Chapter III

Types of leasing companies and leasing undertakings
Leasing business/industry is of recent origin in India. The development of leasing augurs well for the industry. No doubt leasing has good potential but to make a success in this business, it is good to have the right type of leasing which can cater to the needs of different people. Careful watch on the growth and development of the right type of leasing is also another important factor for maintaining the health of leasing companies in India. Leasing companies, which attracted the attention of all types of investors in the beginning, failed to evoke the same amount of response in subsequent years. Investor appears to be more alert and choosy. In order to satisfy the different needs and aspirations of different categories of investors, a leasing company has to adopt new methods to attract enough funds. In the case of commercial joint-stock companies, they have the well defined and regular sources, which cater to the different needs and tastes of their shareholders also.

The mushroom growth of leasing has taught that it is a success for a few, a game of chance for many and an accident for the rest. Further it is not a standardized one for any and everyone has to play this game. “Not everyone can think in terms of equipment leasing alone. I think the time has come for each company to start thinking in terms of specific segments of the markets in keeping with their inherent strengths.” The following paragraph explains the different leasing forms that are prevalent in India.

The following are the more popular forms of leasing. The list is not exhaustive:
1. Operating lease

2. Financial lease

3. Sale and lease back

4. Medical equipment leasing

5. Big – ticket leasing

6. Domestic lease

7. International leasing

8. In house leasing

9. Employee leasing

10. Leveraged leasing

11. Capital lease

12. Direct leasing

13. Upgrade lease

14. Import leasing

15. Staggered revolving lease

16. Participative soft lease

17. Recycled assets revolving lease

18. Swap lease
19. Master lease

20. Joint venture lease

21. Skipped payment lease

22. Trail period lease

23. Straight lease

24. Modified lease

25. Primary and Secondary Lease (Front-ended and Back-ended Lease)

26. Single Investor lease

27. Sales-aid lease

28. Tax Benefit Transfer lease

29. Pay out Lease and Non-pay out Lease

**Operating Leases or Service Leases:**

While reviewing the various types of leasing the executive committee of the equipment leasing association expressed the view that ‘operating lease’ would come to the fore once leasing companies gained experience. Service or operating leases, include both financing and maintenance services. Computers and office copying machines together with automobiles and trucks are the primary types of equipment's
involved in service leases. These leases ordinarily insist on the lessor maintaining and servicing the leased equipment and the cost of this maintenance is included in the lease payments.¹

For those who want to introduce and take advantage of the latest technological developments, this type of leasing is a boon. The lease agreement contains a cancellation clause under which the lessee has the right to cancel or return the leased equipment even before the expiry of the lease period. In the absence of this clause, the lessee may return the equipment by giving prior notice.

Yet another salient feature of this leasing is that the lease contract agreements are drawn for a lesser number of years than the future expected life of the leased asset. Since, the lease periods are less than the total expected life of the asset, the total amortization value in the above contract, may not be equal to the full cost of the equipment. So, the lessor may choose to recover the remaining cost either by further leasing to the same party or to other parties or renewing the lease or by disposal off the leased equipment, at salvage value.

In an operating lease, the owner, or lessor, merely transfers the right to use the property to the lessee for a specified period of time. The Telephone Company leases telephones for a month and Car Rental Companies, lease cars for a day or week on an operating basis. Operating leases normally include maintenance clauses requiring the lessor to maintain the leased assets.

What is an operating lease?

This is defined as a lease other than a finance lease. Operating lease, are not full pay out leases as an individual contract does not usually provide the lessor with the required return. The cancellation clause in the lease contract introduces uncertainty in cash flow and leasing of the asset to multiple lessees during its economic life is necessary to recoup the investment and to earn a profit margin. Such leases are also known as non-pay out leases.

Example of an operating lease:

If a lease contract contains the following clauses:

* The lease term is 2 years @ Rs. 3,000 lease rental payable at the end of each year;

* The asset will be returned back by the lessee to the lessor at the end of the 2nd year;

* The economic useful life of the asset is 5 years;
* There is no BPO, residual value losses are borne by the lessee and the lease is not of any specialized asset.

In this contract, the lease does not secure the lessor the recovery of his capital outlay plus a return, i.e., it does not fulfill the fair value test. The lease is also not for a substantial portion of the economic life of the asset. Other applicable clauses for classifying a lease as finance lease are not fulfilled. Therefore the lease would be considered an operating lease.

In other words, it is a lease, which does not transfer substantially all the risk and reward incidental to ownership. Classification of lease is made at the inception of the lease; if at any time the lessee and lessor agree to change the provision of lease and its results in different category of lease, it will be treated as separate agreement.

Financial Lease:

Under sale and lease back lease and operating lease, there are two parties viz., the lessor and the lessee, whereas under the financial lease there are three parties viz., the lessor, the lessee and the manufacturing company. The lessee, viz., the intending buyer, according to the requirements, may negotiate through the lessor or directly move with the manufacturer and settle the price and the delivery schedules.

