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Financial leases no longer will qualify for lessor depreciation

New tax accounting standard aligns tax rules with accounting treatment



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12th January, 2015

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Come 1st April 2015, financial lease transactions in India will no longer be eligible for tax depreciation claims by the lessor. Instead, the lessee will claim the same.

This aligns the tax position of lease transactions with the accounting treatment. Accounting standards were amended long time back, in the year 2001, to provide that an asset given on financial lease will be capitalised on the books of the lessee, and the lessor will simply show the same as a financial receivable. However, this had not stopped several lessors to choose a different approach for tax purposes and claim depreciation even in case of financial leases. In fact, right upto the Supreme Court¹, the Courts had allowed depreciation on financial lease transactions to the lessor.

However, the CBDT has now decided to implement a tax accounting standard, called Income Computation and Disclosure Standard (ICDS). Several such ICDS drafts were put recently by the CBDT for public comments². One such ICDS pertains to lease transactions as well.

Position for tax purposes:

The ICDS has been put for public comments, and will be finally uploaded when eventually finalised. The statutory basis of the ICDS is sub-section 2 of section 145 of the Income tax Act whereby the CBDT has been given the power to notify tax accounting standards.

A financial lease has been defined almost in the same vein as the definition in accounting standards. There are some differences, the details of which may be significant. However, on a broad understanding, what is a financial lease for accounting purposes will, in all likelihood, also be a financial lease for tax purposes.

In case of such a lease, the lessor will NOT be allowed to depreciate the asset: the lessee will be. The lessee will also be allowed to claim, as an expense, the interest inherent in the lease rentals as a borrowing cost.

Differential treatment no longer possible:

One significant difference between the tax accounting standards and the financial accounting standards is that in the latter case, it is possible that the same transaction is treated differently by the lessor and the lessee. That is, for the lessor, the transaction may be a financial lease, and for the lessee, it may be an operating lease. Sometimes, the reverse is also possible. This differential treatment happens due to two reasons – different discounting rates chosen by the two for computing the present value of the “minimum lease payments”, and the possibility of there being some guaranteed residual value, guaranteed by a person other than the lessee.

¹ <http://indiankanoon.org/doc/48572667/>

² <http://pib.nic.in/newsite/PrintRelease.aspx?relid=114471>



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However, in terms of the tax accounting standard, such a possibility has clearly been denied. The parties are required to give a joint declaration of their mutual agreement that the lease is either a financial lease or operating lease, thereby completing ruling out a difference in approach.

Impact on the leasing industry:

Leasing industry in India has passed through several phases of booms and busts. Currently, it is evident to anyone associated with the leasing industry that the leasing industry was making a comeback. There has been renewed interest on leases of several assets – renewable energy, solar panels, construction equipment, cars, etc. [Our detailed analysis can be viewed [here](#)]

Many of these transactions are not tax driven – that is, they are not structured for tax incentives of the lessor. Therefore, the situation is far from what it was in 1996-1997 when whole lot of leases of windmills, electric meters, etc were done to claim accelerated depreciation by the lessor.

However, the accelerated depreciation benefit is surely important, and particularly in case of windmills where depreciation rate was reset at 80% for the assets installed after 31st March, 2014.

The change in the tax rule will not kill the motivation for such leases, but the denial of a differential treatment for the lessor and lessee will surely have some impact. There are some lessors who do financial leases only. The amendment may have an adverse impact on their working.

Conclusion:

What is most important for any financial product is certainty of tax treatment. The leasing industry has been a substantial victim of tax uncertainty. Over the years, it has faced whole lot of unpredictable tax rulings, whether in the hands of the income tax officers or those under sales-tax laws. From this viewpoint, the tax accounting standard is a welcome move.

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Details of our book – Taxation of Lease Transactions in India, can be viewed at: http://vinodkothari.com/taxation_of_lease_transactions_in_india/

Our annual review on the state of leasing industry in India, “India Leasing Report, 2014” is out now, details of the same can be viewed at: http://vinodkothari.com/wp-content/uploads/2014/12/Brochure_leasing_report.pdf