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Characterisation of LLP for Tax and Treaty Purposes – Indian Perspective

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Characterisation of LLP for Tax and Treaty Purposes – Indian Perspective

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Partnership has been traditionally preferred as business organisation for simplicity and ease of function. While most businesses worldwide are now structured in corporate form, professional services, where personalised expertise is of essence, are, in most countries required to be rendered either by individuals or individuals who come together as partnerships. As the professional firms need to grow transnational and expand their territorial operational area as well as human strength, the feature of unlimited liability on partners for the acts of each other poses a tremendous challenge. This is sought to be addressed by creating a form of partnership, known as Limited Partnership ("LP") and Limited Liability Partnership ("LLP").

A global professional firm could have presence in several countries through partners, or associates or sometimes in a more defined form of a partnership firm. While LPs and LLPs are a preferred structure in many countries including the United States and the United Kingdom, in India only general partnership where all partners have unlimited liability is allowed.[1] Partnership is seen as a "relationship". It is not a separate legal entity and in many countries, cannot hold property in its name. As the world globalises, tricky situations arise in relation to taxation of foreign partnerships doing business with or in other countries, including in case of LPs and LLPs, which may not *per se* fall within the definition of partnership. In the Indian context, a question arises as to how such organisations would be taxed in India. India taxes its residents on their worldwide income whereas the non-residents are taxed on income sourced in India. India also has different rules for determining residence of a company and a partnership or a non-incorporated body. It would be appropriate now to turn to the residency rules applied by India and the scope of taxation under the Indian Income Tax Act, 1961 ("ITA").

I. Overview of Basis of Taxation in India

Section 5 of the ITA describes the scope of income that would be subject to taxation in India based on the residential status of the taxpayer. A resident is liable to tax in India on his worldwide income while a non-resident is liable to tax only on all *Indian sourced incomes*, which includes income received, accrued, arisen or deemed to have been received, accrued or arisen in India.[2] Business income of a non-resident *company* is subject to tax at the rate of 41 percent[3] while a domestic Indian company (and a partnership, whether domestic or non-resident) is subject to tax at the rate of 35.88 percent. A partnership is a taxable entity under the ITA. Once the partnership is taxed on its income, then, the same income is not taxed separately in the hands of the person, who is a partner in such a firm, whether his share is actually distributed or not. We now proceed to consider how LLP is likely to be characterised under the ITA: company or partnership? To examine this, we need to examine two things:

- the definition of company and partnership under the ITA
- how LP or LLP is characterised under the laws of the country where it is formed.

II. Definition of Partnership and Company Under the ITA

Section 2(23) of the ITA defines a partnership as under:

> "'firm', 'partner' and 'partnership' *have the meanings respectively assigned to them in the Indian Partnership Act, 1932* (9 of 1932); but the expression 'partner' shall also include any person who, being a minor, has been admitted to the benefits of partnership" [Emphasis supplied]

The Indian Partnership Act, 1932 ("Partnership Act") governs partnerships in India. Section 4 of the Partnership Act defines a partnership as:

> "the relation between persons who have agreed to share the profits of a business carried on by all or any of them acting for all"; "persons who have entered into partnership with one another are individually called partners and collectively called a firm".

The term "Partnership" as understood in India implies that partners are agents of each other and that each partner has the ability to bind all the other partners fully in relation to the partnership business. All the partners are jointly and severally liable for the actions of any one of the partners and their liability is unlimited. The liability also extends to their private assets. Further, Indian partnership limits the number of partners to a maximum of 20. Clearly, a LLP, being a hybrid entity is different from the partnership as understood in India. In case of LLPs a partner is not liable for professional malpractice that does not involve that partner and thus such partner's liability is limited. Whereas an Indian partnership may or may not be registered, a LLP requires registration. Thus, the term "partnership" as defined under the ITA does not readily include the concepts of LLP and LP within its meaning.

Let us now turn to the definition of company under the ITA.

