What foreign direct investors should look out for when using a limited liability partnership to come to India

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The popularity of limited liability partnerships for investing in India means clarification on the tax and regulatory issues is required, believes Tirthesh Bagadia of Bagadiya & Jain

A limited liability partnership is a widely practised structure for doing business globally, mainly because it is a hybrid entity, that is, it enjoys the benefits of being a partnership firm and at the same time a corporate structure with limited liability.

And with the increase in global trade, multinationals have started exploring the opportunities of setting up an LLP in different jurisdictions. For multinationals looking to set up an LLP instead of a company in India, the main advantage is that at there is no repatriation tax on profits repatriated by an LLP in India. In the case of companies dividend distribution tax is levied at 17% (as in the Income Tax Act on the repatriable profit. Of course there are means by which double taxation can be avoided in foreign countries on such repatriated profits.

The Reserve Bank of India has recently come out with a notification, providing certain regulatory clarification about foreign direct investment (FDI) in an LLP in India. However, there are a number of cross-border taxation issues, particularly under tax treaties, which taxpayers should be aware of concerning the taxability of LLPs and their foreign partners.

Taxability of LLP under Indian income tax law and tax treaties

Section 5 of the Income Tax Act (IT Act), provides for the scope of the income that would be subject to taxation in India based on the residential status of the "person". Section 2(31) of the IT Act specifically includes "firm" within the definition of person.

Under Section 2(23) of the IT Act, the term "firm" shall have the meaning assigned to it in the Indian Partnership Act, 1932 and shall include a limited liability partnership (LLP) as defined in the LLP Act, 2008. Thus, for tax purposes in India, LLPs are on a par with a partnership firm.

And, under Section 167A of the IT Act, tax shall be charged on the total income of firm (while determining the total income, expenditure in the form of interest/remuneration to partners may be available as a deduction) at the rates specified in the Finance Act of the relevant year, that is, 30% (excluding surcharge and cess).

For Indian tax purposes an LLP is considered as an opaque entity, that is, distinct and separate from its partners.

Under Article 1 of the OECD model double taxation convention (OECD Model Convention), a tax treaty shall apply to persons who are residents of one or both the contracting states. It means the two important criteria for LLPs to have access to a tax treaty are:

- The LLP should qualify to be a " person" and
- Such LLP, that is, person, should be resident of one of the contracting states

Whether LLP would qualify as (i) person and (ii) resident of one the contracting states:

(i) Person:

The OECD model convention provides an inclusive definition of the term "person" as under:

"the term 'person' includes an individual, a company and any other body of persons".

OECD clarifications on the inclusion of a partnership under the definition of person:

The OECD commentary provides limited guidance and merely mentions that partnerships will also be considered to be 'persons' either because they fall within the definition of 'company' or, where this is not the case, because they constitute other bodies of persons.

(ii) Resident:

Under article 4 of the OECD model convention, a person who is liable to tax by reason of their domicile, residence, place of management or any other criterion of similar nature is considered to be a person resident of a contracting state.

It means the primary test is that the person should be "liable to tax" so as to be regarded as a person resident of the contracting state.

In the case of cross-border partnerships the issue as to who should be regarded as resident, and so who should get the tax treaty benefits, gets complicated as in one state the partnership may be considered as a fiscally transparent entity, that is, taxed at the partners' level, and itself not liable to tax and the other may treat it as an opaque entity, that is the partnership itself is liable to tax.

This issue gets further complicated in a triangular situation, where the partners are residents of a another jurisdiction, not the one in which the partnership is organised, due to the different tax treatments of partnership under the laws of each jurisdiction.

OECD views on application of DTAAs to tax transparent entities, that is partnerships:

The issue of applicability of tax treaties to tax transparent entities has been discussed at length by the OECD , after which the commentary to the model tax convention was revised. In this context, paragraph 8.4 of the OECD Commentary is relevant:

"8.4 Where a state disregards a partnership for tax purposes and treats it as fiscally transparent, taxing the partners on their share of the partnership income, the partnership itself is not liable to tax and may not, therefore, be considered to be a resident of that state. In such a case, since the income of partnership " flows through" to the partners under domestic laws of that State, the partners are persons who are liable to tax on that Income and are thus the appropriate persons to claim the benefits of the conventions concluded by the states of which they are residents. This latter result will be achieved even if, under the domestic laws of the state of Source, the income is attributed to a partnership which is treated as a separate taxable entity. For states which could not agree with the interpretation of this Article, it would be possible to provide for this result in a special provision which would avoid the resulting potential double taxation where the income of the partnership is differently allocated by the two states."

