KTBA Karachi Tax Bar Association

02ND OF 2025 KTBA ONE PAGER CASE LAW UPDATE (MAY 26, 2025)

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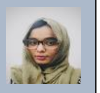

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Dear Members,

A brief update on a judgment by the High Court of Sindh Bench on **"Interest free Loan is Business Income for Borrower"** is being shared with you for your knowledge. The order has been attached herewith the update.

This update is in line with the efforts undertaken by our **"CASE LAW UPDATE COMMITTEE"** to apprise our Bar members with important court decisions.

You are equally encouraged to share any important case law, which you feel that should be disseminated for the good of all members.

You may contact the Committee Convener Mr. Muhammad Tarique or at the Bar's numbers 021-99212222, 99211792 or email at info@karachitaxbar.com & ktba01@gmail.com

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02ND OF 2025 KTBA ONE PAGER
CASE LAW UPDATE
(MAY 26, 2025)

INTEREST FREE LOAN IS BUSINESS INCOME FOR BORROWER

Appellate Authority: High Court of Sindh (the SHC)
Appellant: Elahee Buksh & Company (Private) Limited
Respondent: Additional Commissioner, MTO, Karachi
Section: 18(1)(d) of the Income Tax Ordinance, 2001 (the Ordinance)

Detailed judgment was issued on 04 September 2024

Background: The company obtained an interest-free loan from an associated company to meet its working capital requirements. The department treated the interest free factor as a benefit accrued to the company out of business relationship with its associate and charged income tax at the Market rate of interest on the loan in terms of section 18(1)(d) of the Ordinance. The company contested the chargeability of the interest free benefit as business income on the premise that placement of funds by the associated company with the applicant company to meet working capital requirements was neither a business transaction nor a financing transaction. It placed reliance on different case laws to support its argument.

Decision of the Court:
First ruling of the Court:
The Court distinguished the case laws relied upon by the company by observing that in such cases, the directors of the company gave loans to the company, and it was held that since the relationship of directors with the company is that of fiduciary in nature, they are not engaged in any business relationship. Therefore, the Courts held that interest-free loans given by the directors to the company did not fall within the meaning of benefit derived from any business relationship.

Then the Court relied upon a judgment of the Supreme Court of Pakistan (SCP) in case of Fauji Foundation reported as 2024 SCMR 788 wherein the SCP laid down following two-pronged test for bringing income under the head of "income from business":

i. Benefit/perquisite must have a fair market value, not necessarily convertible into money; and
ii. A person may have received the value of benefit under a past, present or prospective business relationship.

It was held that the moot point for invoking the provisions of section 18(1)(d) of the Ordinance and charging tax on the benefit accrued in the hands of the applicant was to determine whether the above two conditions are fulfilled or not. It also held that the onus to establish that the transaction is ousted from the ambit of section 18(1)(d) in light of the above two tests, lies with the company. Since the company failed to establish that there was no business relationship between the related parties and that the placement of funds did not result in any profit or gain to the applicant, the Court upheld the treatment adopted by the department.

Second ruling of the Court:
The Court decided that the transaction in question between associates also attracts the provisions of sections 108 and 109 of the Ordinance. The department had the statutory powers to examine the transaction to determine whether the company was involved in practice of avoidance of tax and to re-characterize any transaction and charge tax thereon. Since the company did not show that placement of funds was a genuine transaction between associates and that it was not hit by the provisions of Sections 108 and 109 of the Ordinance, the treatment adopted by the department was upheld by the Court.

Conclusion
The implications of this decision are seriously unwarranted in terms that it results in "Double Jeopardy" to the borrower who is already paying tax on higher profits by not have claimed any interest expense against his profits in the first place. Had the same been paid and claimed the amount of profit being offered for income tax would be lower. He is, therefore, paying tax already on higher profits. Hence any padding up of this illicit fictional and notional gain on the top of the real income, on the pretext of not having paid the interest expense, is only making it double. It is against a fundamental law of Taxation that income cannot be taxed twice. (Laxmibat Singhamia vs CIT (1969) 71 ITR 291 (SC), ITO vs Bachu Lal Kapoor (1966) 60 ITR 74 (SC))

Imagine 5M of actual profit being offered for tax and supposedly 5M of interest expense, which didn't have to be paid as the loan was interest free. If this were paid, the above 5M of the profit of would be Zero, which is otherwise being taxed at full. Now if the non-payment of interest is added up on a notion that it's some sort of benefit taken, then the income, which will now be subjected to tax, will stand at 10M. This is double jeopardy or double taxation and is completely unwarranted under the scheme of the Income Tax Ordinance, 2001.

