CHAPTER - 7

Laws and Regulatory Framework

- Indian Contract Act, 1872
- The Transfer of Property Act, 1882
- Income Tax Act, 1961
- Sales Tax and Leasing
- Legal Issues in Leasing
- Regulatory Measures for Leasing
LAWS AND REGULATIONS OF LEASE FINANCING

High growth potential in the leasing industry and the advantage of tax shield, have paved the way for formation of a large number of leasing companies in the recent past. Every industrial house has established a leasing company to function as captive finance house. Some manufacturers are using leasing as a sales aid in marketing their products. Amongst the financial institutions the ICICI was the first to offer leasing in 1983. IFCI, IDBI and UTI followed the suit. Besides, following the amendment of the Banking Regulation Act in 1983, number of leading commercial banks has set up subsidiaries for doing leasing business. Some of the foreign banks also offer leasing as a part of their activities or have set up joint ventures with private groups.

With the rapid increase in leasing business the need for some laws governing the functioning of finance companies/firms was strongly felt. Though there is no special law governing leasing transactions, the relevant provisions of the general law apply to all such transactions. The few important laws governing the leasing transactions are discussed in this chapter. The relevant laws for leasing are as follows.

- Indian Contract Act, 1872
- The Transfer of Property Act, 1882
- The Income Tax Act, 1961
- The Central Sales Tax Act
Indian Contract Act 1872

The basic principles of contract law are applicable to all types of contracts including leasing and hire purchase contracts. Indian Contract Act 1872, refers to the types of contract valid, voidable, breach of contract and also bailment. Then above act enumerates the initiation of the contract, discharge of contract and remedies for breach of contract etc., specially for leasing the Indian Contract Act is provided some provisions related to bailment.

A leasing agreement is primarily and simply a bailment agreement, involving no sale element. For leasing there is no such special law, and are thus governed under the general law of contracts. Section 148 of the Indian Contract Act defines a contract of bailment 'as the delivery of goods by one person to another for some purpose upon a contract that they shall, when the purpose is accomplished, be returned, or disposed of according to directions of the person delivering them'. The person who delivers the goods is called “bailor” and the person to whom the goods are delivered is known as “bailee”.

Thus a leasing agreement can be taken with a bailment agreement in the following manner:

- It involves two parties viz. the lessor and the lessee. The lessor is in the same position as of bailor and the lessee as of the bailee.
- In a lease, the possession of the goods is delivered by the lessor to the lessee. The ownership continues to rest with the lessor.
- The purpose in a contract of lease is to allow the lessee to make economic use of the goods during the lease term.
The goods are to be returned back to the lessor on accomplishment of the purpose or on expiry of the lease term.

Liabilities of Lessee: The liabilities of a lessee under contract of lease are similar to that of a bailee. These are

i) **Reasonable care:** In terms of section 151, a lessee is required to take reasonable care of the goods leased to him, in the same manner as a man of ordinary prudence would do to protect his own goods, if the lessee fails to denote reasonable care he will be liable for loss of or damage to the goods caused by his own, or his employee’s/agent’s negligence. As per section 152, unless there is an agreement to the contrary, the lessee is not responsible for the loss or damage to the goods, if he has taken reasonable care to protect the goods. It is generally therefore that lease agreements specifically make lessee liable for all damages irrespective of lessee’s negligence.

ii) **Not to make unauthorised use:** As per section 154, the lessee must not use the goods for a purpose different from that stipulated in the lease agreement or do any unauthorised act in relation to the goods, if the lessee does anything which is not permissible under the lease agreement, the agreement is immediately determined and the lessor may recover the possession of the goods.

iii) **To return the goods:** As per section 160, the lessee is under an obligation to return the goods, as soon as the time for which they were leased has expired, or the purpose for which they were leased has been accomplished. Besides, the lessee is bound to return the goods to the lessor in
the following cases as when the lessor has exercised his right to terminate the agreement, when the lessee himself has terminated agreement and when some event occurs which under the terms of the lease agreement causes an automatic termination of the lease agreement.

