

CSR AND INCOME TAX ACT: AN ANALYSIS

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Abstract

Corporate social responsibility as a concept rests on the theory that companies utilise resources given by the nature and the society and thus it has a moral responsibility to give back to the society by ensuring welfare of nature and society, and that the actions of companies does not affect only its shareholders. Corporate social responsibility was considered as a voluntary activity that a company indulged in to improve its image and boost societal benefit as well as market competitiveness, until Companies Act 2013 under section 135 codified corporate social responsibility and made it mandatory. However, the effect of this has been dimmed by the Finance Bill 2014 which provides that under section 37 of Income Tax Act, 1961 corporate social responsibility expenditure cannot be claimed as deductions. This paper aims at pointing out and analysing the clash between Companies Act 2013 and taxation law which has not yet been clarified.

Keywords: CSR, Income Tax, Moral Responsibility, Market, Expenditure

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INTRODUCTION

Corporate social responsibility (CSR) in India is based on two theories namely the stakeholder's interest theory and the Gandhian trusteeship theory. The first theory is based on the principle that the actions of a company affect more than just its stakeholders, the society or the public holds an equal stake in the company. The second theory is founded on the concept that a company uses the resources of the nature and society for its own benefit thus it has the moral duty to act as a trustee to the nature and society ensuring its welfare and development.

There is no fixed definition of CSR given by the Indian legal system. Though the scope CSR can be inferred from the definition provided by the European Commission:

*"It is the responsibility of enterprises for their impacts on the society.... Enterprises should have in place a process to integrate social, environmental, ethical human rights and consumer concerns into their business operations and core strategy in close collaboration with their stakeholders."*¹

The above definition sees CSR as an investment societal benefits and environmentally responsible technology that goes beyond legal obligation and increases the market competitiveness of the company. CSR in the form of training, skill improvement, working conditions have a direct impact on productivity, a source of reconciling social development with improved competitiveness.

The new Companies Act 2013 has introduced CSR as a legal obligation under Section 135. The Ministry of Finance has been very considerate to social sector development while interpretation of the CSR provision, the Finance Bill 2014 has dulled the enthusiasm of CSR promoters, by disallowing CSR expenditure as a deduction under Section 37 of Income Tax Act, 1961.

This provision has been attacked with the very basic argument of why would a company spend on CSR when it has zero tax benefit given to the fact that there are other government

¹ EC, Green Paper, Promoting a European Framework for Corporate Social Responsibility, COM (2001) 366 (18/07/2001), para 20, Available at: <http://eurlex.europa.eu/legalcontent/EN/TXT/PDF/?uri=CELEX:52001DC0366&from=EN>, Last accessed on 17/11/16

notified schemes in which the contribution made to them can be claimed as a 100% tax deduction. This paper attempts to shine a light on the conflicts between these two realms.

COMPANIES ACT 2013

Before the Companies Act 2013, there were two views as to whether CSR should be voluntary. The enactment of this act put the debate regarding CSR to a rest by providing express provisions for it. Section 135 and schedule VII of the act combined with the CSR Policy Rules, 2014 (CSRP Rules) govern and determine the scope of CSR initiatives by companies.

The Central Government Ministry of Corporate Affairs (MCA) has listed the guiding principles for CSR in preamble of CSR rules²:

CSR is not mere charity. CSR is a way of conducting business, by which corporate entities contribute to social good.

CSR is the process by which an organisation evolves and thinks about its relationship with stakeholders for common good and shows its commitment by adopting appropriate business process and strategies.

CSR projects of a company should be used to focus on integrating business models of a company with social and environmental priorities to create shared value.

CSR should be used to integrate economic, environmental and social objectives with company's operations and growth.

Section 135 of Companies Act, 2013

Section 135 provides certain conditions, if any one of them is satisfied by a company in any financial year then the mandatory CSR provision is applicable and the company must comply with it every year. These conditions are³:

- A company having net worth of Rs. 500 crore or more during any financial year,
 - A company having a turnover of Rs. 1,000 crores or more during any financial year
- and

² See <http://www.cuts-international.org/pdf/Draft-CSR_Rules_2013.pdf> accessed 17 November 2016

³ See <<https://www.mca.gov.in/SearchableActs/Section135.htm>> accessed 15 November 2016

- A company having a net profit of Rs 5 crore or more during any financial year

The strict rigor of section 135 is somewhat relaxed by the rule 3(2) of the CSRP rules 2014 which provides that if a company does not fulfil any of the said conditions continuously for a period of three financial years it will be exempted from the mandatory CSR under section 135, however the section will again resume if the company reaches any of the marks in any subsequent financial year.⁴

The clause requires the board of directors to ensure that at least 2% of the average net profits of the company for the next three years be spent on the CSR plan approved by the board of the company.⁵

FEATURES AND SCOPE

Any activity which has been undertaken in normal course of business of a company is not a CSR activity.⁶

Any CSR activity that a company undertakes should give preference to local area or the area out of which the company operates.

