

Interest on loan disallowed as assessee diverted loan to AE at much lesser rate without any commercial expediency

Summary – The High Court of Gujarat in a recent case of Cornerstone Exports (P.) Ltd., (the Assessee) held that where action of assessee-company to make advances to group companies at a lower rate of interest than interest rate at which assessee-company borrowed such funds, was not shown to be in any manner actuated by business expediency, disallowance of differential interest was justified

Facts

- The assessee-company had borrowed huge amount from various group companies and had, in turn, advanced large amount to certain companies.
- It claimed deduction under section 36(1)(iii) on the interest paid on the borrowings.
- The Assessing Officer noticed that the amount borrowed by the assessee-company was at an interest rate much higher than the rate of interest at which it had made lending to other companies; that substantial amount was lent to various companies having a common address; and that the same amount borrowed by the assessee-company came to be advanced on the same day at a lower rate of interest. The Assessing Officer concluded that the assessee-company had merely acted as conduit and there was no business expediency on the part of the assessee in making such advances at a lower interest rate. He, therefore, concluded that the money borrowed by the assessee-company had not been utilized for the purpose of assessee's business and, accordingly, he disallowed the differential portion of interest.
- On appeal, the Commissioner (Appeals) upheld disallowance.
- On further appeal, the Tribunal reversed the decision of the Assessing Officer and the Commissioner (Appeals) holding that when the Assessing Officer had in fact allowed part of the interest claimed by the assessee, he could not have made disallowance of part of the interest by applying the principles of section 40A(2).
- On appeal before the High Court:

Held

- The Supreme Court in the case of *S.A. Builders Ltd. v. CIT* [\[2007\] 288 ITR 1/158 Taxman 74](#) had reiterated that the expression 'for the purpose of business' occurring in section 36(1)(iii) is wider in scope than the expression 'for the purpose of earning profits'. The Supreme Court opined that the correct test in such a case is whether the advance made is as a measure of commercial expediency.
- Two things, thus, become clear - first the expression 'for the purpose of business' occurring in section 36(1)(iii) has wider import than the expression 'for the purpose of earning income.' This is settled since long. The second aspect is that in *S.A. Builders Ltd. (supra)* the Supreme Court had applied the principles of commercial expediency in judging the claim of interest. This was made in

the background of the interest borrowing funds being diverted by the assessee to its sister concern without charging interest. It was in this background that the Supreme Court observed that what has to be seen is whether transfer of funds to a sister concern on the ground of commercial expediency.

- In the instant case, at no stage the assessee pointed out any business expediency in making advances at a lower interest rate than the rate at which the assessee-company had borrowed the money. It is undoubtedly true that section 36(1)(iii) permits deduction of interest paid on capital borrowed for the purpose of business or profession and the expression 'for the purpose of business' is seen wider than the expression 'for the purpose of earning income'. Nevertheless the assessee had to point out the business expediency which prompted the assessee to make advances at a lower rate of interest. The assessee failed to bring on record any such material or even plead before the Assessing Officer any business expediency.
- Without upsetting the factual findings of the Assessing Officer, the Tribunal committed two errors in reversing the decisions of the revenue authorities - the first was of applying the principles 'for the purpose of business' being wider than 'for the purpose of earning income' in abstract. Such principles had to be applied in the context of business expediency if the same was demonstrated which, was not done. The second error committed by the Tribunal was to hold that the Assessing Officer has applied the principles of section 40A(2) which, according to the Tribunal, was not permissible. In other words, view of the Tribunal was that the Assessing Officer could have either allowed or disallowed the entire interest component relatable to a particular borrowing of the assessee. However, once the Assessing Officer decided to grant deduction of interest on a particular loan, it was not open for the Assessing Officer to disallow the portion of interest component.
- In this context, it was not found that the Assessing Officer applied the principles analogous to section 40A(2) by holding that the interest paid by the assessee was excessive. In fact the Assessing Officer allowed the deduction to the extent of rate of interest at which the advances were made by the assessee. However, the action of the assessee-company to make advances at a lower rate of interest than the interest liability discharged by the assessee-company in borrowing such funds was not shown to be in any manner actuated by business expediency. The Assessing Officer was perfectly justified in disallowing such component of interest.