The lessee can avoid his liability to return the goods, if the goods were lost/destroyed when it is not his fault. However, when the goods are lost after the stipulated date for the return of the goods the lessee cannot avoid this liability. If the lessee fails to return the goods, the lessor may sue him for damages, or may bring an action for sale proceeds of the goods when wrongfully disposed off by the hirer.

iv) **Not to set up an adverse title:** The lessee must protect the lessor’s title by informing him, as soon as practicable, of any adverse claim on the goods leased.

v) **To pay lease rental:** The lessee is under an obligation to pay the lease rentals at the times and in the manner laid down in the lease agreement.

vi) **To insure and repair the goods:** A lease agreement may also require a lessee to get the goods insured and/or repaired as and when necessary. But if the agreement does not provide so, the lessee is under no express/implied obligation to do the same.

**Liabilities of Lessor:** The obligations of lessor are as follows

i) **Delivery of goods:** The lessor is required to enforce the delivery of goods to the lessee and to supply him the necessary documents to enable him to use the goods lawfully. If the goods are not delivered the lease does not
commence. As regards the place, time and mode of delivery, the rules laid down in the Sale of Goods Act, 1930 shall apply.

ii) **Peaceful possession:** In a lease agreement the lessee is allowed only the possession of the goods to make economic use of the goods. Thus, the lessor must ensure that the lessee enjoys quiet possession of the goods during the currency of the agreement.

iii) **Fitness of goods:** The lessor must ensure that the asset leased is in a reasonably fit condition for the purpose for which the lessee is to use it. This applies where the lessee has made known his particular purpose to the lessor and he relies upon lessor's skill and judgment.

iv) **To disclose all defects:** The lessor must disclose to the lessee, the faults or defects of the goods leased; of which the lessor has knowledge and which might interfere with their use or expose the lessee to extra-ordinary risks. If he fails to do so and the lessee suffers a loss due to such non-disclosure, the lessor must compensate the lessee. The lessor must remove the defects as reasonable examination would have disclosed. However, he shall not be liable for latent defects in goods, whether discoverable or not.

Remedies available to the lessor and lessee against breach of obligations by the others are explained below:

**Remedies to the Lessor:**

- **Forfeiture** – The lessor has a right to forfeit the rentals paid by the lessee upto the date of termination, irrespective of the fact that the amount exceeds the amount of benefit received by the lessee upto that date. The
lessee may however, seek a relief in equity. As regards an initial deposit, its forfeiture depends on the purpose of deposit. If the deposit is a security for the asset and the lessee has caused some loss to the asset, it can be forfeited. If the deposit is a security for rent, and the lessee fails to pay rent, it can again be forfeited.

- **Damages** – Where the asset has been converted by the lessee, in case of a lease for a fixed term the lessor may claim damages for conversion. The measure of damages is the value of goods expected to be at the end of the lease period. Where the lease is for affixed term and the lessor terminates the agreement for lessee’s breach before the expiry of lease period, the lessor can recover the arrears of rent along with damages for any specific breach, e.g. interest for non-payment of rentals.

- **Repossession** – Upon breach of any obligation by the lessee giving the lessor the right to repudiate the contract, the lessor may serve a notice upon the lessee for termination of the agreement and asking for repossession of the goods. For repossession of the asset, the lessor may use such physical force as may be reasonably necessary lessee’s premises. It is thus, desirable that a right to enter the lessee’s premises should be provided in the lease agreement.

**Remedies to the Lessee:**

Where the contract is repudiated for lessor’s breach of any obligation, the lessee may claim damages for loss resulting from termination. The measure of damages is the increased lease rentals (if any) the lessee has to pay on lease of other asset.
plus the damages for depriving him from the use of the leased asset from the date of termination to the date of expiry of lease term.

- **Insurance of leased asset and claims:**

  - **Necessity** – the general practice is to get the leased asset insured. Generally, it is the lessee’s responsibility. If the lessor obtains the insurance, he either claims reimbursement of the same from the lessee or adjusts the rentals suitably.

  - **Risks insured** – Insurance on leased assets is normally obtained to cover:
    a) risk of loss/damage by fire, riot, strike, burglary, act of god, faulty handling, electric failure etc.,
    b) risk to life or limb of the operator or third parties.

  - **Insurable interest** - The insurable interest in the leased asset vests both with the lessor and the lessee and thus, any of them may obtain insurance. The lessee may obtain insurance cover against his own liability (that is, the amount he is required to pay to the (lessor), or for the full value of the goods.