India's views on OECD commentary

India is not a member of OECD and has not formally endorsed the OECD approach to the taxation of partnerships and has specifically reserved its right to amend article 4 in its tax treaties to specify that its partnerships must be considered as residents of India in view of the country's legal and tax characteristics.

Article 3, relating to persons, and Article 4, to residents, of India's treaties with different countries is accordingly worded to cover this reservation. Some of the examples in this respect are as follows

- Under the India – USA treaty partnerships are specifically included under the definition of term person and in reference to partnerships, the term "resident of a contracting State" applies only to the extent that the income derived by such partnership is subject to tax in that state as the income of a resident, either in its hands or in the hands of its partners or beneficiaries.
- Under the India – Canada treaty the definition of "person" includes partnerships which are treated as taxable units under the taxation laws of a contracting state and the term "resident of a contracting state" applies to any person who is liable to tax under the laws of that state by reason of their domicile, residence, place of management or any other criterion of a similar nature.
- Under the treaties that India has signed with Netherlands, Germany, France and Mauritius the definition of "person" includes an individual, a company and any other entity which is treated as a taxable unit under the laws of the respective contracting state and the term "resident of a contracting state" applies to any person who is liable to tax under the laws of that state by reason of their domicile, residence, place of management or any other criterion of a similar nature.
- Under the India – UK treaty the definition of "person" only includes a partnership which is treated as a taxable entity under the IT Act and not any other partnership and the term "resident of a contracting state" applies to any person who is liable to tax under the laws of that state by reason of their domicile, residence, place of management or any other criterion of a similar nature.

It means that in view of India's reservation about the OECD's views on application of the DTAAs to tax transparent entities, that is, partnerships, and the way Indian treaties with other countries specifically include partnership/any other entity which is treated as a taxable unit under the tax laws of India, as a person resident of India, partnerships taxable in India should have access to DTAAs.

And, in view of the above discussion, since for tax purposes LLPs in India are considered as taxable entities in India on a par with a partnership in India, it is likely that LLPs will also be considered as resident for tax treaty purposes and consequently have access to, and benefits of, DTAAs.

Taxability of partners of LLP under IT Act vis-à-vis DTAAs

Under section 2(23) of the IT Act, a partner of an LLP is included in the definition of the term

"Partner" under the Indian Partnership Act, 1932. It means that, for tax purposes, partners (including foreign partners) of LLPs are co-terminus with partners of a partnership.

As mentioned above, a partnership/LLP is chargeable to tax in India under section 167A of the IT Act at 30%. Consequently, under section 10(2A) of the same law, a partner's share of income from a partnership/firm is exempt from tax in the hands of partner.

In the Indian context, a partner in an LLP would principally earn these sets of income:

- a share of profits in the LLP;
- interest on capital contributed by partner; and
- remuneration

A share of profits in the LLP

A partner's share, including a foreign partner's share, in the profits of an LLP is exempt in their hands under section 10(2A) of the Act as an LLP is a taxable entity under the Act and pays tax on profits earned by it.

Of late, in India, in certain high profile assessments, the tax authorities have been disallowing the section 10(2A) exemption in the hands of the partners where the income earned by an LLP is itself exempt in the hands of the LLP.

However, a recent circular by the Central Board for Direct Taxes on the taxation of firms/partners made it clear that "the entire income credited to the partners' account in the firm would be exempt from tax in the hands of the partners, even if the firm is also not chargeable to tax on account of an exemption or deduction".

Interest on capital contributed by a partner

Interest on capital contributed by an LLP to a partner up to 12% a year on a simple interest basis is taxable as "business income" under section 28(v) of the IT Act.

It is pertinent to note here that from a regulatory perspective at present there is no clarity on whether interest on capital contributed by a foreign partner is permissible under the FDI regulations for LLP. This is because external commercial borrowings (ECBs) to an LLP are not allowed and accordingly in the case of such interest payments, capital brought in by a partner may be regarded as ECBs.

Remuneration to partner

Remuneration paid by an LLP to a working partner is taxable as business income under section 28(v) of the the IT Act. It means, for Indian income tax purposes all the sets of income derived by a partner including a foreign partner from an LLP is taxable (except for share of profit) as business income of the partners.

