

Article



Lessor's Entitlement to Depreciation on Finance Leases: *Kabhi Haan Kabhi Naa*

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Introduction

“Leases” and “taxes” seem to be so intimately connected that our judiciary needs to intervene time and again to put things in place. The intervention too, does not seem to work every time; our Courts have decided and then reversed what they decided and such instances are many. The result is too many flip-flops.

Similar is the case with depreciation allowance by income tax authorities in finance leases: the issue has been in “issue” for a very long time. The introduction of Accounting Standard-19 (AS) on Leases issued by the ICAI created depreciation dichotomy between the Standard and the tax laws on financial lease transactions. Then CBDT's Circular negated the effect of the AS on depreciation allowance under the Income Tax Act, 1961. Then came the judgment of Hon'ble Supreme Court, followed by Income Tax Appellate Tribunal's ruling, holding the lessee to be eligible person to claim depreciation. The latest flip comes from the Supreme Court itself in *M/s ICDS vs. Commissioner of Income Tax, Mysore and Another*¹ dated 14th January, 2013, where depreciation benefit goes to the lessor's kitty.

The author, in this article, has made an attempt to track the series and throw light on the same.

The numerous U-Turns

Before AS-19

Before the introduction of AS-19 on leases, no distinction was made between financial leases and operating leases. In all the leasing transactions, therefore, the owner of the asset was entitled to depreciation under Section 32 of the Income Tax Act, 1961, provided other requirements of the Section were met.

Introduction of AS-19²

Financial leases were distinguished from operating leases. For accounting purposes, the lessee capitalizes the assets taken under financial lease arrangement in its books; which in turn gives rise to a depreciation expense for the asset in the books of the lessee. While under operating leases, depreciation is recognized as an expense in the books of the lessor. As such depreciation allowance, in financial leases, goes to the lessee.

¹ <http://indiankanoon.org/doc/184005439/>

² <http://220.227.161.86/27285asb-as-19.pdf>



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CBDT's Diktat

Central Board of Direct Taxes (CBDT) however, *vide* its Circular 2/2001, dated 9-2-2001³ clarified that by itself, the accounting standard (i.e. AS-19) will have no implication on the allowance of depreciation on assets under the provisions of the Income-tax Act. The owner of the asset is entitled to the depreciation if the same is used in business; and the ownership is to be determined by the terms of contract between the lessor and the lessee. As *Vinod Kothari*, the author of renowned book "*Lease Financing and Hire Purchase*" opines, "The Circular, read with the accounting standard leads to a new era of dichotomy between accounting standards and tax treatment. While we have all lived with distinction between tax depreciation and book depreciation, here is a new angle to the dichotomy: a distinction between tax ownership and accounting ownership."⁴

Asea Brown Boveri Ltd vs. Industrial Finance Corporation⁵

The Supreme Court in the case of *Asea Brown Boveri Ltd vs Industrial Finance Corporation* quoted *Vinod Kothari* to define a financial lease as nothing but a loan in disguise, where the lessor is merely the legal owner of the asset; all the risks and rewards incidental to the ownership of the asset are transferred to the lessee; and the lessor enters into the transaction only as a financier.

Taking this view, it can be said that the rightful claimant of depreciation in financial leases is lessee and not the lessor; since the status of the lessor is that of a financier only.

The view was reinforced in *IndusInd Bank Ltd vs. ACIT (ITAT Mumbai Special Bench)*⁶. The Special Bench of ITAT accepted the meaning of financial leases as elaborated in the *Asea Brown case (supra)* and regarded the same to have universal application except where it has been otherwise defined in any statute. On the question of admissibility of depreciation in financial leases, the ITAT put it straight,

"Whereas in the case of operating lease, it is the lessor who is the real owner of the asset, but in case of finance lease, it is the lessee who is to be regarded as the real owner of the asset. *Ex consequenti only the lessor can*