  - **Claims** – Where the lessee has obtained insurance for full value of the goods, he can claim the full value from the insurer, irrespective of whether the lessee has suffered any loss or not. Where the insurance has been obtained on behalf of the lessor, he can claim the value of interest insured direct from the insurer. Where the goods have been insured in the name of lessor only, then only he can claim.

  - **Treatment of claim proceeds** – Where the asset is fully destroyed, the lessor takes the insurance proceeds towards his receivable and the agreement comes
to an end. The deficit (or surplus) is to be computed by working out the present value of rentals outstanding but payable in future. The discounting rate and the method of calculation of present value, must therefore be specified in the agreement. Where the asset is partially damaged, the insurance proceeds should normally be applied for repair of the asset. Alternatively, the lessor should adjust the proceeds towards the amount financed and recomputed the rentals on the balance amount then outstanding. The proceeds should in no case be adjusted towards the rental obligations of the lessee.

Sub-Lease of Leased Asset:

Right to Sub-Lease- As stated earlier, the lessee must not do any act which is inconsistent with the terms of the lease agreement. Lease agreements generally exclude the right to sub-lease the leased asset. Thus, the lessee must not sub-lease the asset unless the agreement expressly provides or the right to sub-lease can be inferred from the circumstances. For example, in a lease of earth moving equipment, the lessee has the right to sub-lease by implication. Where the right to sub-lease is within the apparent authority of the lessee, the sub-lease shall be valid and the sub-lessee shall be entitled to retain possession of the asset, even if the act of sub-lease amounts to breach of the main lease agreement.

Effect of Sub-Lease – The effect of a valid sub lease is that the sub-lessee becomes a lessee of the original lessor as well. The sub lessee and the
original lessor have the same rights and obligations against each other as between any lessee and lessor.

Effect of termination of main Lease – A right to sub-lease is restricted to operating of the main lease agreement. Termination of the main lease agreement will automatically determine the sub-lease. This may create some unwarranted complications for the sub-lessee, particularly where the sub-lease is for a fixed term. Such a situation may be avoided by executing tripartite agreement, between the lessor, the lessee and the sub-lessee.

Another most important and relevant Act for lease business is The Transfer of Property Act, 1882.

The Transfer of Property Act, 1882

Real estate leasing is regulated under the provisions of the Transfer of property Act. Real estate or immovable property has been defined to include land, benefits arising out of land and things attached to earth, or permanently fastened to anything attached to earth.

Section 5 of the Act defines transfer of property by which a living person conveys property, in present or in future, to one or more other living persons or to himself. Living person includes a company or association or body of individuals whether incorporated or not.

Section 105 of the Act defines a lease of immovable property as ‘a transfer of a right to enjoy such property, made for a certain time, express or implied, or in perpetuity, in consideration of a price paid or promised, or of money, a share of crops, service or any other thing of value to be rendered periodically or on
specified occasions to the transferee, who accepts the transfer on such terms'.

The transferor is called the lessor, the transferee is called the lessee, the price is
called the premium, and the money, share, service or other thing to be so
rendered is called the rent.

The important provisions of the Act relating to lease are mentioned below:

i) **Duration of Leases** - (Sec. 106) In the absence of a contract or local
law or usage to the contrary, a lease of immovable property for
agricultural or manufacturing purposes shall be deemed to be a lease
from year to year terminable, on the part of either lessor or lessee, by
six months’ notice expiring with the end of a year of the tenancy; and
the lease of immovable property for any other purpose shall be
deemed to be lease from month to month terminable, on the part of
either lessor or lessee, by fifteen days notice expiring with the end of
a month of the tenancy.

ii) **Exclusion of day on which term commences** – where the lease term
is expressed as commencing from a particular day, in computing the
terms of lease, such day shall be excluded. Where no day of
commencement is named the lease term begins from the making of
the lease. (Sec. 110)

iii) **Lease Agreement and Registration** – A lease of immovable
property from year to year, or for any term exceeding one year, or
reserving a yearly rent, can be made only by registered document. The
lease document shall be executed by both lessor and the lessee. All
other leases of immovable property may be made either by a registered document or by oral agreement accompanied by delivery of possession. (Sec. 107)

iv) **Rights and Liabilities of the Lessor:** Unless there is a contract or local usage to the contrary, the lessor has the following rights and liabilities (Sec. 108)

a) The lessor is bound to disclose to the lessee any material defect in the property, with reference to its intended use, of which the former is and the latter is not aware, and which the latter could not with ordinary care discover.

