LLP AND SME
FORMATION, PROSPECTS AND PROBLEMS

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ABSTRACT

This article highlighted the concept of Limited Liability Partnership (LLP), Legislation; Formation of LLP based SMEs and its problem and prospects. It also stress the need for LLP based Small and Medium Enterprises sector for the growth of Indian business. It also draw attention to the benefits of forming LLP based SME and its present trend. This article also highlighted the steps needed to overcome the hurdles and the taxation aspects of LLP based SMEs. The future scenario and some of the recent policy reforms related to LLP based SME formation in India are also underlined.

KEYWORDS:

INTRODUCTION

In India, firms and business organization have been governed and regulated by several laws and statutory bodies. Organizations are of several forms right from proprietorship, partnership firms, limited liability form of firms, public limited and so forth. Each form has its own limitations, advantages and disadvantages during their course of their operations. The firms take of different forms based on their financial soundness, managerial capabilities, and professionalism.

MEANING OF LIMITED LIABILITY PARTNERSHIP

Limited Liability Partnership entities, the world wide recognized form of business organization has now been introduced in India by way of Limited Liability Partnership Act, 2008. A Limited Liability Partnership, popularly known as LLP combines the advantages of both the Company and Partnership into a single form of organization.

In an LLP one partner is not responsible or liable for another partner's misconduct or negligence; this is an important difference from that of an unlimited partnership. However, unlike corporate shareholders, the partners have the right to manage the business directly. An LLP also limits the personal liability of a partner for the errors, omissions, incompetence, or negligence of the LLP’s employees or other agents.

LLP has a separate legal entity, liable to the full extent of its assets; the liability of the partners would be limited to their agreed contribution in the LLP. Further, no partner would be liable on account of the independent or un-authorized actions of other partners, thus allowing individual partners to be shielded from joint liability created by another partner’s wrongful business decisions or misconduct.

Limited Liability Partnership is generally managed by Designated Partners, who are responsible for managing the day to day affairs and ensuring the compliances of all applicable laws. The SME sector largely works through the regular partnership or proprietorship structures, wherein the partners and sole proprietor, as the case may be, are personally liable for all liabilities of the business vehicle.

FORMATION OF LLP IN INDIAN LEGISLATIVE HISTORY
1957: Suggestion to introduce LLP legislation rejected by 7th Law Commission on Partnership Act, 1932. The suggestion was made by the iron, steel and hardware merchants’ chamber at that time. The ground for seeking the creation of such business organisation was that the Companies Act had become cumbersome for private companies, with directors and shareholder interests protection clauses, company secretary being compulsory, etc. It was rejected inter alia on the basis that the whole purpose of the recent Companies Act amendment would fail if this proposal was accepted.

1997: Abid Hussain Committee on Small Scale Industries recommended introduction of LLPs in India

2003: Naresh Chandra Committee Report (Regulation of Private Companies and Partnerships) highlighted the grave need to introduce LLPs in India – suggested application of LLPs to service industry. It is pertinent to note that the intent was not to extend to all forms of trade as the form of the private company existed for all forms of trade. The recommendation was that LLPs should be permitted in phase 1 only for professional firms, such as chartered accountants, architects, lawyers, doctors, cost accountants, etc.

2005: JJ Irani Expert Committee on Company Law recommended introduction of LLPs - suggested that small enterprises should be included in the scope of LLPs and there should be a separate LLP Act. They viewed that this could provide flexibility to small enterprises to form joint ventures and enter into agreements that enable them to access technology.


2007: 2006 LLP Bill referred to Parliamentary Standing Committee (PSC) which was headed by Mr. Ananth Kumar for examination.


May 1, 2008: Union Cabinet gave its approval to introduction of a new bill (2008 LLP Bill) replacing the 2006 LLP Bill.


October 24, 2008: LLP Bill 2008 passed by the Rajya Sabha.
December 13 2008: LLP Bill 2008 passed by the Lok Sabha.

January 7, 2009: President’s assent given to the LLP Bill 2008.