Section 2(17) of the ITA defines a company as under:

> "company means –

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(i) any Indian company, or

(ii) any body corporate incorporated by or under the laws of a country outside India, *or*

(iii) any institution, association or body which is or was assessable or was assessed as a company for any assessment year under the Indian Income-tax Act, 1922 (11 of 1922), or which is or was assessable or was assessed under this Act as a company for any assessment year commencing on or before the 1st day of April, 1970, or

(iv) any institution, association or body, whether incorporated or not and whether Indian or non-Indian, which is declared by general or special order of the Board[4] to be a company:

Provided that such institution, association or body shall be deemed to be a company only for such assessment year or assessment years (whether commencing before the 1st day of April, 1971, or on or after that date) as may be specified in the declaration."

From the above definition, it appears that for the purposes of the ITA, "company" has a much *wider connotation* than the word bears under the Indian company law and includes even an unincorporated institution, association or body, whether Indian or non-Indian, which is declared by the CBDT to be a company.[5] The Indian Companies Act, 1956 defines company as follows :

"company" means a company formed and registered under this Act or an existing company as defined in clause (ii)[6]

(The language of clause (ii) is not included here as it is not relevant for the purposes of this analysis.)

Next, we examine the rules of residence of a company and a partnership or an un-incorporated body under the ITA.

A. Residency Rules for a "Company" under the ITA

Section 6(3) of the ITA lays down the residency rules with regards to a company, as follows:

"A company is said to be resident in India in any previous year, if –

(i) it is an Indian company; or

(ii) during that year, the control and management of its affairs is situated *wholly in India.*" [Emphasis supplied]

Hence, a non-resident company would be treated as tax resident of India if its control and management are situated "*wholly*" in India. Thus, if a LLP is classified as a "company" under the ITA, then, if even a fraction of the control and management is outside India, such LLP would be regarded as non-resident for Indian tax purposes. Accordingly, it would be liable to Indian taxes only on its Indian source income.

B. Residency Rules for a "Partnership" under the ITA

Section 6(4) of the ITA lays down the residency rules with regards to a partnership entity, as follows:

"Every other person is said to be resident in India in any previous year in every case, except where during that year the control and management of his affairs is situated *wholly outside India*." [Emphasis supplied]

As per the above, a partnership (whether domestic or non-resident) would not be treated as tax resident of India if its control and management is situated wholly "*outside*" India.

Thus, if a foreign LLP were classified as a "partnership" under the ITA, then if even a *fraction* of the control and management is *in* India, the foreign LLP would be regarded as a resident for Indian tax purposes. In such a situation, the foreign LLP should be liable to Indian taxes on its worldwide income.

III. Characterisation of LP or LLP Under the Laws Where They Are Organised

It is evident that for the purposes of determining taxability of a foreign LP or LLP in India, it would be necessary to determine how it is characterised for tax purposes in India. For this we would need to examine what is the nature of the LLPs and LPs in the country where they are organised. It is a well-established principle under private international law, that a corporation created in one country is to be recognised as a corporation in any other part of the world.[7] We now examine this in further detail with reference to U.K. LLP and U.S. LLP in the following paragraphs.

A. Characterisation of a U.K. LLP

Some of the key features of a LLP under the Limited Liability Partnerships Act 2000 (LLP Act) in the U.K., are as follows:

- Section 1 (2), clearly states that a LLP is a body corporate (with legal personality separate from that of its members);
- Section 2, specifically provides for the incorporation of a LLP. A LLP has to be registered with the Registrar of Companies and a certificate of incorporation is issued as proof of this fact;[8]
- Every member of a LLP is the agent of the LLP.

Accordingly, under the domestic law of U.K., the LLP is regarded a body corporate. For the purposes of the ITA in India, the U.K. LLP may be regarded as a company since it is "incorporated by or under the laws of a country outside India". If this were the case, then a U.K. LLP would be resident in India only if its management and control are wholly situated in India. Thus, even when a few of its partners are located or present in India, it cannot be regarded as resident in India.

B. Characterisation of a U.S. LLP

While in case of the U.K., the LLP Act clearly states that LLP is a body corporate, the U.S. laws do not seem to use the term "body corporate". Hence for determining the meaning of this term, one would need to draw upon the definitions contained in various dictionaries, the reference to the character and nature of the LP and LLP in the respective legislation in the U.S. and characterisation of similar entities made in other jurisdictions.