What is factually the subject of Section 18 of the Ordinance is the waiver of interest after being charged earlier and not when it hasn't been charged in the first place. As such, therefore, there is no such benefit derived by the appellant except what was declared in the return of income.

We understand that this very point was neither raised by the appellant company nor was it ever considered by the learned bench. The question of having a business relationship, therefore, becomes too insignificant in the face of this simple arithmetic.

IN THE HIGH COURT OF SINDH AT KARACHI

Present:
Muhammad Junaid Ghaffar, J.
Jawad Akbar Sarwana, J.

ITRA 205 of 2023

M/s. Elahee Buksh & Company (Pvt.) Ltd.

v.

The Additional Commissioner (Audit-III) Inland Revenue, Range-A-III, MTO Karachi and Two Others

Applicant	:	M/s Elahee Buksh & Company (Pvt.) Ltd. through Mr. Emad-ul-Hassan, Advocate.
Respondent No.1	:	The Additional Commissioner (Audit-III) Inland Revenue, Range-A-III, MTO Karachi,
Respondent No.2	:	The Commissioner (Appeal-IV), Inland Revenue, Range-A-III, MTO Karachi,
Respondent No.3	:	The Appellate Tribunal Inland Revenue (Pakistan), Karachi Bench, all Respondents through Mr. Irfan Mir Halepota, Advocate
Date of hearing	:	24.04.2024
Date of Judgment	:	04.09.2024

J U D G M E N T

Jawad Akbar Sarwana, J.: The Applicant taxpayer, a private limited liability company incorporated under the Companies Ordinance, 1984, M/s. Elahee Buksh & Company (Pvt.) Ltd. (hereinafter referred to as "the Applicant taxpayer"), obtained an interest-free loan from a related party/associated company, M/s. Khayaban-e-Iqbal (Pvt.) Ltd. (hereinafter referred to as "Kh-e-Iqbal (Pvt.) Ltd."). The Revenue Respondents found the transaction to be a benefit out of business, and the interest income accrued therefrom was charged to tax under Section 18(1)(d) of the Income Tax Ordinance ("ITO"), 2001. The Applicant taxpayer, aggrieved by this treatment of the Revenue and the

Orders dated 30.06.2021,[1] 28.11.2022,[2] and 10.05.2023[3] has preferred this ITRA under Section 133 of ITO, 2001.

2. The brief background of the matter is that the Applicant taxpayer filed a Return of Income Tax for the Tax Year 2015, whereafter the Taxation Officer issued a show-cause notice ("SCN") dated 23.08.2016 to the Applicant taxpayer under Section 122(9) read with 122(5A) of ITO, 2001 to show cause, inter alia, as to why u/s 18(1)(d) of ITO, 2001, the interest as per prescribed rate should not be charged to tax on the funds parked in the books of accounts of the Applicant taxpayer. In its reply, the Applicant taxpayer denied the liability of tax accruing from the loan, explaining that the loans received were from related parties based on "no interest", duly disclosed in the company's audited accounts. The Taxation Officer did not accept the explanation submitted by the Applicant taxpayer and applied KIBOR rate of 7.38% to the loans received, creating an interest income of Rs.16,733,318 chargeable to tax, and leading to a tax demand of Rs.5,009,716 payable by the Applicant taxpayer as per the amended Order u/s 122(5A) of ITO, 2001 passed by the Additional Commissioner Inland Revenue ("ACIR") dated 30.06.2021. The Applicant taxpayer preferred first appeal with the CIR (Appeals-IV), who upheld the said amended Order of ACIR vide its Order dated 28.11.2022. Thereafter, the Applicant taxpayer filed second appeal before the Additional Commissioner (Audit-III), Internal Revenue ("IR"). In the second appeal, the ACIR vide its Order dated 10.05.2023 did not find any infirmity in the two orders below and upheld the same. Aggrieved by the Orders, the Applicant taxpayer filed this ITRA.

2. The Applicant taxpayer proposed the following questions of law to be framed in this ITRA:

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[1] Amended Order dated 30.06.2021 under Section 122(5A) of the Income Tax Ordinance, 2001, passed by Respondent No.1, available on pages 37 to 61 (13 sheets) of the ITRA.
[2] Order dated 28.11.2022 under Section 129(1) of the Income Tax Ordinance, 2001, passed by Respondent No.2, available on pages 75 to 119 (23 sheets) of the ITRA.
[3] Order dated 10.05.2023 under Section 122 (5A) of the Income Tax Ordinance, 2001, passed by Respondent No.3 available on pages 121 to 125 of the ITRA.