b) The lessor is bound to deliver the goods on lessee's request.

c) The lessor is required to ensure that the lessee enjoys quiet possession during the period of the lease.

v) **Rights and Liabilities of the Lessee** – Unless there is a contract or local usage to the contrary, the lessee has the following rights and liabilities (Sec. 108):

a) Any accession to the leased asset during the lease term shall be treated as a part of the leased asset.

b) If by flood, fire, violence etc., any material part of the asset is wholly destroyed or rendered substantially and permanently unfit for the purpose for which it was leased, the lease shall at the option of the lessee, be void. However, the lessee is not entitled to
this benefit if the injury is caused by the wrongful act or default or the lessee himself.

c) If the lessor neglects to make, within a reasonable tie after notice, any repairs which he is bound to make to the asset, the lessee can make the same repair and claim reimbursement from the lessor, out of rent or otherwise.

d) If the lessor neglects to make any payment which he is bound to make, and which, if not made by him is recoverable from the lessee, the lessee may make such payment and claim reimbursement from the lessor, out of rent or otherwise.

e) The lessee may, at any time whilst he is in possession of the asset, remove the fixtures to the property introduced by him, provided he leaves the property in the state in which he received it.

f) The lessee may transfer absolutely or by way of mortgage or sub-lease the whole or any part of his interest in the property, and any transferee of such interest or part may again transfer it. However the lessee shall continue to be subject to the liabilities attaching to the lease.

g) The lessee is bound to disclose to the lessor any fact as to the nature or extent of the interest which the lessee is about to take, of which the lessee is, and the lessor is not, aware, and which materially increases the value of such interest.
h) The lessee is bound to pay or tender, at the proper time and place, the premium or rent due to the lessor.

i) The lessee is required to keep, and on the termination of the lease to restore, the property in the same condition as it was at the time when he received it, subject only to reasonable wear and tear. The lessee should allow the lessor and his agents to inspect the property. The lessee should also make good any defect caused by any act or default on his part, within 3 months of a written notice from the lessor.

j) If the lessee comes to know of any proceeding, encroachment or interference with the lessor's right over the property, he should bring the same to the lessor's notice.

k) The lessee should use the property as a person of ordinary prudence would use his own property, and only for the purposes for which it was leased.

l) The lessee must not erect any permanent structure in the property without lessor's consent.

m) The lessee must put the lessor into possession of the property on determination of the lease.

TAX ASPECTS OF LEASING

Leasing can be used as a vehicle for transferring the investment related tax shields from the lessee to the lessor and the former can share a portion of the tax benefits accruing to the latter through a reduction in lease rentals. When the
transaction is treated as lease, the lessor shall be eligible for depreciation on the asset. The entire lease rentals will be taxed as income of the lessor. The lessee correspondingly, will not claim any depreciation and will be entitled to expense off the rentals.

In the Indian context, another dimension of tax that looms large is the sales tax - particularly the sales tax on lease rentals. The enactment of the 46th amendment to the constitution and the consequent imposition of sales tax on genuine lease transactions have been matters of great concern for the leasing industry.

**Income Tax Act, 1961**

Under the provisions of the Income Tax Act, 1961, computation of ‘taxable income’ of an assessee involves computing the income under various heads of income. Computation of income under each head is governed by different sets of provisions. There are five heads of income viz. salaries, income from house property, profits and gains of business and profession, capital gains and income from other sources.

Incomes from leasing operations i.e. lease rentals or charges are taxable under the head ‘Profits and Gains of Business and Profession’. The operating leases practiced regularly shall be taxed under Income from other sources. Where as financial lease is treated under ‘Business’ head.

**Depreciation Allowance on Leased Assets:**

As per the provisions of the Income Tax Act, 1961 relating to depreciation allowance as stated in (Sec. 32). The salient provisions are as follows.
• Depreciation on a business asset is allowed as a tax deductible expense if (a) the asset is owned by the assessee and (b) the asset is used by the assessee for the purposes of business.

