

# Quick Notes on Leasing

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## Meaning of Financial Lease vs. Operating Lease

- For characterization of a lease, the substance over form test prevails over any quantitative test.
- Substance over form test
  - if in substance, the lessor takes risks/rewards which are not common in financial transactions, the lease is an operating lease
  - if the lessor does not take any asset based risks/rewards, the lease is a financial lease
  - sometimes, the risks/rewards are apparent
  - examples of operating leases:
    - lease rentals are pay per use
    - end of the lease term, lessor will have full control over the asset and the asset is expected to substantial have
      - e.g. property leases
      - car lease where there is no assurance as to transfer of the car to the lessee
- Where risks/rewards are not apparent, one applies the illustrative tests
- If the substance is clear, there is no need to apply the illustrative tests
- Illustrative tests are 5: -either of these would be financial lease
  - Lease transfers ownership – conditional sale
  - Lease contains bargain purchase option:
    - What is bargain purchase – the price is such that it is certain on day 1 that the option will be exercised. All HP will fall here
  - PV of MLPs equals substantially the whole of fair value (cost) of the asset
    - “Substantially” is quantified in US GAAPs as 90% or above
    - it is common practice to use the same test all over
  - the lease term (including the lessee’s right of renewal) covers 75% or more of economic life of the asset
  - the asset is so tailored that outside of a lessee, the asset would have no economic value
- the most common test in practice is the PV of MLPs test
- MLPs mean what?
  - For the lessor:
    - Unconditional lease rentals for a non cancelable period
    - Guaranteed RV
    - Cancellation penalty
  - For the lessee
    - Unconditional lease rentals for a non cancelable period
    - Guaranteed RV, where guarantee is by the lessee
    - Cancellation penalty

- So, on GRV, there is a basic difference
  - In case of the lessor, it is taken as MLP no matter who guarantees it
  - In case of the lessee, it is taken only where the lessee has given the guarantee
- Second point of difference between the lessor and lessee:
  - Discounting rate for computing MLPs
    - For the lessor – lessor's IRR
    - For the lessee – lessee's incremental borrowing rate (that is, the rate at which the lessee would borrow if he were to take a loan for the asset in question)
- Normal situation – financial lease for the lessor is financial lease for lessee, and vice versa (**A**)
- Because of the 2 differences above, it is possible that
  - A lease is a financial lease for one, and operating lease for another
- Financial lease for the lessor, operating lease for the lessee (**B**)
  - Possible due to residual value risk hedging by the lessor
    - With vendor guarantee etc
- Financial lease for the lessee, operating lease for the lessor (**C**)
  - Possible due to lessor's IRR being quite high (high expected RV), and the lessee's borrowing rate being low
- B is the best, C is the worst
- Why?
  - For the lessor, operating lease treatment does not help
  - It is the lessee who wants to attain off balance sheet, for the lessor there is no off balance sheet accounting; it is on the lessor's balance sheet irrespective of whether fin lease or op lease
  - For the lessor, there are distinct disadvantages of attaining op lease treatment:
    - One, income accounting is distorted. Less income in the beginning, more later
    - Two, if a lessor securitises an operating lease portfolio, it does not become off the balance sheet

## Basic rules for discounting

- Pre tax rate for pre tax cashflow
- Post-tax rate for post tax cashflows
- Pre tax cost of capital if the cashflows are pre tax, post tax cost of capital if the cashflows are post tax
- Risk free rate if the cashflows are risk free, risk adjusted rate if the cashflows are risky
- Inflation adjusted rate if the cashflows are inflation adjusted; otherwise, simple discounting rate

## Is prepayment profitable?

General answers:

1. If interest rates have gone up over time, prepayment is generally profitable
2. Basic understanding is the prepayment is an option that the client is exercising
3. Client will exercise the option only where it is profitable for him to do so
  - a. so when is it profitable for the client?
  - b. Only where the interest rates have fallen,
  - c. So, if interest rates have increased over time, prepayment is generally profitable to the lender
4. Therefore, generalizing:
  - a. prepayment is always profitable for the lender in increasing interest rate scenario
  - b. in constant interest rate scenario, lender seeks to compensate himself for the loss of profit; however assuming the amount paid on prepayment can be reinvested, prepayment is profitable
  - c. in falling interest rate scenarios, prepayment goes against the lender
5. In case of long term loans, the only reason why prepayment may be a pain for the lender is that the lender may have tied long term liabilities. He may also have to pay penalties in case he prepays them

