

## **DISCUSSION PAPER**

### **SUBJECT: FOREIGN DIRECT INVESTMENT IN LIMITED LIABILITY PARTNERSHIPS**

1.1 The Department of Industrial Policy and Promotion has decided to release Discussion Papers on various aspects related to FDI. In the series of these Discussion Papers, this is the fifth paper on 'Foreign Direct Investment in Limited Liability Partnerships'. Views and suggestions are invited on the gamut of issues raised in the enclosed discussion paper, particularly on Paragraph 6.0: *'Issues for consideration'* by October 31, 2010. It is requested that, to the extent possible, facts, figures and empirical evidence may be furnished, in the context of the specific observations/suggestions made.

1.2 The views expressed in this discussion paper should not be construed as the views of the Government. The Department hopes to generate informed discussion on the subject, so as to enable the Government to take an appropriate policy decision at an appropriate time.

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### **SUBJECT: FOREIGN DIRECT INVESTMENT IN LIMITED LIABILITY PARTNERSHIPS**

#### **1.0 INTRODUCTION**

1.1. The Limited Liability Partnership Act, 2008 (LLP Act) was notified on April 1, 2009. With the passing of this Act, a new hybrid entity, incorporating the features of both- a body corporate, as well as a traditional partnership-can be formed for the purposes of undertaking business in India. The LLP has not yet been recognized under FDI policy. The LLP structure lies between that of a company where FDI is permitted and that of a partnership, where it is generally not permitted. Key features of an LLP, as well as a comparison between the other existing ownership structures, are provided in the Annexure.

#### **2.0 LIKELY USERS OF THE LLP STRUCTURE**

2.1 The LLP model is attractive to professional sectors for its lower compliance costs, greater flexibility in operations, better control over management and limited liability. Many professionals in India, such as advocates/lawyers, chartered accountants and doctors are precluded from practicing through companies. The LLP structure would be particularly advantageous for providing such professional services.<sup>1</sup> As is the practice outside India, LLPs could prove very useful for certain professionals who are unable to use the corporate structure and who do not find the partnership structure viable.

2.2 Further, allowing FDI in entrepreneurial projects carried out through the LLP model would encourage small entrepreneurs in India to explore business ventures with foreign investment/collaboration. Other than professionals and small entrepreneurs, the LLP structure may also be preferred by small businesses. Additionally, foreign entities having project offices in India could consider reducing risk by using the LLP structure. Further, any structure where different members want to control different segments and also bear full responsibility for their acts, could conveniently use the LLP structure. This includes infrastructure project SPVs where different partners bring in different expertise into the project.

2.3 The report of the Naresh Chandra Committee, on regulation of private companies and partnerships (1997), had suggested that "*the LLP form should initially be made*

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<sup>1</sup> Professional services are those where unique functions are performed by independent contractors or consultants, whose occupation is the rendering of such services. Such service providers would include accountants, brokerage firms, business consultants, business development managers, engineers, law firms, software engineers and web designers. Such services may be delivered through a host of structures, including partnerships, firms and corporations, in addition to delivery by individuals holding professional licenses.

*available only to those providing defined professional services like lawyers, company secretaries, accountants as these professions are already governed by regulations that adequately controls and disciplines errant professional conduct".* The committee report suggested that LLPs may be extended, at a later stage, to other services and business activities, once the experience gained with this form of organization has been evaluated and tested. However, taking into consideration representations from various industries, the LLP Act has not restricted the use of LLPs only to professional services. All activities are permissible.

### **3.0 INTERNATIONAL EXPERIENCE**

3.1 Such hybrid entities are prevalent across the globe. They are commonly used by Private Equity/Venture Capital Funds and professionals. In countries like the United States (some states), Canada, Germany, Poland and China, LLPs can be formed only by professional service providers.

3.2 In the United States of America, the concept of LLP originated in 1991, through the Texas Statute. It is now adopted by almost every state in the US. Other 'hybrid' entities include Limited Partnerships and Limited Liability Companies. In the United Kingdom, LLPs are governed by the LLP Act, 2000. LLPs are treated as incorporated entities for legal purposes. In Singapore, LLPs are governed by the LLP Act, 2005, which is similar to the UK legislation. The Indian LLP Act is similar to the UK and Singapore LLP statutes, though it is unique in its tax treatment.