• Assets which qualify for depreciation allowance are buildings, machinery, plant or furniture. Plant includes ships, vehicles, books, scientific apparatus and surgical equipment used for the purpose of business.

• Depreciation is computed at the rates prescribed under the income tax act, 1961 based on the Written Down Value (WDV) method. Plant and machinery have been classified under three blocks with rates of depreciation of 25 percent, 40 percent and 100 percent. In the case of office buildings, the rate of depreciation is 10 percent and the general rate applicable to furniture and fittings is 10 percent. Where the actual cost of plant and machinery does not exceed Rs. 5000, the entire cost is allowed as depreciation in the year in which such plant and machinery is first put to use.

• Prior to the enactment of the Finance Act, 1991. Depreciation was treated as an annual allowance not linked to the period of use during the year. But the Finance Act, 1991 has introduced a provision that if an asset acquired during a year has been used for the purpose of business for a period of less than 180 days during the year, depreciation on such asset will be allowed at 50 percent of the depreciation computed as per the provisions of the Act.

Rates of Depreciation: The applicable depreciation rates of the generally leased assets are as follows; Motor Cars - 20 percent, Plant And Machinery(residuary rate) - 25 percent, Lorries, Buses or Taxies, Aero planes, Moulds used in Plastic and
Rubber Industries – 40 percent, Bottles and Crates – 50 percent, Pollution Control Devices, Energy Saving Devices, Rollers in Flour Mills, Gas Cylinders etc. – 100 percent.

Issues Involved in the Context of Income Tax:

In the context of the aforesaid provisions of the Income Tax Act, some issues concerned to the lessor’s claim for depreciation allowance on leased asset as follows.

First, it must be noted that the IT ACT, 1961, does not explicitly state that a lessor is eligible to claim depreciation allowance on leased assets. Claiming depreciation allowance, the lessor can fulfill the two conditions, they are the first condition what constitutes the ‘use of the asset’. It can be argued that the lessor uses the asset in his business of leasing assets in his business of leasing assets and therefore he can claim the depreciation allowance. Secondly, it is also possible to argue that the lessor transfers the right of use to lessee. This implies that neither the lessor nor the lessee can claim depreciation allowance because none of them fulfills both the conditions. The courts and the appellate tribunals which have examined this issue have however ruled that the leased assets are deemed to be used in the lessor’s business of hiring out assets and therefore the lessor is eligible to claim depreciation tax shields.

A second issue that has not been fully resolved to date is whether the lessor can claim depreciation allowance at rates applicable to plant and machinery if (a) the assets offered on lease are assets other than plant and machinery, say chairs on lease to a theatre; or (b) the assets offered on lease are used as “personal assets” by the lessee-consumer lease. With regard to classification of an asset into one of the four
eligible categories—buildings, machinery, plant, or furniture and fixtures—the courts have taken a stand that the use of the asset in the assessee’s business determines its classification. In general any asset used in the assessee’s trade is treated as a plant. Extending to this, if lessor uses assets in the business i.e., leasing, can be regarded as plant. If this is accepted, will enable the lessor to claim a higher depreciation allowance on leased assets like furniture and fixtures and assets forming the subject matter of consumer leases.

The third issue pertains to the lessor’s claim for depreciation in the case of sale and lease back transactions where the asset is sold at a price higher than its book value (Written Down Value) to the lessor. As per explanation 3 to sec 43(1) of the I.T. Act, the lessor’s claim can be disputed by the assessing officer. This explanation states that ‘where, before the date of acquisition by the assessee, the assets were at any time used by any other person for the purpose of his business and profession and the assessing officer is satisfied that the main purpose of the transfer of such assets, directly or indirectly to the assessee was the reduction of liability to income tax, the actual cost to the assessee shall be such amount as the assessing officer may, with the previous approval of the Deputy commissioner, determine having regard to all circumstances of the case’.

Summing up, we find that there are no capital allowances like investment allowance associated with the investment in plant and machinery. Therefore, other than the tax shield on depreciation, the lessor doesn’t derive any other investment related tax shield.
**Sales Tax and Leasing**

The Sales Tax Act, 1957 is concerned with the levy and collection of sales tax on inter state sale of goods. Central Sales Tax Act (CST), 1957 enacted by the parliament. Sales tax laws are enacted by the state legislatures. With the enactment by the Indian Parliament of the Constitution (Forty Sixth Amendment) Act, 1981, Indian States have been empowered to enact law for the levy of tax on 'the transfer of the right to use any goods for any purpose for cash, deferred payment or other valuable consideration'.

