INSIGHTS

Direct Tax

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SC | Interest on borrowed funds used for investment in equity of subsidiary for business purpose allowed under Sec 36(1)(iii) of the Act [1]

Sec 36(1)(iii) of the Act permits deduction of interest on capital borrowed used for business or professional purposes; however, if the borrowings are utilized for acquiring an asset for expansion of existing business, the interest thereon is not allowable as deduction, until such asset is first put to use.

In a significant ruling, the Supreme Court has held that interest on borrowed capital is allowable as business expenditure under Sec 36(1)(iii) of the Act where a taxpayer, engaged in the business of investing in shares, uses such borrowed funds to acquire shares of another company through its subsidiary, which is financed by the taxpayer via equity infusion. The Apex Court reiterated that allowability of such interest is governed by the test of 'commercial expediency'.

Brief Facts

- The taxpayer is a Trust, carrying on a composite business of film distribution, money lending, speculation and investment in shares (including through subsidiaries). A single, common set of books of account was maintained for all activities, with complete interlocking of funds under the management of its trustees.
- It availed loan from a bank and the interest paid thereon was claimed as a deduction under Sec 36(1)(iii) of the Act.
- It transferred such borrowed funds to its subsidiary via equity infusion and the subsidiary in turn used a portion of such funds to purchase shares of M/s Shaw Wallace & Co Ltd.
- The remaining major portion of the funds stayed with the subsidiary on which no interest was charged or recovered by the taxpayer from the subsidiary. Thus, only a partial amount of borrowed funds was utilised to purchase shares on behalf of the taxpayer.
- The AO allowed deduction of interest on a proportionate basis i.e. to the extent of value of the shares purchased in the name of taxpayer and disallowed the balance interest attributable to the amount lying unutilised with the subsidiary.
- Being aggrieved by the same, the taxpayer preferred an appeal with CIT(A), which was dismissed. Consequently, the taxpayer preferred appeal before Tribunal.

Tribunal's Ruling [2]

The Tribunal held in favour of the taxpayer by observing as under:

- All the conditions essential for allowing deduction of interest under Sec 36(1)(iii) are satisfied in the taxpayer's case wherein the funds were utilised for activities integral to its operations.
- It further noted that the taxpayer's activities constituted a composite and interlinked business comprising of share investment and speculation, inter alia other businesses, carried on under common management with a unified set of books and intermingled funds, thereby establishing a clear commercial nexus.
- The Tribunal held that routing of funds through a subsidiary or group entity did not vitiate the claim, as such deployment formed part of the overall business strategy and did not amount to diversion for non-business purposes.

[1] L.K. Trust v. CIT & ANR [Civil Appeal No 527/2012] (SC)

[2] L.K. Trust v CIT [ITA No. 2032/Bang/1992]

- Relying on settled Supreme Court jurisprudences, it reiterated that the decisive test is the purpose of borrowing at the time it is made.
- Accordingly, applying the principles of commercial expediency in the context of a composite business structure, the Tribunal concluded that the interest expenditure was fully allowable and directed deletion of the disallowance made by the lower authorities.

High Court Ruling [3]

Contradicting Tribunal's ruling, the High Court concurred with the AO in **disallowing** deduction for interest to the extent attributable to the unutilised portion of the amount transferred to the subsidiary, without recovering any interest income. Upholding the proportionate disallowance made by the AO, the High Court observed as under:

> *"If a sister concern of the assessee has utilised the funds of the assessee **without any returns** to the assessee, the AO is justified in negativing the contention with regard to the unutilised amount."*

Supreme Court Ruling

The SC affirmed Tribunal's decision, holding that the deduction of entire interest under Sec 36(1)(iii) was rightly allowable, as the requisite business nexus stood established on principles of commercial expediency.

Key observations by SC are summarised below:

- **"Business Purpose" under Sec 36(1)(iii) has a wider and liberal scope**

  Referring to Sec 36(1)(iii), the Court observed that the condition of utilisation of borrowed capital for the "**purposes of the business"** is satisfied in case of the taxpayer's facts. Relying on its own decision of *Madhav Prasad Jatia*[4], it held that the expression **"for the purpose of business"** bears a wider and more liberal connotation than analogous provisions like Sec 57(iii) and must be tested on the touchstone of commercial expediency.

