

Expenditures Payable to MSME Vendors - Tax deductions on Payment

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After our Finance Minister Nirmala Sitharaman presented her 5th Union Budget ' - for the Amrit Kaal on 1 February 2023, the word Micro, Small and Medium Enterprises has garnered a lot of attention across various sectors.

Micro, Small and Medium Enterprises (MSMEs) form an integral part of the Indian economy. They contribute immensely to the Indian economy in terms of generating employment opportunities, industrialization of backward/rural areas as well as the accounts for 27% of India's GDP. There are about 63.05 million micro industries, 0.33 million small and about 5000 medium enterprises in the country contributing to 50 percent of overall exports. The Micro, Small and Medium Enterprises Development (MSMED) Act was notified in 2006 to address policy issues affecting these MSMEs as well as the coverage and investment ceiling of the sector. Further, by way of a notification with effect from 1 July 2020, the Government of India has notified the following criteria for classification of micro, small and medium enterprises for Manufacturing Enterprises and Enterprises rendering Services:

Category	investment in Plant and Machinery or Equipment	Turnover
micro enterprise	should not exceed INR 10 million	does not exceed INR 50 million
small enterprise	should not exceed INR 100 million	does not exceed INR 500 million
medium enterprise	should not exceed INR 500 million	does not exceed INR 2.5 billion

Existing provisions which are beneficial to MSMEs in Income Tax Act, 1961 prior to Finance Bill, 2023:

1. Concessional tax rates under sections 115BAB, 115BAA and 115BA can be availed (effective tax rates range from 17.16% to 29.12%) subject to conditions
2. Presumptive taxation scheme under sections 44AD (8% of turnover of eligible business), 44ADA (presumptive income will be computed at 50% of the total receipts), 44AE (profits and gains from each goods carriage per heavy goods vehicle / other than heavy goods vehicle) subject to conditions
3. Tax Holidays under section 80-IAC can be claimed (only for registered start-ups) upto 100 percent of profits for 3 consecutive years
4. Section 54GB capital gain exemption available for investment in MSMEs whereby individuals/

HUFs can invest the proceeds from the sale of residential property in a company registered as MSME and the same is utilized for purchase of asset within prescribed time limit.

5. Interest paid to MSME under section 23 of MSMED Act on account of delayed payment is not allowable as deduction from income – thus facilitating better collection of the outstanding dues.

Overall reliefs given to MSMEs by Union Budget 2023

A number of representations have been made by the MSME sector to CBDT over the years on various issues being faced by the MSME sector, one of which is the liquidity challenge they face due to longer credit periods and hurdles in getting timely finance.

Considering the time to time representation from the sector, many relief measures have been introduced in the Union Budget 2023 for this sector, noteworthy being:

1. Revamped credit guarantee scheme has been introduced which will lead to additional collateral-free guaranteed credit of ₹2 lakh and cost of credit has been reduced by 1 %
2. Vivad-se-Vishwas-I scheme to enable refunds up to 95% of the deposit for contracts not executed during the COVID-19 period for MSMEs.
3. An Entity DigiLocker will be set up for use by MSMEs. It will be towards sharing and storing documents online securely with various regulators, banks, authorities and other business entities.
4. **Provisions of Income Tax Act have been amended, where payments to MSMEs will be considered within the ambits of section 43B of the Income Tax Act**
5. The presumptive taxation regime turnover for MSMEs has been enhanced to INR 30 million (provided cash receipts are not more than 5% of the total receipts)

Let's have a closer look with respect to amendments pertaining to the provisions of section 43B of the Income Tax Act, 1961 that have now been extended to payments to micro and small enterprises:

Current Provisions of section 43B:

The intention to introduce section 43B in the Finance Act in 1983 was to make assesseees honor payments of statutory liabilities due to Government bodies which largely included payments for excise duty, employer's contribution to PF, ESIC, bonus etc. and not let assessee enjoy benefits of deduction of claim despite non-payments of such dues. This in a way compelled assesseees' to discharge certain liabilities in time in order to claim its deduction in their tax return. In simpler terms, claim for deduction of certain expenses (eg. Bonus, excise, EPF, interest on certain borrowings etc) was allowed only if the payment was actually made i.e. deduction based on provisions / accruals made in books was prohibited for certain expenses.

In Union Budget 2023, the provisions of section 43B have been extended to payments to MSMEs. So to say provisions which were primarily introduced to help Government statutory bodies in collecting their dues are now being extended to Private sector players to boost their collections and support their growth engine.

Proposed changes in section 43B

Accordingly a new clause (h) has been introduced in section 43B

"any sum payable by the assessee to a micro or small enterprise beyond the time limit specified in section 15 of the Micro, Small and Medium Enterprises Development Act, 2006,"

Section 15 of the MSMED Act provides that payments to micro and small enterprises should mandatorily be released within the time as per the written agreement/contract, which cannot exceed 45 days from the day of acceptance of such goods or services or the day of deemed acceptance and in case, there is no such written agreement/contract, then section 15 mandates that the payment shall be made within 15 days from the day of acceptance of such goods or services or the day of deemed acceptance.

The proposed amendment essentially means payables to be made to micro and small enterprises beyond the time limit specified in section 15 of the MSMED Act shall be allowed as deduction only if actually paid.

Further, the proviso to section 43B, where benefit of deduction was allowed in case of payments which are paid within the due date of filing return of income will not apply in case of payments to MSMEs.

