

INCOME TAX SETBACK ON CSR EXPENDITURES

(IMPACT OF BUDGET 2014)



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ADITYA BIRLA GROUP
FICCI-ADITYA BIRLA
CSR Centre for Excellence

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(IMPACT OF BUDGET 2014)

*Principal Author * :*
Dr. Manoj Fogla

*Advisory Support ** :*

Amitabh Behar, ED, National Foundation for India

Dr. Gautam Vohra, Chairman, DRAG

Dr. K. K. Upadhyay, Head-CSR, FICCI

Gayatri Subramaniam, Convenor, National Foundation for CSR, IICA

K. P. Rajendran, CEO, Four X4

Nisha Agrawal, CEO, Oxfam India

Pooran Pandey, ED, Global Compact Network India

Sanjay Patra, ED, Financial Management Service Foundation

Ms. Shefali Chaturvedi, Senior Director, CII

S. P. Selvi, Executive Director, Credibility Alliance

* The Author is a freelance consultant, can be contacted at mfogla@yahoo.com

** The Advisory support members have contributed to the document, however, the entire content is not necessarily the opinion of the advisory group.

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Income Tax Setback on CSR Expenditures

Introduction

- 1.1.1** The Finance Act, 2014 has brought a very radical & far reaching amendment, as far as CSR expenditures are concerned.
- 1.1.2** There was a lot of expectation that as a corollary to the CSR related amendment in the Companies Act there will be a corresponding amendment in the Income Tax Act, 1961 allowing CSR expenditures as deductions under section 37.
- 1.1.3** On the contrary the Finance Act has proposed that CSR expenditure shall not be allowed as expenditure under section 37 of Income Tax Act, 1961. However, any CSR expenditure which is allowed as deduction under other sections such as section 35, 35AC, 80G etc. is permissible.
- 1.1.4** Now the tax treatment will be different for various types of permissible CSR activities. If the company directly undertakes CSR expenditures, then to spend 2% of CSR the company may have to pay additional 1% as taxes.
- 1.1.5** If the company undertakes CSR expenditures through 80G registered NGOs (including its own foundation) then to spend 2% of CSR the company may have to pay additional 0.5% as taxes.
- 1.1.6** Further, if a corporate undertakes CSR activities through NGOs registered under sections 35 & 35AC or through funds like Prime Minister Relief Fund, National Defence Fund having 100% tax benefit under section 80G then it will get 100% tax advantage and will not be required to pay any additional taxes on account of CSR.

CSR Related Amendments

1.2.1 The Finance Act, 2014 has inserted a new Explanation in sub-section (1) of section 37 clarifying that for the purposes of sub-section (1) of the said section, any expenditure incurred by an assessee on the activities relating to corporate social responsibility referred to in section 135 of the Companies Act, 2013 shall not be deemed to be an expenditure incurred by the assessee for the purposes of the business or profession. This amendment will take effect from 1st April, 2015 and will, accordingly, apply in relation to the assessment year 2015-16 and subsequent years. The proposed amendments are as under:

13. In section 37 of the Income-tax Act, in sub-section (1), the Explanation shall be numbered as Explanation 1 thereof and after Explanation 1 as so numbered, the following Explanation shall be inserted with effect from the 1st day of April, 2015, namely:—

“Explanation 2.—For the removal of doubts, it is hereby declared that for the purposes of sub-section (1), any expenditure incurred by an assessee on the activities relating to corporate social responsibility referred to in section 135 of the Companies Act, 2013 shall not be deemed to be an expenditure incurred by the assessee for the purposes of the business or profession.”

1.2.2 This amendment is a great set back and may defeat the real purpose of bringing CSR related amendments in the Companies Act, 2013. A corporate will now be motivated to contribute to those statutory funds where 100% deduction is available. For instance, a corporate can implement a CSR programme by contributing to the various development programmes. It can also comply with CSR provision by contributing to funds like Prime Minister Relief Fund or National Defence Funds where 100% tax exemptions are available. In other words, all other areas have virtually become redundant or less important. It was strongly expected that the companies would be allowed to deduct CSR expenses under Section 37.