After negotiation with the manufacturers, the lessee requests and enters into an agreement with the lessor, to buy the same equipment from the manufacturer and lease it. Before the lessor takes delivery of the equipment, the lessor gets the agreement signed by the lessee. Financial leases are commonly used for leasing land, building and large pieces of fixed equipment.

The following are the important characteristics of a financial lease:

(I) A financial lease is a long-term lease longer than an operating lease.

(II) Financial lease, like operating lease, is not cancellable.

(III) Whether the lessee uses the asset or not, he is bound to pay the lease rentals, as agreed upon.

(IV) The lease period is closely related to the full life of the asset.

(V) The cost of the equipment is fully amortized.

(VI) The salvage value of the asset is expected to be negligible.

(VII) Some financial leases give the lessee a purchase option at maturity. 

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With reference to the cost of maintenance and repair, under the financial lease, the lessee has to bear all expenses. This is so because a financial lease is a long-term arrangement, wherein it would be quite difficult, if not altogether impossible, for the lessor to estimate and apportion the same, and hence financial leases are also called as 'Net Lease'. Full amortization and non-cancellability are the key features that distinguish financial lease from operating lease. Under this lease, the lessee is legally bound to make the lease payments, irrespective of the fact, whether he continues to use the asset or not. Though cancellation is possible, it could be done, at heavy cost only. Financial leasing has emerged as an important source of long-term financing of corporate enterprises, in the recent past.

In other words, it is a lease, which transfers substantially all the risks and rewards incidental to ownership of an asset to the lessee by the lessor but not the legal ownership. In following situations, the lease transactions are called Finance Lease. The lessee will get the ownership of leased asset at the end of the lease term. The lessee has an option to buy the leased asset at the end of term at price, which is lower than its expected fair value at the date on which option will be exercised. The lease term covers the major part of the life of asset. At the beginning of lease term, present value of the minimum lease rental covers the initial fair value.

The asset given on lease to lessee is of specialized nature and can only be used by the lessee without major modification.5

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What are the principles that would lead to a lease being classified as a finance lease?

A finance lease transfers substantially all the risks and rewards incidental to ownership. Title may or may not eventually be transferred to the lessee. The standard provides certain examples of situations, which would normally lead to a lease being classified as a finance lease. Examples of a lease being classified as a finance lease are:

1. The lease transfers ownership of the asset to the lessee by the end of the lease term, therefore, even if the lease is not for a major part of the economic life and if the lease transfers ownership at the end of the lease term, it would be a finance lease, for example, a one year lease which transfers ownership at the end of one year is a finance lease.

2. The lessee has the option to purchase the asset at a price, which is expected to be sufficiently lower than the fair value at the date on which the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised. This is also known as a bargain purchase option, for example, if a lease contract for three years of a car provides a bargain purchase option to the lessee to buy the car at the end of the lease at a very low price (let say Rs. 10,000 when its fair value at the end of three years is estimated to be Rs. 75,000) such that it is clear that at the inception of the lease that any lessee would exercise that option, the lease would be classified as a finance lease.
3. The lease term is for the major part of the economic life of the asset even if title is not transferred. Interpreting this clause would call for a lot of judgement. For example, if the lease of a car is for three years, the lease would be for a major part of the economic life if one assumes the economic life of a car to be three years. The lease would not be for a major part of economic life if one assumes that the economic life of a car is let’s say six years.

4. At the inception of the lease, the present value (determined using appropriate discount rates, for example, in the case of the lessee, his incremental borrowing rate for similar type of transaction may be used) of the minimum lease payment amounts to, at least, substantially all of the fair value of the leased asset. Minimum lease payments are those that are receivable over the non-cancellable lease period. Minimum lease payments exclude contingent rent, costs for the services and the taxes to be paid by and reimbursed to the lessor etc.

A non-cancellable lease is one that is cancellable only:

(a) Upon the occurrence of some remote contingency; or

(b) With the permission of the lessor; or

(b) If the lessee enters into new lease for the same or an equivalent asset with the same lessor; or

(d) Upon payment by the lease of an additional amount such that, at its inception, continuation of the lease is reasonably certain which means if permission of the lessor is required for cancellation then the lease is non-cancellable though the agreements may term the lease as cancellable. Also a lease cancellable by
mutual consent of the lessor and lessee is a non-cancellable lease. Similarly if
the penalty for cancellation is huge, the lease may almost be equivalent to a non-
cancellable lease. For example, if a 3 year rental contract is cancellable on
payment of the entire 3 year rentals, then it is as good as non-cancellable.

5. The leased asset is of a specialized nature such that only the lessee can use it
without major modifications being made. For example, the lease is in respect of
a highly specialized pharmaceutical plant, which can be used only by the lessee.

Examples which individually or in combination could also lead to a lease being
classified as a finance lease are:

6. If the lessee can cancel the lease, the lessor’s losses associated with the
cancellation are borne by the lessee.

7. Gains or losses from the fluctuation in the fair value of the residual fall to the
lessee.

8. The lessee can continue the lease for a secondary period at a rent, which is
substantially lower than the market rent.

