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TAX INCENTIVES FOR THE INCLUSIVE INVESTORS AND ENTREPRENEURS BELONGING TO LISTED SMES

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Abstract

Choosing a right mode of business fitting the scale of operations to cater the scaling and to create right markets with brand image is a key decision to make for any entrepreneur. While different modes of business are legally and technically possible like sole proprietor, joint venture, partnership, LLP, OPC, Private company, public company both listed and unlisted etc., taxation laws are not the same for all. India's has been a progressive taxation system offering something for everyone. A keen study on the taxation modes and relief mechanisms reveal tremendous saving opportunities to the market players in a listed corporate form. This research paper seeks to bring out the tax advantages and drawbacks of different significant modes of business namely Sole proprietor, HUF, Partnership firms, LLPs and unlisted companies vis-à-vis listed companies. Seven categories have been chosen to bring out the differences viz., Slab rates, Surcharge, Tax on sale of ownership interest, Tax on distribution of profits, Managerial Remuneration, Tax on fresh equity infusion, Tax on distressed business purchase and so on.

Keywords: SME, MSME, Sole proprietor, Hindu Undivided Family, LLP, OPC.

Introduction

Ever since the onset of the global financial crisis, the global economy has been struggling to revive itself and achieve a healthy growth rate. The global growth rate has been recorded at 3.4% and is projected below 4% whereas India's GDP is projected to grow around 7%-8%. This has been possible only because of the key driving force of the Indian economy – the MSMEs. This sector comprising manufacturing, infrastructure, service industry, food processing, packaging, chemicals, and IT has emerged as the most vibrant and dynamic engine of growth of Indian economy over the past few decades[1].

Choosing a right mode of business fitting the scale of operations to cater the scaling and to create right markets with brand image is a very key decision to make for any entrepreneur. While different modes of business are legally and technically possible like sole proprietor, joint ventures, partnerships, LLPs, OPCs,

Private companies, public companies both listed and unlisted etc, taxation laws are not the same for all. India's has been following a progressive taxations system offering something for everyone. A keen study on the taxation modes and relief mechanisms reveals tremendous saving opportunities to the market players in a listed corporate form.

This research paper seeks to bring out the tax advantages and drawbacks of different significant modes of business namely Sole proprietor, HUF, Partnership firms, LLPs and unlisted companies vis-à-vis listed companies. Seven categories have been chosen to bring out the differences viz., Slab rates, Surcharge, Tax on sale of ownership interest, Tax on distribution of profits, Managerial Remuneration, Tax on fresh equity infusion, Tax on distressed business purchase.

Objective

This study mainly focuses on bringing out the taxation implications on the listed SMEs examining the various parameters of investor's concerns and value creation

Methodology

All the information required for this study has been collected and compiled from secondary sources (Registrar of Companies and BSE-SME platform) as the subject matter comprises only listed SME companies. BSE SME is a trading platform floated by The Bombay Stock Exchange under the guidelines of SEBI. Further operation of various frameworks like SEBI Guidelines, ROC (Registrar of Companies) filings, application of SCRA (Securities Contracts Regulation Act) Companies Act 2013 etc., make the secondary data most reliable and accurate fit for research purposes.

DEFINITION OF MSME

The landscape of MSME took a major turn on Wednesday, the 07th of February 2018, with the Union Cabinet approving a proposal to redefine Micro, Small and Medium Enterprises, or MSMEs, based on their annual revenue, replacing the current definition that relies on self-declared investment on plant and machinery. According to the government's new definition, businesses with revenue of as much as Rs 5 crore will be called a micro enterprise, those with sales between Rs 5 crore and Rs 75 crore will be deemed as small and those with revenue between Rs 75 crore and Rs 250 crore will be classified as medium-sized enterprises. Finance minister Arun Jaitley proposed a 25% corporate tax rate for entities with sales of up to Rs 250 crore in the budget.

