Direct Taxation and MSMEs Corporatisation: Gauging Impact

The motto of the tax reforms is to make the stakeholders accountable and responsible citizens of the country towards building a progressive State like INDIA. Looking at the significant contribution of the MSMEs to the country's economy towards achieving the Vision India@2047 target of USD 30 Trillion economy, the benefits of tax reform must be passed on to the State MSMEs through the Corporatisation process.

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INTRODUCTION

Albeit, the Union Government of India has initiated many reformative steps, particularly in Direct Tax (Profit/ Income) and Indirect Taxation (Production/ Consumption). The so-called tax reforms are a proactive acclamation of the Union Govt. to maintain Fiscal Income Equity among the Destitute, Aspirer, Middle-Class, Rich and Super Rich. The motto of the tax reforms is to make the stakeholders accountable and responsible citizens of the country towards building a progressive State like INDIA. Looking at the significant contribution of the MSMEs to the Country's economy towards achieving the Vision India@2047 target of USD 30 Trillion economy, the benefits of tax reform must be passed on to the State MSMEs through the Corporatisation process. Recently, Govt. has taken many proactive initiatives like Digitization, Credit Facility, and Global Competitiveness etc. in the Union Budget FY 2025-26 in support of MSMEs Corporatisation. Unlike the Corporates, the MSMEs are also to be into the Corporatisation, so that they can avail the direct taxation benefits allowed by the Union Government of India from time to time. It is felt that the MSME Corporatisation could be successful through active Direct Tax support from the Government.

Against this backdrop, the Government of India promulgated landmark reform in the **Finance Act 2023** in order to address the issue of working capital scarcity of the MSME Units by enacting **Section 43B (h)** under the **Income Tax Act, 1961.** With the inclusion of Section 43B (h) along with other taxation benefits, the gauging impact of Direct Taxation on the MSME Corporatisation in India is quite visible now.

WHY CORPORATISATION OF MSMEs?

The core intent of MSMEs Corporatisation is to create a robust institutional framework for the MSMEs in India. MSME Corporatisation intends to transform the MSEs from a Sole Proprietorship/Partnership firm structure to a Corporate Structure (One Person Company-OPC/Limited Liability Partnership-LLP/ Private Limited/Public Limited) so that these MSME Sectors could play a crucial role in building India a Global Manufacturing Hub. The Corporatisation process will help the MSMEs to strengthen financially and to operate globally, through developing core competency and competitive scope. Through the Corporatisation of MSMEs, they will create Environmental, Social, and Governance (ESG) framework, which will enhance equity, transparency and accountability, productivity, employment, profitability, and global competitiveness.

The outcomes of the MSME Corporatisation divulge that;

> ***"The MSMEs of India are evolving into structure like corporate, abilities like corporate, perform like corporate and recognize like corporate"***.

HOW DIRECT TAXATION IMPACT MSMEs CORPORATISATION?

The impact of direct taxation benefits on the MSME Sectors has been visible at low stake in India. The State MSMEs were unable to avail of the direct tax benefits at the fullest level due to their inherent structure. With the advent of direct tax reforms, now the MSMEs can avail of Direct Tax benefits like Corporations. To identify the gauging impact of Direct Taxation on MSMEs Corporatisation, a thematic study on the Taxonomy of Direct Taxation and the Taxonomy of MSMEs in India is inevitable.

A. Taxonomy of Direct Taxation

The Central Board of Direct Taxes (CBDT) is the governing and administrative body to look after the Direct Taxation in India. Central Government enacts new rules and modify the existing provisions of Direct Tax through the Finance Act, annually, to streamline the taxation structure of the Country. The Direct Tax is the levy on the Profit/Income earned by the Persons. Persons who are liable to pay taxes are called taxpayers. Taxpayers classified as Individuals, Hindu Undivided Families (HUF), Firms, Companies, Associations of Persons (AOP), Body of Individuals (BOI), Local Authority, and Artificial Judicial Persons.

