

# DIRECT TAXATION AND MICRO, SMALL, AND MEDIUM ENTERPRISES (MSMES) IN INDIA: A COMPREHENSIVE ANALYSIS

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## Abstract

*Micro, Small, and Medium Enterprises (MSMEs) play a crucial role in India's economic landscape, contributing significantly to employment, GDP, exports, and industrial output. Taxation policies have a direct impact on the financial health and sustainability of these enterprises. This paper provides an in-depth analysis of the impact of direct taxes on MSMEs, evaluates tax incentives, and discusses state-specific tax benefits to ensure peaceful, flourishing smooth, efficient and sustainable conduct of the business. Additionally, it examines auditing standards, compliance challenges, and international best practices in MSME taxation. The study highlights the importance of a supportive tax framework to ensure the sustained growth and global competitiveness of MSMEs.*

**Keywords:** Flourishing, MSME, Taxation, Efficient and Sustainable conduct of the business.

## 1. INTRODUCTION & LITERATURE REVIEW

MSMEs are widely regarded as the backbone of India's economy, fostering industrialization and job creation. Despite their economic importance, they face multiple financial and regulatory challenges, particularly in taxation. This paper explores various tax provisions affecting MSMEs and the impact of recent policy changes on their financial viability.

Research on MSME taxation has explored various dimensions, including compliance challenges, tax burden impact, and policy effectiveness. Several studies have emphasized the need for a simplified taxation structure to ensure the growth and sustainability of MSMEs.

- **Rao & Mukherjee (2019)** examined how India's tax policies impact small businesses and concluded that complex compliance structures deter growth.
- **Gupta & Bansal (2020)** analyzed the effect of GST on MSMEs, finding that while it improved transparency, initial implementation challenges led to disruptions in operations.
- **Singh & Sharma (2021)** highlighted that high compliance costs disproportionately affect micro and small enterprises, making it difficult for them to scale operations.
- **OECD Report (2023)** compared international MSME taxation policies, demonstrating how targeted tax relief measures can promote entrepreneurship and innovation.

These studies collectively suggest that an optimized taxation framework, along with financial literacy programs and digitization, can significantly improve tax compliance and financial health of MSMEs.

## 2. OBJECTIVES OF THE STUDY

This study aims to:

- Analyze the impact of direct taxation on MSMEs in India.
- Evaluate the effectiveness of tax incentives and relief measures for MSMEs.
- Examine compliance challenges faced by MSMEs under current tax policies.
- Compare India's MSME taxation framework with international best practices.
- Provide recommendations for optimizing tax policies to support MSME growth.

### 3. DEFINITION AND CLASSIFICATION OF MSMES

In exercise of the powers conferred by sub-section (1) read with sub-section (9) of section 7 of the 'Micro, Small and Medium Enterprises Development Act, 2006 (27 of 2006) and in supersession of the notification of the Government of India, Ministry of Small Scale Industries, dated the 29th September, 2006, published in the Gazette of India, Extraordinary, Part II, Section 3, Sub-section(ii), vide S.O. 1642(E), dated the 30th September 2006 except as respects things done or omitted to be done before such supersession,

The Central Government, hereby notifies the following criteria for classification of micro, small and medium enterprises, namely: —

- (i) a micro enterprise, where the investment in Plant and Machinery or Equipment does not exceed one crore rupees and turnover does not exceed five crore rupees;
- (ii) a small enterprise, where the investment in Plant and Machinery or Equipment does not exceed ten crore rupees and turnover does not exceed fifty crore rupees;
- (iii) a medium enterprise, where the investment in Plant and Machinery or Equipment does not exceed fifty crore rupees and turnover does not exceed two hundred and fifty crore rupees.

In simple words the Micro, Small, and Medium Enterprises Development (MSMED) Act, 2006, classifies MSMEs based on investment and turnover:

- **Micro Enterprises:** Investment up to ₹1 crore, turnover up to ₹5 crore.
- **Small Enterprises:** Investment up to ₹10 crore, turnover up to ₹50 crore.
- **Medium Enterprises:** Investment up to ₹50 crore, turnover up to ₹250 crore.

This classification helps in targeting policy interventions and tax incentives efficiently.

### 4. CONTRIBUTION OF MSMES TO THE INDIAN ECONOMY

- **GDP Contribution:** Approximately 30% of India's GDP is generated by MSMEs.
- **Employment Generation:** MSMEs employ nearly 40% of India's workforce.
- **Manufacturing and Exports:** 50% of total manufacturing output and 45% of exports come from MSMEs.
- **Rural Development:** Around 51% of MSMEs operate in rural areas, fostering economic decentralization.
- **Innovation and Entrepreneurship:** MSMEs contribute significantly to innovation, particularly in sectors such as information technology, textiles, and handicrafts.