Taxability of foreign partners of LLP under DTAAs - for different set of incomes

Share of profits in an LLP

As discussed above, a partner's share in the profits of an LLP is exempt in the partner's hands under section 10 (2A) of the IT Act. And accordingly there would be no need for a foreign partner to take recourse to tax treaty provisions as provisions of the IT Act are more beneficial to him.

Credit of taxes paid by LLP in India

The question is whether a credit for the underlying taxes that are paid by an LLP in India on total income would be available to the foreign partner in its country of residence to avoid the double taxation of the same income.

In view of the above, it is important to note the introduction to the OECD commentary:

Its harmful effects on the exchange of goods & services and movements of capital, technology and persons are so well known that it is scarcely necessary to stress the importance of removing the obstacles that double taxation presents to the development of economic relation between countries.

The guidance in the OECD Commentary also states that the tax credit should be given by the resident country where the tax treatment differs between the two countries, that is, in the present case India treats an LLP as a taxable entity while the other country where the foreign partner is a resident may treat the partners as a taxable entity, and the resident country should adopt a look-through approach for providing the tax credit.

In view of the OECD's guidance and keeping in mind the principal object behind entering into a DTAA with other country, a credit for taxes paid by an LLP in India should be available to the foreign partners whether they may be treated differently/or not treated differently for tax purposes in their country of residence.

Interest on capital contributed by partner

Tax treatment of interest on capital contributed by a partner under tax treaties is subject to the regulatory restrictions observed above - the taxability of interest to a partner under the IT Act.

Characterisation of the payment in the hands of the foreign partner – the issue is whether the payment by the LLP should be characterised as "interest" (article 11) or "dividends" (article 10) or as "business profits" (article 7). Considering the fact that an LLP is treated as a "firm" under the Act [section 2(23)], the LLP is to be characterised as a "firm" and not a "company" as defined under article 3(f) of the OECD model convention, *prima facie*, there may be an argument that the payment should not be treated as dividends under article 10 of the OECD model convention.

While the OECD definition of interest includes income from debt claims, whether or not it carries a right to participate in the debtor's profits, there are certain treaties, such as the India-Netherlands one, which exclude interest expense that carries a right to participate in the debtor's profits from the ambit of interest. Consequently, the expression, "dividends" includes income that carries a right to participate in the debtor's profits.

It is also possible to take a view that interest paid on capital contributed by a partner would not be a "debt-claim" within the ambit of "interest" as defined in article 11. This view can be supported by the Supreme Court's ruling in the case of *Munjal Sales Corporation* (298 ITR 298) where the Court agreed with the assessee's contention that a partner's capital is not a loan or borrowing in the hands of the firm.

Without prejudice to the above, when interest income is alleged to be taxed as "other income" under article 22 (that is, the residual clause) in the hands of a foreign partner, the same may not be taxable in India as in most cases article 22(1) makes it taxable only in the country of residency of the foreign partner.

And if the rationale followed under the IT Act is applied to the tax treaty and interest paid to a foreign partner on capital by an LLP is regarded as "business income" of the foreign partner, the same may still not be taxed in India under article 7 - business profits read with article 5 of the various tax treaties, unless the foreign partner has a permanent establishment (PE) in India.

Remuneration to foreign partner

The issue is whether the payment by LLP to foreign partner should be characterized as "Independent Personal Services" (Article 14) /"Dependent Personal Services"/ "Business Income".

Under the India – UK treaty income derived by an individual as a member of a partnership for professional services is specifically characterised as "Independent Personal Services". However, there are treaties which only include professional services by an individual in their independent capacity as "Independent Professional Services". Taxability of such income in India is based on either number of days the Individual is present in India or availability of fixed base in India to such individual for performance of his services.

For remuneration to be regarded as "Dependent Personnel Services", the existence of an employer – employee relationship between the payer and payee is must. However, in the case of the partners of an LLP, they are considered as owners of the LLP and consequently the payment may not be characterised as income from "Dependent Personal Services".

If the rationale followed under the IT Act is applied to the tax treaty and remuneration paid to a foreign partner is regarded as "business income" of this foreign partner, the same may still not be taxed in India under article 7 - business profits read with article 5 of the various tax treaties, unless the foreign partner has a PE in India.

The rate of withholding tax on payments to the foreign partner would depend upon the characterisation of income. For the taxability of such payments, the provisions of the IT Act or the treaty, whichever are more beneficial to the foreign partner, should be applied.

Need for clarification

There are number of issues when it comes to the cross-border taxation of LLPs and their foreign partners. However, as a number of multinationals are entering into India using the LLP structure, the tax issues and regulatory clarifications will soon see the light of the day.

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