The first five criteria are determinative in nature, i.e., if anyone is met, the
conclusion would be that the lease is a finance lease. For example, where
ownership of the asset is transferred to the lessee at the end of the lease term, the
lease is a finance lease. Even if the ownership continues with the lessor at the end
of the lease term, the lease would be classified as a finance lease, if the lease term
was for a major part of the economic life of the asset. For example, a PC, which is
leased for 5 years, where ownership is not transferred to the lessee at the end of the lease term, would still be a finance lease. The last three criteria are suggestive in nature and may lead to classification as a finance lease, but not necessarily so. For example, where gains or loss from the fluctuation of the residual value is borne by the lessee, it may indicate that the lessee in substance is the owner (because he suffers the risks and enjoys the rewards) and therefore the lease is a finance lease.

Sometimes the lessor may undertake the responsibility to repair, maintain, update and insure the leased equipment with a view to sufficiently induce the lessee to enter into the lease transaction. Repairing, maintaining and updating and insuring the lease equipment by the lessor does not on its own retain the risk while the lessor does this to secure his interest in the lease. For example, most car lease companies, insure the car themselves rather than depend on the lessee to do so, to protect itself from various liabilities. The insurance premium is either recovered from the lessee or built in the overall pricing of the lease rentals. Similarly, repairing and maintaining of the machines by the lessor do not transfer the risk of idle capacity or technological obsolescence from the lessee to the lessor. In many cases repairing and maintaining responsibility is retained by the sellers or the lessors, because the expertise is available with them and besides it is a means to influence and attract sale or lease transactions. Therefore, even if the lessor retains certain responsibilities, the lease would still be classified as a finance lease, if any one of the determinative criteria is fulfilled.
Sale and Lease Back:

Sale and lease back is an arrangement according to which the owner, i.e., the user company or the lessee, enters into an agreement with the leasing company to sell his equipment, approximately at the market value.

Under the same agreement, the lessor leases it back to the lessee, at a predetermined rate for an agreed period. In fact, under this arrangement, the equipment or sold assets are not physically exchanged but it all happens in records only. This is nothing but a paper transaction. However the lessor and the lessee stand to gain at the same time. Immediately after the lease is over, the lessor gets the lease amounts. Similarly the lessee, though he has sold the equipment, is not deprived of the equipment and at the same time he gets the sale proceeds. These sale proceeds would ease the working capital problems of the lessee. The same amount may be used for other developmental purposes also.

Under the sale and lease back arrangement, the lease payments are set up in exactly the same manner – the payments are sufficient to return the full purchase price to the financial institution, in addition to providing a definite return on its investment. Thus, leasing is considered as a source of financing provided by the lessor to the lessee.

In other words, a sale and lease back arrangement involves the sale of an asset already owned by a firm (vendor) and leasing of the same asset back to the vendor from the buyer. This is a special financing lease arrangement in which a firm
(firm A) sells an asset to another firm (firm B) and simultaneously the two firms enter into a financial lease by which firm B leases the asset to firm A. As a result, the seller receives the purchase consideration for the asset (which augment, its liquidity position) and also retains the use of the asset in return for periodic lease payments. This form of lease arrangement enables a firm to receive cash from the sale of asset and also retain economic use of the asset in consideration of periodic lease payments. A sale and lease back arrangement, is generally, preferred by firms facing shortage of working capital funds. The lessor engaged in sale and lease back includes insurance companies, leasing companies, pension funds, private finance companies and financial institutions.

**Medical Equipment Leasing:**

It is one of the specialized leasing companies in the medical area and a unique venture in the highly promising field of medical equipment leasing. There are innumerable diagnostic laboratories, private nursing homes and hospitals. Their number is constantly increasing and so is their need for medical equipment.

In recent years, several general purpose leasing companies, have come into the capital market of India. All of them have made an excellent impact on the investing public, resulting in significant over – subscription of their public issue. In India, however, all the leasing companies are engaged only in leasing general purpose equipment. Standard Medical Leasing Ltd. (SML) was the first specialized leasing company in India and is all set to open new vistas in the leasing industry.
Importance of Medical Equipment Leasing:

(I) Doctors would go in a big way to purchase medical equipment on lease, since the lease rentals are tax deductible. Hence, lease rentals for medical equipment will be the cheapest.

(II) Well-equipped private nursing homes may require on average medical equipment worth around Rs. 5 to 10 lakhs in urban areas and Rs. 3 to 5 lakhs, in rural areas. Since, there is a chance of 100 per cent finance, it is an equal boon to the young and old medical practitioners.

(III) Diagnostic laboratories on an average need equipment to the tune of Rs. 10 to Rs. 15 lakhs. These laboratories may also take advantage of this new facility offered by the Medical Equipment Leasing companies. By doing so, these labs can serve the community with up-to-date machines and raise the standards of medical care.

(IV) Large hospitals, both public and private, also require more funds and they may also make use of this.

