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Introduction

A crucial element in any M&A transaction is the use of financing structures for undertaking any kind of leveraged buyout. In recent years, M&A transactions are increasingly being structured with significant leverage, wherein acquirers rely on borrowings to finance acquisitions. Such leverage is typically serviced via distributions from the target company (such as dividends, buybacks and capital reductions) or through a post-acquisition merger of the target with the acquirer. When structured efficiently, such leveraged acquisitions can enhance returns on equity significantly. As a result, debt financing remains an attractive proposition for investors.

In addition to commercial implications, such financing strategies also raise intricate tax considerations. A particularly contentious issue in the Indian context is the deductibility of interest paid on such borrowings which are used to finance acquisitions—both in the hands of the acquirer and, where the acquisition is followed by a merger of the target with the acquirer or vice-versa, in the hands of the merged entity. Given the significant implications on tax efficiency, understanding the legal framework governing interest deductibility is crucial for businesses.

Section 36(1)(iii) and Thin Capitalisation Rules

Section 36(1)(iii) of the Income Tax Act, 1961 ("**IT Act**") provides for the deduction of interest paid on capital borrowed for the purposes of business or profession. The expression "**for the purposes of business**" assumes critical importance. Whether the borrowing is connected to the business operations of the taxpayer thus becomes the central issue when considering the deductibility of interest expenses.

Additionally, in accordance with the recommendations of the Action 4 Report issued by the Organisation for Economic Co-operation and Development i.e., "**Limiting Base Erosion Involving Interest Deductions and Other Financial Payments**", India enacted a specific set of provisions restricting interest deductibility in cases of cross border intra-group financing or borrowing.[1] These

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1 Section 94B of the IT Act.

provisions limit the deductibility of interest payments to non-resident related parties to 30% (thirty per cent) of Earnings before Interest, Depreciation and Amortisation (EBITDA) or the actual interest paid, whichever is lower. Any excess interest can be carried forward for a period of 8 (eight) years. These provisions target interest disallowance on cross-border structures where debt financing is disproportionately favoured over equity contribution.

From Strategy to Substance: The Judicial Perspective

Commercial Expediency: Supreme Court's Interpretation

The Supreme Court, in *S.A. Builders Ltd. v. Commissioner of Income-tax (Appeals)*[2], emphasized that interest paid on funds borrowed for the purposes of "**commercial expediency**" is deductible. This ruling affirmed that when a holding company advances money to a subsidiary for business purposes, interest paid on such borrowings would typically qualify for a deduction.

Strategic Acquisitions

The deductibility of interest paid on borrowed funds used to finance acquisitions has remained a subject of judicial scrutiny. Nevertheless, Indian courts have generally taken a purposive and business-centric approach by recognizing that if the leveraged acquisition serves a business purpose, interest expenses should be deductible.

This view is particularly reinforced where the acquisition involves a target engaged in a similar business, as such acquisitions are typically viewed as a means of business expansion which directly contribute to the advancement of the acquirer's business operations and market position.

This principle has found judicial support in the following cases:

- *B. Nanji & Co. v. Deputy Commissioner of Income Tax*[3]*:* In this case, the taxpayer, engaged in the real estate business, borrowed funds to acquire shares of a housing finance company as part of its business expansion plan. The Gujarat High Court upheld the deduction of interest paid on the borrowed funds under Section 36(1)(iii) of the IT Act on the grounds that the investment was made to expand the taxpayer's business.
- *Sun Pharmaceutical Industries Ltd. v. Income-tax Officer*[4]*:* The Delhi High Court dealt with a case where an Indian company borrowed funds from outside India for expanding its global business through equity infusion in overseas subsidiaries. Albeit in the context of Section 9(1)(v) of the IT Act, the Court observed that interest payments on such borrowings should meet the "**commercial expediency**" test and be considered as incurred for business purposes.
- *Commissioner of Income-tax v. RPG Transmissions Ltd*[5]*:* The Madras High Court held that interest paid on funds borrowed for acquiring shares of group

2 (2007) 1 SCC 781.

3 2020 SCC OnLine Guj 3459.

4 2025 SCC OnLine Del 497.

5 013 SCC OnLine Mad 3881.

companies for strategic business purposes is deductible under Section 36(1)(iii) of the IT Act.

- *Principal Commissioner of Income Tax, Mumbai v. Concentrix Services (I) (P.) Ltd.*[6]*:* The Bombay High Court similarly held that interest expenses are deductible where the leveraged acquisition is in connection with the businesss activities of the taxpayer.

