LLP Structures for Multinationals having Captive / Development Centers in India -Operating on a Cost Plus Basis: Analysis & Benefits

Recently, the Department of Industrial Policy and Promotion made various amendments to the existing consolidated FDI Policy Circular (“**Amendments**”).[1] One of the key reforms relates to foreign investment in Limited Liability Partnerships (“**LLPs**”).

In light of the Amendments, eligible foreign investments in LLPs would be allowed under the automatic route (i.e., without approval) and downstream investment (without approval) by such LLPs in a company or LLP operating in sectors in which foreign investment can be made in a LLP, would also be permissible.

This is particularly important in the context of multinationals having subsidiaries in India acting as captive / development centers specifically operating in the technology, IT services, BPO sector etc. In light of transfer pricing regulations, most of such captives/ centers are remunerated by their parent / group companies on a cost plus basis. As a result, over a period of time, significant cash could get accumulated at the Indian level and repatriation of such income is always challenging in light of limitations under corporate law and tax inefficiency(ies).

Given such limitations, the Amendments pave way for multinationals to structure their Indian operations using LLPs, which could be more efficient on multiple fronts, especially for repatriation of cash / capital in a tax efficient manner.

In this memorandum, we have analyzed changes pertaining to FDI in LLPs along with highlighting the benefits of using an LLP structure particularly in the context of Indian companies operating on a cost plus basis.

LLPs in India – Reforms

LLPs, introduced in 2008, are hybrid entities with advantages of a company (especially, separate legal entity status and limited liability of stakeholders) and operational flexibilities of a partnership. However, the key limitation was that FDI in LLPs was subject to prior governmental approval and downstream investments by LLPs (with FDI) was not permissible.

In light of the Amendments, FDI in LLPS (up to 100%) has now become permissible under the automatic route (i.e., without approval) in sectors/activities where 100% FDI is allowed and where there are no FDI-linked performance conditions. Further, downstream investment (without approval) by such LLPs in a company or another LLP operating in sectors in which foreign investment can be

1. Please note that the said analysis are based on Amendments made through a recent press note dipp.nic.in/English/acts_rules/Press_Notes/pn12_2015.pdf. However, fine print of the actual amendments (to the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 (“**TISPRO**”), which governs FDI in India) are still awaited.

made, would also be allowed. Consequently, conditions applicable in case of downstream investments by companies have accordingly been extended to downstream investments by LLPs.

Key Considerations

Based on the Amendments, some of the vital considerations for using LLP structures especially for Indian companies operating on a cost plus basis are as follows:

I. Tax Efficiency [2]

The profits of an Indian company are subject to corporate tax at 30% and thereafter an additional dividend distribution tax ("**DDT**") at 15% is levied on a grossed up basis at the time of distribution of dividends. Additionally, there is a surcharge and educational cess on such DDT taking the total cost of dividend distribution in India to around 20%. DDT is a tax levied on the company and not the shareholder and therefore, claiming treaty reliefs / benefits may be open to challenges.

In case of a LLP, its profits are taxed at the same corporate tax rate of 30%. However, distribution of profits to partners of the LLP is specifically exempt from tax and hence, there is no tax (equivalent to DDT) in India when the LLP distributes profits to its partners.

This becomes very crucial in comparison with taxation of companies, and more so in situations where Indian companies have accumulated significant cash as a result of operating on a cost plus basis. The cost plus mark-up may range between 10% – 20% (if not higher), hence cash keeps getting accumulated at an India level.

Thus, by using suitable LLPs structures, profits can be efficiently distributed to overseas parent.

II. Repatriation of Capital

In case of a company, the common ways of repatriating capital are share buy-backs or capital reduction.

In case of buy-back, there are certain statutory thresholds on the quantum of buy back (up to a maximum of 25%) along with conditions regarding the buy-back.[3] Further, distributions made on a buy-back are taxable at 20% on the quantum of gains arising to the shareholders from such buy-back and such tax is levied on the company and not the shareholder. Therefore claiming of treaty reliefs / benefits may be open to challenges.

In the event of a capital reduction, there are no statutory thresholds nor is there any buy back equivalent tax on the distributions made. However, capital reduction is a court process and hence may prove to be time consuming.

