

EY Tax Alert

Supreme Court gives strict interpretation to “derived from” and holds that only income with first-degree nexus to long-term finance qualifies for deduction

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Executive summary

This Tax Alert summarizes a Supreme Court (SC) decision dated 10 December 2025, in the case of National Cooperative Development Corporation¹ (Taxpayer), where issue before the SC was whether certain incomes earned by a statutory financial corporation (namely dividend income on investment in preference shares, interest earned on short-term bank deposits, and service charges received for monitoring Government-funded loans) qualify as profits “derived from” the business of providing long-term finance for the purposes of claiming a specified deduction under the Income Tax Law (ITL) for special reserve created out of such profits.

In this case, the Taxpayer claimed that all these income streams formed part of its long-term financing business and therefore should be eligible for the deduction. The Tax authority, the First Appellate Authority and the Income Tax Appellate Tribunal rejected the claim, and the Delhi High Court upheld those findings.

Concurring with the decision of lower appellate authorities, the SC ruled in favor of the Tax Authority by denying the deduction to the Taxpayer. The SC upheld a strict interpretation of the expression “derived from”, holding that it requires a direct and first-degree nexus with the business of providing long-term finance. Applying this standard, the SC held that dividend is a return on preference share capital (even if invested as surrogate of long-term finance), not on long-term loans; interest on short-term deposits arises from temporary parking of idle surplus funds, not from long-term lending; and service charges received for monitoring Government-funded loans are administrative fees for acting as a nodal agency, not income from deploying the corporation’s own funds. These receipts are therefore ancillary or second-degree sources of income and not profits “derived from” long-term finance.

¹ [TS-1633-SC-2025]



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Background

- ▶ Under the ITL, certain financial institutions such as specified financial corporations, banking companies, co-operative banks (other than a primary agricultural credit society or a primary co-operative agricultural and rural development bank) and housing finance companies are eligible for a tax deduction of up to 20% of their "profits derived from the business of providing long-term finance"², provided they transfer such amount to a special reserve created for this purpose.
- ▶ The deduction is subject to certain quantum limits linked to profits of eligible business and paid-up share capital and general reserves.

Facts of the case

- ▶ The Taxpayer is a statutory corporation mandated to advance initiatives for the production, processing, and marketing of agricultural produce and notified commodities in accordance with cooperative principles. It is engaged in providing long-term finance for agricultural development and eligible to claim the deduction on its profits derived from the business of providing long-term finance.
- ▶ During the concerned tax years³, the Taxpayer earned dividend income from investments in preference shares, interest on short-term bank deposits arising from temporary parking of surplus funds, and service charges for monitoring loans under the Government's Sugar Development Fund (SDF) scheme.
- ▶ The Taxpayer treated all three income streams as part of its eligible long-term finance business, transferred the relevant amounts to its special reserve and claimed the deduction on the basis that these constituted profits "derived from" the business of providing long-term finance.
- ▶ However, the Tax authority rejected the deduction claim on the aforesaid three incomes. It held that dividend income is merely a return on investment in share capital and has no connection with long-term lending; interest on short-term deposits arises from the temporary investment of idle surplus funds and not from the taxpayer's long-term finance activity; and service charges under the SDF scheme represent administrative fees for acting as a Government-appointed nodal agency, since the loans were funded entirely by the Government and not out of the taxpayer's own lending operations. Accordingly, the Tax authority concluded that none

of these receipts constituted profits "derived from" long-term finance and disallowed the claim. This view was consistently upheld by the First Appellate Authority, the Income Tax Appellate Tribunal and the Delhi High Court.

- ▶ Aggrieved, the Taxpayer filed further appeal before the SC.
- ▶ Thus, the key issue before the SC was whether these three income streams - dividend income on investment in shares, interest earned on short-term bank deposits, and service charges received for monitoring Government-funded loans - could be regarded as profits "derived from" the business of providing long-term finance, so as to qualify for the deduction under the ITL.
- ▶ This was in the backdrop that the phrase "derived from" was interpreted by the SC in earlier rulings in multiple cases⁴ as signifying a strict, first-degree nexus distinguishable from the phrase "attributable to" used in other provisions which signifies a broader nexus. However, in the case of CIT v. Meghalaya Steels Ltd⁵ (Meghalaya Steels ruling), the SC held that operational subsidies having close and direct nexus with qualifying business satisfied the test of first-degree nexus.