## Questions on Operating Lease

- Can a client foreclose an operating lease and return the asset?
- Normally an operating lease will have a cancellation option, but only during a given period. It is not open-ended cancellation option
- If the prepayment option is open, that is the lease is cancelable at any time, and the agreement allows the lessor to recover the book value loss, then is it an operating lease at all?
  - If you have the right to recover the book value loss, that would mean it is guaranteed value
  - Remember, the test of an operating lease lies in does the lessor have any residual value risk?
  - If there is no risk, then it is not an operating lease

- Of course, in case of car leases, it may be an operating lease due to the services the lessor is providing
- For example, it may be a wet lease – with maintenance. In that case, it is surely possible to recover the so called book value loss
  - The book value loss is POS- fair market value of the car
- Does the collection of a security deposit mean it is an operating lease?
  - No, not by itself
  - Security deposit also does not mean there is no risk of residual value iwht the lessor
  - Because prima facie, the deposit is refundable
  - Technically, there is nothing called non refundable deposit. Deposit cannot be non refundable, in any case. If it is a deposit, it has to be refundable

## **Tax benefits in lease transactions**

Do lease transactions always result into a tax benefit?

So in case of a loan transaction, what do we pay tax on?  
We pay tax on the interest part

### **In case of a lease?**

The entire rentals. Rentals inherently comprise of Interest + Principal  
Since we are paying tax on the lease rentals, we are paying tax on the prn also  
That is a tax loss

- there is no absolute tax saving in case of a lease
- at best it is a case of tax deferment
- as the absolute amount of taxes paid in a lease and loan will always be the same
- how do we understand the timing of the income or the impact of deferment?  
Let us take an example

So, lease transactions may have a tax benefit or a tax loss, depending on the relative timing of taxable income in either

What is the tax loss in a lease?

- That you are paying tax on the principal also
- The principal recovery is nothing but your money coming back to you
- It is not income, but taxed as income
- There is no problem in paying tax on the interest part, as that is income anyway.  
But the tax loss is the fact that you are paying tax on principal part

Correspondingly, what is the tax benefit?

- That you are claiming depreciation

Therefore, what ultimately matters is:

- Present value of depreciation stream = A
- Versus present value of the principal recovery stream = B
- If  $A > B$ , there is a tax benefit, otherwise, there is a tax loss

### ***So, quick rules on lease post tax economics***

- Almost everyone understands, higher the depreciation rate, more the tax advantage
- However, what most fail to realise it – if the depreciation rate is low, it is actually a tax loss
- Depreciation rate is not your choice, as it is laid by law. You may only choose what is available to you. No doubt, lessors strive to get assets with higher depreciation rate for leasing

Also, what are the other factors that drive the tax economics of leases?

#### **General rule -**

- Present value of depreciation stream = A
- Versus present value of the principal recovery stream = B
- If  $A > B$ , there is a tax benefit, otherwise, there is a tax loss
- So, anything which increases A, or reduces B gives a tax benefit
- Anything that increases B will give a tax loss
- Lease term
  - The shorter the lease term, the worse the tax economics
  - Hence, lease transactions are beneficial only for long term exposures
  - Riders
    - Long term always more credit risk
    - Credit risk is far more important than tax benefits
    - Also, if you want it to be operating lease for accounting purposes, the term should not exceed 75% of economic life
- Lease timing
  - Since depreciation is based on half year rule – even if used for one day, you still get half year depreciation
  - If used for more than 180 days, you get full year depreciation
  - Result – leases are more attractive towards end of the half year
  - The impact is more in case of higher dep assets
- Impact of RV
  - Higher the RV, the post tax is better
  - However, rider here
    - Higher RV also means more risk
    - Credit risk goes up since you keep substantial amount unrecovered

- Always strike a trade off between tax benefit needs and credit risk; credit risk is far more an important issue
- Impact of security deposit to the extent of RV
  - Post tax will always be higher if there is sec deposit equal to RV
  - However
    - Prima facie, all deposits are refundable
    - That means, the client has the right to claim it back end of lease term
    - Unless you have a matching Guaranteed RV
    - GRV would mean the lease may not be an operating lease
    - If you still want to structure the lease as an operating lease, you will have to rely on the cancellation option
    - GRV clause needs to be put carefully in the lease agreement