January 9, 2009: LLP Act 2008 published in the official gazette (YET TO BE NOTIFIED FOR IT).

IMPORTANT OF LLP THE GROWTH IN INDIA

The Limited Liability Partnership Bill, 2008 (LLP Bill), which was passed by the Lok Sabha on December 12 2008, should provide adequate breathing space to small and medium enterprises, which till date have not been able to avail of the benefits of a corporate structure. Some of the essential features of LLP Bill are- There is no upper limit on the maximum number of partners. Any individual/body corporate and a foreign LLP can become a partner in an SME that has adopted a LLP structure and can invest in it as well.

Small retailers, bullion traders, jewellery retailers among others will all be benefited by adopting LLP as they now have an option to convert the family-owned partnerships into a corporate-like structure. This new Act would also benefit the services sector and professionals like chartered accountants, company secretaries, lawyers will have an option to organize themselves as LLPs. This may require modifications in the parent acts which govern such professionals.

Not only does the legislation provide benefits of corporate structure, it does away with the limitations and problems of proprietorship and the regular partnership structure. Limited liability partnership is a concept akin to both partnership and a corporate firm. In layman term,” it is a partnership with a limited liability”. However, the rules related to it are still under consideration. The LLP legislation and the rules related to it would be governing the entities registered under the Act.
PROCESS TO START LLP

1. Acquire DPIN AcquireDSC
2. Register DPIN, DSC with LLP
3. Check Name Availability
4. Download LLP Form
5. File Electronically
6. Track Status
7. Receive Certificate After
8. LLP Ready to Function
CONVERSION INTO LLP

Convert Partnership into Limited Liability Partnership

Deciding the Partners & Designated for Forming

Obtaining the Designated Partner Identification Number (DPIN) & Digital Signature Certificate

Checking Name Availability for LLP

Drafting of LLP Agreement

Filing of Incorporation Document

Filing of Conversion Application

Certificate of Registration

Information for Conversion to the Registrar of Firms

LLP & SME

The SME sector plays a vital role in the growth of the country. It contributes almost 40% of the gross industrial value added in the Indian economy. It has been estimated that a
million Rs. of investment in fixed assets in the small scale sector produces 4.62 million worth of goods or services with an approximate value addition of ten percentage points.

By its less capital intensive and high labour absorption nature, SME sector has made significant contributions to employment generation and also to rural industrialization. This sector is ideally suited to build on the strengths of our traditional skills and knowledge, by infusion of technologies, capital and innovative marketing practices.

While small and medium companies have been given special protection under the Industrial Policy of 1948, wherein banks and financial institutions are required to give loans (lesser in amount) to the sector on a priority basis, it has been difficult for them to raise funds. However, by forming an LLP, it might become easier for SMEs to get loans as security creation will get easier. This is because a LLP would be a separate entity altogether than the partners who constitute it.

The Small and Medium Enterprises (SMEs) have been globally recognized as a priority sector for growth and development and India is not an exception to this generality. In India, the Micro, Small and Medium Enterprises (MSMEs) contribute over 45% of the country's industrial production and around 40% of the total exports. Thirteen million MSMEs in India employ over 31 million people. This sector with a total size of US$140 billion (approx. Rs. 5, 60,000 crores) is the driving force for the long term growth of the Indian economy.

The balanced regional distribution of growth along with development of local skill and resources are added advantage of SMEs which are pivotal in grassroots development, social progress and combating poverty. Transforming MSMEs into world class entities has been the theme of Fifth India Global Summit on MSMEs 2008. MSMEs unhesitantly play a vital role and in fact they are the backbone of the Indian economy and prudence suggests that the backbone not only be protected but Strengthened too on a perennial basis.

**RECENT DEVELOPMENTS**

The Government introduced the revised Limited Liability Partnership (LLP) Bill, 2008, in Rajya Sabha, with the aim of providing a new flexible business model for entrepreneurs and professionals engaged in trade, professional services and technology-based enterprises. The much-awaited draft legislation replaces the LLP Bill of 2006.
A good model to consider is that in the UK where the LLPs would allow for investment in risk and venture capital (as equity) from institutional sources where the liability of the investor would be limited to the extent of its investment.