³ http://law.incometaxindia.gov.in/dittaxmann/incometaxacts/2008itact/sec_032.htm; Point 234; or http://www.incometaxindiapr.gov.in/incometaxindiapr/contents/CBDTFiles/Circulars/CBDTLaws/HTMLFiles/dtcddiv1_p260.htm

⁴ <http://india-financing.com/cbdtcircular.htm>

⁵ Appeal (civil) 3574 of 1998; [(2006) 154 Taxman 512 (SC)]; <http://www.indiankanoon.org/doc/1163314/>

⁶ <http://itatonline.org/archives/index.php/indusind-bank-ltd-vs-acit-itat-mumbai-special-bench-difference-between-finance-lease-operating-lease-explained/>; or



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claim depreciation in case of an operating lease and the lessee in a case of finance lease.”

Therefore, a settled position in law was that in financial leases, it is the lessee who is entitled to claim depreciation on the asset taken on lease, and not the lessor. However, a recent judgment taken by the Supreme Court has turned the tables: lessor is now held to be the rightful claimant of depreciation in financial leases.

The Latest (and possibly the last?) Flip:

*M/s ICDS vs. Commissioner of Income Tax, Mysore and Another*⁷

Facts

ICDS is an NBFC engaged in the business of hire purchase, leasing and real estate etc. The issue came into question when ICDS (the lessor or the assessee) claimed depreciation on the assets leased out by it, i.e. financed by it but registered in the name of the lessees (under the Motor Vehicles Act, 1988). Further, the depreciation was claimed at a higher rate on the ground that the vehicles were used in the business on running them on hire⁸.

Now the case witnessed as many flip-flops as in the history of depreciation in lease transactions. The Assessing Officer outrightly rejected the claim of depreciation holding that the assessee was not the actual owner and user of the vehicles and not using the vehicles “in the business of running them on hire”, but only by way of leasing out to others. On an appeal being made, the Commissioner of Income Tax though accepted the claim of depreciation, but only at normal rates. Then the matter reached Income Tax Appellate Tribunal and the Tribunal decided in favour of the assessee, and allowed depreciation at higher rates⁹, relying on the decision taken by the Hon’ble Supreme Court in *Commissioner of Income Tax, Karnataka, Bangalore vs. Shaan Finance (P) Ltd., Bangalore*¹⁰. An appeal was then preferred to the High Court, which ruled out the decision of ITAT on the basis that the vehicles were not registered in the name of the assessee and having only financed the transaction, the lessor cannot be said to be the actual owner of the vehicles; therefore no depreciation can be allowed to the assessee. It was how the matter reached the Apex Court.

⁷ <http://indiankanoon.org/doc/184005439/>

⁸ [New Appendix 1](#) to the Income Tax Rules.

⁹ <http://itatonline.org/archives/index.php/i-c-d-s-ltd-vs-cit-supreme-court-s-32-a-financier-satisfies-the-ownership-user-test-for-depreciation/>

¹⁰ (1998) 3 SCC 605; <http://www.indiankanoon.org/doc/108872/>



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Observations and Judgment of the Apex Court

The important observations made by the Supreme Court are:

1. Section 32 of the Income Tax Act¹¹ lays down twin requirements of “*ownership*” and “*usage for business*” for a successful claim under Section 32 of the Act.
2. The income tax law requires the use of the asset by the assessee for “the purpose of business”; it does not mandate the use of the asset by the assessee itself. The lessor, in the instant case, is a leasing company, engaged in the business of leasing trucks it purchases. Therefore, it satisfies the criteria of “usage for business” as it used the vehicles in the course of its leasing business.
3. As regards “ownership”, the Supreme Court cited the observations made in *Mysore Minerals Ltd., M.G. Road, Bangalore vs. Commissioners of Income Tax, Karnataka, Bangalore*¹²; definition of the term “owner” in the Black’s Law Dictionary, and the various clauses of the lease agreement that established the lessor to be the “exclusive owner” of the vehicles at all points of time and that the lessee was under an obligation to return the vehicles to the lessor on expiration of the lease.
 - 3.1. The ownership of the vehicle was transferred to the lessee at the end of the lease term, that too at a nominal value of 1% of the original cost of the vehicle: this particular provision in the lease agreement made the Income Tax department hold the assessee (the lessor) to be a mere financier. The Supreme Court ruled out this contention since “*the assessee has a right to retain the legal title of the vehicle against the rest of the world, it would be the owner of the vehicle in the eyes of law*”.
 - 3.2. Agreeing to the observations made by the Tribunal relying on the views of author of “*Lease Financing and Hire Purchase*”, the Supreme Court accepted that the transactions in question are not hire purchase transactions, rather these are lease transactions.