### **4.0 COMPARISON BETWEEN LLPs, COMPANIES AND PARTNERSHIPS:**

4.1 The incorporation process for LLPs is identical to that of incorporation of companies. LLPs are required to submit constitutive documents, details of profit or loss sharing ratio, rights of partners *vis-à-vis* other partners and *vis-à-vis* the LLP, details of designated partners etc. In case of any change in the above, the LLP is mandated to submit information relating to such changes. Given this, it may be argued that LLPs are subject to same level of regulation as are companies. However, in case of certain specified transactions, the Companies Act requires a company to seek specific approval (either of the Board or of shareholders), through either an ordinary or a special resolution etc. No such requirements, however, appear to have been mandated under the LLP Act.

4.2 Further, the Government has reserved the right to make any of the provisions of the Companies Act, 1956, applicable to LLPs by notification (*section 67 of the LLP Act*). Certain protections have also been carved out, whereby the Central Government would be able to take appropriate action against LLPs if there are circumstances suggesting fraud, unlawful purpose or oppression of some partners (*section 43 of the LLP Act*).

4.3 In contrast, some of the provisions of the LLP Act are similar to the law applicable to partnerships. Upon incorporation of the LLP, the partners would be required to enter into a partnership agreement in writing, which would be filed with

the ROC. The mutual rights and duties of the partners of the LLP *inter se* and that of the LLP and its partners, would be governed by the LLP agreement. In the absence of such an agreement, the mutual rights and duties would be determined in the manner set out in the LLP Act.

4.4 Unlike most other countries, LLPs in India do not have pass-through status, as regards taxation. The LLP entity itself is a taxable entity and the income of the LLP is not taxed in the hands of the individual partners. Partners would, therefore, be unable to benefit from tax-structuring of profit distribution. However, the LLP structure still offers certain tax advantages, as, unlike companies, LLPs are currently not subject to certain corporate taxes, such as dividend distribution tax, minimum alternate tax or presumptive taxation.

4.5 Certain features in the LLP structure however could be seen as inhibitors to business. Whereas shareholders of a company have no liability towards the company, partners of an LLP are liable for their own wrongful and fraudulent acts. Also, LLPs cannot raise capital from the market.

## **5.0 ISSUES RELATED TO INDUCTION OF FDI IN LLPs:**

5.1 Under the present Foreign Direct Investment ('FDI') policy, foreign investment in Indian Companies is permitted under: (i) the automatic route and (ii) the approval route (with prior approval of the Foreign Investment Promotion Board ('FIPB')), depending on the sector in which FDI is being inducted. The Foreign Exchange Management (Investment in Firm or Proprietary Concern in India) Regulations, 2000 ('FEMA 24') provide that, persons resident outside India are not permitted to invest in firms and proprietary concerns, unless otherwise approved by the Reserve Bank of India ('RBI'). There are, currently, no specific provisions addressing LLPs. In the context of prescribing a regime for FDI in LLPs, five issues have been identified for analysis, which are discussed below.

### **5.2 OWNERSHIP**

5.2.1 The issue of 'ownership' is relevant because FDI policy prescribes caps on the level of FDI and prohibits foreign ownership in specified sectors. FDI Policy lays down procedures for determining the level of foreign 'ownership' and 'control' in a corporate entity. Under this, a foreign investor 'owns' an Indian company, if he/she owns more than 50% of the share capital of the company. Such an approach may, however, not be applicable to an LLP, as the LLP Act provides flexibility for partners to decide the manner in which they wish to contribute to the capital of the LLP, extract profits, participate in voting and limit their liability. Every partner of a LLP has two rights attached to the partnership interest – one being an 'ownership' right and the other being the right of 'management & control'. The "ownership right" provides the partner with a right to share in the profits/ losses of the LLP. The "right of management & control" allows a partner to participate in the management of the LLP and also provides for the right to vote. However, any transfer of the rights of a partner to a share in the profits and losses of the LLP, does not, by itself, affect the

right of management and control. There appears to be no requirement for an individual/ body corporate, enjoying economic benefits, to be a legal partner in an LLP. Such flexibility in the LLP Act can result in a variety of formulations being available to partners/ LLP . It may, thus, be challenging to set norms for ascertaining ownership & control of a LLP.

5.2.2 One suggestion is that foreign ownership could be determined with reference to the profit sharing percentages, i.e. right to the share of profits of the LLP. This is akin to determining the beneficial interest in shareholding in companies by rights over dividends. Another view is that, ownership, in the context of LLPs, could be determined in accordance with the capital sharing percentage of the foreign investors. Here, the analogue in companies is determining ownership on the basis of equity contribution, regardless of whether the shares issued to foreign investors are with or without the right to vote or dividend. The latter view has been opposed on the ground that partners' capital could be in different proportions, as compared to their profit or loss sharing ratios, for variety of reasons. These could include differences in the time of entry, differences in the withdrawal pattern etc. It is, thus, argued that the latter approach is relevant only in case of distribution on liquidation of a LLP and should not be used for determining ownership.