In India, Direct Taxation is broadly of following types:-

1. **Income Tax**: Directly Levied on Annual Income earned during financial year of a Person as per the Income Tax Act, 1961 and amended 2025. Person liable to pay tax are called Assesses. Assesses have been categorized differently as per the Income Tax Rules-1962. The Income Tax is categorized into five major heads of Income;
    - Income from Salary- Salary & Pension.
    - Income from House Property-Rent of House Property.
    - Income from Business and Profession- Profit earned by the Self Employed Persons.
    - Income from Capital Gains-Profit on Sale of Capital Asset including securities.
    - Income from other Sources- Interest and lottery Income etc.
2. **Corporate Tax**: Corporate Tax levied on companies registered under the Companies Act, 2013 and having taxable profit (Revenue-Expenses) and it governs as per the provisions of the Income Tax Act, 1961 and amended Bill 2025. The aim of Corporate Tax in India is being structured through:-
    - **Applying Progressive Rates of Tax**: The progressive tax structure philosophy based on the share of the contribution to the economy through applying higher tax rates to bigger companies and vice- versa.
    - **Claiming Tax deductions**: The Tax deduction philosophy based on reduction of the burden of overall tax liability through claiming tax deduction on certain expenses (Salary, Interest, Rent etc.) incurred by the corporates.
    - **Allowing Tax Exemption**: The Tax exemption allowed to certain specific sectors of the economy based on the nature, size and location of the business entity.
3. **Securities Transaction Tax:** Security Transaction Tax (STT) is a Direct Tax payable on the value of the Securities (Stocks, Mutual Funds and Derivatives) transacted through a Recognized Stock Exchange in India and does not apply to Commodities and Currency. Security Transaction Tax (STT) is mandatory and charged to both Buying and Selling.
4. **Capital Gain Tax:** Capital Gain Tax is a Direct Tax levied on the gain incurred from the sale of Capital Assets (Immovable & Movable Property, Machinery, Patents and Trademarks etc.). The Capital Gain Tax is taxable in the same year of transaction takes place (Transfer of the Capital Assets). There are two types of Capital Gain Tax i.e.
    a. Long Term Capital Gain Tax (LTCG).
    b. Short Term Capital Gain Tax (STCG).
5. **Gift Tax:** Gift Tax levied on the giving/receiving gifts under certain circumstances and value (excess of Rs. 50,000.00 in a Financial Year), as per Gift Tax Act, 1958.

B. Taxonomy of MSME Sector

The Ministry of Micro Small and Medium Enterprises is the governing and administrative body to look after the MSMEs in India. It regulates the State MSMEs under the Micro Small and Medium Enterprises Development (MSMED) Act, 2006 (Amended Act, 2024). The Ministry has been framing different schemes and strategies for the growth of the MSMEs in India from time to time. The MSMEs reform was visible with the Campaign "**Make-In-India**". **This Make-In-India campaign was the stepping-stone of the MSMEs towards Corporatisation.** The **Ease-Of-Doing Business and Cost-Of-Doing Business** concepts infused into the MSMEs Corporatisation. Now, they are into the "**Global Scalability**" to compete worldwide. The Union Budget FY 2025-26 has taken many initiatives towards building a Corporatisation platform for MSMEs in India, which inter-alia focuses on the MSMEs Re-Classification, in particular.

1. **MSME Re-Classification:**

The investment and annual turnover limit for the purpose of MSME classification as defined under MSMED Act, 2006 has been revised in the Budget 2025-26 to improve efficiency, tech-savvy into process of MSME Corporatisation.

Types of Enterprises*	Investment**	Turnover***
MICRO	< INR 2.5 Cr.	< INR 10 Cr.
SMALL	< INR 25 Cr.	< INR100 Cr.
MEDIUM	<INR 125 Cr.	< INR 500 Cr.

***Enterprises**: Manufacturing & Service Enterprises (Not Trader).

****Investment**: Investment in Net Plant & Machinery (After Depreciation).

*****Turnover**: Annual Turnover (After Export Turnover).

2. **MSME Tax**

Micro Small and Medium Enterprises (MSMEs) have been imposed tax based on their Size, Nature, Location, Sector, Specific Expenditure, Investment in special purpose. The fundamentals of MSME Tax is to reduce the overall TAX Liability Burden by leveraging the Direct Tax benefits offered to the MSMEs.