- **High Court's narrow view considering subsidiary's business as distinct from taxpayer's business, rejected**

  The SC opined that the High Court fell into error in concluding that the utilisation of borrowed funds was done for the subsidiary's business being a business distinct from the taxpayer's business.

  Accordingly, the SC held that utilisation of funds for subsidiary's benefit did not, by itself, negate their nexus with the taxpayer's business.

- **Commercial Expediency held as the key test of 'Business Purpose' over 'Profit Motive'**

  The SC relied on its own decision in *Sharp Business System*[5], wherein it upheld the deductibility of interest on borrowed funds used for acquiring controlling interest in a sister concern to elucidate that *"the transfer of borrowed funds must be examined from the point of view of commercial expediency and not from the point of view whether the amount was advanced for earning profits."*

Our Comments

In enunciating this ruling, the SC has referred its earlier decisions wherein the interest on borrowed funds was held as an allowable deduction under Sec 36(1)(iii) of the Act, where such funds were utilised to extend loan to sister concern for business purpose[6] or to acquire controlling interest[7] in them. Key takeaway from this ruling is that - as long as the purpose for

[3] CIT v. L.K. Trust [2010] 46 DTR 0070 (Kar HC)
[4] Madhav Prasad Jatia v. CIT [118 ITR 200] (SC)
[5] Sharp Business System v. CIT [2025] 181 taxmann.com 657 (SC)
[6] S.A. Builders Ltd v. CIT [2007] 288 ITR 1 (SC)
[7] Refer footnote no. 5

infusion of funds is 'business purpose' and such purpose meets the test of commercial expediency; it is immaterial whether the funding is done through advancement of loan or equity infusion.

ITAT Mumbai | Transaction level choice between DTAA and Act upheld for Capital Gain computation [8]

In a recent ruling, the Mumbai ITAT has upheld the position that each capital gains transaction constitutes a separate source of income, and therefore, a taxpayer is entitled to opt for either the provisions of the Act or the applicable DTAA, whichever is more beneficial as prescribed under Sec 90(2) of the Act, qua each such source of income.

Brief Facts

- The taxpayer, a resident of Singapore, earned capital gains from disposal of investments in Indian Companies.
- While computing this income, the taxpayer selectively applied the exemption under Article 13(4A) of the India-Singapore Treaty (DTAA) to one transaction that resulted in long-term capital gains (LTCG).
- For another transaction resulting in long-term capital loss (LTCL), the taxpayer chose to be governed by the provisions of the Act instead of the Treaty and claimed set-off of the said LTCL against other LTCG under the domestic law.

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Details of transactions and approach adopted by the taxpayer are summarised below:

Sr.	Indian Investee Cos	Date of Acquisition	Nature of Gains	Choice opted (DTAA or Act)
1	*P*	Before 01.04.2017	***LTCG***	*Exemption claimed under Article 13(4A) of India-Singapore DTAA*
2	S	Before 01.04.2017	**LTCL**	LTCL from sale of 'S' shares set-off against LTCG from sale of 'X'&'B' shares under the Act
3	X	After 01.04.2017	**LTCG**	
4	B	After 01.04.2017	**LTCG**	

Revenue's Approach

AO's computation

The AO contended that the transactions at Sr. No. 1 and 2, being shares acquired pre-2017 be clubbed and be governed by the DTAA wherein the resultant gains/loss would be taxable in Singapore i.e. country of residence of the seller under Article 13(4A) of the DTAA.

Resultantly, the LTCG at Sr. 3 and Sr. 4 were assessed as taxable under the Act without allowing set-off of LTCL at Sr. No 2.

DRP's Directions

The DRP observed that the computation of capital gains for an assessment year must be made in terms of provisions of the Act and the DTAA does not provide for any independent computation mechanism.

Further, once the net income is computed under the Act, the taxpayer must consistently opt for either the Act or the DTAA for the entire net capital gain instead of selectively applying such choice of regime to individual transactions.