In a LLP, repatriation of capital contribution is permissible without any statutory thresholds.[4] Further, there is no buy back equivalent tax on the distributions made hence the gains made by a partner on such repatriation would be taxable only in the hands of the partner. Therefore, in the event of capital

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2. All tax rates mentioned in this memo are exclusive of surcharge and cess (unless specified otherwise).
3. In the event the buy-back of shares is from a foreign company, the applicable pricing guidelines and reporting requirements would need to be adhered
4. In the event repatriation of capital is to a foreign partner, applicable pricing guidelines and reporting requirements would need to be adhered.

contribution received by an overseas partner, it may be possible for such overseas partner to claim relief under an applicable tax treaty.

Thus, by using suitable LLPs structures, repatriation of capital contribution may become simpler and more tax efficient.

III. Conversion of Company into a LLP

Existing corporate laws allow the flexibility for a private company to convert itself into a LLP provided: (i) there are no security interests in the assets subsisting or in force at the time of applying for conversion; (ii) all the shareholders of the company (and no one else) become partners in the LLP; (iii) upon conversion, all properties, assets, interests, rights, privileges, liabilities, obligations relating to the company and the entire undertaking of the company would vest in the LLP. However, conversion of a company (with FDI) into a LLP was subject to prior government approval. The Amendments have removed the need for such government approval.

Further, such conversion would be exempt from income tax in the hands of the company and its shareholder, if: (i) total sales / turnover / gross receipts of the company's business in any of the 3 financial years prior to conversion did not exceed INR 6 million (about USD 100,000), (ii) accumulated profits of the company prior to conversion are not distributed to the partners of the LLP up to 3 years post conversion; and (iii) certain other conditions are fulfilled.[5]

Therefore, the said exemption may not be available if the operations of the company are sizeable or if the company intends to distribute profits immediately after conversion.

Relaxation on the need for government approval (for conversion) is a welcome and encouraging step for incentivizing existing foreign owned captives / subsidiaries to convert into LLPS.

IV. Special Economic Zones

Most captives / development centers have units registered under Special Economic Zones ("**SEZ**") to avail of various benefits, particularly tax incentives (subject to fulfillment of the prescribed conditions).

Since the law governing SEZs was enacted before the statutory introduction of LLPs, the SEZ Act[6] does not specifically refer to LLP as an entity which can be used for setting up units in a SEZ.

However, the type of entities covered under the SEZ Act includes firms, association of persons / body of individuals (whether incorporated or not) and therefore LLPs may also be eligible for setting up units in SEZs (and accordingly avail the prescribed benefits). Further, since LLPs are also regulated entities (and recognized under law), there appears to be no reason why such LLPs should not be entitled for availing SEZ benefits.

Although, availing SEZ benefits for companies converting into a LLP would need to be closely examined in lieu of the existing rules prescribed under the SEZ Act along with the practices followed by SEZs in each state.

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5. These conditions are:
   a. capital contribution and profit-sharing ratio of partners in the LLP is in the same proportion as shareholding in the company;
   b. the shareholders do not receive any consideration for conversion, except share in profit / capital contribution in the LLP; and
   c. minimum of 50% partnership interest in the LLP is retained by the shareholders of the company up to 5 years post conversion.
6. Special Economic Zone Act, 2005

In the context of subsidiaries of foreign technology companies, this would be an important consideration for using LLP structures and availing associated SEZ benefits.

V. Corporate Instruments

In case of a company, different classes of equity shares and hybrid instruments like preference shares (compulsorily convertible to equity), debentures (compulsorily convertible to equity), etc. can be issued to foreign investors / shareholders. Further, a company is also allowed to avail external commercial borrowings (“**ECB**”), subject to conditions prescribed.

In case of LLPs, there is flexibility to determine the capital contribution of partners, profit-sharing ratio of partners and the rights of partners with respect to the control and management of the LLP (through the LLP agreement), though issuance of hybrid instruments is not envisaged. However, the Amendments have removed the restriction on LLPs to avail ECBs (which was earlier restricted).

Although, issuance of hybrid instruments may not be possible in a LLP, the relaxation on ECB borrowings provides more flexibility in using LLP structures.

Conclusion

Since their introduction in 2008, LLPs have been looked upon as an attractive vehicle for undertaking business. Although LLPs with foreign investment were few as enabling provisions relating to foreign investment in LLPs was introduced only last year along with prior approval requirements.

However, with the introduction of these reforms which now allow foreign investment in LLPs under the automatic route (without approval), LLPs structures amongst multinationals are likely to increase, particularly, in light of the advantages as outlined in this memorandum. Moreover, it would also be encouraging to see the usage of such structures especially in businesses which operate on a cost-plus basis.

Hope you find the above useful.

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