Big – Ticket Leasing:

Most of the very expensive items such as, construction equipment, big rigs, sophisticated computer systems are financed by big-ticket leasing companies. Under big - ticket leasing, the transactions are usually of big size. The term big – ticket refers to the value of the lease. Although there are no generally accepted values for ‘big – ticket’ and ‘small – ticket’ leases.
The following are considered to be the main advantages of big - ticket leasing:

(I) Reduced marketing costs and administrative overheads.

(II) A new market segment, not easily accessible to small leasing companies with limited funds.

(III) Good scope for excellent recoveries.

(IV) Possibility of favourable rates; the fluctuations in leasing rates will not affect this high value segment with A – Class clients.

**Domestic Lease :**

A lease transaction is classified as domestic if all parties to the agreement, namely, equipment supplier, lessor and the lessee, are domiciled in the same country.

**International Leasing :**

If the parties to the lease transaction are domiciled in different countries, it is known as international lease. The term ‘International leasing’ covers two separate types of activities:

(a) Cross – border or trans-national leasing.

(b) The operations of overseas subsidiaries.
Cross –Border Lease:

Cross-border leasing describe those leasing arrangements where the lessee and the lessor are domiciled in different countries and includes export leasing. Industry and financial institutions both started taking an interest in international leasing towards the end of the 1960's after the financial and marketing advantages of domestic leasing had become more generally recognized. Cross – border leases (where the customer is in a different country from the leasing company, which may or may not be in the same country as the manufacturer) are a legal fiscal minefield.

Overseas Subsidiaries:

Over the past few years, financial institutions have set up leasing subsidiaries overseas, each conducting purely domestic business involving lessees in the same country. Various difficulties associated with cross border leasing have inevitably restricted the growth of this activity.

In-house Leasing:

When a group of companies promote a leasing company for the benefit of other companies in the group, that company is known as 'in house leasing co'. In house leasing offers a lot of benefits to the group companies and the tax benefits are the major advantage. Some leasing companies have also started in house leasing in India, for the benefit of their group of companies, started earlier.
Employee Leasing:

Employee leasing, like sale and lease back, is an arrangement by which an employer transfers all workers or groups, to a leasing company, which then assigns the same employees back to their original employer under the lease agreement. The leasing company is also responsible for the calculation, preparation of pay bills, maintenance of pay roll and the preparation of all reports relating to employees. In the day-to-day administration, the original employer is responsible only for providing professional directions to the staff.

Employee leasing is an arrangement under which an employer transfers all workers or groups to a leasing company, which then assigns the same employees, back to their original employer. Under leasing arrangement, employees get employed by employee leasing company, though may be working with the same employer (who leased them), do the same job, work under same environment with same pay packets. Under changed circumstances, however, employers do not necessarily transfer their paid employees to an employee leasing company to get them back subsequently under leasing arrangement, but do not retain any employee on the permanent pay roll at all and send their requisition for required employees to the employee leasing companies from time to time, depending upon their production programme.
Employee Leasing In India:

Employee Leasing is not a much known concept in India. Lease, *per se* in India means lease of immovable property. Therefore, employee leasing is not legally sustainable. However, etymologically, Employee Leasing is quite akin to an institutionalized approach to Contract Labour System, which is prevalent in India and even legally sustainable.

The most formidable challenge before the Indian industries during post liberalization era, is to withstand price competition both at home and from abroad. Common International Quality Standard Systems and market globalization (which gives more free access for mutual trade among countries even by simplifying and/or abolishing tariff and border restrictions) reduced the non-price competition globally among the manufacturers. Wages cost and non-wages labour cost (NWLC), together form a considerable percentage of total cost for Indian industries, particularly those in an organized sector. The increased burden of NWLC made it inevitable for industries to restrict number of workmen on permanent pay roll.

Moreover, since production plans and programmes are highly flexible for industries, therefore, industries are required to engage workers to share the increased work load time to time. Simultaneously, industries are also required to pay for idle working hours and also required to bear the brunt of NWLC for such workers. Institutionalized contract labour system, i.e., employee leasing, therefore, offer economic benefits to industries, which *inter alia*, enable them to sustain competition by cost minimization.
Leveraged Leasing:

A leveraged lease is a transaction in which a lessor borrows money to purchase property and then leases that property to a lessee. Leveraged leasing has developed over the past few years to satisfy a need for lease financing of especially large capital equipment projects with economic lives of up to 25 years. The leveraged lease can be a most advantageous financing device when used for the proper projects and structured properly. Leveraged lease can also be used by sponsor lessors to leverage their lease investment. The concept of leveraged lease is quite similar to that of the non-leveraged lease, but it is more complex in terms of size, number of parties involved and unique advantages to these parties.