Presently the states of Andhra Pradesh, Bihar, Goa, Gujarat, Haryana, Himachal Pradesh, Karnataka, Kerala, Maharashtra, Meghalaya, Orissa, Rajasthan, Tamil Nadu, Uttar Pradesh, West Bengal and certain other states have amended their existing sales tax laws to provide for levy of tax on lease rentals.

Rates of sales tax vary from state to state, Maharashtra has a provision for the levy of the tax at the rate upto 15 percent, the present rate is 4 percent. Andhra Pradesh is at the rate of 5 percent, Tamil Nadu at 3 percent, Kerala is at 5 percent and Karnataka is also levy the tax at the rate 5 percent. Most of the states levy tax between 4 to 5 percent in India.

Central government can impose tax on sale or purchase of goods:

i) In the course of inter-state trade or commerce,

ii) Outside the territory of a state,

iii) In the course of import into, or export out of, India,
It may however, be noted that central sales tax is levied only on sales in the course of inter-state trade or commerce. Sales outside a state and in the course of import or export are exempt under the Central Sales Tax Act, 1956. A state government can impose tax on sale or purchase of goods within the state. Lease transaction can attract sales tax in three stages: They are as follows

1) The purchase of an asset by the lessor for the purpose of leasing it out to the lessee;

2) The transfer of the right to use the asset to the lessee for a specified period of time, including the renewal of the lease period for cash, deferred payment or other valuable considerations; and

3) The sale of the asset at the end of the lease period;

While levy of sales tax on the first and third incidence was already provided for in the sales tax acts of the various states and under the central sales tax act, after the 46th amendment, a lease can perhaps attract sales tax at all the three points of time. In addition, legislation now taxes the event of ‘transfer of the right to use goods’ by defining the same as a sale. Although simplistic in approach, this legislation has wide implication and given the very abstract nature of such a non physical sale transaction, a number of issues have arisen for resolution. While most of the Indian states have provided for the levy, no parliamentary enactment has yet been passed to levy such tax in Indian union territories.
While the provisions of the bill are for the sole benefit of the states, the center's interest in the legislation can be discerned from the fact that it has succeeded, to an extent, in pacifying the states in the matter of their perennial demand for an ever-increasing share in the central pool of revenue, by offering a channel for alternative resources.

**Situs of Lease Transactions:** Article 286(1) (a) of the constitution۱۰ prohibits a state from imposing tax on sale or purchase of goods where such sale or purchase takes place outside the state. Article 286(2) empowers the parliament to formulate principles for determining when a sale or purchase takes place outside a state. It may be noted that with amendment of Article 366(29A), a sale now includes the 'deemed sales' mentioned in that Article.

**Taxation if Import/Export Leases:** Article 286(1) (b) of the constitution prohibits state legislatures from imposing tax on the sale or purchase of goods where such sale or purchase takes place in the course of import of goods into, or export of goods out of, India. By virtue of Article 366(29A), sale or purchase includes transfer of the right to use the goods i.e. leases. Thus state legislatures are not empowered to impose sales tax on lease transactions in the course of import or export.

For determining as to when a lease can be said to take place in the course of import or export, the Central Government, in pursuance of the powers conferred by Article 286 (2), has formulated certain principles embodied in section 5 of the CST Act, which is as follows: Import or Export –
1) A sale or purchase of goods shall be deemed to take place in the course of the export of the goods out of the territory of India only if the sale or purchase either occasions such export or is effected by a transfer of documents of title to the goods after the goods have crossed the customs frontiers of India.

2) A sale or purchase of goods shall be deemed to take place in the course of the import of the goods into the territory of India only if the sale or purchase either occasions such import or is effected by a transfer of documents of title to the goods before the goods have crossed the customs frontiers of India.

3) Notwithstanding anything contained in sub section (1), the last sale or purchase of any goods preceding the sale or purchase occasioning the export of those goods out of the territory of India shall also be deemed to be in the course of such export, of such last sale or purchase took place after, and was for the purpose of complying with the agreement or order for or in relation to such export”.