The proposed LLP Act would constitute a body corporate with a legal personality, bound by an agreement between the partners at the time of incorporation or conversion from any of the existing forms of business organisation, such as sole-proprietorship, partnership, private limited and unincorporated public companies. The exception for conversion would be the incorporated public companies.

It permits entry and exit of partners, provided the registrar concerned is informed. This spells a change from the present partnership act. It, of course, binds the existing partner of the agreed share of liabilities up to a specified period with the liabilities of LLP devolving on him after the exit.

The profits/losses of the LLP pass through the business and are reported on each partner’s personal tax returns. Such provisions enable partner’s exit easily with the commitment fixed for the twelve-month period of his stay. Creditors’ rights at the time of winding up would be enforceable in the same way as for partnerships, with the exception that the proceedings could be only against the LLP and individual partnerships are liable severally—not jointly as in the present partnership act.

**SCOPE FOR LLP IN SMES**

Limited Liability Partnership as a new form of business organisation for SMEs has been recommended way back since 1972 (Bhat Committee) right until 2000 (SP Gupta Committee) in response to the longstanding demand of SMEs. However, when the concept was eventually considered, the Naresh Chandra Committee on Corporate Governance favoured the services sector, such as chartered accountants, lawyer firms, etc on this front.

The DCSSI (Development Commissioner, Small-Scale Industries) has pushed for coverage of SMEs under the Act at the right time. The document said, “A Limited Partnership Act will be introduced to enhance the supply of risk capital to the small-scale sector. Such an Act would limit the financial liability of the new and non-active partners/entrepreneurs to the capital invested”.

The DCSSI has argued that the flow of equity capital in the SME sector would require creation of LLPs, since the last SSI Census showed that only about 2.16% are constituted as companies, 80% are proprietary concerns and 16.8% as partnership firms. Most SSIs depend on loan capital, which is scarce and untimely, despite government directives to the contrary. This new business form of LLP for India assumes importance in that context.

The ministry of MSME had taken a view that in the light of introduction of Micro Small & Medium Enterprises Development (MSMED) Act and LLP Act, the 24% ceiling for equity investment by industrial undertakings, whether foreign or domestic, in the SME sector, would be done away with. This would pave the way for the SME sector to bring in fresh foreign investment in the form of equity holding. It would also give an incentive to the ministry of MSME to liberalise foreign investment in the SME sector.

The government should modify FDI policy, exchange control laws and other relevant laws to make LLPs eligible investment entity for foreign investment as most of SMEs would now obtain for a LLP status. Hence, there is a need that LLP should now be recognized as an eligible invested wherein foreign investment.

Small and medium enterprises (SME) — the largest job creators in the country accounting for 9% of the GDP — can look forward to greater access to credit by the end of the year. The ministry of corporate affairs will remove certain ambiguities in the limited liability partnership (LLP) Bill to ensure that besides entities in the services sector, firms in the manufacturing sector too can get converted to LLPs.

The facility to get converted to LLPs, together with a set of corporate governance norms soon to be introduced for SMEs, are set to give SMEs a legal form and governance culture well appreciated by banks.

The manufacturing sector is now dominated by SMEs most of which are registered as partnerships and not as a company due to the high compliance cost. Once the bill is passed, they could get converted to LLPs, a new business structure which has an internal governance system that financial institutions and banks would like to see in them, experts tracking the sector said.
Now, 95% of industrial units in the country are SMEs and about 40% of value addition in the manufacturing sector takes place in the segment. Over 90% of SMEs are registered as proprietorships, about 2% to 3% as partnerships and less than 2% as companies as per a survey conducted by the ministry of small-scale industries.

The National Foundation for Corporate Governance, an initiative of the ministry and the industry, is now evolving corporate governance norms for SMEs.

**PROBLEMS IN FORMING LLP BASED SMES**

The new Act provides for two or more persons coming together to set up an enterprise through an priory agreement on what they would like to do, how they should do their business, on profit sharing, and on separating in case of a difference of opinion. These provisions are a big boon to SMEs as they provide for the entry of new investors and restrict the liabilities of the founding partners.