Under a leveraged lease arrangement, the lessor borrows a portion of the purchase price of the asset from a lender, which is typically a commercial bank or a financial institution. The loan is usually secured by the mortgage of the asset and the lease rentals to be received from the lessee. The lender is paid back from the lease payments often directly by the lessee – the surplus left after satisfying that the claims of the lender goes to the lessor. The lessor acts as the owner as well as the borrower and the lender is usually a bank, insurance company, financial institution or a private finance company. As owner of the asset, of course, the lessor is entitled to tax shelters associated with ownership.
A leveraged lease is defined as having the following characteristics:

(I) The lease satisfies the definition of a direct financing lease. Accordingly the lease must meet one of the following criteria:

(a) Lease transfers title to the lessee during the lease period, or

(b) Lease contains a bargain purchase price, or

(c) Lease period is at least 75 per cent of the useful life of the asset, or

(d) The present value of the minimum lease payments is at least 90 per cent of the fair market value of the leased property less any investment tax credit. In addition, collectability of lease payments must be reasonably assured with no major uncertainties regarding future costs to the lessor.

(II) At least three parties are involved; a lessor, a lessee and a long-term creditor.

(III) Financing is in the form of a non-recourse debt and provides the lessor with substantial leverage and

(IV) The lessor’s net investment declines during the early years of the lease and rises during the later years.

The primary difference between a leveraged and non-leveraged lease is that in a non-leveraged lease, the lessor provides 100 per cent of the capital from his own funds, while in a leveraged lease, the lessor becomes the owner of the equipment by providing only a percentage of the necessary capital. The remainder of the capital in a leveraged lease is borrowed from institutional investors on a non-
recourse basis. This loan is secured, by a first lien on the property and equipment, on assignment of the lease and an assignment of the lease rental payments. The lessor can claim all tax benefits incidental to ownership of the leased asset even though the lessor provides only a percentage of the capital needed to purchase the asset.

Leveraged transactions involve three parties: a lessor, a lessee and a lender. The functions of the parties are different. The lessee selects, operates and receives all income from use of the asset and the lessee makes rental payments.

The equity participants referred to as lessors provide the equity contribution to purchase the asset. They may be referred to as equity holders, owner participants or trustors. The lenders (debt holders or loan participants) are typically banks, insurance companies, trusts, pension funds and foundations. The funds provided by the lenders together with the equity contributions make up the full purchase price of the asset to be leased. The lenders provide 60 to 80 per cent of the purchase price on a non-recourse basis to the equity participants. Leveraged leases are capital leases (direct financing leases) that have the following additional characteristics:

- three parties (lessor, lessee and long-term lender)
- long-term debt that is non-recourse to the lessor
- lessor investment that typically declines during the early years of the lease and raises during the later years of the lease.
When the amount involved in a lease agreement is small, it is financed by one or few persons. But if the lease agreement is a big one like ‘big ticket leasing’ the amount required necessarily has to be contributed by many persons. In order to augment the required capital and to spread the risk involved in big lease contracts, the lessor contributes a part of the required capital as equity and the balance is collected by way of loans from third parties. These loans are invariably secured by a mortgage of the asset or by the assignment of the lease payments. Thus the leverage takes place in the capital structure of the lessor. Based on the circumstances, the lessor may operate either with thin equity or thick equity.

From an analysis of the few Indian leasing companies, capital structure and the sources of capital, it is clear that most of them are operating only with thin equity. As owner of the asset, the lessor is entitled to deduct all depreciation charges associated with the asset, as well as utilize the entire investment tax credit. Thus, leveraged leasing is considered to be the most sophisticated financial technique to fund the asset. The lessor provides a part of the ‘equity’ needed to finance the equipment and raises ‘debt’ for the balance amount.

Lease Agreements:

Once the terms of the lease have been negotiated to the satisfaction of both the parties, the lease agreement would be drawn up giving the details, mode of payment, frequency of rentals etc. An owner trust is established by the equity particulars, trust certificates are issued, and a lease agreement is signed by the owner trustee and the indenture trustee, a mortgage is granted on the leased asset.
and the lease and rentals are assigned as security to the indenture trustee.

Lease agreements are written usually for a basic term of an agreed number of months or years. In renewal or purchase, options can be negotiated by the lessee. In recent years, the leasing agreements used by different leasing companies have tended to become broadly alike, but it is unlikely that any form of standard lease generally acceptable to majority of lessors will appear in the near future. Lessors' interpretations of their legal positions are not identical and there will continue to be difference between their individual commercial requirements. The main features of a financial leasing agreement are as follows:

1. The lessor agrees to purchase an asset for leasing to the lessee who in turn agrees to take the asset on lease.

2. The lessee takes on the responsibility for checking the condition of the asset at the time of delivery and normally accepts it on the lessor's behalf. The lessor gives no warranty to the lessee as to the fitness of the equipment but, where there is no direct contractual arrangement between the lessee and the supplier, there is provision in the lease for action to be taken by the lessor on the lessee's behalf against the supplier.

3. The lessee is afforded possession or quiet enjoyment of the leased asset subject to paying the prescribed rentals and complying with the other lease terms and conditions.

4. The lessee covenants to insure and maintain the equipment during the period of the lease.
5. The lessee acknowledges that title to the asset remains with the lessor and he is not to dispose off the equipment or do anything to jeopardize the lessor's interest in the equipment.

6. As user of the equipment, the lessor indemnifies the lessor against any claims made by third parties arising out of the lessor's ownership of the asset.

