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Education Cess
not allowed as deduction with retrospective effect

Background

Section 40(a)(ii) of the Income Tax Act, 1961 ('Act') provides for disallowance of any rate or tax levied on profits or gains of any business or profession in computing the gross total income of a taxpayer. Pursuant to this provision, typically, taxpayers have been disallowing income tax, surcharge, education cess, and interest paid thereon, while computing profits and gains from business or profession.

However, recently, a spate of rulings have held education cess as not part of 'tax' and therefore allowable as a deduction. Notably, the Hon'ble Bombay High Court in the case of Sesa Goa Limited[1] and Rajasthan High Court in the case of Chambal Fertilisers and Chemicals Ltd[2], have held that education cess is not part of 'tax', and accordingly, the same is allowable as a deduction. While deciding the issue, the Courts relied upon the Supreme Court ruling in the case of Jaipuria Samla Amalgamated Collieries Ltd[3] as well as the CBDT Circular of 18 May 1967 and has held that education cess is a deductible expenditure since it cannot be regarded as 'tax'.

The taxpayers have been claiming the deduction for the education cess on the following grounds:

- The intent behind the introduction of education cess was to enable the government to provide and finance basic education.
- This specific utilization objective differs from the purpose of collection of 'tax' which is levied with the intent of utilization for general purposes. Thus, 'cess' should be regarded as separate from 'tax'.
- The 1967 circular referred to above clarifies that cess is intended to be allowed. The circular refers to the wordings of section 40(a)(ii) of the Act as were originally introduced in the Parliament and specific omission of the word 'cess' from the items to be disallowed under section 40(a)(ii) of the Act.

The abovementioned decisions have also been followed by several Tribunal decisions[4] which have upheld the allowability of education cess as a business deduction.

1. [2020] 117 taxmann.com 96 (Bombay)
2. [2019] 107 taxmann.com 484 (Rajasthan)
3. [1971] 82 ITR 580 (SC)
4. Kolkata Tribunal in the case of ITC Limited (ITA No. 685 of 2014) and in the case of The Peerless General Finance & Investment Co. Ltd (ITA No. 937 and 938/2018)

Amendment Proposed by The Finance Bill 2022

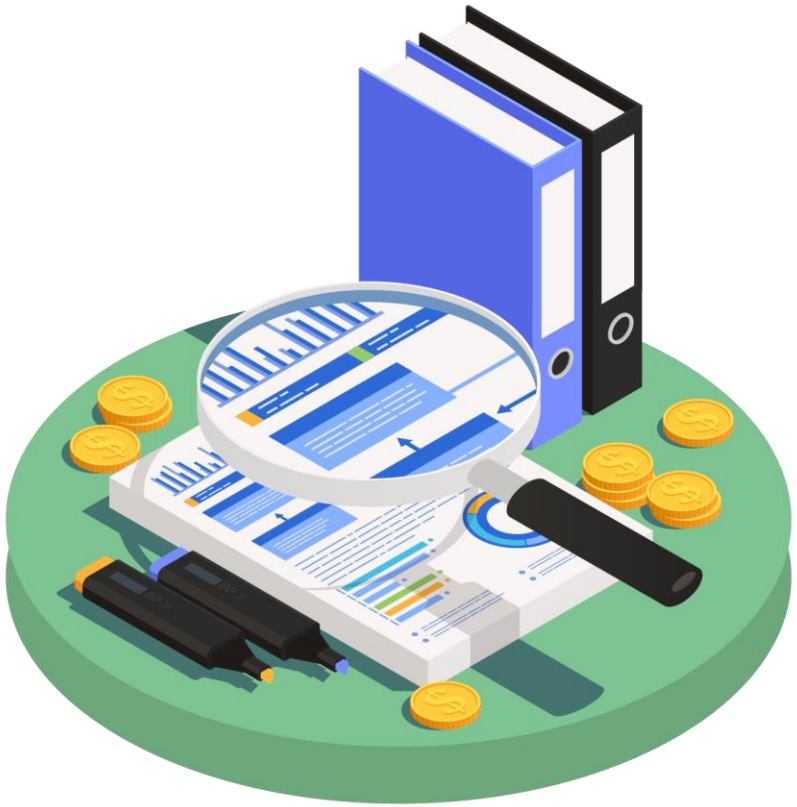
The Finance Bill 2022 has proposed to retrospectively insert an explanation in the above provision to clarify that the term 'tax' includes and shall be deemed to have always included any surcharge or cess, by whatever name called, on such tax. The amendment is to retrospect with effect from FY 2004-05 relevant to AY 2005-06.

As per the Memorandum to the Finance Bill, the rationale for proposing the amendment is to make the intention of the legislation clear and to make it free from any misinterpretation. This would also result in overturning these decisions where the interpretations are against the intention of the legislature and not in line with the judgment of Hon'ble Supreme Court decision in the case of K Srinivasan[5].

Reference has also been made to a recent Kolkata Tribunal decision in the case of M/s. Kanoria Chemicals & Industries Ltd[6] which has discussed the above High Court decisions as well as the Supreme Court decision and has held that cess should not be allowed as a deduction. The Tribunal has relied on the Supreme Court's observation that surcharge and additional surcharge is an additional mode or rate for charging income tax which should form a part of the income tax. Reference has also been drawn from the provisions of Finance Act 2004 and 2011 which refers to education cess as an additional surcharge levied on the income tax.

It has also been noted that the favorable High Court decisions have not discussed the Supreme Court decision of K Srinivasan referred above and thus are per incuriam which means 'through lack of due regard to the law or the facts.'

The Memorandum has also delved into the distinguishing factor on the applicability of the 1967 Circular which has held allowability of cess as a deduction. It has been noted that this circular was in reference to 'Cess' imposed by the State Government which is actually of the nature of 'Cess' and not of the nature of 'Additional Surcharge' being termed as 'Cess' in the relevant Finance Act. The additional surcharge named as 'Cess' and imposed by the Central Government through the Finance Act is nothing but a tax and hence, needs to be disallowed under section 40(a)(ii) of the Act.



5. [1972] 83 ITR 346 (SC)
6. ITA No. 2184/Kol/2018

Takeaway

Education cess was introduced in the budget for the year 2004-05. Basis the Memorandum to the Finance Bill, it can be inferred that education cess has been brought into the statute to enable the government to provide and finance basic education. While proceeds from the collection of tax are intended to be used by the Government for general purposes and running of the state of affairs of the country, cess proceeds are collected and utilized separately with a specific purpose. Considering this basic difference in the purpose of utilization, ‘education cess’ should ideally not get considered akin to ‘tax’.

However, the Memorandum to the Finance Bill which spells out the intent or rationale for proposing an amendment makes it clear that it was never intended to grant any deduction for education cess in the first place. However, since certain rulings have been taking a view that was not aligned with this intent, the need was felt to bring about an express clarification in this regard. Notably, the amendment has been proposed with a retrospective with effect from FY 2004-05. Thus, this will not only impact the potential claims in future but the ones already made in the income-tax returns or additional claims made during the course of the assessments/appeals. It would be interesting to see whether the retrospective of the amendment is challenged and past cases would still survive.

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