Overview of the Tax Implications

1.3.1 The Companies Act requires at least 2% of average Net Profit to be spent on CSR. In other words, the requirement of Companies Act essentially indicates appropriation of surplus net income for charitable purposes. It does not indicate any statutory charge against the gross income. It may be noted that all expenditures are legal charge against the gross income. On the contrary, CSR expenditure is an appropriation of net income. Therefore, the provisions of the Companies Act create confusion by making CSR a post ‘net profit’ issue. Ideally, CSR expenditure

being a legal requirement should be permitted to be deducted as expenditure under section 37(1) of the Income Tax Act, though there is no statutory clarity in this regard.

- 1.3.2** CSR being a statutory requirement should be treated as a valid charitable expenditure, otherwise it would be big disincentive to the Companies. If CSR is not treated as a valid expenditure, then the Companies would be motivated to give funds to only those organisations where they get maximum tax benefit. For instance, Prime Minister Relief Fund, National Defence Fund or organisations notified under Section 35 or 35AC or 80G. Such organisations provide 100% tax benefit. It may be noted that only few organisations such as Prime Minister Relief Fund, National Defence Fund provide 100% benefit under Section 80G however, only 50% benefit is available to the donor in case of other NGOs registered under section 80G.
- 1.3.3** CSR laws permit expenditure on capacity building of employees and on local area development. Such expenditures, could earlier be directly claimed as CSR expenditures under section 37(1) of the Income Tax Act. In other words, there are certain categories of CSR expenditures which can be charged against income within the existing provisions of the Income Tax Act. At the same time giving donation to a charitable organisation is directly not permissible as business expenditure. However, with the proposed amendments any expenditure under CSR will not be allowed as deduction under section 37.
- 1.3.4** There was no specific mention of CSR expenditures under section 37(1) of the Income Tax Act. However there were many case laws where it was held that such expenditures should be treated as admissible expenditure. Now all such judicial precedence will be nullified from a CSR prospective. For instance a company can claim expenditure towards local area development as CSR expenditure. Now with the proposed amendments the company will be motivated to claim such expenditure as normal business expenditures and not CSR expenditures, in the light of the case laws discussed under :
- 1.3.5** Afforestation expenses allowed by Odisha Tribunal : In the case *Orissa Forest Development Corporation Ltd. v. Joint Commissioner of Income-tax* [2002] 80 ITD 300 (CUTTACK), it was held that expenses incurred by the corporation in plantation of new trees was a revenue expenditure even though there was no statutory obligation on the part of the assessee to incur such expenditure.
- 1.3.6** Expenditure on providing drinking water facilities to local residents is deductible. In the case *CIT v. Madras Refineries Ltd.* [2004] 266 ITR 170/138 Taxman 261 (Mad.) it was held that development of local area and establishing drinking water

facility for local area people was a valid expenditure. It was observed that the concept of business is not static. It has evolved over a period of time to include within its fold the concrete expression of care and concern for the society at large and the people of the locality in which the business is located in particular. Being known as a good corporate citizen brings goodwill of the local community, as also with the regulatory agencies and the society at large, thereby creating an atmosphere in which the business can succeed in a greater measure with the aid of such goodwill. Monies spent for bringing drinking water and also for establishing or improving the school meant for the residents of the locality in which the business is situated cannot be regarded as actually outside the ambit of the business concerns of the assessee, especially when the undertaking owned by the assessee is one which is to some extent a polluting industry. Hence, expenditure incurred by the assessee for establishing drinking water facilities to the residents in the vicinity of its refinery and for providing aid to the school run for the benefit of the children of those residents was allowable as deduction.

- 1.3.7** Donation can also be claimed under section 37(1) : If the contribution by an assessee is in the form of donations of the category specified under section 80G, but it could also be termed as an expenditure of the category falling under section 37(1), then the right of the assessee to claim the whole of it as allowance under section 37(1) cannot be denied- *Mysore Kirloskar Ltd. v. CIT* [1987] 166 ITR 836 (Kar.).
- 1.3.8** Odisha High Court on admissibility of Donation if proved as relatable to carrying on of business : In the case *CIT v. Industrial Development Corporation of Orissa Ltd.* [2001] 249 ITR 401 (Ori.) the hon'ble Odisha High Court held that even donation given can be treated as business expenditures provided such donation can be related with the business of the assessee. In this case the donation was disallowed as there was nothing on record to establish that the donation made by the assessee to the Chief Minister's Relief Fund was directly connected with and related to the carrying on of the assessee's business. However, this case provides a landmark ratio of allowing donation as business expenditure. In the case of mining Companies as the funds are specifically for the local area development under CSR, there is no reason why such expenditure should not be allowed under section 37(1).