Under the earlier definition, manufacturers with Rs 25 lakh investment in plant and machinery were termed micro enterprises and those with investments between Rs 25 lakh and Rs 5 crore were regarded as small enterprises. Firms with investments of up to Rs 10 crore are classified as medium.[2]

With the whole economy focusing the attention on strengthening the life business blood of Indian economy, the SME sector, providing opportunities and growth prospects for feasible business models and innovation has seen a meteoric rise in the recent times.

Business Models

Traditionally SMEs have been operating under more conventional forms of business like sole proprietor and partnership. However, other modes of business like LLP, companies etc. are also an option left to the SME entrepreneurs to execute possible business ideas and ventures. Forms of business modes available to the entrepreneurs are;

- Sole proprietor
- Hindu Undivided Family
- Partnership firm
- Limited Liability Partnership
- Private Company
- Unlisted Public Company
- Listed Public Company

While taxation remains the same for sole proprietor (considered individual assessee in Income tax terms) and Hindu

Undivided Family (herein after referred to as HUF), partnership firms and Limited liability partnerships (hereafter referred to as LLP) have the same taxation laws. Listed and Unlisted companies have different tax implications which are discussed at length below.

SLAB Rates

Income tax is charged based on the slab rates which are decided upon in every union budget. Income tax rates applicable to individuals and HUFs are presented in Table.

Income Tax rates applicable to Individuals and HUFs

Up to ₹ 2,50,000	Nil
>₹2,50,000 but ≤₹ 5,00,000	5%
>₹5,00,000 but ≤₹ 10,00,000	20% plus ₹12500
> ₹ 10,00,000	30% plus ₹ 1,12,500

Source: The Income Tax Act 1961 & The Finance Act 2018

While partnership firms and LLPs are charged a flat 30% as income tax on the profit earned, the same differ to a major extent in case of companies termed as domestic companies. The rates are as follows[4];

Income Tax rates applicable to Companies

Gross turnover upto 250 Cr. in the previous year	25%
Gross turnover exceeding 250 Cr. in the previous year	29%

Source: The Income Tax Act 1961 & The Finance Act 2018

The study of slab rates revealed the following issues

1. Running a business under traditional modes of individual, and HUFs offers a very little relaxation as far as tax burden is concerned i.e., up to ₹ 10,00,000/-.
2. Beyond ₹10,00,000/- as both partnership firms/LLP and individual/HUF end up paying at 30%.
3. Registered companies are charged at 25% up to a turnover of 250 Cr and 29% up to a turnover of 29%.
4. Company mode of business scores instantly over partnership because of the obvious numbers advantage as far as tax payment is concerned.
5. The indifference level as calculated in terms of tax is ₹32,50,000/-.
6. Hence it can be stated that any income beyond the stated indifference level, companies end up paying lower than the individuals and HUFs.
7. However, this advantage is available only to high earning companies and businesses which stand to earn in excess of ₹32,50,000/-. But up to that level, more attractive business models are Individual and HUFs.
8. Despite having a sizeable advantage in business mode, business sector education activity on the advantage is still negligible considering the number of companies listed. More activities on educating will definitely lead to the economy gaining more leverage by the strengthening of the SME sector.
9. A closer look at the scenario below income of ₹32,50,000/-, businesses reveals that people are more motivated to operate on the more traditional ways of business than going corporate. Hence there is need for revising tax rates applicable to companies to make them more attractive even below the indifference point of ₹32,50,000/-.
10. Efforts should be made to bring the taxation uniformity if not incentivizing below the indifference level of ₹32,50,000/-.

Surcharge

Surcharge can be stated as the additional amount of tax chargeable on a progressive basis on the income tax payable at the rates on the applicable criteria as specified or modified via the Finance Act through the union budget from time to time. While low earning traditional business forms enjoy exemption from surcharge at

times of minimal earnings, higher earning ones attract surcharge.[5] The Surcharge rates applicable to Individuals and HUFs as detailed in table 3.