Only the subjects mentioned in schedule VII of the Companies act 2013, should be taken up a project for CSR activity.⁷

Any profit or surplus that arises because of CSR activity will not be added to business profit and should be spent on the CSR activity.⁸

Any activity which is exclusively for the benefit of the employees or family members will not be considered as a CSR activity.⁹

A CSR activity can also be conducted in partnership or collaboration with another company as per the rules specified.¹⁰

⁴ See http://www.mca.gov.in/Ministry/pdf/CompaniesActNotification2_2014.pdf

⁵ See <https://www.mca.gov.in/SearchableActs/Section135.html> Section 135(5) of companies act 2013

⁶ Rule 2 (e) The Companies (Corporate Social Responsibility Policy) Rules, 2014

⁷ Ibid

⁸ Ibid at Rule 6 (2)

⁹ Ibid at Rule 4 (5)

¹⁰ Ibid at Rule 4 (3)

A company can undertake CSR activity by itself and or registered society or trust or a company established under S8 of Companies Act 2013, by itself, its holding or subsidiary subject to a cap of maximum 5% of total CSR expenditure of the company in a financial year.¹¹

CSR EXPENDITURE AND INCOME TAX ACT, 1961

Before the introductions of Section 135 and CSRP Rules there were numerous judicial decisions that held that CSR expenditure will be considered as a part of the business expenditure under section 37(1).

Section 37(1) basically says that any expenditure which does not fall under the umbrella of revenue expenditure under Section 30 to Section 36 or is a capital expenditure or personal expenditure shall be considered as a business expenditure if it is wholly and exclusively for the purpose of business or profession shall be allowed as business expenditure while computing income from profit and gains from business or profession. While determining whether a transaction is wholly and exclusively for business purpose the courts of India have taken two stands, the first being that a businessman is the best judge for business expediency¹² and thus the questions whether the expenditure was prudent or necessary are irrelevant questions.¹³ And the second is that the first stand is no bar to the assessing officer from enquiring into the true nature of the transaction, whether it was truly entered into for business purpose or was for some other reasons.¹⁴ Thus the stance taken by the court depends on the circumstances of the case and each case is dealt with on its merits.

DISPUTATIONS

¹¹ Ibid at Rule 4 (2) MCA Notification on Companies' CSR Policy Amendment Rules 2016, Available on <http://caclub.in/companies-csr-policy-amendment-rules-2016-notified-by-mca/> Last accessed on 17/11/16

¹² *Jaipur Electro (P.) Ltd. v. CIT*, [1996] 134 CTR 237 (Raj)

¹³ *Narsingdas Surajmal Properties (P.) Ltd. v CIT*, [1981] 127 ITR 221 (Gau)

¹⁴ *Ramanand Sagar v. Dy. CIT*, [2002] 255 ITR 134 (Bom)

The area of dispute arises when it is examined and questioned whether CSR expenditure is a charge to the income or appropriation of income, a dispute that has not acquired any clarification yet. Schedule VII¹⁵ allows expenditure of various natures, for example:

Direct expenditure on charitable activities in local area

Direct expenditure on charitable activities

Direct expenditure on capacity building of employees and implementing NPOs

Grant to trust and societies

Transfer to other corporates under pooling of expenditure

Donation to Govt. recognised funds where 100% tax relief is available

Some of these such as grants, donations etc. cannot be charged as expenditure against income as they are voluntary appropriation of income, the schedule VII allows all these types of transactions as CSR expenditures.¹⁶ The words “shall ensure” in section 135(5) signify that there is a legal obligation to spend 2% of average net profit of the past three years on CSR activity. Thus, a valid argument that rises is that all CSR expenditure are seen by the legislature as mandatory and thus they cannot be an appropriation.

On the other hand, there are some CSR activities that are undertaken by the companies which result into creation of capital assets such as training facilities, treatment facilities, hospitals, schools etc., will they be categorized as capital expense or revenue expense? This of consequence because Section 37(1) of income tax provides expenditure deduction for expenditure that is not capital in nature. If such expenditure is categorised as capital expenditure, it may promote CSR expenditure which is not capital assets of taxpayers' ownership. According to judicial interpretation if the asset does not belong to taxpayer, the expenditure cannot be classified as capital expenditure.¹⁷

CSR EXPENDITURE EXEMPTIONS

¹⁵ See http://www.mca.gov.in/Ministry/pdf/CompaniesActNotification3_2014.pdf

¹⁶ M. Fogla, PreBudget: Confusing and Debatable Issues in CSR (Taxmann), Available at: <http://www.taxmann.com/file/t3/prebudgetconfusingdebatableissuesundercsr.aspx>, last seen on 17/11/16

¹⁷ [1996] 89 TAXMAN 92 (SC)

Exemption has been provided to CSR expenditure for payment of any sum to a public sector company or a local authority or an institution or an association approved by the National Committee for undertaking eligible scheme or project, under section 35 AC of Income Tax Act.¹⁸ The eligible projects or schemes as mentioned in Section 35 AC are specifically provided for in Rule 11K of the 1962 Rules.¹⁹ If rule 11K is analysed in detail it will be found that many of the guidelines of activities as recommended are compatible with the subjects given in the Schedule VII of the Companies Act, 2013.