Although there has been a growing demand for the abolition of sales tax in the recent past, the Central Government has not been able to persuade the states to think about such abolition through substitution thereof by alternative taxes such as excise duty. A part from the consideration of the federal structure of the constitution and the consequential fiscal independence of individual states, from the viewpoint of income, sales tax cannot be easily substituted by alternative tax measures. The reluctance of the states to lose this lucrative and elastic source of revenue has meant
that the abolition of sales tax remained at the conceptual stage. In regard to this the stated obligation for the taxes by the leasing companies are as follows

**Objections of the Leasing Industry:** Several objections have been raised by leasing companies, challenging the levy of sales tax on lease rental. A few of these are briefly enumerated below:

**Constitutional Validity** – The constitutional validity of the 46th Amendment Act was challenged in the Supreme Court in *Builders Association of India Limited Vs Union of India*. While appellant cited a number of reasons in support of their contention, the Supreme Court upheld the constitutional validity of the 46th amendment empowering the state governments to levy of sales tax on works contracts. The same holds goods for levy of sales tax on transfer of right to use the goods (i.e. leases) also. *20th Century Finance Corporation Limited Vs State of Maharashtra*, the Bombay High Court has upheld the constitutional validity of levy of sales tax on lease.

**The Object of the Amendment** - The leasing industry has strong reasons to feel that the object of inserting the new clause (29A) in Article 366, was to bring into the taxing net transactions which by nature we sales but in form they were camouflaged as not being sales. The amendment was not made with an intention to create new areas of taxability or to confer new powers of raising revenue by imposing tax on leasing or hiring contracts. The leases which are covered by sub-clause (d) of Article 366 (29A) are not plain hiring contracts, but contracts which in substance are ‘sales’. That is, only when the lease transfers the right to use totally in circumstances that the economic benefits of ownership go entirely to the lessee, or in circumstances where
the leasing device is used as an alternate to selling, such lease could be covered by the provision imposing sales tax on leases. The dominant intention of the parties must be to sell. In, ‘Andhra Sugars Ltd. Vs State of Andhra Pradesh’ the Supreme Court held that the taxable event under the sales-tax legislations can only be the sale or purchase, and not the use of the goods. Thus article 366 (29A) purports is not to impose sales-tax on transactions which are not ‘sale’ but to lay down that what in essence is a ‘sale’ cannot escape the tax net by making it as a ‘lease’ (works contract).

**Financial Lease is a Loan** – In a financial lease, the acquisition of goods by the lessor and retention of title by him as the owner is only to secure the lessor’s interest as a financier. There is no real intention on the part of the leasing company to deal in goods. The financial leasing transactions are in reality, loan transactions, which cannot be eligible to sales tax.

**Income - Tax in garb of Sales-Tax** – Even if, the lessor could be regarded as the ‘owner’ and the lease by him as sale, then the aggregate of the lease rentals cannot be taken as the ‘sale-price’. Since the lease rentals comprise of several components apart the recovery of the cost of the asset, major components being interest and compensation for risk of obsolescence, etc., treating the aggregate rentals as the price or turnover amounts to levying sales-tax on interest and the charges for other services, which constitute the lessor’s income. In other words, it would amount to taxing income in garb of sales tax. So to that extent, levy of sales tax on leases is arbitrary, illogical and illegal.

**Premature Levy** – The 46th amendment Act ad also inserted clause (b) to sub article (3) to article 286, provided that any law of a state imposing a tax on leases, works
contracts and hire-purchase, shall be subject to such restrictions and conditions in
regard to the system of levy, rates and other incidents of the tax as the parliament
may by law specify. The leasing industry feels that such an enactment by the
parliament is a pre-condition for the states to impose any tax on these types of
transactions. It is significant to note that the parliament has not so far enacted any
such statute, and thus, levy of tax by states on leases, hire purchase and works
contracts is premature. In view of the above doubts, a strong controversy has
developed over the taxability of leases. The only way of resolving these uncertainties
is, not to take recourse to the courts of law but, that the Government should clarify
the scope of the levy of sales tax on leases.