In case of Individuals and HUFs, applicable surcharge is

Surcharge rates applicable to Individuals and HUFs

Total income >₹ 50 lakh but is ≤₹1 Crore	10 %
Total income >₹ 1 Crore	15%

Source: The Income Tax Act 1961 & The Finance Act 2018

In case of partnership firms, applicable surcharge is payable at a flat rate of 12% if income is more than ₹1 Crore. Whereas a company has to pay surcharge on the following basis as detailed in table 4.

Surcharge rates applicable to Individuals and HUFs

Total income >₹1 Crore but is ≤₹10 Crore	7 %
Total income >₹ 10 Crore	12%

Source: The Income Tax Act 1961 & The Finance Act 2018

In this category of comparison, income tax payable has to be invariably factored as surcharge is calculated on tax payable. Having already concluded that companies offer higher tax savings for earnings beyond the indifference points, the gap further widens by a significant margin because of operation of differential surcharge.

Following are the key issues with respect to surcharge

1. From the bird's eye view, there is a blanket saving of 5% on income tax payable on ₹9 Crores of income for a company form of business as compared to partnership.
2. Companies score at a higher level as compared to individuals and HUFs as the latter end up paying surcharge of 10% on income tax from taxable income from ₹50 lakhs to ₹1 Crore.
3. This gap increases exponentially as companies have to pay only 7 % on tax on further ₹9 Crores of income while the individuals and HUFs end up paying 15% which is an additional saving of 8% for the companies form of business.
4. This gap further deepens by 3% as companies end up paying 12% of income tax as surcharge while the same stands still at 15% of income tax in case of income beyond ₹10 Crores.
5. It is pertinent to note that though the surcharge is being charged at a very low rate on the income tax as compared to other forms of business, such fact is not often given the primary consideration due to lack of investor and tax payer education.
6. Incentivizing surcharge payments is not a suggestible measure to incentivize SMEs as surcharge is payable by the individuals and HUFs only after the cut off limit as may be specified.
7. Lower surcharge will apply only in cases where income is booming beyond the indifference levels. Hence in order to incentivize corporatization of SMEs, exempting surcharge levy below the indifference levels on par with the Individuals and HUFs is a very much suggestible measure.

Tax on Sale of Ownership Interest

The most unique distinguishing factor between a company form of business and the traditional forms of business is the possibility to sell ownership interest partly. The advantage is multifold as it offers significant leverage both from the financial perspectives and taxation perspective.

While it is legally not possible to sell part ownership in case of individual or HUF or partnership or LLP, a company's controlling interest or non-controlling interest can be transferred in any whole number and in any proportion to voting power in the form of shares.

In case of sale of ownership interest in full in conventional business modes, the same is treated as profits or gains of business or profession as slump sale of business and is taxed accordingly as per the rates set forth in this comparison where as

there is significant portion of exemptions for listed companies form of business.

To operate a company on a full scale, absolute ownership of 100% is not needed as controlling interest of either the management or voting rights in excess of 50% is enough as per The Companies Act 2013. This can be done by transfer of shares to the requisite extent. While capital gains arise on sale of shares of a company, tax implications change in case of listed and unlisted companies. In both the cases, profit on sale of shares held for less than 12 months are qualified as short term capital gains and they attract tax at 30% flat rate subject to relaxation available in un expired concessional slab rates as specified above.[6]

In case of shares held for more than a year (12 months), profits on sale are termed Long Term Capital Gains (LTCG) and are taxed at 20% only in case of unlisted companies. LTCG on sale o listed shares was exempt from tax completely until the previous year. Now the same exemption has been restricted to LTCG of ₹1,00,000/- through the Union Budget 2018. Beyond the stated limit it is taxed at 20% after indexation benefit is awarded. However, the savings in tax are still subject to meticulous tax planning and scope for availing full exemptions by deferment of sale of controlling interest is not unplugged. Further slump sale has got all the probability to get taxed at 30% in case of individuals and HUFs beyond the slab rates and partnerships and LLPs at flat 30% and the same remains at 20% in case of listed companies after indexation being awarded. Hence the indifference leveraged advantage of 10% in comparison of listed MSME vs individual and HUF and flat advantage of 10% in comparison of listed MSME vs partnership and LLP is always a definite quantifiable take away for sale of business.