***Very important point in case of prepayment of all sec deposit cases***

- In case of all sec deposit cases (whether refundable or non refundable)
  - You need to be very careful at the time of prepayment
  - From outstanding POS, you cannot just deduct the sec deposit
  - Because the sec deposit was supposed to be refunded only at the end of the term
  - You will suffer a loss if you deduct sec deposit from the POS
  - That is, only the discounted value of the sec deposit should be deducted from the POS
- Impact of refundable sec deposit on lease post tax economics
  - A refundable sec deposit is basically a leveraging device – similar to borrowing
  - You are borrowing from the customer at the same rate as the IRR, irrespective of the interest rate that the deposit bears
  - So, if the stand alone transaction had a tax benefit [post-tax IRR > pre-tax rate \* (1-T) ], then the sec deposit will increase the tax advantage
  - So, if the stand alone transaction had a tax loss [post-tax IRR < pre-tax rate \* (1-T) ], then the sec deposit will increase the tax disadvantage
  - In either case, adding interest on the sec deposit, increases the tax advantage/ disadvantage as the case may be
- Even a non-refundable deposit may be interest bearing = the deposit and the interest both may be adjusted against RV
  - This is by far the most beneficial structure
- Quick few points on non refundable deposit
  - This is basically a client margin

- The only way to seek a client margin in case of leases is non refundable deposit
- However, documentation will not say it is non refundable; it is matched by a GRV clause
- Financial lease/ operating lease classification will still depend on PV of MLPs. The GRV is counted as a part of the MLPs. So quite likely the lease is a financial lease, but you will have to depend on the cancellation option
- Another quick point on refundable deposit
  - A refundable deposit puts you in position of a net borrower towards the end of the contract, as your outstanding net investment becomes negative
  - Once the net exposure becomes negative, you become a net borrower and start paying the same as your IRR
  - Hence, you would like to avoid it by refunding the deposit in parts – instead of holding it till the end
- As between advance rentals and sec deposit
  - Advance rentals are like Sec dep adjustable against rentals
  - When we adjust, it becomes income then
  - In case of adjustment against RV, RV is a capital receipt. It is not income. It only results into reduction of depreciable block. Hence, the tax loss is by way of reduction of depreciable amount.
- Impact of MAT on tax economics of leases
  - If you are covered by MAT, the tax advantage is even lesser
  - To the extent of MAT profits, you are anyway paying tax
  - So, if you are a MAT company, you need to reduce the tax benefits by 21% of book profits, that is, the interest part of the income
- Impact of VAT
  - VAT is not a part of depreciable cost
  - So VAT is always kept separate
  - The impact of VAT is captured in post-VAT IRR

### ***Post tax evaluation from lessee viewpoint***

- Lessor's tax benefit is the lessee's tax loss and vice versa
- Tax loss to the lessee: depreciation
- Tax gain to the lessee: principal repayment embedded in lease payments
- So net lessee gain:  $(\text{PV of prn repayment} - \text{PV of depreciation}) * \text{tax rate} = A$
- There is nothing like a mutually beneficial transaction
- So, to compute effective post-tax cost to the lessee, lessee's IRR should be obtained by equating  $(\text{asset cost} - A)$  with lease rentals.

### **VAT on lease transactions**

- What is VAT? Is it the same as sales-tax?
- Is it the same as lease tax?

- VAT, lease tax, sales tax are all the same
- VAT is sales-tax payable on value added basis
- Lease tax is sales-tax payable on the lease
- Why should there be sales-tax on the lease? Leasing does not mean selling the asset
  - The definition of sale under sales-tax laws has been extended to include lease transactions too. So, a transfer of right to use an asset is also a sale for sales-tax laws
  - Recall the point yesterday – a transfer of right to use is not the same as provision of right to use. That is a license contract does not fall under VAT
  - Most of your transactions will be lease transactions, but if you structured leases where
    - Either possession is not exclusively with the lessee (say, operator is yours)
    - Or the lessee does not have control (say you control the usage)
    - Or you gave on lease a generic asset not a specific asset (for example, *a* car and not *the* car)
    - Either of the above it is not a lease but a service
  - Since goods mean only movable property, a lease of immovable property does not come under VAT
    - What is immovable property?
    - Permanently fixed to earth – cannot be removed without destroying it
    - Recently the Bombay high court held telecom towers to be immovable property
    - No VAT on such leases, but stamp duty ?? stamp duty is applicable at ad valorem rates in case of lease of immovable properties- same rate as in case of buildings, etc

