Note

Lease in the course of Import: Principle of Inextricable Link Rules Again

Sikha Bansal
sikha@vinodkothari.com
Vinod Kothari & Company
November 30, 2012

Check at: http://india-financing.com/staff-publications.html for more write ups.

Note

Case Study: *The State of Tamil Nadu v. Karnataka Bank Limited*

In the case of *State of TamilNadu v. Karnataka Bank Limited*[1], Hindustan Power Plant Limited (HPPL or the lessee) placed purchase order for machines on a foreign company on 14th July, 1997. Thereafter, lease finance arrangement was entered into between HPPL and the Karnataka Bank (the assessee). Confirming that the lessee would enter into lease agreement for financing the import of machines, the lessee requested the assessee to place the purchase order on the overseas foreign supplier to whom the lessee had already placed purchase order. On 17th April, 1998, the assessee and HPPL entered into master lease agreement (MLA). Then on 31st July, 1998, the parties entered into a supplementary agreement.

The assessee claimed exemption under Section 5(2) of the CST Act, pleading that the movement of goods resulted out of the agreement between the assessee and HPPL. The supplementary agreement is not separate from the MLA and does not have an independent existence from that of the MLA. As such, the transaction between the assessee and the foreign company; and that between the assessee and HPPL are not independent transactions.

The revenue contended that supplementary agreement is totally unconnected with the master agreement; the MLA merely specified the general terms of the lease, there were no specifications regarding machinery to be imported and leased out. It was only after the machinery was imported and taken to the lessee's place, that the supplementary lease agreement was signed giving details of the machinery. Therefore, the MLA and the supplementary agreement cannot be read to refer to a single transaction only and cannot lead to a finding that the machinery was imported by the assessee for and on behalf of HPPL. As such, the import by the assessee and the transfer of right to use constitute different transactions and not to be a single one.

The Madras High Court referred to the stand taken by the Apex Court in *Indure Ltd. & Another vs Commercial Tax Officer & Others*[2], reported in *State of Maharashtra vs. Embee Corporation, Bombay*[3], further followed in *Deputy Commissioner of Agricultural Income Tax and Sales Tax, Ernakulam v. Indian Explosives Limited*[4]; wherein the meaning of "in course of import" was expressed as:

> "the sale should be one in the course of import it must occasion the import and to occasion the import there must be integral connection or inextricable link between the first sale following the import and the

[1] Dated : 30.09.2011 (http://indiankanoon.org/doc/25921642/)
[2] [(2010) INSC 753]
[3] [1997] 7 SCC 190
[4] [1985] 4 SCC 119

> actual import provided by an obligation to import arising from statute, contract or mutual understanding or nature of the transaction which links the sale to import which cannot, without committing a breach of statute or contract or mutual understanding, be sapped"

On the basis of the above stated view, the High Court observed that:

> "Thus, but for the purchase order placed by Hindustan Power Plant Limited and later thereon approaching the assessee for financial arrangement, *the question of assessee ever placing any purchase order with the Japanese manufacturer/supplier would not have arisen.* The purchase order placed by the assessee with the foreign supplier in turn clearly refers to the purchase order of Hindustan Power Plant Limited with the Japanese firm and the import itself was in connection with the master agreement between the assessee and the lessee."

Further, the various documents placed by the assessee, in particular the Bill of Lading indicating the name of Hindustan Power Plant Limited showed that the import is linked to the purchase order placed on behalf of Hindustan Power Plant Limited.

Therefore, the receipt of rentals by the assessee was on account of the transaction in the course of import, which is not liable to be taxed by the State.

Our Analysis

What the Law says

Section 5 of the Central Sales Tax Act, 1956 (CST Act) prescribes the circumstances under which a sale or purchase of goods is said to take place in the course of export or import.

Section 5(2) of the CST Act states, "A sale or purchase of goods shall be deemed to take place in the course of the import of the goods into the territory of India only if the sale or purchase either occasion such import or is effected by a transfer of documents of title to the goods before the goods have crossed the customs frontiers of India."

