

# EY Tax Alert

**Supreme Court permits interest deduction on borrowed funds advanced to sister concern as business expenditure**

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## Executive summary

This Tax Alert summarizes a recent decision of the Supreme Court (SC) in the case of L. K. Trust (Taxpayer) v. CIT<sup>1</sup>, on the issue of deductibility under Section (S.) 36(1)(iii) of the erstwhile Income tax Act 1961 (ITA 1961)<sup>2</sup> of interest expenditure on borrowed funds advanced to Taxpayer's sister concern for acquisition of shares in a company. From the amount so advanced, some portion of funds were retained by the sister concern as acquisition of shares did not fructify in its entirety.

Relying on its earlier rulings, the SC held that the meaning of the expression "for the purpose of business" as used in S. 36(1)(iii) is wider in scope than "for the purpose of making or earning income" as used in S. 57(iii) of the ITA 1961. Furthermore, it held that the use of borrowed funds for business purpose should 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. In the earlier rulings, the borrowed funds advanced by holding company on interest-free basis to subsidiary company where it had deep interest, for use by subsidiary in its own business or borrowed funds used for investment in subsidiary for acquiring controlling interest were held to meet the test of commercial expediency. Applying the ratio of past SC rulings, the SC held that even in the facts of the present case, the test of commercial expediency was met even though the borrowed funds were utilized for business of sister concern. Accordingly, the SC held in taxpayer's favour.

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<sup>1</sup> [TS-678-SC-2026]

<sup>2</sup> Corresponding to s.32(b) of current Income tax Act 2025

## Background

- S. 36(1)(iii) of ITA 1961 provides deduction for interest paid in respect of capital borrowed for the purposes of business or profession of a taxpayer. W.e.f tax year 2003-04 onwards, the section also provides that interest on capital borrowed for acquisition of asset for a period beginning from the date on which capital was borrowed for acquisition of asset to the date on which the asset was first put to use shall not be allowed as deduction.
- In the case of *Madhav Prasad Jatia v CIT*<sup>3</sup>, the SC laid down three conditions for allowing deduction on interest on loan in computation of income under the head "Profits and gains of business or profession". Firstly, the loan must have been borrowed by the taxpayer; secondly, it must have been borrowed for the purpose of taxpayer's business; and thirdly, the taxpayer must have paid interest on such loan and claimed deduction for the same. On the second condition, the SC held that the expression for the purpose of business is wider in scope than the expression for the purposes of making or earning income as used in s.57(iii) relevant for computing income under the head "Income from other sources".
- In the case of *S. A. Builders Ltd v. CIT*<sup>4</sup>, the SC held that the test for determining the purpose of business is the test of "commercial expediency". Applying this test, it held that interest expenditure on borrowed funds advanced on interest-free basis to a subsidiary is allowable as a deduction. Elaborating on the principle of "commercial expediency," the SC held that the allowability of interest expenditure is not contingent upon the direct utilization of borrowed funds by the taxpayer in its own business. The SC further held that where a holding company has a deep interest in the business of its subsidiary, no disallowance of interest is warranted in respect of borrowed funds advanced as interest-free loans to such subsidiary, provided the funds are utilized by the subsidiary for bona fide business purposes.
- The principle laid down in *S.A. Builders* was reiterated by the SC in its later decision in the case of *Sharp Business System v CIT*<sup>5</sup>, in which the SC held that interest on borrowings utilized for acquisition of a controlling interest in a subsidiary/sister concern, which is driven by commercial expediency, is allowable as deduction.

## Facts of the case:

It is relevant to note that the matter reached the SC in second round. In the first round, the SC, vide its ruling dated 8 December 2008<sup>6</sup>, had set aside the matter back to Karnataka High Court (HC) for fresh consideration. Thus, there are two SC rulings, two Karnataka HC rulings<sup>7</sup> and extracts from Bangalore Income Tax Appellate Tribunal's (Tribunal) order reproduced in present SC ruling.