SC ruling

The SC ruled in favor of the Tax authority and upheld the denial of deduction by lower appellate authorities. The SC reasoned as under:

- ▶ A strict framework was introduced intentionally by the Finance Act, 1995 by amending the relevant provision. Before this amendment, the provision allowed deduction based on the "total income" of the financial corporation and not the income from qualifying activities. Parliament noticed that financial corporations were diversifying into activities unrelated to core financing but were still claiming tax benefits on their entire profit. Hence, the provision was amended to fix this "mischief" and restrict the scope of deduction to income "derived from" from the qualifying activity. The amendment ensures that the deduction is restricted only to profits that come directly from the core activity of providing long-term credit.
- ▶ The phrase "derived from" connotes a requirement of a direct, first-degree nexus between the income and the specified qualifying business activity. It is judicially settled that "derived from" is narrower than "attributable to". The legislature uses "derived from" when it intends to give a restricted meaning.

² Long-term finance means a loan or advance with a repayment period of not less than five years and lent for specified purposes such as industrial development, agricultural development, infrastructure facility, housing etc.

³ Tax years - 1998-99 to 2003-04 and 2006-07

⁴ Cambay Electric (1978) 113 ITR 84 (SC); Sterling Foods (1999) 237 ITR 579 (SC); Pandian Chemicals (2003) 262 ITR 278 (SC) and Liberty India (2009) 317 ITR 218 (SC)

⁵ [2016] 383 ITR 217 (SC)

- The addition of the words "the business of" after the phrase "derived from", simply clarifies which activity is the source; it does not dilute the requirement for a direct link. Any interpretation suggesting otherwise would upset the settled law.
- The SC held that the Taxpayer's reliance on Meghalaya Steels (*supra*) ruling is misplaced because that decision was concerned with the provisions which allowed deduction for profits derived from "any business" of an industrial undertaking. Importantly, that judgment did not change the strict rule regarding the phrase "derived from" established in earlier cases; it merely applied the rule to a specific situation involving cost reimbursement. The disputed income here is neither a reimbursement of business costs, nor does it come from the core activity of long-term lending. Therefore, the reasoning in Meghalaya Steels cannot be applied here to expand the scope of the deduction, as the specific statutory requirements and the nature of the income are entirely distinct.
- Further, the SC addressed and rejected the Taxpayer's attempt to portray its operations as a "single, indivisible integrated activity" to claim the deduction on all receipts. The SC referred to its earlier decision in the case of Orissa State Warehousing Corp. v. CIT⁶ wherein the SC explicitly rejected the "integrated activity" theory holding that fiscal statutes must be construed strictly based on the plain language used.
- Specifically on dividend income, the SC denied deduction by relying on earlier Constitution Bench SC ruling in Bacha F. Guzdar v. CIT⁷ to hold that dividends arise from the contractual relationship of shareholding, and the immediate source of the income is the investment in shares, not the activity of lending. The SC highlighted that there exists a fundamental distinction between a shareholder and a creditor. The SC observed that the basic characteristic of a loan is that the person advancing the money has a right to sue for the debt. In contrast, a redeemable preference shareholder cannot sue for the money due on the shares or claim a return of the share money as a matter of right, except in the specific eventuality of winding up. Since the statute specifically mandates "interest on loans", the SC held that extending this fiscal benefit to "dividends on shares" would defy the legislative intent. Therefore, SC held that dividend income does not qualify as profits derived from business of providing long-term finance.
- On interest income on short-term deposits, the SC held that there is a vital distinction between the general genus of "Business Income" and the specific species of "profits derived from the business of providing long-term finance". Just because an income falls into the broad bucket of "Business Income" does not automatically mean it qualifies for deduction. The provision granting deduction for special reserve is much stricter and requires more than just being "business income"; it requires the

profit to be directly "derived from" long-term financing. The SC observed that the 1995 amendment (*supra*) was designed precisely to stop the kind of broad "integrated business" claim.

- On service charge on SDF loans, the SC held that the proximate source of this income is the agency agreement with the Government, not the lending activity itself. A fee received for agency services cannot be equated with "profits derived from the business of providing long-term finance," which implies the deployment of the corporation's own funds and the earning of interest thereon. Hence, this income also does not qualify for deduction.

Comments

The SC's ruling reinforces the principle that the fiscal incentive for creating special reserve from long-term lending is confined strictly to profits "derived from" the business of providing long-term finance - an expression that requires a direct and first-degree nexus with the lending activity. The SC clarified that the statutory framework was consciously designed to ring-fence the benefit and to exclude ancillary, incidental or second-degree sources of income. Accordingly, income that is merely connected with, facilitates or arises in the general course of a long-term financing business cannot qualify unless it is directly derived from the long-term loan itself.

In this context, the SC expressly rejected theories that treat a taxpayer's entire operations as a "single, indivisible integrated activity." Even where various functions are commercially intertwined, the test continues to be whether a particular stream of income maintains a proximate connection with the act of granting long-term finance.

The above principle might be relevant in testing the eligibility of various streams of income of financial institutions from the qualifying activity of long-term financing.

⁶(1999) 4 SCC 197

⁷(1954) 2 SCC 563

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