The Black's Law Dictionary, 6th Edition, (1998 reprint) defines the term "body corporate" as

"A public or private corporation".

The Black's Law Dictionary, 6th Edition, (1998 reprint) defines the term "corporation" as follows:

"An artificial person or legal entity created by or under the authority of the laws of a state. An association of persons created by statute as a legal entity. The law treats the corporation itself as a person, which can sue and be sued. The corporation is distinct from the individuals who comprise it (shareholder). The corporation survives the death of its investors, as the shares can usually be transferred. Such

entity subsists as a body politic under a special denomination, which is regarded in law as having a personality and existence distinct from that of its several members, and which is, by the same authority, vested with the capacity of continuous succession, irrespective of changes in its membership, either in perpetuity or for a limited term of years, and of acting as a unit or single individual in matters relating to the common purpose of the association within the scope of the powers and authorities conferred upon such bodies by law."

The following essential characteristics of a "body corporate" emerge from the above definitions:

1. It should be an artificial person or legal entity created by or under the authority of the laws of a state;
2. It should have an existence distinct from the individuals who comprise it;
3. It should be capable of suing and being sued in its own name;
4. It should survive the death of its investors;
5. It should have the capacity of continuous succession, irrespective of changes in its membership, either in perpetuity or for a limited term of years.

The Uniform Partnership Act ("UPA"), regulates LLPs in the U.S. Various states then adopt this UPA with their state specific provisions incorporated therein. In case of the UPA in the state of Delaware, there are various references which need consideration to ascertain if a Delaware LLP satisfies the above listed characteristics of a body corporate. The following are the extracts of some of the relevant provisions of the UPA:

- Section 15-201 of the UPA explains the status of a partnership as:
  - "a partnership is a *separate legal entity* which is an entity *distinct from its partners* unless otherwise provided in a statement of partnership existence and in a partnership agreement" and that "a limited liability partnership continues to be the same entity that existed before the filing of a statement of qualification". [Emphasis supplied]
- Section 15-203 of the UPA lays down the provisions regarding holding of partnership property, as:
  - "unless otherwise provided in a statement of partnership existence and in a partnership agreement, *property acquired by a partnership is property of the partnership and not of the partners individually*". [Emphasis supplied]
- Section 15-306 of the UPA lays down the provisions regarding partner's liability as:
  - "an obligation of a partnership incurred while the partnership is a limited liability partnership, whether arising in contract, tort or otherwise, *is solely the obligation of the partnership*. A partner is not personally liable, directly or indirectly, by way of indemnification, contribution, assessment or otherwise, for such an obligation solely by reason of being or so acting as a partner". [Emphasis supplied]

It can be seen that a Delaware LLP does have many characteristics of a body corporate. There are other states in the U.S. which have similar laws but they do not seem to clearly stipulate the position as to whether a LLP is a body corporate.

C. Characterisation of LLPs in Other Countries

The Canada Customs and Revenue Agency ("CCRA"), in Interpretation Bulletin IT-343R, has issued its view on the meaning of "corporation", particularly as defined in paragraph 95 of the Canadian Income Tax Act, which deals with foreign affiliates. Paragraph 2 of IT-343R, dated September 26, 1977 states:

"A corporation possesses *its own capacity to acquire rights and to assume liabilities*, and any rights acquired or liabilities assumed by it are *not the rights or liabilities* of those who control or own it. As long as an entity has such separate identity and existence, the Department will consider such entity to be a corporation, even though under some circumstances or for some purposes, the law may ignore some facet of its separate existence or identity."

The CCRA has been asked on many occasions for an opinion on whether a particular foreign entity is a corporation and has consistently ruled in the affirmative. IT-343R contains a list of 23 entities that the CCRA has considered to be corporations, including:

- a Liechtenstein foundation;
- a U.S. (Tennessee) limited liability company;
- a Chilean LLC;
- a Russian joint stock company;
- a Kazakhstan LLP.[9]

However, it has not specifically ruled on a U.S. LLP. It is evident that there is a lack of clarity as to the legal characterisation of LPs and LLPS in the U.S.. However, it has been clarified by all the state legislations that such partnerships would be treated as transparent entities for tax purposes in the U.S. and though in some cases the LLP or LP would need to file a return showing the income, tax would be levied on each of the partners and collected from each of the partners and that there would not be any entity level income tax.