On a review of above referred orders, the factual matrix appears to lack full clarity and coherence. Nevertheless, an attempt is made to summarize them as follows:

1. The Taxpayer, constituted as a trust, was engaged in multiple lines of business activity, including money lending, speculative transactions, film distribution and investments in equity shares.
2. In tax year 1988-89, the Taxpayer borrowed loan from a bank for the purpose of acquisition of 0.78m shares of Shaw Wallace & Company Ltd. (SWCL) for a consideration of INR 38m<sup>8</sup>.
3. However, instead of directly deploying the borrowed funds for the intended acquisition, the Taxpayer advanced the funds<sup>9</sup> to its sister concern, Gayatri Holdings Pvt. Ltd. (GHPL)<sup>10</sup>. Subsequently, GHPL transferred the funds to another person G. Venkateshwaran and group of companies<sup>11</sup> (GV), for purchase of SWCL shares.
4. However, the acquisition of SWCL shares was partially concluded for INR 14.82m and not concluded for balance INR 23.18m<sup>12</sup>. But the unutilized balance of borrowed funds did not come back to the Taxpayer and remained with GHPL or GV.
5. The Taxpayer incurred interest expenditure of INR 2.17m on loan borrowed from the bank.

<sup>3</sup> (1979) 118 ITR 200 (SC)

<sup>4</sup> (2007) 288 ITR 1 (SC)

<sup>5</sup> 484 ITR 509 (2025)

<sup>6</sup> Reported in [2009] 183 Taxman 80 (SC)

<sup>7</sup> First ruling dated 28 August 2007 reported in [2008] 297 ITR 53 (Kar)

<sup>8</sup> It is not very clear whether loan borrowed by the Taxpayer was entire INR 38m or only INR 18m (with balance INR 20m borrowed by Taxpayer's beneficiaries) but SC ruling proceeds on the basis that entire INR 38m was borrowed by the Taxpayer.

<sup>9</sup> It is not clear whether the funds were provided by way of loan or advance to GHPL or towards subscription for acquisition of shares of

GHPL

<sup>10</sup> It is not explicitly evident from the record whether Gayatri Holdings Pvt. Ltd. functioned as a subsidiary of the Taxpayer or merely as a related/sister concern. However, a majority of the references in the judicial order characterize the entity as a "sister concern".

<sup>11</sup> The facts captured in the SC ruling and underlying orders lack sufficient details to fully and coherently understand the exact nature of transactions between (a) Taxpayer and GHPL and (b) GHPL and GV.

<sup>12</sup> It appears there were income tax dues payable by GV which prevented GV from transferring rest of SWCL shares.

## Litigation trajectory on deduction of interest expenditure

Sr. No	Authority	Date of the order	Key outcome
1.	Tax authority	-	<ul style="list-style-type: none"> <li>The Tax Authority partially allowed interest deduction on pro rata basis of INR 0.85m to the extent that the borrowed funds were utilized for the acquisition of SWCL shares.</li> <li>The Tax Authority disallowed balance interest of INR 1.32m corresponding to the funds that remained with GHCL/GV.</li> </ul>
2.	First Appellate Authority (FAA)	-	<ul style="list-style-type: none"> <li>The FAA not only confirmed the disallowance of INR 1.32M but also enhanced the assessment by disallowing balance INR 0.85m which was allowed by Tax Authority.<sup>13</sup></li> </ul>
3.	Tribunal	22 February 2001 <sup>14</sup>	<ul style="list-style-type: none"> <li>The Tribunal reversed FAA ruling and allowed deduction for whole of interest expenditure of INR 2.17m.</li> <li>The Tribunal placed reliance on Madhav Prasad Jatia (<i>supra</i>) ruling. It held that since the Taxpayer was engaged in multiple business activities including share acquisition and considering composite nature of Taxpayer's business, the borrowing was for business purpose.</li> </ul>
4.	High Court in first round	28 August 2007 <sup>15</sup>	<ul style="list-style-type: none"> <li>The HC reversed the Tribunal ruling and upheld disallowance of interest cost as per FAA, for the following reasons: <ul style="list-style-type: none"> <li>▶ The loan borrowed was for the purpose of acquisition of shares which was not materialized.</li> <li>▶ S.36(1)(iii) does not permit deduction for the period from the date of borrowing till the asset is first put to use.</li> <li>▶ GHCL's Balance Sheet and notes showed that the acquisition of shares had not fully materialized.</li> <li>▶ Hence, Tribunal had incorrectly allowed deduction of interest cost</li> </ul> </li> </ul>
5.	Supreme Court in first round	8 December 2008 <sup>16</sup>	<ul style="list-style-type: none"> <li>SC remitted the issue back to the HC. <ul style="list-style-type: none"> <li>▶ The reason for which the HC disallowed interest was based on amendment made to s.36(1)(iii) with effect from tax year 2003-04 to provide that interest for the period between date of borrowing till asset is first put to use shall not be allowed as deduction.</li> </ul> </li> </ul>