[Author’s note: The fact that the asset was transferable to the lessee at the end of the lease term at a nominal value, makes the lease a financial lease as per Para 8 of AS-19)
 - 3.3. As far as the provisions of the Motor Vehicles Act pertaining to “ownership” is concerned, it was hold that the said Act creates a legal fiction of ownership in favour of the lessee only for the purpose of the said Act: “*It is not a statement of law on ownership in general*”.

¹¹ <http://law.incometaxindia.gov.in/DIT/Income-tax-acts.aspx>

¹² (1999) 7 SCC 106



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- 3.4. The entire lease rent received by the assessee is assessed as business income in its hands and the entire lease rent paid by the lessee has been treated as deductible revenue expenditure in the hands of the lessee. This reaffirms the position that the assessee is in fact the owner of the vehicle, in so far as Section 32 of the Act is concerned.
- 3.5. In cases like *Commissioner of Income-Tax Vs. A.M. Constructions*¹³; *Commissioner of Income-Tax Vs. Bansal Credits Ltd.*¹⁴; *Commissioner of Income-Tax Vs. M.G.F. (India) Ltd.*¹⁵; *Commissioner of Income-Tax Vs. Annamalai Finance Ltd.*¹⁶, the leasing company was held to be the owner of the asset and held to be entitled to the claim of depreciation, that too at higher rates applicable on the assets hired out.

On the basis of the above, the lessor was held to be the actual owner of the asset; thereby satisfying the twin requirements of Section 32 of the Income Tax Act to claim depreciation

4. On the question of higher rate of depreciation, the Supreme Court held that the words “purpose of business” as used in second proviso to Section 32(1) are having the same import as that used in Section 32(1) itself, and endorsed the observations of ITAT:
- 4.1. The CBDT Circular No. 652 dated 14.6.1993 specifically ruled out the possibility of denying higher depreciation in case of leased vehicles when the actual use is in hiring business.
- 4.2. As the case of *Shaan Finance P Ltd. (supra)* suggests, where the business of the assessee consists of hiring out machinery and/ or where the income derived by the assessee from the hiring of such machinery is business income, the assessee must be considered as having used the machinery for the purpose of business.

Based on the grounds discussed, the decision was rendered in favour of the lessor: depreciation claim was allowed to the lessor and at a higher rate.

Our Analysis

This “*kabhi-haan-kabhi-naa*” behavior of judiciary is creating confusions in the minds of the industry stakeholders. Lessee or lessor, who is the rightful and eligible claimant of

¹³ (1999) 238 ITR 775 (AP)

¹⁴ (2003) 259 ITR 69 (Del)

¹⁵ (2006) 285 ITR 142 (Del.)

¹⁶ (2005) 275 ITR 451 (Mad)



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depreciation under the income tax laws?: the question associated with finance leases has been seemingly clarified by the highest Court and the answer is “lessor”; but this indicates that the legal ownership is the sole criteria for allowing depreciation; the beneficial ownership holds no weight while determining the eligibility. Further, the contradictory treatment of depreciation in accounting parlance and taxation still persists.

For the time being, the latest pronouncement by the Supreme Court is to be taken as the settled position of law.

Read other relevant articles, case law studies:

1. [Depreciation Dichotomy between Accounting Standard and Tax Laws on Financial Lease Transaction](#)
2. Other Leasing related case laws [here](#).
3. Our [dedicated page on Leasing](#) related articles.