### 5. TAXATION AND INCENTIVES FOR MSMES

Governments at both central and state levels offer tax reliefs and incentives to MSMEs:

- **Lower corporate tax rates** to encourage entrepreneurship.
- **Production-linked incentive (PLI) schemes** to boost manufacturing.
- **GST composition scheme** to ease indirect tax compliance.
- **Credit Guarantee Fund Scheme (CGTMSE)** for financial assistance.
- **MSME SAMADHAAN** for resolving payment delays.

### 6. DIRECT TAXATION PROVISIONS FOR MSMES

#### 6.1 Corporate Tax Rates

- **Section 115BA:** 25% tax rate for domestic manufacturing firms.
- **Section 115BAA:** 22% tax rate for companies opting out of deductions.
- **Section 115BAB:** 15% concessional tax rate for new manufacturing companies.

**6.2 Special Provisions Under Section 43B(h)** The Finance Act 2023 introduced Clause (h) under Section 43B to ensure timely payments to micro and small enterprises, allowing deductions only on actual payments made.

#### Section 43B(h) of the Income Tax Act

The IT Act's Section 115BA addresses the applicable tax rates for Indian manufacturing enterprises under specific circumstances

The Finance bill 2023 would include a new insertion of clause (h) to section 43B of the income tax act 1961.

To assure on-time payments, the stated clause would have been inserted as a Socio-Economic Welfare Measure and has been realized through the Micro and small companies. Section 43B of the Act furnishes for specific deductions to get permitted on the real payments.

To this section, the Finance bill 2023 would have newly inserted the clause which would be stated as under-

**Section 43B (h):** “any sum payable by the assessee to a MICRO or SMALL enterprise beyond the time limit specified in 15 of the Micro, Small and Medium Enterprises Development Act, 2006,”

*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 (27 of 2006), shall be allowed (irrespective of the previous year in which the liability to pay such sum was incurred by the assessee according to the method of accounting regularly employed by him) only in computing the income referred to in section 28 of that previous year in which such sum is actually paid by him:*

**Provided that** nothing contained in this section except the provisions of clause (h) shall apply in relation to any sum which is actually paid by the assessee on or before the due date applicable in his case for furnishing the return of income under sub-section (1) of section 139 in respect of the previous year in which the liability to pay such sum was incurred as aforesaid and the evidence of such payment is furnished by the assessee along with such return.

Section 15 of the MSME Development Act, 2006 defines that

“Where any supplier supplies any goods or renders any services to any buyer, the buyer shall make payment therefor on or before the date agreed upon between him and the supplier in writing or, where there is no agreement on this behalf, before the appointed day\*:

Provided that in no case the period agreed upon between the supplier and the buyer in writing shall not exceed forty-five days from the day of acceptance or the day of deemed acceptance”

It is understood from the aforementioned discussion, as agreed between the buyer and supplier the payment shall get made by the buyer, but it could not be more than 45 days from the acceptance date or the day of the deemed acceptance i.e from the acceptance day of the goods or service.

\*‘Appointed day’ means the day following immediately after the expiry of the period of fifteen days from the day of acceptance or the day of deemed acceptance of any goods or any services by a buyer from a supplier.”

**CBDT Circular 1/2024, dt. 3-Jan-2024, Explains that**

Promoting timely payments to Micro and Small Enterprises (is the object). Section 43B of the Act provides for certain deductions to be allowed only on actual payment. Further, the proviso of this section allows deduction on accrual basis, if the amount is paid by due date of furnishing of the return of income.

In order to promote timely payments to micro and small enterprises, payments made to such enterprises have been included within the ambit of section 43B of the Act vide FA 2023. A new clause (h) has been inserted in section 43B of the Act to provide that 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 (MSMED) Act 2006 shall be allowed as deduction only on actual payment. However, it has also been provided that the proviso to section 43B of the Act shall not apply to such payments.

Section 15 of the MSMED Act mandates payments to micro and small enterprises within the time as per the written agreement, which cannot be more than 45 days. If there is no such written agreement, the section mandates that the payment shall be made within 15 days. Thus, this amendment to section 43B of the Act allows the payment as deduction only on payment basis. It can be allowed on accrual basis only if the payment is within the time mandated under section 15 of the MSMED Act.

Applicability: This amendment takes effect from 1st April, 2024 and will accordingly apply in relation to the assessment year 2024-25 and subsequent assessment years.

## 7. STATE-SPECIFIC TAX BENEFITS FOR MSMES

Different states offer customized tax incentives to MSMEs:

- **Andhra Pradesh:** 100% stamp duty refund and 25% electricity subsidy.
- **Gujarat:** 5-year electricity duty exemption and 50% technology upgradation subsidy.
- **Tamil Nadu:** 50% grant for effluent treatment plants and 25% capital subsidy.
- **Uttar Pradesh:** 50% interest subsidy and full stamp duty waivers.
- **Maharashtra:** 100% stamp duty exemption and 25% capital subsidy.

These policies vary across states, creating disparities in MSME growth depending on regional policy frameworks.

## 8. COMPLIANCE CHALLENGES FACED BY MSMES

- **Complex tax filing procedures** lead to delayed compliance.
- **Limited financial literacy** results in missed tax benefits.
- **High cost of compliance** deters small enterprises.
- **Frequent tax policy changes** create uncertainty.
- **Delayed tax refunds** impact cash flow and business operations.