(i) Whether the impugned order passed by the Appellate Tribunal Inland Revenue (Pakistan), Karachi is a judicious and speaking order?

(ii) Whether provisions of Section 18(1) of the Income Tax Ordinance, 2001 are applicable in case of interest free loan between associated companies of a group?

(iii) Whether placement of funds by an associated Company without any underlying business transaction is covered under the Explanation to section 18(1)(d) of the Income Tax Ordinance, 2001?

(iv) Whether there is any loss to the revenue by not booking interest on the interest free loan between associated Company by the Appellant?

3. During the course of arguments, we reduced the questions of law to questions (iii) and (iv) above, and Counsels submitted their argument on the following reframed questions:

(i) Whether placement of funds by an associated Company is covered under the Explanation to section 18(1)(d) of the Income Tax Ordinance, 2001?

(ii) Whether there is any loss to the revenue by not booking interest on the interest free loan between associated Company by the Applicant?

4. Learned Counsel for the Applicant taxpayer has argued that transactions between associated companies, having common ownership as well as directors, do not amount to a business relationship; hence, section 18(1)(d) is/was not applicable to the case at hand. He contended that the Respondents failed to appreciate that the placement of funds were interest-free loans placed by an Associate Company to meet the working capital requirements and, as such potentially, are neither a business transaction nor a financing transaction. Kh-e-Iqbal (Pvt.) Ltd.'s funds placement was temporary, and there was no agreement between the Applicant taxpayer and its Associate Company. Finally, he contended that the Revenue had not given any specific reason for their decision. Therefore, the Orders

passed by the Respondents were erroneous and liable to be set aside. In support of his contentions, the Counsel for the Applicant taxpayer relied on 2015 PTB (Trib.) 386, *Commissioner Inland Revenue v. Lucky Cotton Mills (Pvt.) Ltd.*, 2017 PTD 864 (DB, Sindh High Court), and *Wisal Kamal Fabrics (Pvt.) Ltd. v. Commissioner Inland Revenue Lahore and Another*, 2019 PTD 1077 (DB, Lahore High Court).

5. The learned Counsel for the Respondents argued that the relationship between the Applicant taxpayer and its Associate Company was a business relationship, and the Respondent officers and Tribunals, have passed well-reasoned Order(s) after giving the parties an opportunity of hearing. As such, the impugned Order(s) should be upheld by this Court.

6. We have heard the learned Counsels for the parties and reviewed the record. As mentioned above, the issue to be decided in this matter is whether the placement of funds in terms of interest-free loans received by an Applicant taxpayer from its Associate Company amounts to a business transaction and a benefit covered under section 18(1)(d) of ITO, 2001.

7. Section 18 and its sub-section[4] applicable to the case in hand reads as follows:

> "**Income from business** (1).---The following incomes of a person for a tax year, other than income exempt from tax under this Ordinance, shall be chargeable to tax under the head "Income from Business"
>
> . . .
>
> (d) the fair market value of any benefit or perquisite, whether convertible into money or not, derived by a person in the course of, or by virtue of, a past, present, or prospective business relationship
>
> Explanation.-- For the purposes of this clause, it is declared that the word `benefit' includes any benefit

[4] Income Tax Ordinance, 2001 amended upto 30.06.2015

> derived by way of waiver of profit on debt or the debt itself under the State Bank of Pakistan, Banking Policy Department's Circular No.29 of 2002 or in any other scheme issued by the State Bank of Pakistan."

8. Section 18(1)(d) states that any benefit a person receives during a business relationship is subject to income tax. The main condition is that the benefit must be received during the business relationship. The question arises as to whether the relationship between the Applicant taxpayer and the Associate Company involves a business relationship. The Counsel for the Applicant taxpayer did not place any reported judgment involving a discussion of section 18(1)(d) in the context of associates advancing interest-free loans. The three reported cases relied upon by the Counsel for the Applicant taxpayer (as mentioned above) concerned the treatment of loans made by the directors of a taxpayer company to the same company. The Division Bench of this Court and the Lahore High Court, in these Report Judgments, concluded that the Company's directors, who manage the company, have a fiduciary relationship with the company and are not engaged in a business relationship with it. Therefore, interest-free loans given by the directors of a company to their taxpayer company did not fall within the meaning of benefit derived during the course of a business relationship. Consequently, in the facts and circumstances of the two cases, section 18(1)(d) of the Ordinance did not apply to the profit earned from the interest-free loans which the company's directors advanced to the said taxpayer company.