### **5.3 VALUATION**

5.3.1. The LLP Act states that every contribution to the capital of the LLP shall have a monetary value, determined by a chartered accountant. However, no valuation guidelines have been prescribed as yet. One approach could be adopting, similar to companies, a discounted free cash flow method for valuations in LLPs. Such valuations could take into account various factors, including the extent of contribution in the partnership capital, the share in profits, the extent of voting rights in the partnership, the extent of liability sharing and the share in proceeds on liquidation of the partnership.

5.3.2 This requires that adequate disclosure requirements, with respect to transactions in LLPs, may need to be introduced. RBI has prescribed valuation guidelines governing the acquisition and sale of shares by a foreign investor in an unlisted Indian company. It needs to be considered as to what extent these guidelines could be applied to LLPs.

### **5.4 CONTROL**

5.4.1 For companies, FDI policy defines 'control' as the ability to appoint the majority of the Board of Directors. As an LLP does not have a Board of Directors, alternative formulations have to be sought. An LLP is managed by one or more of its members (described as 'Designated Partners' in the LLP Act), as provided in the LLP's deed. The Designated Partners are appointed collectively by the members of the LLP, by casting votes in accordance with the LLP deed. Thus, the Designated Partners appointed to manage the affairs of the LLP, could be equated to the Board of Directors of a company. The extent of voting interest that a member may have, in

terms of his ability to appoint a Designated Partner, could determine the extent of control exercised on the LLP by such a member. This would, possibly, be specified in the LLP deed.

5.4.2 Thus, for the purpose of the FDI Policy, one option could be to consider the voting rights of a foreign investor in a LLP, for determining whether the LLP is controlled by a foreign investor or by a domestic investor. The structure in the case of LLPs is similar to that of companies, which are permitted to have different classes of shares, with differential voting rights. Whether the different classes of shares should individually, or in the aggregate, be considered to determine 'control', also needs resolution.

5.4.3. However, it must be recognised that the LLP Act does not prescribe the manner of management of the LLP. It leaves it to the discretion of the partners to agree upon specific aspects related to powers of the partners, voting rights, meeting of partners and other matters incidentals thereto. It is, thus, possible, to confer the management decisions / control of a LLP on a few identified partners, including non residents, irrespective of their ownership holding. Further, as the law also delinks economic and legal ownership i.e. a partner in a LLP can transfer his economic interest without transferring his share in the LLP-ascertainment of 'control' of an LLP can be extremely challenging. It can, thus, be argued that interpreting 'control' as the right to take majority decisions, may not be relevant in the context of LLPs.

5.4.4 The LLP Act itself has no provision which can provide a benchmark for the determination of control in LLPs. It provides freedom to the partners to decide the manner in which management decisions will be taken. It is possible that decision making is divided in the LLP amongst committees or governing councils having partners from different fields of expertise, instead of a single body of partners taking decisions uniformly. Although this could be an efficient method for decision making, it is not possible to determine the partners who take the majority management decisions of the LLP. Although the LLP Act suggests that the decisions of the LLP shall be taken by a majority (in the absence of a specific agreement), there do not appear to be guidelines within either-the LLP Act, or the LLP rules-on how to determine the majority in making key decisions.

5.4.5 The LLP Act provides that every LLP shall have at least two designated partners who are individuals and at least one of them shall be a 'person resident in India'. The designated partners are responsible for ensuring effective compliance with the provisions of LLP Act and liable for all penalties imposed on LLP for any contravention. Under the LLP Act, the term 'person resident in India' means a person who has stayed in India for a period not less than 182 days during the immediately preceding one year. By this definition, it is possible to appoint foreign residents (who have stayed in India for more than 182 days in the preceding one year), as designated partners.

## **5.5 TREATMENT OF DOWNSTREAM INVESTMENTS**

5.5.1 As per the FDI Policy for companies, all downstream investments by an investing or investing-cum-operating company, which is owned or controlled by non-resident entities, are to be considered as indirect foreign investment. The issue is whether LLPs should be similarly treated.