7. The leasing agreement stipulates the lessor's rights of action, in the event of, default by the lessee, during the lease period.

8. The agreement provides either for the return of the equipment to the lessor at the end of the lease period or the sale of the equipment by the lessee, acting as agent for the lessor.

**Capital Leasing :**

A lease is classified and accounted for by a lessee as a capital lease if it meets any of the following criteria:

1. The lease transfers ownership to the lessee at the end of the lease term.

2. The lease contains an option to purchase property at a bargain price.

3. The lease term is equal to 75 per cent or more of the property (except for used property leased in last 25 per cent of its useful life).

4. The present value of minimum lease rental payments is equal to 90% or more of the fair market value of the leased property less related investment tax credit retained by the lessor (does not apply for used property leased in last 25 per cent of its useful life).
Direct Leasing:

A direct lease results when a lessor either owns or acquires the assets that are leased to a given lessee. In other words, the lessee did not previously own the asset it is leasing. The lessor may be the actual manufacturer of the asset, or it may be a leasing company or subsidiary that acquires the asset from the manufacturer and then leases it to the lessee. A lessee will normally specify the manufacturer, the model number and other relevant characteristics of the asset it wishes to lease.

In contrast with sale and lease back, under direct leasing a firm acquires the use of an asset that it does not already own. A direct lease may be either arranged either from manufacturer/supplier directly or through the leasing company. In the first case, the manufacturer/supplier himself acts as the lessor, while in the second case, the lessee firm arranges for the purchase of the asset, for the leasing company (lessor), from the manufacturer or the supplier and also enters into an arrangement with the lessor for the lease of the asset.

In direct lease, the lessee, and the owner of the equipment are two different entities. A direct lease can be of two types: Bipartite lease and Tripartite lease.

*Bipartite Lease*: - There are two parties in the lease transaction: equipment supplier-cum-lessee and lessee.

*Tripartite Lease*: - Such type of lease involves three different parties in the lease agreement: equipment supplier, lessor and lessee.
Upgrade Leasing:

This is a revolutionary concept in leasing and a bold one at that. Under this kind of lease, the leasing company undertakes to replace outdated equipment with modern ones on specific rental terms. This provides a vital cover against risk of obsolescence. This helps the lessee to update the production system and to take advantage of the latest technical knowledge. So to say, the lessee is free from technical obsolescence and he can freely concentrate upon production and other activities.

Under this type of lease, automatic exchange during the lease of automoded equipment with newer model upgraded equipment generally made available by manufacturer lessors. This type of lease is typically structured as an operating lease with in-built facilities, like up-gradation of the equipment, addition to the general equipment configuration and so on.

Import Leasing:

In an import lease, the lessor and the lessee are domiciled in the same country but the equipment supplier is located in a different country. The lessor imports the asset and leases it to the lessee. It is expected that the Government may permit acquisition of sophisticated equipment from abroad on a lease basis. In view of this, the leasing company may propose a tie up with a reputed foreign company. In India also, some of the newly started leasing companies have proposed to start this type of leasing activity. In fact, this activity requires a lot of
government support and suitable changes in the import & export and foreign exchange regulations.

**Staggered Revolving Leases:**

Staggered revolving lease works on the overdraft concept and has gains for the banker, the lessee and the lessor. The lessee obtains an overdraft from a bank, which benefited by way of earning interest. The benefit of the lessee is that he can use his overdraft over and over again to take on lease more equipment from the lessor. The benefits accruing to the lessor are higher compounded returns, low reselling of funds required low operating costs, and the perpetual nature of the lease.

**Participative Soft Leases:**

In this kind of lease the lessee is involved in funding a part of lease which enables him to write off up to 55 per cent of his cost in the first year alone. The leasing company benefits by way of higher returns on lower capital employed.

**Recycled Asset Revolving Leases:**

This package is specially designed for industrial modernization and replacement of assets.
Swap Lease:

Swap lease allows the lessee to exchange equipment in need of major repair with proper working replacement equipment to avoid costly maintenance and repair delays. In this type of lease, the lessor maintains the asset and if necessary, replaces it with similar equipment in working condition.

Master Leases:

A blanket lease covers numerous articles of equipment that arrive over a period of time. This avoids expensive duplication of leasing documents.

Joint Venture Leasing:

Several lessees join together to lease an otherwise prohibitively expensive piece of equipment.

Skipped Payment Leases:

In situations, where equipment might remain idle during a particular portion of a company's fiscal year, a lease, which is designed to omit payments during this period each year is known as skipped payment leases.

Trial Period Lease:

Certain leases provide trial use period upto 6 months. During this period, the lessee decides whether the machinery will accomplish the required task and more
importantly generate revenue. This removes a good deal of the speculative risk from the lessee’s acquisition of an asset.

**Straight Leasing:**

Straight lease requires the lessee firm to pay lease rentals over the expected service life of the asset and does not provide for any modifications to the terms and conditions of the basic lease.

**Modified Lease:**

Modified lease provides several options to the lessee during the lease period. For example, the option of terminating the lease may be provided by either purchasing the asset or returning the same.

