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Ghost of sale and leasebacks – will we exercise it now?

- Analysis of Madras High court ruling in First Leasing Company Ltd vs. Assistant Commissioner of Income Tax
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In the heydays of leasing in India, sale and leaseback transactions had become popular amongst leasing companies and were equally misused by them, so much so that all sorts of sham transactions were undertaken in the garb of sale and leaseback which put to question the sanctity of such transactions in India.

During the 1996-98 period one of the most infamous cases was the sale and leaseback of electric meters by state electricity boards (SEBs). For SEBs it made perfect sense as it amounted to cheap borrowing by the cash starved SEBs who had practically no other source of borrowing. For leasing companies and others looking for a tax break, it was a perfect deal as there was 100% write off in case of assets costing Rs 5000 or less. Thus an electric meter will qualify for 100% deduction. Several SEBs had undertaken such transactions in those days. Obvious enough the sole motive was tax deduction no one would care about the value, quality, existence etc of the meters. In some cases, the asset was bought on 30th March to be used only for a day, assets revalued heavily at the time of sale to leasing companies etc.

Lease of non-existing assets such as electric meters, computers, glass bottles, tools, etc, lure of depreciation allowances caused the tax authorities to come down hard on sale and leaseback transactions calling them tax evading transactions. The whole fiasco of such sham transactions resulted in leasing going off the market completely.

The burns of the past continue to linger even after a decade and half since SLB transactions were completely written off. In the recent ruling of *First Leasing Company Ltd vs. Assistance Commissioner of Income Tax*¹, the sanctity of a sale and lease back transaction was being discussed. The Madras High Court held that merely because sale and lease back (SLB) agreement provided for deduction of lease instalments from current consumption charges, it cannot be construed that the transaction is not a sale and leaseback but a mere loan transaction; merely because the assets were eligible for 100% depreciation does not mean that the transaction was doubtful. The Madras High Court held that as long as the SLB transaction was legally tenable in law and there was no reason to doubt the transaction depreciation would be allowed to the leasing company (assessee).

In the present case, the Tamil Nadu Electricity Board (Board/ lessee) had sold certain meters, shunt capacitor banks and outdoor circuit breakers to the assessee and the assessee leased it back to the Board. The assessee claimed depreciation on these assets which were disallowed by the Assessing Officer on the pretext that the SLB transaction was a mere loan transaction.

While the Commissioner (Appeals) held that the assessee satisfied all conditions for claiming depreciation and allowed depreciation, the Tribunal took the view that since

¹ <http://www.taxmann.com/topstories/10101000000087952/madras-hc-accepts-a-novel-sale-and-lease-back-transaction-allows-lessor-to-claim-depreciation-on-let-out-asset.aspx>



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there was no actual delivery or handing of possession of the assets in the sale and lease leg, the transaction was a pure financial transaction and disallowed depreciation.

On an appeal preferred to the Madras HC, it held that:

- a. There is no legal prescription on physical delivery of the asset to be a pre-requisite for SLB transaction.
- b. The agreement clearly stated the offer and acceptance for sale of the assets
- c. The existence of the assets was not doubted.
- d. Certain clause in the standard agreement which indicated that the lessor would purchase the assets identified by the lessee which may not be applicable in the present case cannot be said runs contrary to the substance of the transaction. Superfluous clauses that do not vitiate the nature of the contract or results into breach of the terms cannot be said to be impacting the substance of the transaction.
- e. A guarantee from the state government with regard to the payment of the lease rentals cannot be equated to be an escrow account.
- f. Where there are no circumstances to prove that the transaction was bogus and/ or there are no evidences to prove that the records were falsified, the assessee's claim of sale and lease back of the assets cannot be summarily rejected on the grounds that there was "considerable doubt" on the existence of the asset or the transaction itself.

In a similar case of *CIT vs. Rajasthan State Electricity Board*², the sale and leaseback transaction was questioned as mere financing however the Rajasthan High Court found the transaction to be genuine and allowed lease rentals for deduction.

In terms of the facts of the Madras High Court ruling, what the court overlooked was the fact that a) most of the assets were purchased in March, 2001 and the lease commenced on 31st March, 2001, b) the assets were in several thousands and were wide-spread geographically and c) at the end of the lease term the lessee had the option to renew the lease for Re. 1 rentals for 20 years secondary lease period.

The High Court did show concern that the non-identification of the assets surely put to question the sale of the assets from the electricity board to the assessee but was left unaddressed. Further as per AS 19 -- accounting for leases one of the indicators for classifying the transaction as financial leases was where the lessee continued the lease for a secondary period at a rent which was substantially lower than market rent. In the present case, the lease was renewable at Re.1 for a secondary period of 20 years.

These were some of the glaring facts that were overlooked by the High Court and it heavily relied on the ruling of *CIT vs. Shaan Finance (P) Ltd.*³ for ascertaining whether the criteria for depreciation allowance was met.

² (2006) 204 CTR (Raj) 415



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The facts above certainly indicate that the motivation for undertaking the transaction for the leasing company was claiming 100% depreciation.

Structuring of deals to take advantage of law are not uncommon however when such transactions are put to question before the judiciary, the Courts must look at the substance of the transaction and not by the mere dressing up of the transactions as in the present ruling. In a ruling of *CIT vs. The Instalment Supply Ltd*³ the Delhi High Court had looked into the substance of the lease transaction to deliberate whether the transaction was a financial lease in the garb of operating lease. The Delhi High Court held that transaction was not *bona fide* as the assessee-lessor could not have been interested in acquiring spare parts and leasing them. The transaction was motivated by the lessor's entitlement to 100% depreciation, the very existence of the assets for lease and their independent functionality were put to question. The transaction was taken to be a mere financing transaction.

The Madras High Court ruling is surely not significant in terms of enriching the position on tax qualifications of a true lease and concerns on depreciation but is yet another ruling in the series of “why not” rulings (another series being “no you can't” rulings).

On a positive note, the author could say that the Madras High Court ruling sets in place the existential crisis of sale and leaseback transactions in India and infuses a little more confidence in the leasing players to undertake SLB transactions and shed the jitters of the past. However, cannot end without a caveat that if the leasing companies were to undertake genuine transaction in substance, it will add value to the flourishing leasing industry in India, however if they were to go overboard, the underlying fear of the return of all sorts of maligned transactions of 1996-98 is not misplaced.

³ [1998] 231 ITR 308/97 Taxman 435 (SC)

<http://www.taxmann.com/fileopen.aspx?Page=CASELAWS&id=10101000000080672&source=link>

⁴ <http://itatonline.org/archives/>



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