## **5.6 TREATMENT OF NON-CASH CONTRIBUTIONS**

5.6.1 Under Clause 32 of the LLP Act, “a contribution of a partner may consist of tangible, movable or immovable or intangible property or benefit to the LLP, including money, promissory notes, other agreements to contribute cash or property and contracts for services or to be performed”. This effectively means that a partner may contribute in a LLP “other than for cash”. However, as per the existing FDI policy, issue of shares for consideration other than cash requires prior FIPB approval. Discussion Paper No 4 raises various issues relating to issue of shares for non cash considerations in the case of companies. Whether the final decision on this subject taken for companies should apply *mutatis mutandis* to LLPs is an issue that needs resolution.

## **6.0 ISSUES FOR CONSIDERATION:**

*a) Should FDI be permitted in LLPs at all? Can it be argued that given its limited attractiveness for large investments, allowing FDI in LLPs will not significantly accelerate FDI into the country while disproportionately increasing the regulatory burden? Does the present uncertainty on how this business model will proceed, as well its yet unestablished case law, magnify these concerns?*

*b) What should be the definition of ‘person resident in India’? The definition provided in the LLP Act or the definition provided in FEMA?*

*c) Given the complexity of some of the issues raised in Section 5, would it be preferable to adopt a calibrated approach to the induction of FDI in LLPs? Initially, should FDI in LLPs be restricted to sectors without caps, conditionalities or entry route restrictions? Should FDI be allowed upto 100% in these sectors or should there necessarily be an Indian partner? Should such approval be confined to the government route?*

*d) Should LLPs be mandated not to make downstream investments and should foreign owned or controlled Indian companies be barred from investing downstream in LLPs? Should investment by FII/FVCI or ECBs be prohibited for LLPs?*

*e) Following the Foreign Exchange Management ( Investment in Firm or Proprietary Concern in India ) Regulations 2000, should it be mandated that foreign participation in the capital structure of LLPs should be on a percentage basis, received only by way of cash consideration by inward remittances through normal banking channels, or by debit to the NRE/FCNR account of the person concerned maintained by an authorised dealer? Should it also be mandated that*

*foreign investments in LLPs engaged in agricultural/plantation activity or real estate are prohibited?*

*e) Should FDI policy treat LLPs akin to companies? In such a case, how should the issues relating to ownership, valuation, control, downstream investment and non-cash contributions, raised in Section 5 above, be addressed? Should this be only through the government route?*

*f) Will treating LLPs akin to companies under FDI policy demand the stipulation of certain features of the LLP agreement? Should this include unambiguous specification of profit /loss sharing percentage; clear specification of the power to appoint Designated Partners; congruence of legal and economic ownership; timely notification of changes including conversion from and to companies/partnerships? Should it be mandated that LLPs cannot have corporate bodies other than companies registered under the companies Act as partners? Is inclusion and coverage of such issues in FDI policy warranted? Would the consequent increase in the regulatory burden be justifiable?*

*g) What additional regulatory safeguards are required to enfold LLPs into FDI policy? Are amendments to any existing regulations required? Should the responsibility for periodic monitoring of compliance with FDI stipulations be allotted to a particular agency?*

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**ANNEXURE****COMPARISON BETWEEN A PRIVATE LIMITED COMPANY / PUBLIC LIMITED COMPANY / LLP / PARTNERSHIP CONCERN**

<b>CRITERIA</b>	<b>PRIVATE LIMITED COMPANY</b>	<b>PUBLIC LIMITED COMPANY</b>	<b>LIMITED LIABILITY PARTNERSHIP</b>	<b>PARTNERSHIP CONCERN</b>
<b>REGISTRATION , MEMBERSHIP AND CHARTER DOCUMENTS</b>				
<b>Applicable Law</b>	Companies Act, 1956	Companies Act, 1956	LLP Act 2008	Partnership Act, 1908
<b>Mandatory registration</b>	Yes, with Registrar of Companies	Yes, with Registrar of Companies	Yes, with Registrar of Companies	Optional
<b>Charter Documents</b>	Memorandum and Article of Association	Memorandum and Articles of Association	LLP Agreement	Partnership Agreement
<b>Charter Documents needs to be filed with regulator</b>	Yes, with Registrar of Companies	Yes, with Registrar of Companies	Yes, with Registrar of Companies	Optional
<b>Identification number</b>	Company Identification number granted by ROC	Company Identification number granted by ROC	LLP Identification number granted by ROC	Optional. Partnership registration granted only to registered Partnerships
<b>Minimum Paid-up Capital</b>	Rupees 100,000	Rupees 500,000	Not specified	Not specified
<b>Number of members</b>	Minimum - 2 Maximum - 50	Minimum - 7 Maximum - No Limit	Minimum - 2 Maximum - No Limit	Minimum – 2 Maximum - 20
<b>Identity of Partners / directors</b>	Mandatory, needs to obtain Director Identification Number	Mandatory, needs to obtain Director Identification Number	Mandatory, needs to obtain Designated Partner Identification Number	Not required
<b>Liability of</b>	Limited	Limited	Limited	Unlimited

