

Interest on borrowed funds utilised to grant loan to subsidiary not allowed due to lack of commercial expediency: Bangalore ITAT

17 September 2021



Summary

The **Bangalore bench of Income Tax Appellate Tribunal (ITAT)**, in a recent case¹, has held that payment of interest by the taxpayer on borrowed funds utilised to provide loans to subsidiary engaged in a different line of business is not allowable as a deduction² due to lack of commercial expediency.

Facts of the case

- The taxpayer is engaged in the business of land development and construction. The taxpayer transferred an amount of INR 6.9 crore and INR 7.1 crore to its subsidiaries Davanam Constructions Sdn Bhd, Malaysia (DCSB) and Amethyst Hospitality (P) Ltd. (AHPL), respectively.
- DCSB was engaged in the same line of business as the taxpayer. However, AHPL was engaged in the hospitality business.
- Out of INR 7.1 crore transferred to AHPL, INR 1.9 crore was for investment and the remaining INR 5.22 crore was given as an interest-free advance for its business.
- The proportionate financial cost (INR 40,46,607) on interest-free advances given to AHPL (i.e. on INR 5.22 crore) was disallowed by the tax officer³.
- The taxpayer filed an appeal against the tax officer's order before the Commissioner Appeals [CIT(A)]. The CIT(A) upheld the order of the tax officer. While arriving at the conclusion, the CIT(A) also observed that there was an increase in loans and fixed assets in the books of the taxpayer and, therefore, it could not be said that it was having sufficient interest-free funds available with it.
- The taxpayer challenged the order before the ITAT.

Tax department's arguments

- The tax department contended that cost of funds given to DCSB was allowed, as it is in

¹ Davanam Constructions Private Limited [TS-851-ITAT-2021(Bang)]

² under Section 36 (1)(iii) read with Section 37 of the Income-tax Act 1961 (the Act)

³ under section 36(1)(iii) read with Section 37 of the Act

the same line of business and there is some commercial expediency in advancing the amount to it. However, the same is not true for AHPL since it is engaged in an unrelated line of business and, accordingly, there is no commercial expediency in advancing loan to it.

- It was further argued that the taxpayer has not derived any business advantage by advancing such a huge amount to AHPL. Accordingly, interest payment on the said borrowings cannot be allowed as a business expenditure.

Taxpayer's arguments

- The taxpayer contended that the borrowings were specifically utilised for the purpose of business⁴.
- The loan was advanced to AHPL basis the principle of commercial expediency and the same was utilised by AHPL for its business operations. The transaction was in the nature of shareholders activity or stewardship activities.

ITAT's observation and order

- The ITAT noted that the Supreme Court ruling in case of S.A. Builders⁵ could not be

applied in the instant case, as the taxpayer was not able to establish any commercial expediency for advancing of such interest-free loan to AHPL.

The Supreme Court in the case of S.A. Builders had explained the term 'commercial expediency' to mean something which leads to business advancement, leads to preservation of business expenditure, is not personal in nature and there is a nexus between the grant of interest-free loan and business interest.

The purpose for which the loan has been granted is relevant and the not the source from which the fund has been obtained.

- In the instant case, it was observed that the taxpayer and AHPL were in different lines of business and further, post receiving the loan, AHPL used the same funds to make advances to its related parties from year-to-year and such loan received was not at all used for business purposes.
- Accordingly, ITAT upheld the decision of CIT(A) to disallow finance cost on funds utilised for providing interest-free loan to AHPL.

⁴ as required u/s 36(1)(iii) of the Act

⁵ S.A. Builders v. CIT [2007] 288 ITR 1 (SC)

Our comments

The Supreme Court judgement in case of S.A. Builders (supra) clarified that the main criterion for deciding the allowability of interest cost on funds given to subsidiaries as loan would be commercial expediency.

However, this ruling by Bangalore ITAT further clarifies that loan granted to a subsidiary engaged in a different line of business cannot be considered within the ambit of commercial expediency.

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