### ***Basic VAT principles***

- State laws only have VAT
- There is no VAT in case of CST Act
- Vat allows the benefit of set off – that is taxes paid on inputs can be offset against taxes payable on outputs
- VAT credit of one state cannot be offset against vat payable in another state
- However, within the state, it is entity wide – that all the input taxes paid by the entity
- Some states have specific anti-leasing provisions
- This includes Gujarat, Kerala, UP

## ***Applicability of CST***

- As CST is not vatable, try avoiding CST transactions
- Where all is CST applicable? If the sale is inter-state

## ***What is the meaning of inter-state sale?***

- Two limbs
  - Sale causing inter-state movement
  - Sales happening during inter state movement by endorsement of documents
- Following factors are relevant
  - Did the goods move from one state to another?
  - Did they move due to a sale?
- Following factors are irrelevant
  - The addresses of the parties
  - The place of agreement
  - The place of invoicing
  - The place of payment
  - Virtually everything except the two factors that are relevant
- Meaning of import/ export sales
  - Import sales and export sales are free from VAT
  - Meaning of import sale
    - Exactly in lines of sec 3 (a) and 3 (b) of CST act
      - A sale causing the goods from move from out of India to India
      - A sale that happens by endorsement of docs before the goods have crossed the customs frontiers of India
    - When do goods cross the customs frontiers? What are the customs frontiers?
      - Any place where the customs keep the goods before they are cleared for home consumption
      - So it is not the goods must not have reached India
      - Even if they have reached, and they are with customs, a sale that happens by endorsement of docs (for example, bill of lading), will be an import sale
      - In common parlance, such sales are called high seas sales

## ***What is an intra state sale?***

- What is not import, export or inter- state has to be intra state
- The question is, intra which state?
- So in case of intra state sale, the jurisdiction is fixed by situs – that is, situation of goods at the time of sale
- Can it be addressed to the buyer in a different state?
  - Yes
  - The transaction is taxable in the state of situs
- So, in case of lease transactions
- What is special?
  - There are two sales, but there is one delivery
  - If the delivery is international, or inter state, question is which of 2 sales cause the movement
  - This a contentious question
    - Supreme court rulings in the case Khosla and Co recognize principle of 2 sales causing a single movement
    - However, Binani Bros (Sc) does not accept it
  - In case of inter-state movements for lease transactions. AP high court ruling in ITC Classic accepted the specific nature of a lease transaction. This was affirmed by SC in 20<sup>th</sup> Century. Hence, in case of leases, the rules are as follows:
    - If the sale by the supplier is inter state, the lease is also inter state; hence, taxable under CST act
    - If the sale by supplier in intra state, the lease is also intra state, hence taxable under VAT law of the lessee state
    - If the supplier charged X state VAT, we would normally believe the lease is also chargeable in X state
    - In case of import transactions as you want the lease to be free from tax, you would rather like to play safe and also adopt endorsement of docs route
      - In case of endorsement
        - It is not that the lease agreement is dated post the date of purchase
        - The lease agreement is always a master agreement and signed before any order is placed
        - In fact, before placing the order, also get a requisition from the lessee
        - All import docs carry the name of the lessee also – Lessor, a/c Lessee form
        - However, once you get the B/L, do an endorsement in favor of Lessee. Let lessee file of bill of entry and take delivery
        - This would mean the lease is an import sale, and completely outside VAT laws

## ***Domestic CST Purchase***

- In case of all domestic purchases, if the purchase is CST purchase, the lease is highly disadvantageous
  - Why?
  - Supplier will charge you full tax (CST) unless you give a declaration form
  - This means, you will have to register in the destination state and get a C form from there
  - Now, on the lease rentals, CST is payable
  - This is also full rate, unless lessee gives u a declaration form
  - So, unless both parties use C forms, the tax becomes prohibitive
  - Besides, CST is not vatable

## ***General rules***

- Inter state sales by supplier – that is supplier charging CST, avoid a lease. Go for a loan. Lease may not be viable with additional burden of 2%
- Import transactions –lease is clearly viable as no VAT is payable on the lease