**Primary and Secondary Lease (Front-ended & Back-ended Lease):**

Under primary and secondary lease, the lease rentals are charged in such a manner that the lessor recovers the cost of the asset and acceptable profit during the initial period of the lease and then a secondary lease is provided at nominal rentals. In simple words, the rentals charged in the primary period are much more than that of the secondary period. This form of lease arrangement is also known as front-ended and back-ended lease.
**Single Investor Lease:**

There are only two parties to the lease transaction, the lessor and the lessee. The leasing company (lessor) funds the entire investment by an appropriate mix of debt and equity funds. The debts raised by the leasing company to finance the asset, are without recourse to the lessee, that is, in the case of default in servicing the debt by the leasing company, the lender is not entitled to payment from the lessee.

**Sales-aids Lease:**

By the advent of intensive competition in product marketing, a number of companies adopted this technique as a marketing tool because under this scheme, a manufacturer directly extends facility of leasing either by one of his own subsidiaries or through a third party, a leasing company. This kind of leasing arrangements normally have a very strong psychological advantage even where the lessee is in a position to raise lease finance through their own contracts.

Under sales-aids lease, the equipment supplier arranges for lease finance in various forms by:

- Providing reference about the customer to the leasing company;
- Negotiating the terms of the lease with the customer and completing all the formalities on behalf of the leasing company;
Writing the lease on his own account and discounting the lease receivables with the designated leasing company. The effect is that the leasing company owns the equipment and obtains an assignment of the lease rental.

The sale-aid lease is usually with recourse to the supplier in the event of default by the lessee either in the form of offer from the supplier to buy back the equipment from the lessor or a guarantee on behalf of the lessee.

**Tax Benefit Transfer Lease:**

The objective of these kind of leases is to make the economically distressed companies to en-cash the benefits of investment tax credits and other various fiscal incentives which they were not in a position to enjoy because of the non-tax paying conditions of the company. In this kind of leasing in which, the lessor pays, a down payment on the cost of capital, of the equipment and executes a note exactly identical to the lease rentals to be received from lessee. Thus, these notes are equal to the amount to be repaid to the financial institutions towards their loan repayment and the interest to be accrued during the contract period. Thus, no money is to be repaid by the lessor to the financial institution. Accordingly, the lessee's cost of the equipment is reduced by the initial payment made by the lessor to the financial institution.
Pay out and Non – Pay out Lease :

The pay out lease implies that the lessor will collect payment, which will equal to his cost of purchasing the equipment so that it may be leased to the lessee.

The non-pay out lease means that the lessor will collect less than his equipment cost over the term and take the equipment back to release it.

Difference Between Lease Financing and Hire-Purchase Financing :

Having discussed the various forms of leases and lease financing, it would be appropriate to make a comparison between lease financing and hire purchase financing. Hire purchase financing is quite well known to all in trade and business while leasing is gradually gaining wide acceptability. Both Leasing and hire purchase provide a source of financing fixed assets. On the face of it, both these financing systems appear more or less the same. But there are substantial differences between them. The following points of distinction are worth consideration from points of view of the lessee and the hirer:

1. In leasing, the ownership is not transferred to the lessee. But in hire purchase, the ownership is transferred to the hirer on payment of last instalment.

2. In leasing, the entire lease rentals are tax deductible expenses. But in hire purchase, only the interest component and not the entire instalment is deductible.
3. In leasing, depreciation and other allowances cannot be claimed by the lessee. But in hire purchase, depreciation and other allowances, can be claimed by the hirer.

4. In leasing, lessee cannot realize salvage value of the asset on the expiry of the lease life of the asset. But in hire purchase, hirer can realize the salvage value of the asset after payment of last instalment and expiry of the life of the asset.

5. Lease financing is said to be "off-balance sheet financing". Financial statements fail to reveal the leased asset and shown as a footnote in the Balance Sheet. This in turn helps the company to overcome the debt – equity which normally stands in the way of borrowing. But in hire purchase, the installments are shown as a term liability.

6. Leasing are used to acquire capital goods such as, computer, aircraft, construction equipment, drilling equipment, air conditioning and data processing etc. But under the hire purchasing, the capital goods are purchased but the cost of the goods are not as costly as in the case of, lease equipment.

7. In leasing, the responsibility of maintenance will differ from one type to another type of lease contract. Based on the type of lease, it may have to be looked after either by the lessor or lessee. But in hire purchasing, it is the duty of the hirer to maintain the equipment. The seller has nothing to do with the maintenance of the equipment or asset.
8. Leasing is considered to be 100% financing and it does not require any margin money. But under the hire purchasing, margin is generally 25 to 30% of the asset.

9. There are no separate finance charges under leasing arrangement. In fact, the lease rentals are supposed to take care of many such costs coming under the hire purchase. But under the hire purchase, finance charges will be calculated on the amount advanced by the companies.

10. The leasing companies have been permitted to raise funds up to 10 times of their net worth, by way of public deposits. But the hire purchasing comes under the Sale of Goods Act.