These provisions will definitely help the MSMEs in ease of doing business by promoting timely clearance of dues, avoiding bad debts and have a positive impact on their fund flow, however at the same time, this will also increase additional compliances on entities/organizations dealing with MSMEs. While the motive of the provisions are clearer, there are certain questions that may arise in order to fulfil and give impact of the said provisions while computing the taxable profits in upcoming years. We have captured some of them below classifying the same under two categories i.e. interpretational issues vis-à-vis scenarios and procedural aspects.

Interpretation Issues vis-à-vis scenarios:

1. Firstly, the conjoint reading of Finance Bill, 2023 and the memorandum to the finance bill gives rise to a question whether the deduction will be available only up to 45 days or even after that as long as the payment is made within the same financial year. So, for instance, if the invoice is raised on May 10, and the payment is made within 9 months, which is exceeding the 45-day limit but is still paid within the financial year, will the deduction be allowed or will this lead to permanent disallowance of that expense?

Mr. Nitin Gupta, Chairman of CBDT has clarified that such payments will be allowed^[1].

He has further added “.... that the corresponding expenditure will be allowed when the payment is made. The purpose is that it doesn't elongate beyond the particular period of time....The Act is saying that the payment which is made within the time limits prescribed in the MSME Act, will be allowed as deduction. Beyond that, if you want to make a claim it is an expenditure because it's a purchase or a service or anything, it can be allowed only on actual payment basis. Until it is not paid, it will not be allowed as a deduction. So, the intent is to not allow deduction on an accrual basis”

Let us take another example – if an invoice is raised on February 28 and which becomes due for payment say in April but as on 31 March the same is outstanding for payment – so should the tax auditor show this as a disallowance or allowance if the payment is honored in April within the 45 days' time limit? On plain reading of clause h, it should be possible to claim such expenses as the payments are not over-due as per the timelines of MSMED Act as on 31 March. Having said that, if such payments are not honored even in subsequent year, what should be the treatment then?

Further, the question also arises on the outstanding balances of earlier years before the amendment. Balances which are already claimed in FY 2022-23 or prior years but are unpaid during FY 2023-24, there ought not to be any impact of the same on taxable profits for FY 2023-24.

2. Constitutional validity of MSMED provisions (including section 15 and section 23) were challenged in Madras High Court in the case of M/S. Eden Exports Company vs Union Of India where the Court has dismissed the writ filed in this regard giving due weightage to the intention behind the legislature enactment to support MSMEs. Accordingly the provisions cannot be challenged as being ultra vires to the Constitution of India and have to be complied with.

While treatment to above aspects shall evolve gradually with the law, there are also some of **procedural challenges** which are discussed below:

1. The provisions apply only to payments to micro or small enterprises. It must be noted here that payments to medium enterprises are not covered in this provision. This will need an additional data collation and classification exercise for entities to comply with the provision. Corporates operating on PAN India level dealing with huge number of MSMEs will have to complete this classification exercise of all MSMEs into 3 categories.
2. Many organizations have standard credit terms as per their policy for all vendors. Further, the payment terms as per the MSMED Act may not match to the credit terms provided by organizations to their customers and hence the organizations will have to relook at their fund flow / budget forecast accordingly. In order to give support to MSME sectors, the cash flows of other organizations may get pressed too.

It is also pertinent to note that the agreements which were mutually concluded and agreed upon with the micro and small enterprises will need to be relooked and addendums may have to be entered into. One needs to check if it is possible to argue that the payments terms as per the agreement overrides any other requirements as per MSMED Act considering that the MSME itself agreed to a different timelines. This argument seems difficult in light of dismissal of writ challenging the constitutional validity mentioned above.

3. Considering the due dates for payments have to be looked at in terms of section 15 of MSMED Act, i.e. in case of goods – delivery receipt can be one of the good documentary evidence but in terms of rendering a service - more so in case of part performance one is expected to keep a document trail to track the due dates as per provisions of section 15 of MSMD Act.
4. For invoices booked in fag end of a year, data will have to be separately maintained to track the payments made within the due dates provided as per MSMD Act.
5. Since the provisions are based on payment mechanism, partial payments honoring the payment obligation will very well be allowed as a claim of deduction. But in such cases a separate track will have to be maintained with respect to outstanding balances and their due dates.
6. Tax Audit reporting columns in the form 3CD will have to be changed to include the reporting matrix as per this provision. This will result in additional compliance burden on assesseees to maintain the payment data for each invoice /good/service taken.
7. The question also arises whether this amendment may put micro and small enterprises on negative footing as against a non-registered vendor? Will this lead to better competitive edge for non-registered dealers as against micro and small enterprises considering payments terms?

In order to adhere to the compliances organizations are expected to amend and streamline their system /processes and maintain thorough document trail to prove in courts of law if there are any factual disputes on this issue. Hence, tightening the MSMEs trackers is the one of necessary aspect the organizations will need to take to task.

Concluding Remarks

These provisions will surely help in providing great relief to the cash flows of the MSMEs. It will be a boost to their fund flows thereby helping them expand and ease their financial burden. Such statutory protection for the dues is a welcome move considering MSMEs are significantly contributing to India's socio-economic growth and are expected to boom by multifold. With right policies MSMEs will surely play an important role in making India to meet its goal of sustainable fiscal growth and this amendment is one of the relief measures that will help MSMEs.

(With sincere thanks to Mr. Romesh S.A. Sankhe, Chartered Accountant, for providing guidance on above)

(* The views provided in above article are purely personal)

[1] <https://www.bqprime.com/business/will-examine-interest-on-refund-tds-on-benefits-issue-says-cbdt-chairman-nitin-gupta>