It appears that as far as U.S. LLPs are concerned, they may not be viewed as partnerships as defined under the ITA (see the definition of partnership under the ITA above). Further, these entities may also not be regarded as company under the ITA unless they are treated as foreign body corporate and thus fall within the definition of "company" under the ITA. In such situations, it may be relevant to consider if the Central Board of Direct Taxes[10] ("CBDT") would declare such LLP to be a company in India.

The definition of a company, as reproduced above, was introduced by the Finance Act, 1971, with effect from April 1, 1971. This definition was explained by the CBDT vide Circular no. 72 dated January 6, 1972, the relevant extract is reproduced hereunder:

"this power to declare any association to be a "company" for tax purposes has been made use of for several years past with a view to conferring the status of a 'company' on foreign companies *as also on entities which are not otherwise within the scope of that concept*. Such declaration is given by the Board, ordinarily, in the case of any *entity which possesses the ordinary characteristics of a company limited by shares and which is a legal person according to the laws of country in which it is incorporated."* [Emphasis supplied]

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Thus, the CBDT would accord the status of "company to a U.S. LLP, if the above conditions are fulfilled

IV. Applicability of Tax Treaty to LLPs

Under the ITA, in respect of a taxpayer from a country with which India has signed a double tax avoidance agreement ("tax treaty"), the provisions of ITA apply only to the extent they are more beneficial to the tax payer. In other words, the non-resident has the option of being taxed under the provisions of the ITA or the tax treaty, whichever are more beneficial. However, it is important to note that generally the tax treaties provide that the tax treaty applies only to 'persons' who are 'residents' of either India or the other country. Thus it is important to examine as to whether the LP or the LLP would be eligible to claim the benefits available under the applicable tax treaty. We now examine the situation in case of India-U.K. and India-U.S. tax treaties in case of U.K. LLP and U.S. LLPs. Before examining the treaty provision, let us consider the position of the OECD in respect of the treatment of a partnership for treaty purposes.

A. OECD's Position in Relation to Partnership

The OECD[11] has done some work on this issue and in the official commentary[12] to the OECD Model Convention on Article 4, in para 8.4 it specifically states that where a particular country 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 country.

B. Application of India-U.K. Treaty to U.K. LLP

The India-U.K. treaty would apply to "persons" resident of one or both the countries. A person is defined under India-U.K. treaty to include an individual, a *company* and any other entity which is treated as a taxable unit under the taxation laws in force in the respective countries. It does not include partnership, except for an Indian partnership, which is treated as a taxable unit under the ITA. This indicates that a U.K. general partnership is outside the purview of the applicability of the India-U.K. tax treaty. But is a U.K. LLP in the same position as general partnership? In order to consider this, let us examine the definition of company under this tax treaty. A company, under this treaty is defined to mean:

- "any body corporate" or
- any other entity which is treated as a company or body corporate for tax purposes.

As we have already discussed earlier in this article, a U.K. LLP is characterised as "body corporate" under the LLP Act of the U.K. Accordingly, even though the U.K. LLP is fiscally transparent for income tax purposes in the U.K., it would seem that a U.K. LLP should be regarded as a "person" since it is stated to be a "body corporate" under the LLP Act. It would seem that the specific language of the India-U.K. tax treaty overrides the OECD's position as stated above.