3. **MSME Tax Benefits**

- **Income Tax Deduction**: Section 80JJ of the Income Tax Act, 1961 allows Tax Deduction to MSMEs for 5 years from the year of its incorporation.
- **Tax Holiday**: Section 80-IB of the Income Tax Act, 1961 allows Profit Linked Tax holidays to MSMEs for 5 years from the year of its commencement of business in priority sectors like Oil, Gas, Fertilizers and Clean Tech etc.
- **Start-up Tax Benefit**: Section 80-AIC of the Income Tax Act, 1961 allows special tax benefit for startups for three consecutive years.
- **Reduced Tax Rate:** Section 115BA of the Income Tax Act, 1961 allows reduced tax rates at 25% to MSMEs having annual turnover under Rs. 400 cr. and concessional tax payment @22% U/s 115BAA on Total Income, excluding depreciation and deductions under Section 115JB of the Income Tax Act, 1961.
- **Capital Gains Exemption**: Section 54GB of the Income Tax Act, 1961 allows exemption to MSMEs on Capital gains from the sale of a long terms assets in the equity shares of a qualified start-up.
- **Investment Allowance**: Section 32AC of the Income Tax Act, 1961 allows investment allowance @15% to MSMEs on the cost of investment in Plant & Equipment.
- **Tax Relief:** Section 79 of the Income Tax Act, 1961 provides Tax Relief to the Start-ups towards set-off and carry forward the past losses for 10 years of its Incorporation.
- **Application of MAT:** Unlike large companies, MAT is applicable to MSMEs @15% U/s 115 BAB of Income Tax Act, 1961 unless otherwise those are opting for concessional rate U/s 115BAA.
- **R & D Expenditure:** Under Section 35 (2AB), MSMEs can claim tax deductions at 200% for expenses incurred on in-house research and development activities.
- **Accelerated Depreciation:** MSMEs can claim accelerated depreciation on certain assets like machinery and equipment.
- **Export Promotion:** MSMEs setup under SEZ/ EOU, engaged in export activities can enjoy Tax holidays (Reduced/Nil Tax).
- **Simplified Tax Filling:** Section 44AD of the Income Tax Act, 1961 allows presumptive taxation for business with turnover up to Rs. 3 Cr.

> With the inclusion of Section 43B (h) along with other taxation benefits, the gauging impact of Direct Taxation on the MSME Corporatisation in India is quite visible now.

C. Direct Taxation and MSMEs Corporatisation-An Interplay

In order to address the issue of working capital scarcity of MSMEs, the Union of India, enacted landmark provisions read in conjunction with the applicable provisions of the Income Tax Act, 1961, MSMED Act, 2006 and Companies Act, 2013, exclusively for MSMEs. A peer review of the relevant provisions will entail the gauging impact of direct taxation in MSME Corporatisation with a special focus on Section 43B (h) of the Income Tax Act, 1961, in particular.

1. **Demystifying Section 43B(h) of the Income Tax Act, 1961:**

- **Objective:**

a. To maintain the steady flow of working capital cycle and to manage the cash flow budget through ensuring timely payment to MSEs.

b. To have better Tax planning for the large enterprises.

c. To build strong MSME Supply Chain Eco-System.

- **Applicability**: Normally applies to MSE enterprises registered under MSMED Act, 2006 and having UDYAM registration number (Not to a Wholesaler and Trader).
- **Provision:** Section 43B(h) of Income Tax Act, 1961 stipulates that any sum owed to Micro and Small enterprises for goods supplied and services rendered is eligible for deduction in the same year, if paid, within stipulated time defined under Section-15 of the MSMED Act, 2006.
- **MSME Payment Rule**: Assesses are allowed Tax Deduction in the same year under Income Tax, if paid, within 15 days (without agreement) and within 45 days (with Agreement).
- **Penalty**: Delay payment beyond 15 days/45 days as the case may be, payee is liable to pay Interest @ 3 times of the Bank Rate Notified by the RBI.
- **TAX Benefit**: Provides incentive by allowing 100% tax deduction in the same year of the amount paid to Micro and Small enterprises within the stipulated timeline.

2. **Dis-Allowance U/s 43B(h) of the Income Tax Act, 1961:**

a. Any expenses outstanding prior to FY 2023-24.

b. Any Retention money paid to MSME dis-allowed.

c. Any penal interest towards delay payment NOT eligible as expenses under Income Tax Act, 1961 Permanent Dis-Allowance. (Section 40(a)(ai) vis-à-vis 43B.

d. Any capital expenditure not claimed as a deduction not eligible u/s 43B(h).

e. Purchases are not claimed as deduction (they offered tax benefit u/s 28 on Gross Profit Margin), thus, not eligible u/s 43B(h) of the Income Tax Act, 1961.

3. **Disclosure Requirement:**

i. **Disclosure under MSMED Act, 2006:**

Section 22 of MSMED Act, 2006 deals with specific disclosure requirement related to outstanding amount & Interest due to the MSMEs in the Annual Statement of Accounts.

