

Corporate Social Responsibility- A Concept Note and Tax issues

by

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Background:

The Companies Bill 2012 was passed in the Lok Sabha on 18th December 2012. It requires the assent of the President to become an Act. The bill seeks to consolidate and improve corporate governance and further strengthen the regulations for corporates.

The Companies Act 2013 has introduced several provisions which would change the way Indian corporates do business and one of the noticeable features of the bill is introduction of the most debated concept of Corporate Social Responsibility (CSR). CSR, which has till now been voluntary contribution by corporates has now been included in law.

The Ministry of Corporate Affairs, Government of India (MCA) has published a set of draft rules required to make the Companies Act, 2013 operational.

Section 135 of the 2013 Act

The Bill requires large companies (determined with reference to net worth, turnover or profit) to constitute a Corporate Social Responsibility Committee consisting of at least one independent director. Companies must make every endeavour to ensure that they spend a minimum amount ***(2% of the average net profits for preceding 3 years)*** on activities pursuant to their CSR policy.

The Section states that every company having:

- 1) Net worth of Rs 500 crore or more, or
- 2) Turnover of Rs 1000 crore or more or
- 3) Net profit of Rs 5 crore or more during any financial year

shall constitute a Corporate Social Responsibility Committee of the Board. Reporting will be done on an annual basis commencing from FY 2014-15

For the purposes of this section, "Average net profit" shall be calculated in accordance with the provisions of section 198 of the 2013 Act. 'Net Profit' for section 135 and these rules shall mean, net profit before tax as per books of accounts and shall not include profits arising from branches outside India

Tax treatment of CSR spend will be in accordance with the IT Act as may be notified by the Central Board of Direct Taxes (CBDT).

Draft CSR Rules

The draft Rules provide for the following:

CSR activities may generally be conducted as projects or programmes (either new or ongoing) excluding activities undertaken in pursuance of the normal course of business of a company.

The CSR Committee constituted under Section 135(1), shall prepare the CSR Policy of the company which shall include the following:

- a) Specify the projects and programmes that are to be undertaken.

- b) Prepare a list of CSR projects/programmes which a company plans to undertake during the implementation year , specifying modalities of execution in the areas/sectors chosen and implementation schedules for the same.
- c) CSR projects/programmes of a company may also focus on integrating business models with social and environmental priorities and processes in order to create shared value.

The CSR Committee shall prepare a transparent monitoring mechanism for ensuring implementation of the projects / programmes / activities proposed to be undertaken by the company.

- d) CSR Policy of the company should provide that surplus arising out of the CSR activity will not be part of business profits of a company.
- e) CSR policy should specify that the corpus would include the following
 - f) 2 percent of the average net profits,
 - g) Any income arising therefrom, and
 - h) Surplus arising out of CSR activities
- i) Where a company has set up an organization which is registered as a Trust or Section 8 Company, or Society or Foundation or any other form of entity operating within India to facilitate implementation of its CSR activities in accordance with its stated CSR Policy, the following shall apply:
 - j) The contributing company would need to specify the projects/programmes to be undertaken by such an organization, for utilizing funds provided by it;

- k) The contributing company shall establish a monitoring mechanism to ensure that the allocation is spent for the intended purpose only;
- l) A company may also implement its CSR programs through not-for-profit organizations that are not set up by the company itself. Such spends may be included as part of its prescribed CSR spend only if such organizations have an established track record of at least three years in carrying out activities in related areas
- m) Companies may collaborate or pool resources with other companies to undertake CSR activities.
- n) Only such CSR activities as are undertaken within India will be taken into consideration.
- o) Only activities which are not exclusively for the benefit of employees of the company or their family members shall be considered as CSR activity
- p) Companies shall report, in the prescribed format, the details of their CSR initiatives in the Directors' Report and in the company's website

Schedule VII to the Act-- CSR activities

The draft Rules essentially elaborate on the legislative provision and seek to operationalize the same with some details.

At the outset, the CSR activities of the company are to be carried out through projects or programmes for the purposes detailed in Schedule VII to the Act.