However, to determine whether such a "person" is eligible to the tax treaty benefit, it would be necessary to examine if the LLP is also a "resident" of the U.K. within the meaning of this term under the India-U.K. tax treaty. Article 4 (1) of the treaty defines "resident of a Contracting State" to mean any person who, under the laws of that State is liable to taxation therein by reason of his domicile, residence, place of management or any other criterion of a similar nature. Not only does the U.K. LLP have to be a *person*, but it should also be *liable to tax* in the U.K. under its domestic laws. Inland Revenue Tax Bulletin – in its Issue 50 – clarifies that LLPs are in law regarded as "bodies corporate" and will be subject to aspects of company law, but for tax they will generally be treated as "partnerships". It further states that section 10 of the LLP Act ensures that where a LLP carries on a "business with a view of profit" the members will be treated for the purposes of income tax, corporation tax and capital gains tax as if they were partners carrying on business in partnership. That is to say, the LLP will be regarded as transparent for tax purposes and each member will be assessed to tax on their share of the LLP's income or gains.

It appears from the above, that a U.K. LLP may not satisfy the definition of "resident" under the India-U.K. tax treaty.

C. Application of India-U.S. Treaty to U.S. LLP

The India-U.S. tax treaty applies to persons resident of one or both the countries. A person is defined under India-U.S. tax treaty to include an individual, an estate, a trust, a partnership, a company, any other body of persons, or other taxable entity. It specifically includes "partnership" within the definition of "person" under the tax treaty.

However, for the treaty to apply to a LLP or LP, it would be necessary to examine whether it is also a resident of the U.S. Para (1) of Article 4 of the treaty defines the term "resident" to mean

> "any person who, under the laws of that State is liable to tax therein by reason of his domicile, residence, citisenship, place of management, place of incorporation, or any other criterion of a similar nature, provided however that
>
> (a).....
>
> (b) in the case of income derived or paid by a partnership, estate, or trust, this term applies only to the extent that the income derived by such partnership, estate etc. 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.

It would appear that a U.S. partnership and LP or LLP, though a person, would be considered resident for the purposes of the India-U.S. treaty only to the extent that the income derived by it in the U.S. is subject to tax in the U.S. as the income of a resident in its hands or in the hands of its partners. In other words, if there is any partner of the LP or LLP, whose income is *not* subject to tax in the U.S. as income of resident in the U.S., then, to that extent, the LP or the LLP would not be considered to be resident of the U.S. for the purposes of this treaty. This tax treaty may only apply to a U.S. LP or LLP to the extent that the partners of the LP or LLP are subject to tax in the U.S. as residents of U.S., unless the LP or LLP fall within the definition of "person" by virtue of being a "company". In this treaty, company is defined to mean:

- "any body corporate; or
- any entity which is treated as a company or body corporate for tax purposes".

As already discussed above, the U.S. laws are unclear as to whether a LP or LLP is a "body corporate" in so far as they do not specifically say so, as in case of the U.K. LLP Act. Further, the tax laws applicable to LLPs and LPs indicate that these entities are treated as fiscally transparent for tax purposes. This

means that it will be the partners who are subjected to tax on their income and not the LP or the LLP. Accordingly, LPs and LLPs fail the test of being "entity which is treated as company or body corporate for tax purposes". A U.S. LP or LLP's eligibility to tax treaty could well be limited to the extent the partners in the LP or LLP are subject to tax in the U.S. on their income from the LP or LLP.

V. Taxability in India of LP or LLP

From the discussion under India-U.K. Treaty for LLP, we have seen that a U.K. LLP should be regarded as "company" within the definition of company under section 2(17)(ii) of the ITA, since it is a body corporate under the U.K. LLP Act. It follows that a U.K. LLP should be resident in India only if the control and management of the U.K. LLP is wholly situated in India. We have seen that under the India-U.K. tax treaty, such LLP may not be eligible to the treaty provisions. If the treaty benefit is denied, the U.K. LLP would be simply a non-resident in India to whom treaty provisions do not apply. In such a situation, its taxability would be determined under the provisions of the ITA as they apply to a foreign company. If the U.K. LLP has a source of income in India, then, it would be taxed on that income as per the nature of its income. Business income would be taxed in India if it has a business connection[13] in India.