Debt-Push-Down Structures

The use of debt-push-down structures is common in M&A transactions. Typically, this involves the incorporation of a Special Purpose Vehicle ("**SPV**") that borrows funds to acquire shares in a target company, which is subsequently merged with the SPV. The allowability of interest deductions in such transactions is assessed at two distinct stages:

- *Pre-Merger:* Prior to the merger, the commercial rationale and operational substance of the SPV and the purpose of its borrowings are examined by courts for determining potential interest deductions. In the pre-merger phase, the SPV must demonstrate operational substance—not merely exist on paper—by engaging in activities such as conducting due diligence, engaging in negotiations, arranging financing on commercial terms, or undertake initial integration planning. Further, the constitution documents of the SPV should also indicate that the SPV's business activities are aligned with those of the target. Such operational and functional involvement of the SPV establishes economic substance and strengthens the case for interest deductibility.

- *Post-Merger:* Once the SPV merges with the target company, the focus shifts to how the merged entity undertakes operations and carries forward the strategic intent underlying the acquisition. While the SPV originally borrowed funds to acquire the target company for strategic business purposes, the financial obligations of the SPV are inherited by the merged entity. As a result, the conduct of business post-merger becomes a critical factor in assessing the allowability of interest deductions. In evaluating interest deductibility, courts and tax authorities assess whether the debt has facilitated desired commercial outcomes and place particular emphasis on whether there is sustained implementation of the strategic objectives that originally justified the leveraged acquisition.

Thus, where the merged entity continues to operate and derive desired commercial benefits post the merger, the interest expenses may be considered as incurred for "**business purposes**" as envisaged under Section 36(1)(iii) of the IT Act.

Interest deductibility in amalgamation context was discussed in the case of *Commissioner of Income-tax-I v. Amar Ujala Publication Ltd.*[7]. In this case, the taxpayer borrowed funds to acquire a target company, which was later merged with the taxpayer. The Delhi High Court allowed interest deductibility for the merged entity on the principle that: (i) the borrowed funds were utilised for acquiring the target and (ii) post-merger, the funds available with the merged entity were being employed for business purposes of the merged entity, substantiating the strategic acquisition

6 2019 SCC OnLine Bom 13354.

7 2016 SCC OnLine Del 2760.

undertaken by the taxpayer.

Additionally, the Shome Committee's recommendations issued in 2012 with respect to General Anti-Avoidance Rules ("**GAAR**") also support the deductibility of interest paid on borrowed funds used in acquisitions that culminate in a merger. Specifically, Example 27 of the Shome Committee Report illustrates a scenario where an entity borrows funds to acquire shares of another entity which is followed by a merger of the two entities. The merged entity subsequently claims interest deductions on the borrowed funds. In this regard, the Shome Committee states that such a transaction is not abusive and GAAR would not apply if the merger is undertaken pursuant to court orders.

Judicial Divergence: Disallowance in absence of business nexus

While Indian courts have generally recognised interest deductibility in cases of leveraged acquisitions, there remains judicial divergence where such borrowings lack a clear nexus to the borrower's business. For instance, in *Commissioner of Income-tax v. Sujani Textiles (P.) Ltd.*[8], the Madras High Court disallowed interest deductions under Section 36(1)(iii) of the IT Act since the loan was procured for investing in another company that bore no nexus with the borrower's business activities. Similarly, in *Commissioner of Income Tax v. Smt. Leena Ramachandran*[9], the Kerala High Court disallowed the interest deductions as the borrower was not in the business of trading shares.

Key Principles for Interest Deductibility

The key principles emerging from the prevailing jurisprudence indicate that interest deductions under Section 36(1)(iii) of the IT Act may be permitted in cases of leveraged acquisitions, provided one or more of the following conditions are met:

- The investment serves a strategic business purpose for the borrower;
- It is essential for the business operations of the borrower;
- The target entity operates in the same or related line of business as that of the borrower, thereby facilitating the expansion of the borrower's business; or
- There are identifiable synergies between the borrower and the target that can be demonstrated from a commercial standpoint.

Striking the Balance: Business Purpose, Legal Substance and Deductibility

Interest deductibility under Indian tax provisions, particularly in the context of leveraged acquisitions, is shaped by a combination of statutory interpretations and judicial pronouncements. The overarching principle established by the courts emphasizes the importance of demonstrating a clear business purpose behind the borrowings. The business purpose must reflect a genuine commercial rationale, such as expanding market share, achieving operational synergies, or optimizing capital structure. The business purpose test is generally met in case of control deals where the acquirer undertakes the acquisition to expand its own business (on a consolidated basis).

The above aligns with the intent of tax laws, which aim to ensure that the borrowed funds and consequently, interest deductions are legitimately connected to the operations and strategic

8 1983 SCC OnLine Mad 324.

9 2010 SCC OnLine Ker 1348.

goals of the borrowing entity. While the prevailing legal position is accommodating—especially where there is a demonstrable business nexus—a careful consideration of the specifics of each transaction along with business contours is essential.

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