9. It is evident from the factual plane of the above-mentioned reported authorities that the three reported cases relied upon by the Counsel for the Applicant taxpayer are different from the case in hand. The present matter concerns an Associate Company placing funds with the Applicant taxpayer and not the directors extending a loan to the Applicant taxpayer. The question before us is an entirely different one, i.e., whether the provisions of section 18(1)(d) can be invoked in cases of placement of funds, in the form of interest-free loans, placed by the

Associate Company with the Applicant taxpayer. The Supreme Court of Pakistan in *The Commissioner Inland Revenue, Islamabad v. Messrs. Fauji Foundation and Another*, 2024 SCMR 788, paragraph 7, laid down the following two-pronged test for bringing income under the head of "income from business":

> "It would appear from the perusal of the provision reproduced above [Section 18(1)(d)] that it prescribes a two-pronged test for bringing income under the head "income from business". The first is that any benefit or perquisite must have a fair market value, not necessarily whether it can be converted into money. The second is that a person may have received the value of that benefit or perquisite during or under a past, present, or prospective business relationship. The coexistence of both is necessary. The absence of one of them will not constitute income from a business."

10. In the *Fauji Foundation* case (supra), the Supreme Court first determined whether the Revenue had succeeded in establishing that the taxpayer's gain from a long-term investment was liable to be taxed as business income. Thereafter, the apex Court turned to the second constituent component of the test. In both the first and second limbs of the test, the Supreme Court sought to apply the legal proposition to the facts of the case to examine whether a business relationship existed between the taxpayer and the subsidiary company. To this end, the Supreme Court noted that the Revenue had not brought any material on record which disclosed definite information that the taxpayer had made such investment in furtherance of its business or in connection therewith. In the present case, the SCN under Section 122(9) r/w Section 122(5A) clearly identified to the Applicant that:

> "You have acquired interest free loan of Rs,226,738,736 **from related party** which may be a deemed benefit out of business activity, hence the interest as per prescribed rate for the period under consideration shall be charged to tax u/s 18 of the Ordinance."

11. The Taxation Officer of the SCN mentioned and identified to the Applicant taxpayer that total income had been undervalued arising out of the loan advanced by the Associate Company to the Applicant taxpayer. The onus was now on the Applicant taxpayer to rebut the same on the cogent ground that the loan did not meet any one of the limbs of the *Fauji Foundation* case (ibid.). Instead, the Applicant taxpayer conceded that there was a loan and that it was on a "no interest" basis. This was all it submitted on the matter. Such defence on its own was not sufficient. The taxpayer did not submit how such placement of funds during the course of, or by virtue of, a past, present, or prospective business relationship did not amount to the taxpayer company deriving any benefit from it. Neither the Applicant taxpayer's reply to the SCN nor, in the subsequent proceedings, did the Applicant bring any evidence on record to show that Section 18(1)(d) was not applicable. There was no explanation as to the purpose of the interest-free loans in the proceedings before the Revenue Authorities until filing of this Reference, when, for the first time, the Applicant taxpayer submitted that the interest-free loans were allegedly a temporary placement by the Associate Company and potentially based on the need to meet working capital requirements of the Applicant taxpayer. Yet even this plea was/is not substantiated by any supporting documentary evidence. Nothing was placed before the Revenue or us to show that there is no business/trading relationship between the related parties and that the placement of funds did not result in profit or gain or benefit to the Applicant taxpayer.

12. There is another aspect of the transaction, i.e. once it was an admitted position that the Applicant taxpayer had received funds from its Associate Company, the former had to address the statutory provision under the scheme of the ITO, 2001 referring to transactions between associates. To this end, Section 108 of the ITO, 2001 under Chapter VIII of the Ordinance titled: "Anti-Avoidance" at the material time,[5] read as follows:

[5] Income Tax Ordinance, 2001 amended upto 30.06.2015

“CHAPTER VIII

ANTI-AVOIDANCE

Section 108. Transactions between associates. — (1) The Commissioner may, in respect of any transaction between persons who are associates, distribute, apportion or allocate income, deductions or tax credits between the persons as is necessary to reflect the income that the persons would have realised in an arm’s length transaction.

(2) In making any adjustment under sub-section (1), the Commissioner may determine the source of income and the nature of any payment or loss as revenue, capital or otherwise.