JUDGEMENTS-CSR

Before the introduction of Section 135 there were a lot of judicial decisions in which the courts were faced with the question of if CSR expenditure under Companies Act 1956 is qualified as business expenditure under section 37(1) of the income tax act. The decisions do differ as per the factual situations however a common rule did appear from them- CSR expenditure qualified as business expenditure if “wholly and exclusively laid out for purpose of business or profession”

Few such judgments have been discussed below:

*Sri Venkata Satyanaryana Rice Mill Contractors Co. v. CIT*²⁰: The assessee was in the business of rice export from Andhra Pradesh. Before exporting rice a permit had to be obtained from the District Collector, which were granted only after payment was made to a welfare fund established by the District Collector. The assessee claimed the contributions made to the welfare fund as business expenditure. The ITO disallowed the deduction by holding that the said payment was neither mandatory nor statutory but was only discretionary and further that the welfare fund had not been approved for the purposes of S. 80G. The ITAT held that though there was no compulsion on the part of assessee to make contribution to welfare fund the scheme showed that an advantage would accrue for the benefit of the assessee on the payment of the contribution and, therefore, the same was allowable as deduction.

The Andhra Pradesh HC disallowed this deduction by adjudging this expenditure as a compulsory extraction and therefore contrary to public policy.

¹⁸ See <http://www.taxexemption.in/35ac.html>

¹⁹ See http://www.cainindia.org/news/7_2010/incometax_rules_rule_no_11k.html

²⁰ [1996] 89 TAXMAN 92 (SC)

On appeal, the Supreme Court reversed the decision of the HC and held this to be business expenditure. According to the Supreme Court, the correct test for determining the nature of business expenditure was not whether it was compulsory for the assessee to make the payment or not but commercial expediency²¹

*CIT v. Andhra Bank*²²: The assessee claimed an amount of Rs. 2,04,34,107 spent on Andhra Bank Rural Development Trust, which is engaged in conducting several trainings for providing self-employment to rural youth. After the training, the bank also provided finance to the rural youth. This amount, claimed by the assessee was disallowed by the Assessing Officer because this activity was nowhere related to banking and thus could not be claimed to be for business u/s 37 (1). The CIT (A) on consideration of the detailed objectives of the trust and the scheme conducted by the assessee of training and empowerment of rural youth allowed the expenditure.²³

*Krishna Sahkari Sakhar Karkhana v. CIT*²⁴: The assessee was a registered cooperative society which engaged in sale of sugar. It paid a sum to an Education Fund of the State Federal Society as required under S. 68 of the Maharashtra Cooperative Societies A. The cooperative society claimed deduction of the same as business expenditure. The ITO allowed the claim but the Commissioner set aside the assessment and directed disallowance of the claim. On appeal, the Tribunal upheld the disallowance stating that the contribution made by the assessee to the education fund was not “wholly and exclusively” for the benefit of the assessee and there was no relation between the contribution made by the assessee society and any advantage gained by it as a result thereof. On appeal, the Bombay HC allowed the expenditure u/s 37(1).²⁵

CONCLUSION

The explanation attached to section 37(1) has now made the concept of corporate social responsibility in the current demography more questionable and dismal. It excludes all CSR expenditure from under the umbrella of business expenditure as the CSRP Rules specify that only activities that are not taken for business purpose are termed as CSR activities. Also,

²¹ Ibid

²² MANU/IH/0457/2014, decided on 18/07/2014

²³ Ibid

²⁴ [2000] 112 TAXMAN 246 (Bom)

²⁵ Ibid

these leads to shelving of all the judgments discussed above and many more which had favoured the assessee-corporation in allowing taxation exemption for CSR activities.

The bill's explanatory memorandum states that CSR expenditure is not solely for carrying on business and thus is not allowed as a deduction under Section 37(1) of the Income Tax Act. Though it had been well established through judicial decisions that when income is used for self-imposed obligations it is constituted as application of income and where income moves out of an independent title it is diversion of income.²⁶

The aim of CSR policy is to include Corporate India in the development of the Indian society and give them the role of a stakeholder in the community. Section 30 to section 36 provides expenditure deductions for eligible projects which mean that the tendencies of the companies will shift towards spending in those areas only as they will want to get maximum tax benefit irrespective of the needs of the local area thus negatively affecting the fund flow in other social sector programmes. Thus, it can be concluded that the Financial Bill 2014 offers companies a mixed bag for CSR initiatives.

²⁶ M. Allirajan, 'Cos can avail tax benefits on CSR expenditure' (The Times of India, 04/09/2014), Available at <http://timesofindia.indiatimes.com/business/indiabusiness/CoscanavailtaxbenefitsforexpenditureonCSR/articleshow/41640139.cms>