In one case, the Mumbai Bench of the Income Tax Appellate Tribunal ("ITAT"), considered the taxability of a U.K. partnership in India. The ITAT in this case did not consider the issue of applicability of tax treaty, nor did it consider whether the U.K. partnership was resident in India. However, it is relevant to discuss this case here to appreciate how Article 15 of the India-U.K. tax treaty is sought to be applied to a U.K. partnership in India. The services rendered by the U.K. partnership were professional services and the taxability in India was considered under Article 15, for independent personal services. The question was: were the U.K. professionals by themselves or in their capacity as members of the partnership, present in India for more than 90 days? The ITAT concluded that for computing the number of days' presence in India, it was not necessary that the partner himself had to be present. The presence of an associate of the firm constituted the presence of a "member" of the firm. Accordingly, the income attributable to the services provided by the members who were present in India was considered taxable in India.

As regards a U.S. LLP, in absence of the use of the expression "body corporate", it remains important to analyse each state specific LLP law to determine the true character of that entity. Hence, it is likely that LLPs organised in some states, which have the characteristics of a "body corporate" may be characterised as a "company" under section 2(17)(ii) of the ITA. In that case, such U.S. LLP would be non-resident in India if its control and management were not wholly situated in India. In that case, only the income sourced in India would be subject to tax in India. If the characteristics of a particular LLP fail to satisfy the criteria of a foreign "body corporate", so that the LLP falls within the definition of partnership or "association of persons"[14] in India, then, such LLP could become resident in India if any part of management or control of such a LLP is situated in India. In that event, its worldwide income could be subjected to tax in India.

The next question to address for a LLP which is engaged in rendering professional services is, how would Article 15 be applied to it? Under Article 15, the U.S. LLP, which is a person under the tax treaty, would be taxable in India if it had a fixed base available to it in India or if the stay of this person in India was for more than 90 days. The question once again is, whose presence in India would be considered for this purpose? Would it be the presence of the partner or any member of the LLP, who is rendering professional services as defined under Article 15?

Professional firms also render consultancy services, which may not fall within the definition of professional services under the relevant tax treaty. In that case, they could be regarded as receiving other income or business income. Which Article would apply in such a situation, would it be Article 7 or Article 15 (or 14 in certain tax treaties)?

VI. Conclusion

While in case of a U.K. LLP, the issue of characterisation of the entity is clearer due to the clear legal position stated in the U.K. LLP Act, a lot needs to be done in case of LPs and LLPs in other jurisdictions. There also needs to be clarity in terms of treatment of partnerships in general. In view of the fact that globalisation would see more professional firms organised either as partnership, LP or LLP which would render services in India, there is an earnest need to have clarity as to the characterisation of these entities both for treaty purposes and domestic law purposes. India is also considering enacting LP and LLP laws. It would go a long way in giving impetus to the globalisation process for Indian enterprises if the respective competent authorities would exchange protocol so as to bring certainty to this aspect.

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1 There is a move by the Central Government to bring about legislation for Limited Liability Partnership for which, a report has been submitted by the Naresh Chandra Committee to the Government.

2 Section 5(2) of the ITA.

3 Unless mentioned otherwise, all the rates in this memorandum are inclusive of the currently applicable surcharge at the rate of 2.5 percent.

4 "Board" refers to the Central Board of Direct Taxes ("CBDT"), the apex tax administering body in India.

5 N.A. and B.A. Palkhivala, *The Law and Practice of Income Tax*, 55 (7th Ed.).

6 Section 3(1)(i) of the Indian Companies Act, 1956.

7 Dicey and Morris, '*The Conflict of Laws*', 13th Edition Vol II, Pg 1105. It further states that the law of the country where the entity is created will determine the legal nature of the entity itself, *i.e.*, as to whether it is a corporation or a partnership.

8 Section 2 and 3 of the LLP Act.

9 "*Canadian Finance Minister Releases Proposed Non resident Trust Rules*", Jack Bernstein, Aird & Berlis LLP, Tax Notes International, November 24, 2003, 701.

10 The apex tax administering body in India.

11 Organisation of Economic Co-operation and Development.

12 Volume I, updated as of April 29, 2000.

13 Business connection is a term similar to PE under a tax treaty, but with much wider scope than a PE.

14 "Association of persons" is another taxable entity which comes into existence where persons come together for sharing the profits of a business carried on by them.

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