The Act, however, falls short of addressing the basic need of the small manufacturing enterprise sector, namely, access to risk capital. If there is a specific provision to the effect that the LLPs can raise capital through initial public offerings, joint ventures with foreign firms, pension funds and venture capital funds, Indian SMEs have a sure chance of becoming globally competitive.

They are already in the transformation mode. This is seen in their silence to the drop in the reserved items list, interest in the cluster initiative, and their qualitative scaling up of exports by enhancing capacities in health, safety and environment standards. They talk of market access, trade facilitation, intellectual property right protection, innovation, R&D and global participation. But, for all these, capital continues to pose a challenge.

It is, therefore, time that the LLP Act should not only apply to SMEs but also provide for their access to capital markets. Sebi should open a new window of regulation and the stock markets should work on facilitating the new breed of small entrepreneurs. Differential transaction tax on bourses could help accelerate the process, once the Act itself provides for their entry appropriately. SMEs’ hopes still seem to hang in balance for entry into stock exchanges.

Global competition is the name of the game today. Across countries, across regions there is a drive to enhance competitiveness. Competitiveness of nations, industry
sectors and individual units. The pressure of competition is being felt with increasing intensity as the world opens up to trade and commerce in the post WTO regime. No where is the impact being felt as hard and as harsh as the SMEs sector.

SME Sector plays a major role in India's present export performance. 45%- 50% of the Indian Exports is contributed by SSI Sector. Direct exports from the SSI Sector account for nearly 35% of total exports. Besides direct exports, it is estimated that small-scale industrial units contribute around 15% to exports indirectly. This takes place through merchant exporters, trading houses and export houses. They may also be in the form of export orders from large units or the production of parts and components for use for finished exportable goods.

It would surprise many to know that non-traditional products account for more than 95% of the SSI exports. The exports from SSI sector have been clocking excellent growth rates in this decade. It has been mostly fuelled by the performance of garments, leather and gems and jewellery units from this sector. The product groups where the SSI sector dominates in exports are sports goods, readymade garments, woollen garments and knitwear, plastic products, processed food and leather products.

Further, in job work situations, the input service tax paid by the principal becomes a cost to them in the absence of any output excise duty/service tax liabilities, while the job worker is required to pay excise duty on the final selling price of the principal. Apart from issues such as timely & adequate availability of finance/credit, technological innovation, trained manpower, the key challenges, are to ensure the 12 % rate of growth in real terms and enhance its contribution to the national GDP.

**STEPS NEEDED TO OVERCOME THE PROBLEM**

Perhaps key steps needed to overcome these include ensuring of an enabling policy environment for such sustained, high growth rate. Promote measures to accelerate the opening–up of SME sector to the globalize (WTO) environment changing role of the states in the development of a National policy for the Small industry and to integrate economic development of the Indian Small industry with the global economy in a truly multilateral trade regime.

Largely, the SMEs operate as job workers catering to the needs of Original Equipment Manufacturers (OEMs) and therefore, the current prohibition to claim SSI exemption on production of branded goods may be removed. The job workers also face a challenge in
terms of valuation of their goods, since excise duty is currently being levied on the principals’ selling price. Besides, extension of excise exemption to the job workers supplying to SME who in-turn are producing exempted goods may result in cost-competitiveness for the SMEs.

CII too has been proactive with the Ministry of SSI in fuelling the growth of exports from this sector, by actively engaging with its overseas counterparts by way of Enterprise series of Trade fairs, Buyer-Seller meets and overseas delegations.

The Government may consider extending the Input Service Distributor concept to include job workers so that the credit of input service tax may be distributed by the Principal to the job worker for effective neutralization.

To facilitate flow of credit at reasonable rates, Rs.4,000 crore provided as special fund out of Rural Infrastructure Development Fund (RIDF) to Small Industries Development Bank of India (SIDBI). This will incentives Banks and State Finance Corporations (SFCs) to lend to Micro and Small Enterprises (MSEs) by refinancing 50 per cent of incremental lending to MSEs during the current financial year.

