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When does a Lease Commence?

Bringing out the inherent distictinction between Lease Agreement and Agreement to Lease

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Lease transactions are not uncommon these days. Having emerged as one of the prudent means of financing, lease transactions also get certain tax incentives. But inherent complexities in these transactions may result in a tug of war between the assessees and the tax authorities. In a recent decision in *Go Airlines Private Limited vs. Union of India*[1], the Delhi High Court denied exemption to the assessees on the transaction being not considered a lease, but merely an agreement to lease. This brief write up throws light on the case and makes an attempt to study the implications of the same.

Facts of the Case

Go Airlines (India) Pvt. Ltd. and Kingfisher Airlines Pvt. Ltd. (the petitioners) are companies engaged in the business of operation of aircrafts. The petitioners entered into contracts (dated 27th March, 2006 and 18th July, 2006 respectively), with non-resident companies for taking on lease airbuses with a scheduled date of delivery (in May, 2007 and in October, 2007 respectively). The petitioners then filed exemption application under Section 10(15A) of the Income Tax Act, 1961 (the Act).

Section 10(15A) of the Act states,
"In computing the total income of a previous year of any person, any income falling within any of the following clauses shall not be included-
……
"(*15A*) any payment made, by an Indian company engaged in the business of operation of aircraft, to acquire an aircraft or an aircraft engine (other than a payment for providing spares, facilities or services in connection with the operation of leased aircraft) on lease from the Government of a foreign State or a foreign enterprise under an agreement, not being an agreement entered into between the 1st day of April, 1997 and the 31st day of March, 1999, and approved by the Central Government in this behalf :
Provided that nothing contained in this clause shall apply to any such agreement entered into on or after the 1st day of April, 2007.
Explanation.—For the purposes of this clause, the expression "foreign enterprise" means a person who is a non-resident;"

However, the applications were rejected by the Central Board of Direct Taxes on the ground that aircrafts, for which lease agreements were signed, did not exist on the date of the agreement and therefore these agreements were not valid lease agreements. Section 10(15A) of the Act extends exemption to valid lease agreements signed before April 1, 2007; and as per the provisions of the Transfer of Property Act, the existence of the property is essential for a valid lease agreement.

[1] http://www.indiankanoon.org/doc/112967906/

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As such, the aircrafts being not in existence at the date of signing of agreements, the agreements cannot be said to be valid lease agreements.

The petitioners, on the other hand, contended that the benefit under Section 10(15A) of the Act depends on the date of the agreement per se: it is the only material and determinative factor; the aircraft need not be in existence on date when the agreement is entered into and the lease period can begin from a future date.

Ratio Decidendi

The Delhi High Court looked into the series of amendments made in Section 10(15A): initially the benefit was extended to the agreements entered into on or before 1st April, 2005; later the cut-off date was changed to 1st October, 2005 and then 1st April, 2006 and lastly to 1st April, 2007 (last amendment being made in the Finance Act, 2006 passed on April 18, 2006). The Court pointed out that, "the petitioners, therefore, were fully cautious and aware of the sunset clause in the form of the date in the proviso and when the agreements in question were entered into and that after the particular date, the benefit/advantage would not be available."

Coming to Section 10(15A) of the Act, the Court stressed that, "The relevant words are "any payment made to acquire an aircraft or an aircraft engine on lease". The proviso stipulates that this clause shall not apply to any such agreement entered into on or after 1st April, 2007."

As regards the validity of the lease, the Court noted that the aircrafts were scheduled to be delivered in future. The lease period was to be commenced from the date of delivery of the aircraft and was for a period of 72 months. Recourse was taken to the Transfer of Property Act in which "transfer of property" has been defined as an act by which a living person conveys property, in present or in future, to one or more other living persons, or to himself, and one or more other living persons; and "to transfer property" is to perform such act. It was emphasized that, "The words "in present" or "in future" refer to the conveyance and do not relate to the word "property""[2]. Further, "Till a property comes into existence and is capable of being identified, it cannot be transferred or conveyed. Once a property comes into existence and can be identified, it can be made subject matter of conveyance, which is operative from a future date. When property is not in existence, the contract operates as an agreement to be performed in future."

[2] JugalKishore Saraf versus Raw Cotton Company, (1955) 1 SCR 1369

Similarly, distinction was drawn out between a "sale" and an "agreement to sell" as made under the Sale of Goods Act, 1930. As per Section 4(2) of the Sale of Goods Act, "Where under a contract of sale the property in the goods in transferred from the seller to the buyer, the contract is called a sale, but where the transfer of the property in the goods is to take place at a future time or subject to some condition thereafter to be fulfilled, the contract is called an agreement to sell." Further, as per Section 6(3) of the Sale of Goods Act, "Where by a contract of sale the seller purports to effect a present sale of future goods, the contract operates as an agreement to sell the goods." As such, the right and title in the property cannot pass and be conferred on the purchaser till the goods come into existence. In *Benjamin's Sale of Goods*[3], the learned author has elucidated that when the seller neither owns nor possesses the goods, they can be made subject matter of a contract but such contract operates only as an agreement to sell and no property passes in the future goods.

