Sec. 36(1)(iii) and principle of commercial expediency

Section 36(1)(iii)- Principle of Commercial expediency

As per Sec 36(1)(iii), Deduction shall be allowed for “The amount of interest paid in respect of capital borrowed for the purposes of business or profession”

For the purpose of claiming deduction under the Section 36(1)(iii), presence of the undersigned three factors are essential. The assessee must have paid interest in respect of capital borrowed for purpose of business or profession.

In this article we are discussing the meaning of “purpose of business or profession”.

The meaning of “purpose of business or profession “ can be understood w.r.t. the following Land Mark Case Laws

FACTS: The assessee company advances the money borrowed to sister concerns as interest free loans and claim deduction of interest on money borrowed.

Held by the Supreme court: that interest deduction can be claimed even when the monies borrowed has been given to its sister concern as an interest free loan if it was commercially expedient to do so. That the expression “commercial expediency” is an expression of wide import and includes such expenditure as a prudent businessman incurs for the purpose of business of profession. It has been repeatedly held by the Apex Court that the expression "for the purpose of business" is wider in scope than the expression " for the purpose of earning profits.

“The High Court and the other authorities should have examined the purpose for which the assessee advanced the money to its sister concern, and what the sister concern did with this money, in order to decide whether it was for commercial expediency.

The words may give the impression that any expenditure incurred for business purpose will be allowed. However, that is not always true, as expenditures which are prohibited by the act, or take the colour of expense of personal nature can’t be said to be incurred for the measure of commercial expediency.

For ex. If the assessee borrows funds and advances it to sister and the sister concern/s utilize the same for some business purposes, the test of commercial expediency is fulfilled.

However if the directors of the same sister concerns utilize the borrowed money for personal benefits or even payment of income tax liability of sister concern, the test of commercial expediency is not fulfilled.

**Proportionate Commercial Expediency:** The concept of proportionate commercial expediency comes into play when expenditure incurred is partly incurred for business or when interest paid on money borrowed is recovered in part from the lendee (being the case when advance money not utilized in commercial expediency).
For eg., In the case of CIT v. H.R. Sugar Factory (P) Ltd. The asseessee company borrows funds @ 20 % and lends it to director @ 8%. As per the concept of proportionate commercial expediency 12% interest is to be disallowed.

**Conclusion drawn from S.A. Builders**: The concept of commercial expediency is much wider in scope and includes all expenditure incurred to run the business more efficiently (not necessary profitably). The answer whether the particular expenditure has been commercially expended will depend on the facts and circumstances of the case as well as the act.

What is to be seen is the purpose for which borrowed money is finally utilized. If the money is utilized in a way that makes commercial sense and helps in running the intended business of the asseessee more efficiently, then it can be said that the interest paid in respect of borrowed money has been incurred for the purpose of commercial expediency.

**2. A.C.I.T V. Tulip star Hotels Ltd. (2012)(SC)**

FACTS:- The asseessee borrowed funds and used it to subscribe to the equity capital of its subsidiary company. The subsidiary company used the said funds for the purpose of acquiring the Centaur Hotel, Juhu Beach, Mumbai. The asseessee paid interest on the borrowed money and claimed that a deduction u/s 36(1)(iii).

The AO rejected the claim, but the CIT (A), Tribunal & High Court (338 ITR 482) allowed it by relying on **S.A. Builders Ltd vs.CIT** 288 ITR 1 (SC). It was held that as the asseessee, being a holding company had a deep interest in its subsidiary, and hence if the holding company advanced borrowed money to a subsidiary and the same is used by the subsidiary for some business purposes, the asseessee would be entitled to deduction of interest on its borrowed loans.

On appeal by the department, HELD by the Supreme Court

Issue notice on the applications for condonation of delay as also on the special leave petitions. In our view, **S.A. Builders Ltd. vs. Commissioner of Income-Tax (Appeals) and Another**, reported in 288 ITR 1, needs reconsideration.
Conclusion from TulipStar Hotels Ltd.: The Apex Court has realised that the principle laid down in S. A. Builders Ltd vs. CIT 288 ITR 1 (SC) is too wide and sets the boundaries too loose to have an effective interpretation and implementation of the principle of commercial expediency.

There is a need of the hour to clearly establish the principle of commercial expediency to avoid confusion and unnecessary litigations.

Some other recent case laws:

1. C.R. Auluck and Sons P. Ltd. v. CIT (2014) 360 ITR 193 (P&H)(HC)

Assessee's sister concern was incurring huge loss and its account was declared non-performing asset by bank. The plea of loss of reputation and goodwill of assessee in view of sister concern being declared non-performing asset was held not justified, and hence, assessee failed to establish commercial expediency. Therefore, disallowance of interest was justified.(AY. 2005-06)

2. Jayesh Raichand Shah v. ACIT (2014) 360 ITR 387 (Guj.) (HC)

The Assessee took loan from the three persons, namely, BS, TS and JS and the interest paid to them at the rate of 16 per cent per annum. It was also found by the AO as well as the Tribunal that the assessee made a gift of Rs. 20 lakhs to each of the three persons and, immediately thereafter, the three persons placed the same amount in the hands of the assessee on which interest at the rate of 16 per cent to Rs. 7,46,965 was claimed as deduction. The entire series of transactions were illusory, colourable and not genuine for the purpose of the business. There was no borrowing of capital and, therefore, the requirement of s. 36(1)(iii) was not fulfilled and, therefore, the disallowance by the AO was justified.

For any queries or discussions, you can mail me camohitmittal583@gmail.com

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Sir iska matlab yeh hai ki jo loan par intt. Lag hai uski deduction nahi milegi kyuki jo iss loan ko invest se jo income ho rahi hai (dividend) wo exempt hai asper section 14 a . Is liye yeh int disallowed ho raha hai. Agar galat keh raha hu toh please comment in it

Dear Gautam, The personal loan taken by director is for investment in shares. Provisions of Sec 14A with Rule 8 D comes into play and the director will not be allowed deduction of interest on loan taken.

Dear sir i want to know if a director take personal loan from bank and subscribe equity shares of company in which he is director.is the intt allowed to director on loan or not. I think it should be allowed. But i do not have legal reference give your precious comment Thanks & Regards Gautam gupta

I may be clarified if an employer pays certain amount towards mobile phone what is the procedure to claim deductions