It is imperative that in order to attain the desired growth rate of 12 %, and increase the GDP contribution (to 7%+) of this sector to the national economy, future focus has to be in areas of Cluster development, Finance, Technology, Operating Environment & the implementation of the Micro, Small & Medium Enterprises Development (MSMED) Act 2006.

**TAXATION ASPECTS IN LLP BASED SME’s**

One of the challenges faced by SMEs is the lack of government focus on reforming tax structure particularly, the indirect taxes with an objective of simplification of tax laws and reducing the burden of tax compliances. This would benefit everyone; however, SMEs would benefit to a greater extent than most as they are less equipped to deal with the intricacy of tax compliance.

While, the Government has endeavored to raise the exemption limits for the Small Scale Industries (SSI) (currently, at Rs. 15 million for Excise and Rs.0.1 million for Service tax), considering that government has more than doubled the investment criteria for SME in recent years, a northward boost to the exemption limit would improve their efficiency.
With significant decline in the export revenue of most of the SME dominant sectors such as leather, handicraft, auto ancillary, marine etc, there is an urgent need to introduce specific export promotion schemes for SMEs under the Foreign Trade Policy. The entry norms prescribing high turnover or investment (such as minimum investment of Rs 10 million for an Export Oriented Unit (EOU) Scheme; Rs 1 million to claim customs duty exemptions on Served From India Scheme) should also be relaxed with a reduction in processing fees for various licenses/authorization.

An initiative towards ab-initio exemption from the payment of service tax on notified services for use in exports could bring down the compliance cost substantially and would also help in the current liquidity crunch. The exporter units may also be allowed to avail the facility of simultaneous refund of CENVAT (Central Value Added Tax) credit along-with rebate of export duties, which would help the exporters accelerate the neutralization of credits and add to cash flow favorably.

LLP, as proposed in the present Bill, is a hybrid business form offering the flexibility of a company and a partnership. The Ministry of Corporate Affairs (MCA) wants a liberal tax regime for proposed Limited Liability Partnership (LLP) set-ups compared to partnership firms to encourage professionals establish the new form of business.

MCA has written to the Finance Ministry in this regard, suggesting that LLPs should be allowed to choose whether the tax would be paid by the firm or by individual partners. Partnership firms have to bear tax liability as the firm and not as partners. However, MCA wants LLPs to be given an option to partners if they whether they want to pay the tax themselves. The profits distributed among partners are not taxed as they are paid after deduction of tax.

Currently, LLPs does not exist in India and a bill to that effect is pending in Parliament. The issues regarding taxation will arise and attraction of converting into LLP or forming an LLP will partly depend on taxation policy.

The Indian Partnership Act, 1932, would not apply to the LLPs formed except under certain conditions prescribed in the Bill.

**FUTURE SCENARIO**
While the Manufacturing sector would continue to be the flagbearer of the SME growth, however many of sunrise industries such as Information technology (IT), Biotechnology (BT), Pharmaceuticals and Nanotechnologies along with IT enabled services that are in the service sector will also play a significant role in the growth and development of SMEs. Though the challenges confronting them are quite different from those faced by traditional manufacturing industries, however issues such as IPR protection and managing rapid up scaling of operations would be equally important.

CONCLUSION

The Limited Liability Partnership will prove to be an efficient business vehicle as it is a combination of the organizational flexibility of the partnership with the LLP concept of a company. The Small and medium enterprises development act give a legal form & governance and it is appreciated by banks to give financial aid to the SMEs for their business.

The government should modify FDI policy, exchange control laws and other relevant laws to make LLPs eligible investment entity for foreign investment as most of SMEs would now obtain for a LLP status. Hence, there is a need that LLP should now be recognized as an eligible invested wherein foreign investment. The Government has to let deal with the taxation of SMEs in the business. To competitive global SMEs the LLP will be suitable innovate tools for SMEs to be used in their business but at the same time some of the policy measures should add in reforms.

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