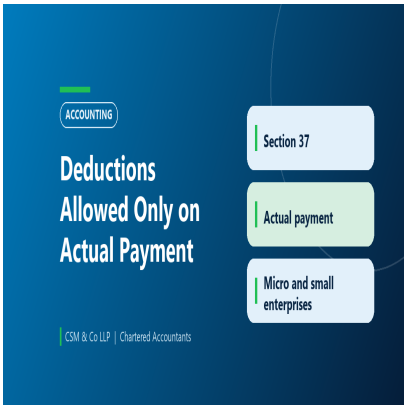


Deductions Allowed Only on Actual Payment: Section 37 (Earlier 43B) and Dues to Micro and Small Enterprises (Tax Year 2026-27)

Description

Last updated: 29 August 2026 · Written and reviewed by CA Meet Dhrangadhariya, CSM & Co LLP

Quick summary

- Section 37 of the Income-tax Act, 2025 allows certain expenses only in the year they are actually paid, whatever the accounting method: taxes, duties and cess, employer's contribution to provident, superannuation and gratuity funds, leave encashment, interest to specified financial entities, railway dues and dues to micro and small enterprises.
- Most of these are allowed in the year of accrual if paid on or before the due date for filing the return (section 37(3)); the exception is the amount owed to a micro or small enterprise beyond the time limit in section 15 of the MSMED Act, which is allowed only when it is actually paid.
- Interest converted into a loan or debenture is not treated as paid.
- A deduction allowed in the year of accrual is not allowed again when it is paid (section 37(5)).

Many businesses account for expenses when they are incurred, but the Income-tax Act, 2025 allows a short list of expenses as deductions **only when they are actually paid**. This was section 43B of the 1961 Act, including the clause (h) added in 2023 for dues to micro and small enterprises. It is now **section 37**.

The rule (section 37(1) and (2))

The sums listed below, which are otherwise allowable as deductions, are allowed while computing business or professional income **only in the tax year in which they are actually paid**, irrespective of any contrary provision, the method of accounting regularly followed, or the year in which the liability was incurred:

1. **Tax, duty, cess, surcharge or fee**, by whatever name called, levied under any law in force.
2. The employer's **contribution to a provident fund, superannuation fund, gratuity fund or any fund for the welfare of employees**.
3. The amount payable by an employer **in lieu of leave at the credit of an employee** (leave encashment).
4. Any sum referred to in **section 32(a)**.
5. **Interest on loans, advances or borrowings from specified financial entities**, as per the terms of the loan agreement.

6. An amount payable to **Indian Railways** for use of railway assets.
7. An amount payable to a **micro or small enterprise beyond the time limit in section 15 of the Micro, Small and Medium Enterprises Development Act, 2006**.

Payment by the return due date (section 37(3))

For items 1 to 6, if the sum is paid **after the end of the tax year but on or before the due date for filing the return** under section 263(1) for that year, the deduction is allowed **in the year in which the liability was incurred**. Item 7 (MSME dues) is **excluded** from this relief.

Example. A company owes ?4,00,000 as the employer's PF contribution for March 2027 and pays it on 10 July 2027, before the return due date. The deduction is available for tax year 2026-27, since payment was made by the return due date. If it paid on 15 November 2027, after the due date, the deduction is allowed only in the year of payment, tax year 2027-28.

Dues to micro and small enterprises (item 7)

Under section 15 of the MSMED Act, 2006, a buyer must pay a micro or small enterprise by the **agreed date, which cannot be more than 45 days from the day of acceptance of the goods or services**, or within **15 days** if there is no written agreement. The Income-tax Act adds a tax consequence: an amount that is payable to a micro or small enterprise **beyond that time limit** is deductible only in the year in which it is **actually paid**.

- It applies to **micro and small** enterprises only, as classified under the MSMED Act (section 66(11) and (30) of the Income-tax Act refer to the classification under that Act). **Medium enterprises** are not covered.
- **No grace till the return due date.** For MSME dues, payment after year end does not bring the deduction back to the earlier year (section 37(3)).
- The disallowance relates to the amount **payable** beyond the limit. If the invoice is not yet beyond the limit on the last day of the year, we read the section as not applying to it at that date, but if it remains unpaid after the limit, it falls in the rule. Take advice on year end creditors.

Example. On 31 March 2027, a buyer owes a micro enterprise supplier ?5,00,000 for an invoice accepted on 1 January 2027. With a 45 day agreement the due date was 15 February 2027, so the dues are beyond the limit at year end. If paid on 20 April 2027, the deduction is for tax year **2027-28**, not 2026-27. Had the buyer paid before 31 March 2027, the deduction would be in 2026-27.

Other points

- **Interest converted into a loan (section 37(4)):** if interest on a loan from a specified financial entity is converted into a loan, advance, debenture or any other instrument that defers the liability to a future date, it is **not treated as paid**.
- **No double deduction (section 37(5)):** a sum deducted in the year the liability was incurred is not deducted again when paid.
- **Employee contributions (section 37(6)):** the section does not apply to a sum received from an employee as a contribution to a fund. The employee's contribution is dealt with separately in section 29(1)(e), which allows it if credited to the fund by the due date as prescribed.
- **Payment means actual payment.** A journal entry or a provision is not payment. A payment by account payee cheque or electronic mode counts.

Practical steps for a business

1. **Keep a list of MSME creditors** (check the supplier's udyam registration), with invoice dates and payment due dates.
2. **Pay MSME dues within 45 days**, or within the agreed shorter period, wherever possible.
3. **Pay statutory dues** (GST, PF, ESI, professional tax, TDS) before the return due date.
4. **Reconcile year-end creditors** and disclose the details in the tax audit report, where an audit is required (see our post on tax audit).
5. **Document the payment date** with bank statements.

Frequently asked questions

Which expenses are allowed only on actual payment?

Tax, duty, cess, surcharge or fee levied under any law; the employer's contribution to a provident, superannuation or gratuity fund or any fund for employees' welfare; payment in lieu of leave at the credit of an employee; interest on loans from specified financial entities; amounts payable to Indian Railways for use of railway assets; and amounts owed to a micro or small enterprise beyond the time limit in section 15 of the MSMED Act (section 37(2)).

Does a late payment by the return due date still get the deduction?

For all items except dues to micro and small enterprises, payment on or before the due date for filing the return under section 263(1) for that year gives the deduction in the year the liability was incurred (section 37(3)).

What is the rule for MSME dues?

An amount payable to a micro or small enterprise beyond the time limit in section 15 of the MSMED Act is deductible only in the year it is actually paid. Paying it after year end but before the return due date does not bring it back to the earlier year (section 37(3) excludes clause (g)).

What is the time limit in the MSMED Act?

Section 15 requires payment by the agreed date, which cannot be more than 45 days from acceptance of the goods or services, or within 15 days if there is no agreement.

Does it apply to medium enterprises or traders?

The clause covers a micro or small enterprise supplier. It does not cover a medium enterprise.

What about interest converted into a loan?

If interest on a loan from a specified financial entity is converted into a loan, advance, debenture or similar instrument that defers payment, it is not treated as paid (section 37(4)).

Official sources

- Income Tax Department: Income-tax Act, 2025 (sections 26, 34, 37, 263)

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Author
meetsoni