The study revealed the following observations.

1. Though saleability of ownership interest in part is in itself a unique advantage, taking away the taxation advantage partially is not a recommendable course of action.
2. Through the Union Budget 2018, the erstwhile available exemption of 100% on LTCG has been taken away and only exemption of up to ₹10,00,000/- is now available.
3. This will go on to cause unnecessary hardship in tax planning to the investors.
4. Also the same measure will act as an indirect exit barrier beyond taxable LTCG of ₹1,00,000/-.
5. The Union Govt needs to reconsider the decision of de-incentivizing the investors from investing by placing exit restrictions.
6. A measure to exempt LTCG on investments in listed SMEs on the BSE is a more suggestible action to promote active growth of the listed SMEs.

Tax on Distribution of Profits

Take home profit in case of the traditional form of businesses has always been an advantage as drawings are not a subject matter of taxation. But the same has been a hardship for the companies as distribution of profits by a company attracts dividend distribution tax (DDT) at the rate of 15% plus a surcharge of 12% together with education cess of 3% totaling to 20.36%.[8]

Since this is only a repatriation and investors in receipt of the income are set to avail an exemption of up to ₹10,00,000/- in form of receipt of dividend income per year, a wide range of indifference points emerge depending on the comparison criterion. Following are the detailed observations noted in the study.

1. Taxation of profit distribution, though is subject to operation of different indifference issues, operates as a demerit from the macro perspective as the earner ends up paying two-fold tax to the framework.
2. Companies end up paying at either 25% or 29% based on the slab rates as applicable in the first instance and then

at the rate of 20.36% on the same tax - paid profits in case of distribution of profits as dividend.

3. This will disincentivize the companies from paying dividend on a full-fledged scale as value erosion happens towards payment to taxes.
4. Companies tend to re-invest the profits earned instead of dividend pay out and the same measure disincentivizes individual and small scale investors from investing in shares and securities as periodic return is neither guaranteed nor expected in general from all companies.
5. Such regressive measures will tend to take away the attractiveness of the listed company form of business.
6. Though the Government may have policy of getting more taxes from corporate houses, bringing listed SMEs also under the same net is definitely a demerit to the most happening sector in Indian context to go the corporate way.
7. Exempting listed SMEs from payment of Dividend Distribution Tax (DDT) would be a very much long awaited welcome change to beam up the growth of listing activity amongst SMEs in India.

Managerial Remuneration

While there is no scope for the proprietor or the kartha to act as an employee to the business and claim remuneration from the business, other forms of business offer such scope.[9] In case of partnership firms, allowable remuneration to the working partners as per Sec 40(b) is noted as under in table 5.

Managerial remuneration allowable to Partnership firms for the purpose of tax computation

On first ₹3,00,000/- of profits or in case of loss	Higher of ₹1,50,000 or 90% of book profits
On the balance of book profits	At the rate of 60%

Source: The Income Tax Act 1961 & The Finance Act 2018

It has to be noted that such deducted remuneration add up to the individual incomes of the drawee and would contribute in progression to utilization/exhaustion of slab rates leading up to 30%.

Sec 197 of The Companies Act 2013, regulates the managerial remuneration in case of registered companies which lays out a restriction of maximum of 11% as managerial remuneration to the Managing Director or Whole Time Director or Manager with various other allied restrictions. The raider of this income going to add to the individual incomes of the drawee applies equally good in this case also as is applied in case of partnership firms. Though it appears partnership firms score on a higher ground theoretically, in the case of operation of scale and various indifference points along with diversified tax governance procedures, comparison becomes futile.

The observations made in this regard are briefed hereunder.