Item No.	Disclosure required under MSMED Act, 2006	Amount as on 31st March of Current Year	Amount as on 31st March of Previous Year
i.	Principal and Interest amount remains unpaid to Vendor as at the end of each accounting year.		
ii.	Interest amount paid beyond the appointed day as per Section 16 of the MSMED Act, 2006.		
iii.	Interest amount accrued and remaining unpaid at the end of the accounting year.		
iv.	The amount of disallowance interest on account of delay under section 23 of the MSMED Act, 2006.		

ii. **Disclosure under Income Tax Act, 1961:**

- **Return On Investment (ROI)**: ROI calculation to be disclosed in three schedule of ITR 3,5 & 6.
- **FORM 3CD**: As per Section 44 AB when assesses income crosses ₹1 cr. they shall conduct TAX Audit and file return in FORM 3CD before the Income Tax Department. The threshold limit is ₹10 cr. in case 95% of the business transactions are done through digitization mode.
- **Non-Admissible Interest**: Notwithstanding anything U/s 43 of Income Tax Act, 1961, the amount of interest is not admissible under Section 23 of the MSMED Act, 2006 for the purpose of computation of Income under Income Tax Act, 1961.

iii. **Disclosure under Companies Act, 2013:**

Specified companies are required to file Half Yearly Return in FORM MSME-I with the ROC (Registrar of Companies) for delayed payment to MSMEs for more than 45 days from the date of acceptance of the services or goods with the reason.

4. **Other Mandatory Requirement**

Schedule-III of Companies Act, 2013 laid down the disclosure requirement of the corporates in their Audited Annual Accounts in respect of the Age Wise Payables to MSME Vendor(s) in the prescribed format.

Particulars	Outstanding for following periods from due date of payment						Total
	Unbilled Trade payables	Trade payables not due	Less than 1 year	1-2 years	2-3 years	More than 3 years	
MSME							
Others							
Disputed Dues-MSME							
Disputed Dues-Others							

5. **Key Issues under Section 43B(h) of the Income Tax Act, 1961**

- The Vendor/Supplier ought to have registered under provision of the MSMED Act, 2006 on the date of entering onto the agreement for availing benefits U/s 43B(h) of the Income Tax Act, 1961. Cited Case law "**Silpi Industries v Kerala State Road Transport Corporation [2021] 129 taxmann.com 228 (SC)[29-06-2021]**".
- Depreciations of the Capital Assets are allowed as an allowance to MSMEs and is eligible u/s 43B(h) of the Income Tax Act, 1961. Cited case law, "**Lemnisk (P.) Ltd. v. Dy." CIT [2022] 141 taxmann.com 195 (Bangalore – Trib.)**.
- Presumptive Taxation (Allowed), even 43B is a non-obstante provision. Cited case law, "**Good Luck Kinetic vs. Income Tax Officer" 58 Taxman.com 267 (Panaji ITAT (2015).**
- The date of cheque handed over to MSEs will be the due date of payment; it is immaterial when the cheque gets encashed. Cited case law "**CIT, Bombay v/s Ogale Glass Works Limited [1954 AIR 429]".**

- Creditor agrees to convert a portion of interest into shares/debenture to be taken as actual payment. Cited case law, "**[CIT v. Rathi Graphics Technologies Ltd. [2015] 64 taxmann.com (Delhi)]**".

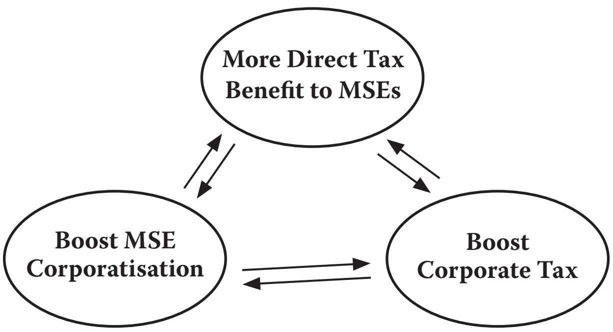
- The advance payment made to the MSEs allowed as a deduction in the year of payment itself, even if it does not fall due for payment in that year. Cited case law, "**CIT v. United Glass Mfg. Co. Ltd. [2012] 28 taxmann.com 429 (SC)**"

"Even CS firms can be registered as MSEs under MSMED Act, 2006 to avail the benefit of Section 43B (h) on the fees payable to them".

D. The Gap

Even though, the Direct tax benefit are on the card to One Person Company (OPC) and Limited Liability Partnership (LLP), MSEs in India are unable to avail such benefits at the fullest extent. This happens due to the inherent character, functional modality and structure of MSEs in India. Thus, the MSEs in India needs a regulated Corporatisation mechanism, so that they will be more inclined to function under the OPC/LLP/Company chatter.