CSR activities are to include:

- Eradicating extreme hunger and poverty
- Promotion of education
- Promoting gender equality and empowering women
- Reducing child mortality and improving maternal health
- Combating human immunodeficiency virus, acquired
- Immune deficiency syndrome, malaria and other diseases
- Ensuring environmental sustainability
- Employment enhancing vocational skills
- Social business projects
- Contribution to the Prime Minister's National Relief Fund or any other fund set up by the Central Government or the State Governments for socio-economic development and relief and funds for the welfare of the Scheduled Castes, the Scheduled Tribes, other backward classes, minorities and women; and
- Such other matters as may be prescribed
- The 2013 Act provides that the company shall give preference to the local area and areas around it where it operates

It is not clear whether only the above activities will constitute CSR activities, as the list specified under Schedule VII of the Act seems like an inclusive list and not exhaustive

Tax treatment of CSR

(i) Tax treatment of CSR spending will be in accordance with the IT Act as may be notified by the Central Board of Direct Taxes (CBDT)

The Companies Act's focus on CSR is a matter of expenditure of funds by companies rather than as a matter of conduct or corporate behavior. Therefore, CSR excludes "activities undertaken in pursuance of the normal course of business of the company". This means that companies' normal business conduct will not be taken into account for CSR.

The expenditure on CSR is not one contemplated under Section 37 which provides for allowance of any expenditure, not being in the nature of capital expenditure or personal expenses of the assessee, which is laid out or expended wholly and exclusively for the purposes of the business or profession.

Therefore, if any expenditure on CSR is not considered as permissible CSR spending, it is not clear whether this amount would this get disallowed for tax purposes.

Suitable amendments to the Income tax Act are necessary to ensure allowance for deduction of CSR expenditure. This would avoid needless litigation. Corporates should ensure that the CSR activities are within the norms given by CBDT to ensure that there is no disallowance under the Income tax Act. It is to be hoped that the CBDT guidelines are not restrictive. CBDT may take a cue from the various decisions, some of which are cited below:

- ***CIT vs. M/S Karnataka Financial Corpn 2010-TIOL-27***

The High Court held the amount spent towards the development of infrastructural facilities of villages and construction of a new market to organize self help group would certainly promote the business of the assessee

- ***Delhi Cloth & General Mills Co. Ltd. vs. CIT 198 ITR 500***

The Delhi High Court held expenses incurred by company for running DCM Football Tournament was an admissible deduction

Though these decisions were rendered under section 37, they are in line with socio economic development which is contemplated as CSR policy.

(ii) It has been provided that surplus arising out of the CSR activity will not be part of business profits of the company. This is a welcome measure.

(iii) The draft Rules contain some details on how the companies can undertake CSR activities. For example, CSR can be implemented through trusts or Section 8 companies set up for this purpose. The company may itself set up such entities or may use entities set up by other persons for CSR programmes.

An issue that would arise is whether for Income tax purposes, contribution to the trust by the corporate would be allowed wholly or restricted to 50% under Section 80G. Under Section 80G contributions to only certain trusts are given 100% deduction. Suitable amendments should be made to Section 11 and Section 80G to provide for allowance of contribution to such trusts. The Government may also be concerned that donations otherwise received by such trusts get the benefit of 100% deduction. These are areas of concern and require clarification.

(iv) The draft Rules provide that activities which are solely for the benefit of employees or their family members are excluded from the scope of CSR activity. Understandably, this is a measure to ensure that CSR obligations are more widely undertaken, but it undermines the general principle that employees are a key stakeholder in the business of the company.

However it may also be noted that Section 40A(9) provides that deduction shall not be allowed in respect of any sum paid by the assessee as an employer towards the

setting up or formation of, or as contribution to any fund or trust, other than certain specified trusts, for the welfare of employees. This Rule ensures corporates do not circumvent Section 40A(9) by including welfare trusts solely for employees under CSR.

The draft Rules provide that only activities which are not exclusively for the benefit of employees of the company are permissible. Since only trusts solely for employees are excluded from the purview of CSR spending, employers could still give some benefit, such as medical, hospitalization, and schooling to their employees through trusts constituted for the benefit of the general public.

Conclusion

- (1) There are some limitations by which certain activities would not count towards CSR.

Only CSR spending within India would be recognized under the Act. Any activities undertaken outside India will be excluded. This may have some impact on Indian companies having international operations, where CSR activities conducted in other jurisdictions would not be taken into account for the purpose of fulfillment of obligations under section 135. However, it is to be noted that net profit for the purposes of this section shall not include profits arising from branches outside India.

- (2) The tax treatment of CSR spending will be in accordance with the IT Act as may be notified by the CBDT. Surplus arising out of the CSR activity will not be part of business profits of a company.

Companies will have to ensure that the amount spent under CSR is in accordance with the CBDT guidelines to avail allowance of the expenditure