

Interesting Issues - CSR Expenditure

Section 37 of the Income Tax Act, 1961 ('Act') provides for deduction of revenue expenditure incurred, not being personal expenses and not being those covered by provisions of Section 30 to 36 of the Act, wholly and exclusively for the purpose of the business or profession against income chargeable under the head Profits and Gains from Business or Profession.

Finance Act (No.2) 2014 has inserted Explanation 2 to the Section 37 which provides that any expenditure incurred by the assessee on the activities¹ relating to Corporate Social Responsibility ('CSR') referred to in Sec 135 of the Companies Act, 2013 shall not be deemed to incurred for the purpose of business or profession.

The Explanation is inserted for removal of doubts. The amendment is effective from 01.04.2015 and thereby will apply for the Assessment Year 2015-16. The explanatory memorandum to Finance Act (No.2) 2014 provides that the objective of CSR is to share burden of the government in providing social services by companies having net worth/turnover/profit above a threshold and in case such expenses are allowed for tax purposes it would result in subsidizing, to the extent of tax impact say 1/3, such expenses by the government.

The language of the explanation indicates that the explanation inserted by Finance Act (No.2) 2014 is to clear the doubt or clarificatory in nature, though it was made applicable from Assessment Year 2015-16.

In this article, we made an attempt to discuss on certain interesting Issues arise from the language used while inserting the Explanation 2 to Section 37 of the Act.

Issue #1:

The first issue is whether the explanation has retrospective application, mainly because the same was introduced to remove the doubts. The tax authorities interpret that when an explanation has been introduced to remove the doubts, the said explanation will be deemed to have retrospective application.

The Honourable Delhi Tribunal in the matter of The National Small Industries Corp Limited² had an occasion to consider whether the Explanation 2 to Section 37 has a retrospective or prospective application.

The facts of the matter are that the tax authorities have denied expenditure pertaining to CSR activities incurred by The National Small Industries Corp Limited based on the interpretation that Explanation 2 to Section 37 has a retrospective application and also applicable to Assessment Year 2012-13 even though the amendment was carried with effective from Assessment Year 2015-16.

¹ Referred to in Schedule VII of the Companies Act, 2013

² National Small Industries Corp Ltd ITA NO.1367/Del/2016

The Honourable Tribunal has held that Explanation 2 to Section 37(1) cannot be construed as disadvantage to the assessee in the period prior to amendment. It went on to hold that such explanation is a disabling provision, as set out in Explanation 2 to Section 37(1), and refers to CSR expenses under Section 135 of Companies Act, 2013 and as such cannot have application for period not covered by this statutory provision which itself came into existence in 2013. The Tribunal has held that matter in favour of The National Small Industries Corp Limited by placing reliance on the decision of Honourable Supreme Court in the matter of CIT v Vatika Townships Private Limited³, wherein it was held as under

Our belief in the nature of the law is founded on the bed rock that every human being is entitled to arrange his affairs by relying on the existing law and should not find that his plans have been retrospectively upset. This principle of law is known as lex prospicit non respicit: law looks forward not backward. As was observed in Phillips vs. Eyre: a retrospective legislation is contrary to the general principle that legislation by which the conduct of mankind is to be regulated when introduced for the first time to deal with future acts ought not to change the character of past transactions carried on upon the faith of the then existing law

We welcome the judgment of Honourable Delhi Tribunal for clearing the air that Explanation 2 to Section 37(1) is prospective in nature. There are numerous occasions where the judiciary has held that just because the explanation has been inserted to clear the doubts, such explanations would not have retrospective application. What has to be seen that whether such explanation has a substantial impact or not. If such explanation has a substantial impact on the way the matters held by tax payer, such explanation cannot be held to be having retrospective application despite of the fact that they have been introduced for removal of doubts.

Issue #2:

The next issue, we like to deal with is, whether CSR expenditure incurred voluntarily is also covered by Explanation 2 to Section 37(1) and hence attracts disallowance?

On a perusal of Explanation 2 of Section 37(1) inserted by Finance Act (No.2) 2014 provides that any expenditure incurred by the assessee on the activities relating to CSR referred to in Section 135 of the Companies Act, 2013 shall be disallowed.

Hence, in order to be ineligible under terms of Explanation 2 to Section 37(1), the prerequisite is such CSR expenditure has to be incurred in terms of Section 135 of Companies Act, 2013. As per the said section, the obligation on CSR is applicable to the companies which meet the following criteria in the immediately preceding financial year⁴:

- Net worth of Rs. 500 Crores or more;
- Turnover of Rs 1000 Crores or more;
- Net Profit of Rs. 5 Crores or more

³ (2014) 367 ITR 466

⁴ Companies (Amendment Act) 2017 w.e.f 19/09/2018

From above it is clear that CSR obligation is not applicable to all companies. Hence, the question is whether a company which is not obliged under Section 135 of Companies Act, 2013, if expends on CSR activities, will such expenditure get disallowed under Explanation 2 to Section 37(1) of Act. On a plain reading of Explanation 2 to Section 37(1), one can infer that such explanation is applicable to those companies which incurred CSR expenditure voluntarily also. However, we believe that this was not the intention.

Such question has come up for consideration by the Honourable Tribunal of Raipur in the matter of ACIT v Jindal Power Limited⁵. The Honourable Tribunal has stated vide Para 19 as under:

..... This disallowance is restricted to the expenses incurred by the assessee under a statutory obligation under section 135 of Companies Act 2013, and there is thus now a line of demarcation between the expenses incurred by the assessee on discharging corporate social responsibility under such a statutory obligation and under a voluntary assumption of responsibility. As for the former, the disallowance under Explanation 2 to Section 37(1) comes into play, but, as for latter, there is no such disabling provision as long as the expenses, even in discharge of corporate social responsibility on voluntary basis, can be said to be "wholly and exclusively for the purposes of business". There is no dispute that the expenses in question are not incurred under the aforesaid statutory obligation. For this reason also, as also for the basic reason that the Explanation 2 to Section 37(1) comes into play with effect from 1st April 2015, we hold that the disabling provision of Explanation 2 to Section 37(1) does not apply on the facts of this case.

From the above, it is evident that Explanation 2 to Section 37(1) will not come into play in case of discharge of CSR on voluntary basis and be allowed as expenses as long as they incur wholly and exclusively for the purpose of business or profession.

⁵ Jindal Power Ltd 70 Taxmann.com 389