<sup>13</sup> This appears from HC order in second round (Refer Sr. No. 6 of Table). However, from HC order in first round, it is not clear whether FAA disallowed entire interest of INR 2.17m or merely confirmed partial disallowance of INR 1.32m as made by Tax Authority.

<sup>14</sup> Only partial extracts reproduced in SC ruling available.

<sup>15</sup> CIT Bangalore vs. L.K. Trust [2008] 297 ITR 53 (Karnataka)

<sup>16</sup> L.K. Trust vs. CIT [2009] 183 Taxman 80 (SC)

Sr. No	Authority	Date of the order	Key outcome
			<ul style="list-style-type: none"> <li>▶ The SC had earlier held<sup>17</sup> that the said amendment was applicable prospectively. The tax year involved in present case is 1988-89 and, hence, the amendment had no applicability to the facts of the case.</li> <li>▶ The SC expressed no opinion on the Tax Authority's contention that the taxpayer was not entitled to deduction even independent of the amendment.</li> </ul>
6.	High Court in second round	1 March 2010 <sup>18</sup>	<ul style="list-style-type: none"> <li>• On reconsideration of the matter, the HC partially reversed Tribunal's order to the extent it allowed INR 1.32m and held as follows: <ul style="list-style-type: none"> <li>▶ With respect to interest amount of INR 0.85m which relates to funds utilized for acquisition of SHCL shares, the Tax Authority was justified in granting the deduction.</li> <li>▶ With respect to balance interest amount of INR 1.32m which relates to the funds lying with GHCL/GV and not utilized for acquisition of SHCL shares, such deployment could not be regarded as being for the Taxpayer's business purposes. Hence, Tax Authority was justified in disallowing such interest.</li> <li>▶ Accordingly, the HC confirmed partial disallowance of interest attributable to funds not utilized for acquisition of SHCL shares, concurring with the findings of the Tax Authority.</li> </ul> </li> </ul>

The Taxpayer filed further appeal before the SC.

<sup>17</sup> DCIT vs. Core Health Card Ltd [2008] 298 ITR 194 (SC)

<sup>18</sup> High Court of Karnataka in Income Tax Appeal No. 175 of 2001

## SC ruling:

The SC ruled in favor of the Taxpayer and reversed the HC ruling to the extent it had disallowed interest cost relating to funds not utilized for acquisition of SHCL shares which remained with GHCL/GV and held as follows:

