

# Analytical Speaking

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## Note on rental contracts versus lease contracts

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Legally, there is no distinction between a lease and a rental contract. Every lease implies a bailment of goods coupled with a right to use. The same is true for every rental contract also. Therefore, every lease is a rental contract and every rental contract is a lease. The words lease, hire and renting are synonymous.

In industry parlance, however, the word “rental” is used in context of short term hiring contracts where the purpose of hiring-in an asset is purely temporary. For instance, if someone needs a car for a day or a month, it is called a rental contract, and not a lease contract. The word “lease” is associated with longer term – where the lessee intends to use the asset for long-enough a period.

### **Accounting distinction:**

Leases are classified as financial and operating leases from accounting viewpoint. Where the overwhelming purpose of the lease is mere financing, and the use of the leasing form is merely a matter of mutual convenience, the lease is treated as a financial lease. Such a lease has the substance of a funding contract.

Every lease other than a financial lease is an operating lease.

Since a short term rental contract cannot be a financial lease, therefore, in view of accounting standards, a rental contract will also be an operating lease.

### **Legal distinction between a lease and a license contract:**

There is a legal distinction between a lease and a license contract. In the latter contract, while a right of use is given, the right of use is not exclusive, and the goods remain in the effective control of the owner. In other words, while a right of use is given, it is not given away.

The legal distinction between a lease and a license was noted by the AP High Court in *Rashtriya Ispat Nigami*. This ruling has subsequently been affirmed by the Supreme Court in the same case on appeal, and also followed in the case of *Bharat Sanchar Nigam*.

A rental contract may be treated as a license contract if the lessor has not passed effective control over the asset to the user. If the user is given the exclusive and unlimited right to use, it suggests a rental contract. However, if the goods are operated by the owner, and/or are subject to owner’s fetters or controls, the same may be treated as a license.

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### Lease and service contracts:

There is a legal distinction between a lease and a service. Lease amounts to transfer of right to use. In a lease, the owner transfers the right to use goods, and the user uses the goods. In a service, the owner is the user: the owner uses the goods for the benefit of the counterparty. Thus, in a service contract, neither possession nor effective control is given to the counterparty.

Thus, granting of:

- Possession, right to use, effective control → lease
- Possession, right to use → license
- Possession → bailment
- Neither → service

### Sales Tax laws:

Sales-tax laws treat a transfer of right to use as a sale. This will be applicable to a financial lease, operating lease as well as a rental contract.

However, in view of the SC rulings noted above, there is no question of a “sale” in a license contract.

### Service tax laws:

Service tax is currently applicable on financial leases. There is no service tax on operating leases or rental contracts.

In case of license contracts, service tax has been imposed under the caption “transfer of possession without effective control”. It appears that this was done to overcome the effect of the SC ruling in case of *Bharat Sanchar Nigam*.

### Conclusion:

To conclude,

- There is no distinction between financial lease, operating lease, rental or license from the viewpoint of the owner’s property rights.
- Financial lease is capitalized on the books of the lessee; none of the other lead to capitalization on the books of the lessee.
- From income tax viewpoint, the distinction is based on whether the lease is a true lease or disguised funding transaction. Based on SC ruling in the case of Asia

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Brown Boveri, it can be contended that a financial lease will not be treated as a true lease. Hence, the lessor's depreciation claim may be denied. All other cases will entitle the lessor to depreciation.

- Sales tax is applicable on every financial lease, operating lease and rental contract. It is not applicable in case of a license or a service contract.
- Service tax is applicable in case of a financial lease (interest part) and in case of a license/service, on the entire receivables of the service-provider.

### **What is better:**

Assuming it is possible to structure a contract based on mutual convenience, the following is a guide to choosing the proper format.

- Since goods taxes and service/excise tax in India are not integrated, it is better to devise a contract based on what is most tax efficient for the customer.
- If the customer is in the business of selling goods or otherwise is a dealer under sales-tax laws, he will find it better to pay sales-tax on the inputs, which can be fully offset.

If the customer is a service provider and is liable to service tax, it would be better to structure the contract