Interpretation of the Law

The essential requirements of a sale, to be considered as a sale in the course of import, will be applied *mutatis mutandis* in the case of a lease. Precisely, the lease shall be considered to be lease in the course of import, if:

Note

1. The lease has occasioned the actual import, it has triggered the import. ***There should be an inextricable link between the lease and the import.***
2. The lease is effected during the import, before the goods cross the customs frontiers of India, typically known as high sea leases.

The Principle of Inextricable Link

The principles in order to determine whether a sale has taken place in the course of import or not, were elaborately dealt with in the case of *K. Gopinathan Nair & Etc vs State Of Kerala (1997, SC, Majority through S.B. Majumdar, J.)*[5], wherein the Supreme Court projected the following propositions for deciding whether the concerned sale or purchase of goods can be deemed to take place in the course of import:

> "(1) The sale or the purchase, as the case may be, must actually take place.
> (2) Such sale or purchase in India must itself occasion such import, and not vice versa i.e., import should not occasion such sale.
> (3) The goods must have entered the import stream when they are subjected to sale or purchase.
> (4) The import of the concerned goods must be effected as a direct result of the concerned sale or purchase transaction.
> (5) The course of import can be taken to have continued till the imported goods reach the local users only if the import has commenced through the agreement between foreign exporter and an intermediary who does not act on his own in the transaction with the foreign exporter and who in his turn does not sell as principal the imported goods to the local users.
> (6) There must be either a single sale which itself causes the import or is in the progress or process of import *or though there may appear to be two sale transactions they are so integrally inter-connected that they almost resemble one transaction so that the movement of goods from a foreign country to India can be ascribed to such a composite well integrated transaction consisting of two transactions dovetailing into each other*.
> ……."

If the aforesaid conditions are satisfied, then the transaction of sale or purchase will fall within the sale or purchase in the course of import and accordingly will earn exemption under Section 5(2) of the CST Act.

The case cited above affirmed the basic stipulations as to integrated lease transactions put forward by Vinod Kothari[6], as may be listed down:

---

[5] [(1997)10 SCC 1] http://indiankanoon.org/doc/1093509/

[6] Vinod Kothari: Lease Financing and Hire Purchase including Consumer Credit; Fourth Edition, 1996, p.910

Note

1. The lessor purchases the goods on the basis of specifications given by the lessee. In fact, the lessee is, as a general rule directly responsible for choosing the equipment and the supplier. Any normal lease agreement would contain clauses to this effect and expressly provide that the lessor has not taken any part in the selection of the goods.

2. A privity of contract between the supplier and the lessee, though not direct, cannot altogether be denied, because the supplier would commercially treat the lessee as his customer, not the lessor. The lessor enters into the fray only after the supplier has convinced the lessee about the goods and an agreement to buy has been made. Should there be any defect in the goods, the lessee gets directly in touch with the supplier and express authority for this purpose is given by the lessor. The right of claiming any damages, etc. on account of fitness of the goods is assigned to the lessee. In short, the lessor and the supplier are never in any commercial seller-buyer relationship except that the supplier makes the bill on and receives the payment from the lessor. This may not be entirely tenable in law but to a man from the leasing world this practice is prevailing.

3. No one can deny that the lessor's purchase is expressly for the second contract, that is, the lease. The lessor is not generally or independently in the business of dealing the goods which he leases. In fact, the lessor mostly has not even seen the equipment that is leasing out.

4. Under the contract, the lessor cannot divert the goods to any other lessee. In fact, as the goods are as per specifications and upon a specific request from the lessee, there cannot be any chance of diversion.

5. It would be against reality to contend that the contract of lease could not have occasioned the movement, since the movement was occasioned by the preceding purchase, as it is wrong to contend that the contract of lease was nowhere in sight when the lessor bought the goods. As the purchase by the lessor could not have been visualised except for the purpose of lease, the lease formed the motive force of the purchase. In other words, the purchase itself was occasioned by the lease, and so, it is clear that the lease occasioned the movement.

6. In order to occasion the inter-state movement, it is not necessary that the lease should precede such movement. Hence, the fact that the lease takes effect only after the movement is complete does not change the picture.

Note

Keeping in view the propositions laid down by the highest Court of the Land to identify a lease in course of import, the stand taken by the Madras High Court is totally justified.