Intra state transaction – VAT paid upfront is off settable, but there is a loss of timing

- In case of imported goods, if endorsement of delivery docs done, the lease is a sale in course of import and hence no tax payable
- Controversies
  - Some people say: endorsement of docs of title – does it mean you have sold the goods?
    - No, endorsement of docs does not by itself amount to a sale.
  - Some say – SC ruling in A & G Projects does not accept second sale being exempt from tax
    - This ruling is applicable to sec 6 (2) (b) – the section has nothing to do with import sales
- However, to establish a sale in course of import, following essentials:
  - First, the lease agreement must contain provisions whereby delivery can be effected by delivering docs
  - The doc must have come in joint name, and thereafter endorsed
  - Lessee must have filed bill of entry
  - Keep a copy of the endorsed B/L as that would otherwise go to the lessee.
  - Date the endorsement
  - That date is the date of commencement of the lease

- Subsequent to the date of endorsement, no further costs w.r.t. the goods should be borne by lessor/ financed – for example
  - Installation costs
  - Freight from customs port to site
  - Any local goods which inseparably get attached to the imported goods
- For example, something is coming from overseas. There are local components also. The lease agreement provides for the composite goods to be leased under the agreement. Surely this cannot be a lease in course of import, as what u are leasing has not even come into existence until it is assembled
- If u are charging VAT, charge all-inclusive rentals. If u are separately collecting VAT, it is anyway payable to the govt
- Example
  - Turbines come from Korea. Indigenous components locally acquired
  - Indigenous products are branch transfers
  - Can it be a lease in course of import?
  - If the imported goods and local goods are indistinguishable/ inseparable, there cannot be a lease until the composite goods come into existence.
  - However, if it is possible to make it as separate lease of each of components, then the imported lease will be out of VAT
  - The local components will be locally vatable

**VAT on conditional sale: not applicable as treated as a mortgage**

## **Service tax**

- You may be doing
  - Financial Lease
  - Operating Lease
  - Service contract – where you retain possession or control
  - Hire Purchase
- Applicability of service tax:
  - Financial Lease – applicable on 10% of the interest part
  - Operating Lease – not applicable, but
    - If the lessor is doing fleet management – it is possible to contend that the entire transaction is a service
    - However, if separate charges for rentals and fleet mgt, then the service part chargeable
  - Service contract – where you retain possession or control
    - Service tax applicable on the full receivables
  - Hire Purchase
    - – applicable on 10% of the interest part

- conditional sale
  - since it is a sale, no question

## Applicability of TDS

- Applicability of TDS:
  - Financial lease – yes, under sec 194I – the rate is 10%
  - Operating lease – yes, under sec 194I – the rate is 10%
  - Service contract – yes, under sec 194C – the rate is 2%
  - Hire purchase
    - Not applicable
  - conditional sale
    - applicable on the interest part

## Sale of receivables by NBFCs

### *Finance Lease*

Carrying value of the portfolio: Rs 10 Crores

Sold at:

- 11 Crores – premium structure
- 10 Crores – sold at par
  - Profits, the spread, will be paid over a period of time. Normally the seller is also the servicer, therefore, it is paid by way of servicing fee
- Sale at a premium
  - Can it go off the books?
  - Can you book a profit?
- Apparently yes
  - However IAS 39 puts lots of conditions for off balance sheet treatment for financial instruments
  - A financial lease is a financial instrument
  - Conditions: 3 possible scenarios
    - Has the seller retained substantially all risks/rewards
    - Has the seller transferred substantially all risks/rewards
    - Has the seller retained some risks/rewards
  - Second scenario – no questions, the asset will be off the books
  - First scenario – generally asset will not be off the books
  - Third scenario – yes, if the lessor has surrendered control over the asset
- What are the risks /rewards?
  - Credit risk
  - Excess spread

- Transactions in practice happen
  - With full recourse – clearly, it cannot go off the books
  - Without any recourse – clearly it will go off the books
  - With limited recourse – credit enhancement
  
- Meaning of surrender of control
  - If the buyer has the practical ability to resell the asset, then the control is taken to be surrendered

### ***Operating Lease***

- Lessor owns the asset, and capitalizes the asset, not the receivables
- What he sells is the receivable
- So can he put the asset off the books?
  - no

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