Tax Impact under various types of CSR activities

- 1.4.1** As discussed above, the corporates would be more inclined to make CSR donations in schemes with tax incentives such as 80G, section 35, section 35AC etc., because

of the tax benefits. If the corporate does direct CSR spending then the effective tax rate will increase. For instance, the corporate tax rate is currently 33.9% inclusive of surcharge, if the company undertakes direct CSR activities then to spend 2% on CSR the company will have to pay another approximately 1% as taxes as CSR expenditure can be done from post tax income.

- 1.4.2 On the other hand, if a corporate undertakes CSR activities through section 80G registered NGOs then it will get 50% tax advantage, still it will have to pay another 0.5% approximately as tax, since CSR expenditure can be done from post tax income after 50% tax rebate.
- 1.4.3 Further, if a corporate undertakes CSR activities through NGOs registered under sections 35 & 35AC or through funds like Prime Minister Relief Fund, National Defence Fund having 100% tax benefit under section 80G then it will get 100% tax advantage and will not be required to pay any additional taxes on account of CSR.

Concluding Remarks

- 1.5.1 Overall the Finance Act, 2014 has created a fix with regard to the admissibility of the CSR expenditures. It is the job of the government to align various legislations. The Companies Act, 2013 mandates various types of CSR expenditures including giving grant to Prime Minister Relief Fund, National Defence Fund etc. The Act also provides a list of priority activities under Schedule VII, which the companies can undertake under CSR. Now slum development will also be included as CSR expenditure.
- 1.5.2 **However, differential tax treatment of the legally permissible CSR expenditure will defeat the very purpose of enacting various priority activities under CSR. Why should a company incur CSR expenditure on priority areas without having any tax benefit, when it can incur the same with 100% tax deductions. The Government should provide a level playing ground for all kinds of CSR expenditure.**

About Publishers

Credibility Alliance (CA) is a consortium of Voluntary Organizations committed towards enhancing Accountability and Transparency in the Voluntary Sector through good Governance. Registered in May 2004 as an independent, not-for-profit Organization, CA emerged as an initiative from within the Sector after an extensive consultative process over a period of two years involving thousands of VOs all over India. As an Organization, CA aspires to build trust among all stakeholders through improving Governance within the Voluntary Sector. As an initiative whose hallmark has been the participatory approach, CA has developed suitable Norms through wide-ranging consultation with & participation of diverse Organizations within the Sector by developing a large membership base.

With the mission 'to build credibility of the Voluntary Sector through creation and promotion of Norms of Good Governance and Public Disclosure', CA's core programme areas comprise of: Accreditation, Capacity Building, Networking and Information Dissemination.

Centre for Promoting Accountability (CPA) is an organisation "To promote accountability and sustainability amongst organisations in the non-profit & CSR sector". It is promoted by Financial Management Service Foundation and is a part of FMSF family.

CPA assists civil society organisations to achieve development effectiveness by promoting transparency and accountability. CPA achieves this through an integrated process of accompaniment, systems development in financial management and governance, training and capacity building, research and publication, reviews and evaluations.

CPA came into existence in the year 2007. CPA firmly believes on the values of accountability, transparency and good governance. CPA is also involved in research and publication of materials that promotes accountability and involved in information dissemination on financial management, governance and legal regulations.

FICCI-Aditya Birla CSR Centre for Excellence has evolved in consonance with Mahatma Gandhi's dream: ethics-based business practices leading to improvement in the quality of life for the common people. The centre envisions- To incubate, nurture and accelerate a paradigm of sustainable and inclusive CSR in India and across the globe, thereby raising the Human Development Index through poverty alleviation.

The Centre for Excellence is a joint endeavor of Federation of Indian Chambers of Commerce & Industry (FICCI), a rallying point for free enterprise in India since 1927 and the Aditya Birla Group - a prominent business group with a mission to deliver superior value to customers, shareholders, employees and society at large.



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214, DDA Building No. 1, District Centre,
Janakpuri, New Delhi -110 058.
www.credibilityalliance.org



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FICCI-ADITYA BIRLA
CSR Centre for Excellence
www.csrfce.org



404, White House, 382, Sant Nagar,
East of Kailash, New Delhi 110065,
Website: www.cpaindia.in

Send your feedback to : selvi@credibilityalliance.org, cpa@cpaindia.in, kkupadhyay@gmail.com, mfogla@yahoo.com

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