1. Option to pay managerial remuneration and deductibility of the same as an expenditure is a highlight of the company form of business compared to individual and HUF forms of business.
2. But, on a deeper examination, operation of DDT and limits on managerial remuneration without linkage to shareholding ultimately decrease the attractiveness of the unique feature.
3. While partnership allows up to 90% up to ₹3,00,000/- and 60% beyond ₹3,00,000/-, companies are not restricted by The Income Tax Act. But The Companies Act, 2013 restricts the same to 11%.
4. Raising the managerial remuneration to promote the management's interest will add on to reducing the possibility of management frauds and scalability of the business as well.
5. Raising the managerial remuneration without linkage with shareholding is not suggestible as the real investor may lose

out on the profits earned from the share capital invested.

6. Hence a method of aligning managerial remuneration with the percentage of shareholding in place of existing 11% restriction is a suggestible measure.

Tax on Fresh Equity Infusion

While fresh capital infusion in to the business bears no tax consequence in individual, HUF or Partnership, listing status of the company makes a difference in case of companies. The Finance Act, 2012 imposed a tax liability on fresh issuance of equity shares by an unlisted company to investors other than "Registered Venture Fund", if the issuance is made at a value more than the fair value. This could make SMEs subject to heavy tax outgo, since they often go for fund raising through equity issuance to investors. Such a tax liability, however, does not attract if the shares of the company are listed on recognized stock exchanges, including SME Exchange. Hence it can be concluded that listed MSMEs can bring in fresh capital from angel investors or venture capital financiers or raise fresh capital from the public at zero tax burden whereas unlisted companies have to suffer the tax wrath. In sum, with regard to the tax on fresh equity infusion, the following observations have been made and solutions are offered for certain issues.

1. The measure of taxing unlisted companies for capital infusion will go a long way in companies showing interest to get listed than operating in the semi regulated sector of unlisted companies.
2. But the same is not sufficient to channelize the investment or to shift business models from individuals, HUFs and Partnership firms to listed companies.
3. Capital infusion restrictions are not in place for traditional business models like individuals, HUFs and Partnership firms.
4. However placing such restrictions with out proper thought will have a catastrophic effect on the trade sector and investment channelizing.
5. Working out a model for mandatory conversion of business form beyond a scale of operations to listed SMEs and then to main boarding is a more feasible and suggestible measure for better channelization of investment and control.

Tax on Distressed Business Purchase

While the provisions applicable to slump sale in case of individuals, HUFs and Partnership firms, govern sale and purchase of business the same differ from unlisted companies to listed companies. Income-tax Act levies a tax inter alia on the buyer of shares of an unlisted company, if the transaction is conducted at a value less than its book value. Hence acquisition of distressed assets could attract heavy tax. Such a tax liability, however, does not attract if the shares of the company are listed on recognized stock exchanges, including SME Exchange. Hence listed SMEs stand a greater chance of implementing turn around strategies for sick companies that operate on a feasible business opportunity and lopsided management techniques and/or scale disadvantages. In this regard, the following have been noticed.

1. Having in place asset acquisition restrictions for unlisted companies definitely encourage companies to get listed to reap benefits.
2. But the same measure alone will not be enough to bring investment from individual investors in own business ventures or to go corporate.
3. Sec 50C of The Income Tax Act, 1961 operates on similar lines which seeks to tax real estate transactions below the market value as “Other Income”. But the same is not in place for acquisition of other business assets from an erstwhile business.
4. Similar restrictions shall also be made applicable to individuals, HUFs as well

as to make listed SME segment more attractive as a business model.

Conclusion

While business is an art of extracting money out of the opportunities available or created, seeking the best available mode of business and gauging the scale and scalability of commercial operations is equally a matter of skill and meticulous comprehension of various business models and regulatory frameworks. Following the laws of land is a mandate for any business while taking advantage and reaping the benefits set forth in the same framework is a matter of trade acceleration and market scaling.

Given the tax advantages alone listing an SME offers a handful for scaling businesses. This is evident to this extent that quite a few SEBI registered merchant bankers like Sarthi Capital Advisors Private Limited have now started recommending listing to take advantage of tax savings and market placement.

If given proper reach to the MSME business community, major issues in the SME sector like global market identity and appeal, scalability, credit availability, branding, funding business ideas, tax and compliance burdens etc., are set to ease out for better and accelerated trade and service growths.

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