## 9. AUDITING STANDARDS AND REPORTING REQUIREMENTS FOR MSMES

### 9.1 Disclosure Under Section 22 of MSMED Act

- Disclosure of MSME Registration: The auditor is required to verify whether the company has any outstanding dues to Micro, Small, or Medium Enterprises (MSMEs), as defined under the Micro, Small and Medium Enterprises Development (MSMED) Act, 2006.
  - If the company has outstanding dues, the auditor must disclose whether the dues have been paid within the prescribed time period (usually 45 days).
  - If not paid within the stipulated period, the auditor should highlight the amount due to MSMEs as outstanding payables.
  - Any interest payable for delayed payments should also be disclosed

### 9.2 Tax Audit Report (Form 3CD) Clause 22

*Disclosure Requirements with Respect to MSMEs in the Tax Audit Report:-*

#### 1. Clause 22 of Form 3CD (MSME Dues)

Under Clause 22 of the Tax Audit Report (Form 3CD), the tax auditor is required to provide specific disclosures regarding MSME-related payments. These include:

- Dues to Micro and Small Enterprises: The tax auditor must disclose the following:
  - Whether the business has any dues outstanding to micro and small enterprises that are registered under the MSME Development Act.
  - If there are any outstanding dues, the period of delay beyond the stipulated payment period (45 days).
- Interest Payable: If there are any delayed payments to MSMEs, the tax auditor is also required to disclose if the business is liable to pay interest on those delayed payments.

### 9.3 Simplified Financial Reporting

- SME Accounting Framework: The Institute of Chartered Accountants of India (ICAI) introduced a separate framework for Small and Medium Enterprises (SMEs) under the Accounting Standards for SMEs (AS for SMEs). While it is not mandatory for all MSMEs to follow this framework, it provides simplified accounting and reporting standards tailored to the needs of MSMEs.
  - This framework allows for a simpler accounting treatment of transactions, reduced disclosure requirements, and easier compliance with financial reporting obligations.
- Exemption from Full Application of Indian Accounting Standards (Ind AS)*
- Ind AS: Large companies listed on stock exchanges, or companies exceeding certain thresholds in terms of turnover and net worth, must comply with Indian Accounting Standards (Ind AS).
  - However, MSMEs are generally exempt from applying Ind AS. The Ind AS is intended primarily for large companies, and MSMEs are encouraged to follow the generally accepted accounting principles (GAAP) or the simplified SME framework provided by ICAI.
  - This reduces the compliance burden for MSMEs as Ind AS can be complex and demanding, particularly for smaller businesses without significant accounting resources.

## 10. INTERNATIONAL BEST PRACTICES IN MSME TAXATION

- **United States:** Tax credits and SBA loan programs ease MSME burdens.
- **Germany:** Mittelstand firms receive lower corporate tax rates.
- **Singapore:** MSMEs benefit from tax rebates and R&D incentives.
- **United Kingdom:** VAT exemptions simplify tax filing.
- **Australia:** Instant asset write-offs and simplified GST reporting assist MSMEs.
- **Canada:** Special tax incentives support start-ups and small businesses.

## 11. CASE STUDIES: THE IMPACT OF TAXATION ON MSMES

**Case Study 1: GST Impact on Textile MSMEs** A textile MSME in Gujarat faced increased compliance costs post-GST implementation. While the GST Input Tax Credit (ITC) scheme helped larger firms, smaller enterprises struggled with documentation and refunds, impacting their profitability.

**Case Study 2: Corporate Tax Reduction Benefits** A small manufacturing unit in Tamil Nadu benefited from the reduced corporate tax rate (22% under Section 115BAA), allowing it to reinvest in new machinery, boosting production and employment.

**Case Study 3: State-Specific Incentives in Maharashtra** A Pune-based MSME availed Maharashtra's 100% stamp duty waiver on land purchases, reducing initial capital costs and enabling business expansion.

## 12. RECOMMENDATIONS FOR MSME TAX POLICY IMPROVEMENTS

- **Simplify tax filing** through MSME-specific portals.
- **Increase financial literacy programs** to educate MSME owners on tax benefits.
- **Enhance digital infrastructure** for seamless tax compliance.
- **Ensure timely processing of tax refunds** to maintain liquidity.
- **Introduce tax rebates** for MSMEs investing in R&D and technology.
- **Create a unified MSME taxation policy** to minimize interstate discrepancies.

## 13. CONCLUSION

The taxation framework plays a crucial role in shaping the growth trajectory of MSMEs in India. While various incentives and policy measures have been introduced, challenges in compliance, refund delays, and policy inconsistencies remain. Adopting international best practices, streamlining tax procedures, and enhancing financial awareness will be critical in fostering a more resilient MSME sector. A long-term vision that includes further tax simplifications, enhanced incentives, and a structured support system will ensure the sustained contribution of MSMEs to India's economic growth.

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