- S.36(1)(iii) has three important words or phrases i.e (i) Interest, (ii) Borrowed and (iii) For the purpose of business or profession
- On the first phrase, while “interest” is defined widely in s.2(28A) to mean “interest payable in any manner in respect of any moneys borrowed or debt incurred”, for the purposes of s.36(1)(iii), its scope is restricted to interest on money borrowed and not on debt incurred. It is the payment which becomes due because creditor does not have money at its disposal. It represents profits the creditor might have made from use of money or conversely, loss suffered due to not having such use. The general idea is that creditor is entitled to compensation for the deprivation.
- On the second phrase, S.36(1)(iii) covers only capital borrowed and not debt incurred. The capital, in this context, means money and not any other asset purchased on credit<sup>19</sup>.
- On the third phrase, the meaning of the expression “for the purpose of business” as used in S. 36(1)(iii) is wider in scope than “for the purpose of making or earning income” as used in S. 57(iii) of the ITA 1961 (Madhav Prasad Jatia v CIT (*supra*)).
- On a plain reading of the HC order, the HC disallowed the deduction since, according to HC, the business of subsidiary company<sup>20</sup> cannot be considered in law as business of the Taxpayer. The HC faulted the Tribunal’s finding based on commercial expediency. The HC went on to observe that the amount borrowed was ultimately utilized for the benefit of Taxpayer’s subsidiary and not for taxpayer’s business as such. The HC fell in error in taking such view.
- Considering the ratio of earlier SC rulings in S. A. Builders (*supra*) and Sharp Business System (*supra*), where the principle of commercial expediency was favorably applied in the context of interest-free advances to subsidiary and investment in sister concern for acquisition of controlling interest, the line of reasoning adopted by Tribunal on interpretation of s.36(1)(iii) was correct. The Taxpayer was entitled to seek deduction on the amount of interest paid in respect of capital borrowed to the tune of INR 38m for the purpose of business.

## Comments

The SC ruling represents a liberal application of principle of commercial expediency espoused by the SC in S. A. Builders case (*supra*). It may be noted that the present SC ruling is of 2-Judge bench. Similar issue is pending before 3-Judge bench of SC in the case of Popular Vehicles and Services Ltd <sup>[21]</sup>.

While the SC, in the present case, has rendered a decision favorable to the Taxpayer, upholding the allowability of interest on funds borrowed and advanced to a sister concern, the precise factual substratum supporting such conclusion is difficult to decipher from several orders in the long drawn two rounds of litigation.

There are factual ambiguities on several aspects like quantum of exact borrowing by the Taxpayer, modality of deployment (whether as loan or share subscription in GHCL), the purpose of routing of GHCL, the arrangements and transactions with GV, etc.

Nevertheless, this ruling supports that in scenarios where borrowed funds are advanced to a sister concern or subsidiary and deployed by them for their bonafide business purpose, the test of commercial expediency laid down in S.A. Builders Ltd. (*supra*) is applicable. Alternatively, in cases involving deployment of borrowed funds towards acquisition of shares representing controlling interest resulting in commercial expediency, the principle laid down in Sharp Business Systems (*supra*) is applicable. In both scenarios, the test of commercial expediency is met and interest deduction is allowable.

<sup>21</sup> Civil Appeal No. 5760/2011, 9009/2011

<sup>19</sup> Reliance placed on Bombay Steam Navigation Co. Pvt. Ltd v. CIT [1965] 56 ITR 52(SC)

<sup>20</sup> The reference to “subsidiary company” is not clear since GHCL was not subsidiary of the Taxpayer

# Our offices

## Ahmedabad

22nd Floor, B Wing, Privilon  
Ambli BRT Road, Behind Iskcon Temple  
Off SG Highway, Ahmedabad - 380 059  
Tel: + 91 79 6608 3800

## Gandhinagar

8th Floor, Building No. 14A  
Block 14, Zone 1  
Brigade International Financial Centre  
GIFT City SEZ  
Gandhinagar - 382 355, Gujarat  
Tel: + 91 79 6608 3800

## Bengaluru

12th & 13th Floor  
"UB City", Canberra Block  
No.24 Vittal Mallya Road  
Bengaluru - 560 001  
Tel: + 91 80 6727 5000

Ground & 1st Floor  
# 11, 'A' wing  
Divyasree Chambers  
Langford Town  
Bengaluru - 560 025  
Tel: + 91 80 6727 5000