13. In the backdrop/context of Section 108, the Applicant taxpayer had entered into a transaction with its associate which involved the placement of funds, described as an interest-free loan, and the onus was on the Applicant taxpayer to bring forth such material to negate the adjustment proposed to be made by the Revenue Authorities in respect of such placement of funds accruing interest income, and that the transaction did not attract the provisions of law relating to “anti-avoidance” under the ITO, 2001. It is relevant to mention here that the chapter heading of Chapter VIII is “anti-avoidance,” which implies that the legislature introduced this chapter to provide the Revenue with the framework and powers of anti-avoidance to address transactions aiming to avoid the incidence of tax on the taxpayer's part. Section 108 requires that anti-avoidance be looked into, particularly in cases of transactions between associates. Thus, in transactions between associates, the Revenue has the statutory powers to examine transactions between associates to determine whether the taxpayer is involved in practices of avoidance of tax and, if so, then, under the anti-avoidance provisions of law, to make such adjustments as provided under the law. In this regard, there was nothing brought on record by the Applicant taxpayer to show that with the placement of funds by the Associate Company, the Applicant taxpayer did not derive any benefit, whether convertible into money or not, that there was no business

relationship between the associates and that this transaction was not appropriate for the exercise of powers by Revenue under the anti-avoidance provisions of ITO, 2001.

14. In addition to Section 18(1)(d) and Section 108 of the ITO, 2001, the Revenue subjecting to tax the interest earned on the placement of funds made by the Associate Company to the Applicant taxpayer was also in the nature of recharacterization of the payment as a part of Revenues powers for anti-avoidance under Section 109 of the ITO, 2001. Section 109 of the ITO 2001,[6] states as follows:

> "**Section 109. Recharacterisation of income and deductions**. — (1) For the purposes of determining liability to tax under this Ordinance, the Commissioner may –
>
> (a) recharacterise a transaction or an element of a transaction that was entered into as part of a tax avoidance scheme;
>
> (b) disregard a transaction that does not have substantial economic effect; or
>
> (c) recharacterise a transaction where the form of the transaction does not reflect the substance.
>
> (2) In this section, "tax avoidance scheme" means any transaction where one of the main purposes of a person in entering into the transaction is the avoidance or reduction of any person's liability to tax under this Ordinance."

15. The Applicant taxpayer had the opportunity to negate the recharacterisation on the part of the Revenue Authorities to treat the placement of funds between the associates as business to obtain a benefit for the purpose of tax avoidance and to charge tax on such benefit during the proceedings before the Revenue, but the Applicant taxpayer did not offer any information to the Revenue not to recharacterize the transaction. According to the Annual Audited Accounts provided to the Revenue, the funds placed with the Applicant taxpayer were entered in the Balance Sheet under the heading

[6] Income Tax Ordinance, 2001 amended upto 30.06.2015.

“Liability” and not credited to its Capital Account. If the funds had been applied to capital, then it would amount to capital expenditure, which could not be allowed when computing income. However, the Revenue treated the funds as revenue receipts that could be taxed. The Applicant taxpayer submitted no explanation to the Revenue not to apply principles of recharachterization and other anti-avoidance provisions under Chapter VIII of the ITO, 2001.

16. We note that the Revenue did not articulate the recharacterization in the impugned Orders; however, Chapter VIII and its Sections 108 and 109 are a part of the statute in relation to transactions involving associates. The Applicant taxpayer knew the powers of the Revenue to recharachterise the placement of funds and should have addressed this aspect. The Applicant taxpayer also did not show that the placement of funds was a genuine transaction between associates, and not hit by the provisions of Chapter VIII on anti-avoidance. By not responding to the Revenue Authorities recharachterization of the placement of funds as to why the transaction between associates did not attract the provisions of Chapter VIII of the ITO, 2001, the Applicant taxpayer must now face the consequences.

17. We are of the view that the Applicant taxpayer has not brought on record any material to show that Section 18(1)(d) of ITO, 2001, read in the light of Sections 108 and 109 of the ITO, 2001, was not attracted to the facts and circumstances of the case at hand. Accordingly, the first question for a determination of whether the placement of funds by an associated Company is covered under the Explanation to section 18(1)(d) of the Income Tax Ordinance, 2001 is answered in the affirmative, against the Applicant taxpayer and in favour of the Revenue Authorities. Whereas the second question, whether there is any loss to the Revenue by not booking interest on the interest-free loan between the associated company by the Applicant, is answered in the affirmative against the Applicant taxpayer and in favour of the Revenue Authorities.

18. The upshot of the above is that no grounds are made out to interfere with the impugned Orders.

19. The Reference filed by the Applicant taxpayer is dismissed in the above terms with no order as to costs.

20. Office is instructed to send a copy of this Order to the learned Appellate Tribunal in terms of Section 133(5) of ITO, 2001.

J U D G E

J U D G E

Announced in Court on 04.09.2024

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