"Expanding the Direct Taxation benefit to the MSEs, will facilitate not only the MSEs Corporatisation but also will infuse more corporate tax revenue the Indian economy".



E. Why MSMEs Into OPCs/LLPs?

1. Understanding One Person Company (OPC)

Section 2 (62) of the Companies Act, 2013 deals with "One Person Company-OPC" which is known as a type of Private Company having one person as its member, can enjoy status of separate legal entity, Limited Liability, can appoint his/her nominee, perpetual succession and with fewer compliances.

Exemption to OPC

- Certification of Annual Returns by a Company Secretary-U/s 92 of the Companies Act, 2013.

- Holding Annual General Meetings –U/s 22 of the Companies Act, 2013.

- Board Meetings and Directors- U/s 49, 152 & 173 of the Companies Act, 2013.

- Signatures on Financial Statements - U/s 134 and 137 of the Companies Act, 2013.

- Contracts by One Person Company-U/s 93 of the Companies Act, 2013.

Benefits to MSMEs as OPC under Direct Taxation

- Low Corporate Tax @ 25% for OPCs having turnover up to ₹400 Cr.

- Exemption from Minimum Alternate Tax (MAT) for OPCs having turnover up to ₹5 Cr.

- Allowed carry forward and set off losses for up to 8 years to OPC.

- Deduction of up to ₹1.5 lakhs under Section 80C for investments made by the OPC.

- OPC having annual turnover up to ₹3 cr. may opt for presumptive taxation scheme (Tax liability is @ 6% / 8% of total turnover) under Section 44AD of the Income Tax Act, 1961.

Thus, the above direct taxation benefits will help to reduce tax liabilities. Higher retention of profit margin leads to surplus funds for investment.

"OPC are Operating like Corporates and provide benefits like MSMEs"

2. Understanding Limited Liability Partnership (LLP)

Limited Liability Partnership Act, 2008 deals with "Limited Liability Partnership-LLP" which is known as a hybrid type of enterprise that enjoys benefits of Partnership Firm and Company, minimum of two partner as its member, can enjoy status of separate legal entity, having Limited Liability, Partner(s) can enter into transactions and give loan to the LLP and perpetual succession like company.

Benefits to MSMEs as LLP under Direct Taxation

- Flat Tax rate @30% on their Profits irrespective of Turnover.

- LLP's having option to pay Alternate Minimum Tax (AMT) @18.5% on their Profits.

- LLP having less than Rs.1 cr. is not subject to Surcharge.

- Under Section 40(b) of the Income Tax Act, 1961 interest to partners, any payment of salary, bonus, commission or remuneration is allowed as deduction.

"LLP enjoys status like the Partnership Firm and Company with Limited Liability"

F. Suggestive Measures

There are a few areas of concern to be looked into at the length and breadth for bringing the MSMEs into the Corporatisation (OPC/LLP/Pvt. Limited/Public Limited) process.

- More Direct Tax Benefits to the MSEs, so that the MSEs that were Sole Proprietorship/ Partnership Enterprises will be inclined to operate through One Person Company and/or Limited Liability Partnership (LLP).
- Direct Tax exemption limit to be commensurate with the recent threshold limit of re-classification of the MSMEs.
- A separate CHAPTER to be included in the Income Tax Bill, 2025 of Direct Taxation Provisions ONLY for CORPORATISED MSMEs.

CONCLUSION

At the outset, the survival and growth of the MSME sector mainly depend on the strong financial health wherein the Direct Taxation is playing a pivotal role. In this respect, the Union of India has taken various steps to allow financial benefits through direct taxation. However, due to the non-corporatisation of the MSMEs, the direct taxation benefits are yet to be availed by them. Nevertheless, the process of the Corporatisation of the MSMEs is on the card, towards building a favorable MSME Eco-System so that the MSMEs will be in a position to avail the direct taxation benefits like Tax Holiday, Tax Rebates, Tax Deductions, Tax exemptions, and other Direct Taxation benefits. Looking at the presence and contribution of MSMEs to India's economy, they need a regulated direct tax enactment, so that they can avail the taxation benefits to the fullest. Undoubtedly, with the introduction of regulated direct tax enactment for the MSMEs in India, they will be encouraged to be in the Corporatisation process. Once, the MSMEs are in the Corporatisation process, they will prove to be the game changer and will drive the growth engine of the Country's economy in achieving the USD 30 Trillion economy by 2047.

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