3rd & 4th Floor  
MARKSQUARE  
#61, St. Mark's Road  
Shantala Nagar  
Bengaluru - 560 001  
Tel: + 91 80 6727 5000

1st & 8th Floor, Tower A  
Prestige Shantiniketan  
Mahadevapura Post  
Whitefield, Bengaluru - 560 048  
Tel: + 91 80 6727 5000

Ecospace  
1st Floor, Campus 1C  
Ecospace Business Park  
Outer Ring Road,  
Bellandur - Sarjapura Area, Varthur  
Hobli,  
Bengaluru Urban - 560103

## Bhubaneswar

8th Floor, O-Hub, Tower A  
Chandaka SEZ, Bhubaneswar  
Odisha - 751024  
Tel: + 91 674 274 4490

## Chandigarh

Elante offices, Unit No. B-613 & 614  
6th Floor, Plot No- 178-178A  
Industrial & Business Park, Phase-I  
Chandigarh - 160 002  
Tel: + 91 172 6717800

## Chennai

6th & 7th Floor, A Block,  
Tidel Park, No.4, Rajiv Gandhi Salai  
Taramani, Chennai - 600 113  
Tel: + 91 44 6654 8100

## Delhi NCR

Aikyam  
Ground Floor  
67, Institutional Area  
Sector 44, Gurugram - 122 003  
Haryana  
Tel: + 91 124 443 4000

3rd & 6th Floor, Worldmark-1  
IGI Airport Hospitality District  
Aerocity, New Delhi - 110 037  
Tel: + 91 11 4731 8000

4th & 5th Floor, Plot No 2B  
Tower 2, Sector 126  
Gautam Budh Nagar, U.P.  
Noida - 201 304  
Tel: + 91 120 671 7000

## Hyderabad

THE SKYVIEW 10  
18th Floor, "SOUTH LOBBY"  
Survey No 83/1, Raidurgam  
Hyderabad - 500 032  
Tel: + 91 40 6736 2000

THE SKYVIEW 20  
2nd Floor, 201 & 202  
Right Wing, Survey No 83/1  
Raidurgam, Hyderabad - 500 032  
Tel: + 91 40 6736 2000

## Jaipur

9th floor, Jewel of India  
Horizon Tower, JLN Marg  
Opp Jaipur Stock Exchange  
Jaipur, Rajasthan - 302018

## Kochi

9th Floor, ABAD Nucleus  
NH-49, Maradu PO  
Kochi - 682 304  
Tel: + 91 484 433 4000

## Kolkata

22 Camac Street  
3rd Floor, Block 'C'  
Kolkata - 700 016  
Tel: + 91 33 6615 3400

6th floor, Sector V,  
Building Omega, Bengal Intelligent  
Park, Salt Lake Electronics Complex,  
Bidhan Nagar  
Kolkata - 700 091  
Tel: + 91 33 6615 3400

## Mumbai

14th Floor, The Ruby  
29 Senapati Bapat Marg  
Dadar (W), Mumbai - 400 028  
Tel: + 91 22 6192 0000

5th Floor, Block B-2  
Nirlon Knowledge Park  
Off. Western Express Highway  
Goregaon (E)  
Mumbai - 400 063  
Tel: + 91 22 6192 0000

3rd Floor, Unit No.301  
Building No.1, Mindspace-Gigaplex  
IT Park, MIDC, Plot No. IT-5  
Airoli Knowledge Park  
Airoli West, Navi Mumbai - 400 708  
Tel: + 91 22 6192 0003

18th Floor, Altimus  
Pandurang Budhkar Marg  
Worli, Mumbai - 400 018  
Tel: + 91 22 6192 0503

## Pune

C-401, 4th Floor  
Panchshil Tech Park, Yerwada  
(Near Don Bosco School)  
Pune - 411 006  
Tel: + 91 20 4912 6000

10th Floor, Smartworks  
M-Agile, Pan Card Club Road  
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



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