11. In leasing, the investment allowance will not be made available either to the lessor or the lessee. But in hire purchasing, it can be claimed by the hirer.

**Lease Versus Purchase: A Finance Decision**

Suppose a firm decides to purchase a certain asset desirable but prefers not to finance the acquisition solely with equity funds. The firm can pay for the asset either with borrowed funds or with a financial lease. The purpose of this section is to compare the relative merits of these two methods of financing.

A check-list should be prepared of factors to be examined by a firm's management before commencing the financial evaluation. Matters frequently requiring consideration include the following:
1. **Capital adequacy** : It is important that a firm has adequate shareholder’s equity for its planned level of trading. Any possible problems should be eliminated by issuing new capital, or retaining a greater proportion of earnings, rather than taking on further debt obligations (assuming loan or lease finance were to be available).

2. **Financing strategy** : The method of finance to be selected for a new project should be compatible with a firm’s overall financing strategy. It may be appropriate to provide for a mix of financial instruments in order to reduce risk. Companies may wish to structure debt payments so as to avoid loan maturities coinciding and to arrange sources of finance so as not to be unduly dependent on particular types of debt, such as foreign currency loans giving risk to possible exchange losses. The part to be played by leasing in a firm’s overall financing strategy may very well depend on the view taken after concerning the extent to which leasing may enable the firm to increase its overall debt-raising capacity.

3. **Liquidity** : A firm needs to retain sufficient liquidity to meet any sudden unexpected shortfall in cash flows or additional operating or capital expenditure.

4. **Availability** : The initial availability of the various types of finance should be ascertained. Fixed-rate finance for the period required might, for example, only be available by leasing the equipment rather than through loan arrangements. Firms should also assess the importance of a guaranteed continuing availability of the finance, as in the case of a financial lease, rather than the possibility of
repayment on demand as normally stipulated in overdraft and certain other types of loan arrangements.

5. **Marshalling of security:** There may be ways of arranging finance secured on the asset of a firm, including fixed or floating charges and leasing, which increase its overall debt capacity.

6. **Benefit eligibility:** Although most types of investment incentives are equally available for purchased and leased equipment, it is important that the method of finance does not adversely affect a firm's eligibility for government grants and other benefits.

7. **Restrictions:** The chosen method of finance needs to comply with all restrictive covenants and governmental regulations. There may be borrowing restrictions in a firm's Memorandum or Article of Association or in a debenture trust deed. Additional borrowing may not be permitted under exchange control regulations.

8. **Administrative convenience:** Firms may be attracted to those methods of finance, including leasing, which simplify book-keeping procedures and assist expense budgeting and cash flow forecasting.
The second stage in the financing decision is the comparison of the costs of the various available sources of finance. To simplify the financial evaluation, it is necessary to make certain assumptions concerning the characteristics of the leasing and borrowing cash flows.

The principal assumptions made (usually on an implicit basis) when comparing the cost of leasing and borrowing are as follows:

1. The decision to acquire the equipment has already been taken by the firm carrying out the evaluation.

2. Lease finance is equivalent to borrowing and does not increase debt capacity.

3. The firm has sufficient borrowing requirements to remain in a debt situation. There are no periods of overall cash surplus.

4. Rentals and interest rates equally reflect the firm's creditworthiness.

5. Lease finance and the available forms of borrowing have similar risk characteristics, i.e., there are no differences in the types of security interest in the equipment afforded to the providers of the finance or in other terms such as a lender's right to require repayment on demand.

6. Inflation may be disregarded. All of the cash flows are money oriented rather than real cash flows.
7. Any uncertainty about future corporation tax rates is ignored, so that tax cash flows may be discontinued at the same rate as other cash flows.

8. There are no economies of scale achievable by leasing, for example, as a consequence of the lessor negotiating with the supplier a reduction in the cost of the equipment or of being able to obtain a higher selling price for the equipment is achieved at the end of the lease period.

9. Leasing provides the best means of a firm taking advantage of any first year capital allowances from which, because of a lack of taxable capacity, it cannot itself immediately benefit.

Lease Versus Purchase: A Capital Budgeting Decision

In our discussion of lease versus purchase as a financing decision, we indicated that the capital budgeting decision had been made (the acquisition was mandatory), and our concern lay in selecting the optimum mode for financing. Thus, we presume conditions of certainty as to the financing and lease payment cash flows, and discounted them at the after-tax cost of debt. By contrast, if the firm were considering the lease proposal as a distinct capital project to be ranked against all other projects, the cash flows would not be considered certain. Sales and operating costs change and tax-rates payments also vary with business conditions. In the case, the financial manager would discount the separate cash flows of ownership or leasing at a rate appropriate to the level of risk.
Moreover, it is axiomatic in capital budgeting that the return on investment be computed independently of the cost of financing yet interest charges are explicitly included in the ownership calculation. The reason for including interest in the calculation is the need to find the difference in the after-tax cash flows between the leasing and borrowing alternatives. The project has already been accepted, and the decision was made independently of financing. We had to look directly to those cash flows, which would affect the financing decision.