


Tax Alert

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Scope of Eligible CSR expenditure expanded recently. Expenditure on expanded CSR activities allowable as deduction for tax purposes

Scope of Eligible CSR activities expanded to cover scientific research on COVID-19 vaccines undertaken by pharmaceutical companies and contribution to specified institutions for scientific research. Expenditure on expanded activities would also be eligible for deduction under the Income-tax Act, 1961.

Background

- The Companies Act, 2013 ('the Companies Act') mandates specified companies to spend two percent of average net profits of three preceding financial years, towards Corporate Social Responsibility ('CSR') activities.¹
- Schedule VII of the Companies Act prescribes list of eligible CSR activities. As per clause (ix) of the Schedule VII, the company can contribute to specified organisations as part of its CSR obligation.
- As per the existing Companies (Corporate Social Responsibility Policy) Rules, 2014, ('CSR Rules'), expenditure incurred on activities undertaken in pursuance of normal course of business of a company would be excluded from the CSR contribution.
- The Central Government issued Notification E- F. No. CSR-07/2/2020-CSR-MCA dated August 24, 2020 to promote research and development for vaccine, drugs and medical devices relating to COVID-19 treating it as a part of CSR activities.

¹ As per section 135(1) of the Companies Act, 2013, company having net worth of rupees five hundred crore or more, or turnover of rupees one thousand crore or more or a net profit of rupees five crore or more during the immediately preceding financial year would be liable to spend at two percent of average net profits of three preceding years, towards CSR activities.



- Further, the Central Government issued Notification no. 13/18/2019-CSR dated October 11, 2019 and CSR-07/2/2020-CSR-MCA dated August 24, 2020 to cover contribution to public funded universities, IITs and other specified institutions within scope of CSR activities.
- Explanation 2 to section 37(1) of the Income-Tax Act, 1961 ('the IT Act'), specifies that expenditure incurred on CSR activities under section 37 will not be regarded as incurred for the purpose of business or profession. Thereby expenditure incurred on CSR activities is not deductible business expenditure. However, the expenditure on expanded activities as above would fall under section 35 of the IT Act.
- Hence, a question arises whether the research and development expenses on vaccines, drugs and medical devices relating to COVID-19 and contribution to specified institution as a part of CSR activities would be allowable as deduction under the Act.

Research & Development expenditure of pharmaceutical companies

- As per Notification no. E- F. No. CSR-07/2/2020-CSR-MCA dated 24 August 2020, any company engaged in research and development activity of new vaccine, drugs and medical devices in their normal course of business may undertake research and development activity of new vaccine, drugs and medical devices related to COVID-19 for financial years 2020-21 to 2022-23. Expenditure on such research on COVID-19 vaccines would be treated as CSR expenditure if such research and development activities are carried out in collaboration with any of the institutes or organisations mentioned in item (ix) of Schedule VII to the Companies Act.
- Such expenditure would also qualify to be CSR expenditure even though it is incurred in pursuance of normal course of the business.
- While explanation 2 to section 37(1) of the IT Act disallows expenditure incurred on CSR activities, Memorandum to Finance (No. 2) Bill, 2014 and Circular no. 1/2015, dated 21-1-2015, suggest that the Explanation to section 37(1) would not be applicable to CSR expenditure allowable under section 30 to 36 of the IT Act.
- In terms of clause (4) of section 43, which defines scientific research, references of scientific research related to a business or a class of business includes any scientific research which may lead to or facilitate an extension of that business or all businesses of that class. For a company engaged in pharmaceutical business, research on COVID-19 would certainly fall within the definition of scientific research related to a business / class of business.
- Section 35(1)(i) of the IT Act allows deduction in respect of revenue expenditure incurred on scientific research related to business carried on by the taxpayer, section 35(1)(iv) allows deduction in respect of capital expenditure incurred on scientific research related to a business. Thus, a Company would be able to claim deduction in respect of both revenue and capital expenditure incurred for research & development expenses relating to COVID-19 under section 35 of the IT Act and the same will not be hit by the Explanation 2 to section 37(1) of the Act.



CSR donation to specified institutions

- As per clause (ix) of the Schedule VII of the Companies Act, companies can contribute to research and development projects in the field of science, technology, engineering and medicine, funded by the Government or Public Sector Undertaking, public funded Universities, Indian Institute of Technology (IITs), National Laboratories and other specified institutions engaged in conducting research in science, technology, engineering and medicine aimed at promoting Sustainable Development Goals, as part of CSR obligation.
- Section 35(1)(ii) of the IT Act allows deduction of sum paid to a research association which has object of scientific research or to a university, college or other institution for scientific research, provided that such association, university, college or other institution is approved and notified by the Central Government.
- Further, section 35(2AA) grants deduction in respect of payment to National Laboratory or a university or an Indian Institute of Technology or a specified person with a specific direction that such sum shall be used for scientific research undertaken under a programme approved by the prescribed authority.
- Thus, CSR contribution for scientific research to public funded university or institution specified under clause (ix) of Schedule VII would be allowed as deduction under section 35, if such university or institution is notified under section 35(1)(ii) or approved under section 35(2AA) of the IT Act.

Dhruva Comments

- India is the first country to impose a legal obligation on the companies to contribute specified sum towards social responsibility. However, by virtue of the Explanation 2 to section 37(1) of the Act, such CSR expenditure is not considered eligible for tax deduction. Disallowance of expenditure under the IT Act increases burden of the companies.
- The relaxations provided for in the notification should be examined in detail by companies (especially pharmaceutical companies) so that the twin objective of expanded CSR mandate as well as tax deductibility leads to focussed outcomes and overall tax and cash flow efficiency.



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