[8] Alibaba.com Singapore E Commerce Pvt Ltd v. DCIT ITA 2070/Mum/2025 (Mum Trib.)

Accordingly, the AO was directed to aggregate all the four transactions, comprising of three gains and one loss. This resulted in denial of Treaty exemption of LTCG and additions under the Act.

Tribunal's ruling

Before the Tribunal, the issue centred on the taxability of LTCG arising from the sale of pre-2017 investments under domestic law, which the taxpayer claimed as exempt under Article 13(4A) of the Treaty.

Relying on jurisdictional rulings in case of Matrix Partners India Investment Holdings LLC[9], Montgomery Emerging Markets Fund[10] and Prashant Kothari[11], the latter being held on identical facts, the Tribunal held in favour of the taxpayer. Key observations made by the Tribunal are summarised below:

- **Sec 90(2) of the Act allows transaction-wise application of beneficial tax regime**

  The Tribunal held that *"each transaction constitutes a separate source of income and therefore, in accordance with Sec 90(2) of the Act, the taxpayer is entitled to avail the benefit of the domestic law under the Act or the applicable DTAA, whichever is more beneficial, qua each such source of income"*

  "Merely because the transactions fall under the common head "Capital Gains" would not obliterate their independent character as separate sources of income".

- **DTAA cannot be thrust to the taxpayer's disadvantage**

  Once each transaction resulting in capital gain or loss is treated as a separate source of income, a taxpayer is allowed to make a beneficial choice between the Act and the Treaty under Sec 90(2) of the Act.

  Accordingly, if a transaction resulting in capital gains is not taxable in India by virtue of exemption available under the Treaty then such exempt gains *"cannot be forced into the computation mechanism under the Act for the purpose of setting off losses arising from other transactions,"* as this would lead to indirect taxation of income otherwise not taxable in India.

Our Comments

The Tribunal has reaffirmed the taxpayer's approach which has been previously upheld in its earlier rulings, of exercising a choice between the DTAA and the Act on a transaction-by-transaction basis thereby allowing exemption of gains under the DTAA for certain transactions while simultaneously permitting carry forward and set-off of losses under the Act for others.

As regards the issue of setting off capital losses under the Treaty, although not directly addressed in the present ruling, it has been observed in *Matrix Partners (supra)*, that such netting is presently not permissible under the Treaty in absence of an express provision permitting it, unless the Treaty is specifically amended to that effect.

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[9] Matrix Partners India Investment Holdings LLC v DCIT ITA No 3097 /Mum/2023 (Mum Trib.)

[10] Joint CIT v. Montgomery Emerging Markets Fund [2006] 100 ITD 217 (Mum Trib. - Special Bench)

[11] Prashant Kothari v. Int. Tax Ward 3(1)(1) [2025] 174 taxmann.com 1244 (Mum Trib.)

ITAT Chennai | Bona fide business reorganization resulting in tax free externalization of funds, upheld [12]

Sec 47(iv) of the Act exempts any transaction involving the transfer of a capital asset by a holding company to its wholly owned subsidiary (WOS), provided the holding company (or its nominees) holds the entire share capital of the subsidiary, and the subsidiary company is an Indian company. Such transactions are therefore not chargeable to capital gains tax in India.

In a recent ruling, with a factual matrix involving a two-step business restructure comprising of transfer of stake in an Indian WOS to another Indian WOS by a foreign parent, followed by merger of both the Indian WOS, the Chennai Tribunal held that such transfer, being driven by commercial expediency of facilitating the subsequent merger of both the Indian WOS constituted a bona fide transaction not taxable in India. The Tribunal further held that a transaction cannot be disregarded merely because the consideration was received by the foreign taxpayer without tax incidence, in the absence of evidence on tax abuse or lack of commercial substance.

