Remuneration must be authorised by the LLP Agreement and should be in accordance with terms of LLP agreement. As per CBDT circular No. 739 dated 25-3-1996, the LLP agreement should specify either the amount of remuneration payable to each individual working partner or lays down the manner of quantifying such remuneration. A general clause that remuneration should be as per section 40(b)(v) of Income Tax Act or that remuneration will be as mutually agreed upon partners at the end of year will not be sufficient to allow deduction of remuneration of working partner of LLP.

**Remuneration paid above limits of section 40(b) will be exempt at hands of partner of LLP** – Remuneration paid to partner over and above limits of section 40(b) will be taxed at hands of LLP but will be exempt at hands of partner. For example, if remuneration paid was Rs 3 lakhs, but actual allowable as per section 40(b) was Rs 2 lakhs, the excess Rs one lakh will be taxed at hands of LLP. However, this amount will be treated as share of profit at hand of partner and will be exempt.

**Interest To Partners** –

Interest paid to partners is deductible at the hands of LLP within limits prescribed under section 40(b) of Income Tax Act if requirements of section 184 are satisfied. As per section 185 of Income Tax Act, if the requirements of section 184 are not satisfied, firm will be assessed as firm but shall not be eligible for deduction of remuneration or interest to partner. Interest paid/credited to partner will be allowable as deduction to LLP and it will be taxed at the hands of partner of LLP.

**The conditions for allowing deduction of interest are as follows –**

- Payment of interest should be authorised by the partnership deed and should be in accordance with terms of partnership deed
- Interest should not pertain to period prior to partnership agreement and (c) Interest should not exceed 12%.

**Disallowance of interest and interest u/s 40A(2)** – As per section 40A(2) of Income Tax Act, any expenditure incurred by an assessee in respect of which payment has been

made to specified persons (relative, director of company, partner of firm, person having substantial interest in business of assessee etc.), is liable to be disallowed in computing business profit to the extent such expenditure is considered to be excessive or unreasonable, having regard to the fair market value of goods or services or facilities etc. Thus, even if payment of remuneration or interest is allowable as per section 40(b) of Income Tax Act, it can be disallowed under section 40A (2) of Income Tax Act.

**Signing Of Income Tax Return –**

Income Tax return shall be signed by designated partner of LLP. If for unavoidable reasons, the designated partner is unable to sign and verify the return, or where there is no designated partner, any partner of LLP can sign and verify income tax return [section 140(cd) of Income Tax Act].

**Income Tax Rate for LLP –**

For the Assessment Year 2010-11 (Financial Year 2009-10), income of LLP will be taxable @ 30% plus 3% education cess (total 30.9%). There is no Dividend Distribution Tax (DDT).

**Wealth Tax on LLP –**

Indian LLP will not be liable to wealth tax. Foreign LLP will be liable to wealth tax.

**NO MAT or DDT –**

Since LLP is not treated as company for income tax purposes, there will be no Dividend Distribution Tax [DDT] or Minimum Alternate tax [MAT].

**No Presumptive Taxation Scheme –**

LLP cannot avail presumptive taxation scheme under sections 44AC or 44AD of Income Tax Act.

### **Liability of Partner Towards Liability Of Income Tax Of LLP –**

All partners of LLP are jointly and severally liable for income tax liability, but a partner can escape the liability if he proves that non-recovery cannot be attributed to any gross neglect, misfeasance or breach of any duty on his part [section 167C of Income Tax Act].

### **Conversion of Partnership Firm In to LLP –**

Conversion of partnership firm to LLP will not have any tax implications if the rights and obligations of the partners remains the same and there is no transfer of any asset or liability after conversion. [Explanatory memorandum to Finance (No. 2) Bill, 2009]. However, there is no specific amendment or provision to that effect in the main Income Tax Act.

### **Conversion of Private or Unlisted Company to LLP –**

The LLP Act makes provision for conversion of private company or unlisted public company into LLP. There is no specific provision in Income Tax Act for treatment of income tax in such cases.

In CIT v. Texspin Engg (2003) 129 Taxman 1 = 44 SCL 239 = 180 CTR 497 = 263 ITR 345 (Bom HC DB), it was held that when a firm is converted into a limited company, it is not transfer by way of distribution u/s 45(4) of Income Tax Act. There is no transfer of asset as contemplated u/s 45(1) of Income Tax Act. Hence, question of capital gains tax does not arise. It was also held that depreciation for the year is allowable to the firm for the year. Section 34 of Income Tax Act does not apply as the assets are not 'sold, discarded, demolished or destroyed'.

Thus, there should be no capital gains tax if the rights and obligations of the partners remains the same and there is no transfer of any asset or liability after conversion.