Similar principles can be applied in case of leases: in leases, the right to enjoy the property is transferred from the lessor to the lessee, therefore, "A lease is not a mere contract, but it is a transfer of interest that creates a right in *rem*." As such, "there cannot be a lease of a property which is not in existence and is still to be manufactured because till the time property is manufactured, there cannot be any transfer of interest. If the subject matter "good" or the property is only not in possession of the lessor but the property to which he may never establish title, the so called lease will be construed as an agreement to lease upon happening of a contingency."[4]

As far as the instant case is concerned, the aircrafts were not in existence at the time of signing of the agreements: this does not satisfy the requirements of Section 10(15A). The Court observed, "The said provision stipulates that there should be an agreement to acquire an aircraft on lease. The aircraft should be in existence for a lease to be executed and implemented. It will not apply to cases where the aircraft is not in existence and still to be manufactured. The use of the word "lease" is significant and signifies transfer of rights by the lessor to the lessee in praesenti, i.e., on or before 1st April, 2007, which is not possible unless the aircraft is in existence. A contract for a lease is to be distinguished from a lease because lease is actually a conveyance of interest in the goods/property, whereas a contract for lease is merely an agreement that such conveyance shall be entered into or begin/operationalize on a future date."[5]

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[3] 8th Edition

[4] Mohendra Nath Mookerjee vs. Kali Proshad Johuri, (1903) ILR 30 Calcutta 265)

[5] State of Maharashtra Vs. Atur India (P) Ltd. (1994) 2 SCC 497)

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The Judgment

The Court reiterated that, "It is only when an Indian company acquires aircraft on lease under an agreement, which was entered into on or before the 1st day of April, 2007, benefit under the said Section is available." So, there are two pre-requisites to get the exemption: "the agreement should have been entered into on or before 1st April, 2007 and there should be acquisition of aircraft under the lease before the said date, have to be satisfied." Therefore, a lease, which is to operate and begin after 1st April, 2007 would not qualify for advantage and benefit under the said section. Pointing out the intent behind the Section, the Court remarked,

> "The intention behind the said proviso is to restrict and not grant benefit after the particular/specified cut-off date i.e. 1st April, 2007. However, the legislature did not want to deny benefit in respect of earlier agreements, which had fructified and had been entered into and were already in operation before the said date. Thus, earlier operational lease agreements have been protected/saved. The words "to acquire aircraft on lease" mean an existing lease and not the lease, which is to begin or be operative in future on or after 1st April, 2007. To acquire an aircraft on lease means a lease agreement and postulates actual conveyance on/or before the cut of date, i.e., 1st April, 2007."

Our Analysis

When it comes to differentiating between a lease and an agreement to lease, the High Court has taken a prudent stand. Delivery of the goods to the lessee for the purpose of its use is an essential feature of the contract of lease.

Vinod Kothari, in *"Lease Financing and Hire Purchase including Consumer Credit"*, puts it as, "As the essence of bailment is to put the lessee in possession of the goods, the bailment does not take effect until the goods are delivered to the bailee or the bailee's agent." Further, "*The agreement of lease cannot commence without or prior to delivery of the goods, to the lessee or his agent*....Quite often, in context of leases, financial leases are so much preoccupied with the intrinsic financial nature of the contract that they tend to overlook the observance of basic legal requirements. For example, it is not uncommon to find a lease agreement commencing with reference to the disbursements to the supplier, no matter that the goods are nowhere in the place as at then. Such a clause in the agreement is inoperative: ***the lease agreement***

entered into prior to the handing over of possession remains an executory contract until the date of actual delivery."[6](Emphasis supplied)

In his book, Mr. Vinod Kothari provided the rules as to lease term[7], where he stated: "A lease cannot commence before the goods are delivered, or where the terms of the hiring imply lessor's obligation to make the goods usable, unless they are made usable."

Coming to Section 10(15A) of the Act, the intention of the legislature seems to extend the benefit to agreements to acquire the aircraft or an aircraft engine on lease, entered on or before April 1, 2007. The agreements in question were not valid lease agreements (these agreements were merely executory lease agreements, i.e. agreements to lease) since the goods, i.e. the aircrafts were not in existence at the time the agreements were entered into. Therefore, the High Court comes with a rational and well-analysed judgment.

[6] Lease Financing and Hire Purchase including Consumer Credit, Vinod Kothari; Fourth Edition 1996; p.558-559

[7] Lease Financing and Hire Purchase including Consumer Credit, Vinod Kothari; Fourth Edition 1996; p.561