Facts

- The taxpayer, a French Holding Company, held 60% stake in its subsidiary (VSIAPL) since 2012. In 2018, it acquired the remaining 40% from its JV partner resulting in 100% holding in VSIAPL.
- In 2019, it transferred the entire stake in VSIAPL to another WOS (VIPL) followed by a fast-track merger of both the WOS i.e. VSIAPL and VIPL.
- The sale of shares held in VSIAPL i.e. WOS_1 to VIPL i.e. WOS_2 was executed to enable merger of WOS_1 and WOS_2 under the fast track route.
- The taxpayer claimed exemption under Sec 47(iv) of the Act in respect of transfer of shares in WOS_1 to WOS_2.
- The Revenue denied exemption under Sec 47(iv) on the ground that the subsequent acquisition of 40% stake and sale within 18 months, indicated a trading intent, and therefore the shares transferred to the WOS_2 constituted stock-in-trade instead of capital assets.
- Alleging that the business structure was a colourable device to achieve tax-free repatriation of funds from India to the taxpayer's foreign jurisdiction, the Revenue argued that the merger could have been otherwise achieved directly under the Companies Act, without sale of shares.

Tribunal's ruling

The primary issue for consideration before the Tribunal was whether the transfer of shares held by the taxpayer in its Indian WOS to its other Indian WOS, constituted a colourable tax avoidance device.

The Tribunal ruled in favour of the taxpayer holding that such a transaction constituted a bona fide transfer, squarely covered by exemption under Sec 47(iv) of the Act, in absence of proof of tax abuse.

Key observations by Tribunal are summarised below:

- **Tax efficiency alone does not invalidate a bona fide transaction**

  The Tribunal reiterated that a bona fide transaction cannot be disregarded merely on the grounds of perceived tax advantage without any material to establish sham or lack of commercial substance. Noting that the two-step business restructuring i.e. first sale of shares to WOS_1 and subsequent merger of WOS_1 and WOS_2, was done to

[12] M/s Valeo Bayen v DCIT [IT(TP)A No.63/Chny/2023] (Chny Trib.)

expedite the process of merger through the fast track route, the Tribunal held that *"Revenue cannot sit in the armchair of a businessman and dictate the manner in which business decisions are to be taken"* and therefore the *"authenticity of the transaction cannot be questioned for the* ***only reason that the taxpayer has received consideration without paying taxes***[13] *as per the provisions of the Act."*

Thus, the choice of structuring must remain within the taxpayer's commercial discretion and tax benefit resulting from such bona fide structure cannot be viewed from the lens of tax avoidance.

- **Genuineness of restructuring without change in beneficial ownership and economic interest, upheld**

The Tribunal further observed that the structure resulted into reorganisation of shareholding, with no change in ultimate beneficial ownership, thereby indicating continuity of economic interest, with the capital asset effectively remaining within India.

Again, in the absence of any material suggesting that the transaction is circular, self-cancelling, or devoid of real economic effect, the transaction could not be questioned for genuineness.

- **Classification of asset transferred: "Stock in trade" vs. "Capital asset"**

As regards AO's contention on treatment of the shares transferred by the taxpayer to its WOS as 'stock in trade' instead of 'capital asset', thereby justifying denial of exemption under Sec 47(iv), the Tribunal held that such classification of shares must be determined holistically by considering the nature and intention of holding since inception.

In this case, the 60% stake which was held as a long-term investment since 2012, could not be reclassified as stock-in-trade merely because there was a subsequent acquisition of balance 40% followed by sale within 18 months, without a comprehensive evaluation of the taxpayer's intent and conduct.

Our Comments

This ruling reinforces the settled position that tax planning within the framework of law is permissible. However, the ruling is based on the facts that no material suggesting tax abuse was recorded by the Revenue for the two-step structure comprising of share sale followed by fast-track merger, more particularly when such structure results in receipt of consideration by the foreign taxpayer without payment taxes in India.

[13] Bold and underlined for emphasis

Glossary

Abbreviations	Term
Act	Income-tax Act, 1961
AO	Assessing Officer
CIT(A)	Commissioner of Income Tax (Appeals)
DRP	Dispute Resolution Panel
DTAA	Double Tax Avoidance Agreement
ITAT	Income Tax Appellate Tribunal
LTCG	Long Term Capital Gains
LTCL	Long Term Capital Loss
Sec	Section
SC	Supreme Court

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