<b>Partners / members</b>				
<b>Legal Entity</b>	Yes , can sue or be sued in the name of Company	Yes , can sue or be sued in the name of Company	Yes , can sue or be sued in the name of LLP	No, only Partners can sue or be sued.
<b>Perpetual Succession</b>	Yes	Yes	Yes	No.
<b>COMPLIANCE</b>				
<b>Prior approval of Name</b>	Mandatory. Name should be in accordance with the Companies Act	Mandatory. Name should be in accordance with the Companies Act	Mandatory. Name should be in accordance with the LLP Act	Not required.
<b>Board meetings</b>	Mandatory, at least four in every year.	Mandatory, at least four in every year.	Depends upon the procedure prescribed in the LLP Agreement.	Depends upon the procedure prescribed in the Partnership Agreement.
<b>Shareholders meeting</b>	Mandatory	Mandatory	Not applicable	Not applicable
<b>Preparation of Minute Books</b>	Mandatory	Mandatory	Depends upon the procedure prescribed in the LLP Agreement.	Depends upon the procedure prescribed in the LLP Agreement.
<b>Appointment of Auditors</b>	Mandatory	Mandatory	Mandatory	Mandatory
<b>Maintenance of other statutory registers</b>	Mandatory	Mandatory	Not Applicable	Not Applicable
<b>Maintenance of Books of accounts</b>	Mandatory	Mandatory	Mandatory	Mandatory
<b>Filing of Annual return and Balance sheet with the statutory</b>	Mandatory with ROC	Mandatory with ROC	Mandatory with ROC	Not required

<b>authority</b>				
<b>Invitation to the public to subscribe for any Shares or debentures of the Company</b>	Restricted	Possible	Restricted	Restricted
<b>Listing on stock exchange</b>	Restricted	Possible	Restricted	Restricted
<b>Issue of shares / interest other than cash</b>	Not Possible except sweat equity	Not Possible except sweat equity / ESOP	Possible	Possible
<b>Merger/ amalgamation</b>	Possible	Possible	Possible	Not possible
<b>ACCOUNTING AND TAXATION</b>				
<b>Obtaining PAN /TAN</b>	Mandatory	Mandatory	Mandatory	Mandatory
<b>Audit requirement</b>	Mandatory	Mandatory	Mandatory	Mandatory
<b>Filing of ITR</b>	Mandatory	Mandatory	Mandatory	Mandatory
<b>Accounting Standards</b>	Applicable	Applicable	Not yet issued	Not applicable
<b>Tax Rate</b>	33.21%	33.21%	30.90%	30.90%
<b>MAT</b>	19.93%	19.93%	NA	NA
<b>DDT</b>	16.61%	16.61%	NA	NA

**Other Provisions Relating to LLPs:**

1. The Registrar of Companies (ROC) has powers under section 36 to inspect documents (such as incorporation documents, details of partners, statements of Accounts, returns etc) of LLP
2. The ROC has powers under Section 37 to levy penalties for submission of false statements
3. The ROC has powers under Section 38 to obtain any such information from the LLP as it considers necessary for the purposes of the LLP Act
4. Central Government has powers under Section 39 to compound the offences of LLP Act
5. The Tribunal has powers under Section 41 to direct the LLP and its partners to make good any default under the LLP Act.

6. The Central Government has powers under Section 43 to appoint competent persons to investigate the affairs of the LLP. There is a detailed investigation procedure laid down under the LLP Act.
7. Section 79(2) prescribes 39 items whereby the Central Government has powers to make rules for a LLP.
8. As per Rule 8 of the LLP Rules, all LLPs are compulsorily required to get their accounts audited by a Chartered Accountant. However, compulsory audit of accounts is not required when the turnover in any financial year does not exceed 40 lakhs or the contribution does not exceed 25 lakhs.
9. As per section 34(2) of the LLP Act, every year on or before six months from the end of the financial year, each LLP is required to file a Statement of Accounts and Solvency in Form signed by Designated Partners.
10. As per section 35(1) of the LLP Act, every LLP is required to file an Annual Return with the Registrar in Form 11, within sixty days from the end of the financial year.