**Legal Issues in Leasing**

Lease transactions are centered round the contract between the lessor and lessee. The
rights and obligations of the parties to the contract are therefore governed by the
binding clauses included in the contract. However, such clauses are also subject to
laws relating to commercial transactions like the law of contracts, Sale of Goods Act
and other specific laws like the Consumer Credit Act. The legal issues considered in
leasing can be supplier-lessee-lessee relationship, insurance, usage and maintenance,
sub-lease, set-off provisions, defaults and remedies, cancellability, warranties,
technology transfer, supply or purchase contract.

**Supplier-Lessor-Lessee Relationship:** The legal relationship between the three
parties-supplier, lessor and lessee becomes particularly important when the
performance guarantees have to be enforced against the supplier. Since the sale
contract is concluded between the supplier and the lessor, the later enjoys the right of
enforcing such guarantees against the supplier. Normally the lease agreement contains a clause to the effect that the lessor will undertake to enforce the contractual obligations of the supplier to the extent it is necessary to protect the lessee's interest.

One way of resolving this problem in favour of the lessee is to enter into a tripartite commercial agreement between the supplier, the lessor and the lessee wherein the first party recognizes the interests of the third party.

**Insurance:** A finance lease agreement invariably requires the lessee to insure the equipment against such risks as are normally insured against by the owners of similar equipment. These risks include risks of loss or damage to the leased equipment itself and the risk of damage caused by leased asset to third parties and their parties and their property which can be substantial in the case of an asset such as aircraft. The risk of loss or damage to the equipment will include loss or damage caused by fire, accidents, strikes, riot, burglary, faulty handling and such other causes as the lessor may specify. In the case of asset like ships or aircraft insurance cover for war, expropriation and hijacking risks is warranted. Since the cost of insurance cover increases with the number and nature of risks to be covered, thereby increasing the overall cost of transaction, the lessee and the lessor must arrive at an acceptable risk-cost tradeoff. Usually the insurance policy is drawn in the name of the lessor for an amount equal to the replacement market value or purchase price as may be specified in the lease agreement.

**Usage and Maintenance:** With movable equipment, the first concern is the geographic area in which the equipment is permitted to be used. The more areas in which the equipment is used, the greater is the risks to it. Typically, the lease
agreement specifies the location(s) where the equipment can be used. But then the lease agreement cannot be too rigid on this point where the asset involved is say, an aircraft or a shipping container. Too many restrictions on the movements of such assets can impair the lessee’s ability to make rental payments. The lessor must however ensure that (i) its title or lien on the asset is respected in all the jurisdictions in which the asset can be located and (ii) the ‘use of the asset’ in any location complies with the requirements of the local legal framework governing the operation of the asset. The finance lease usually requires the lessee to maintain the equipment in good working condition at his cost. In this context the lessor must specify the extent to which he will allow modification to the leased equipment. Since the leased asset and all its parts must be clearly identifiable, the lessor will have to limit the extent to which the lessee can remove and replace parts. At the same time he has to ensure that the restrictions placed do not prevent the lessee from carrying out his maintenance obligation.

**Sub-Lease:** The issue of sub-lease is one of the important issues to be considered while structuring a lease agreement. The lease agreement can expressly permit or prohibit sub-lease. Where sub-lease is permitted, the lessor can impose restrictions on the identity of the sub-lessee, the duration of the sub-lease and the usage of the equipment. Alternatively the lessor can require the lessee to obtain his prior approval before entering into a sub-lease arrangement. Normally when the first lessee wants to sub-lease, the lessor calls for a tripartite agreement involving himself, the first agreement executed between the lessor and the first lessee. Among other things, the
sub-lease agreement spells out the rights and obligations of the lessor, the first lessee and the sub (second) lessee.

Set-Off Provisions: The set-off provisions are primarily meant to protect the interests of the lessor. An example is the ‘hell or high water’ clause which requires the lessee to make periodic rental payments and perform lease covenants under all circumstances regardless of the condition and fitness for purpose of the equipment. Likewise the lease agreement may bar the offsetting of any counter claims and defenses against the lease payments. The lessee must ensure that the ‘no set-off’ provisions are not so drafted as to waive any claim the lessee may have against the lessor in a separate action.

Defaults and Remedies. Defaults can be broadly categorized into three types. They are asset itself, non-payment of rent and the general financial condition of the lessee and insolvency of the lessee. If lessee violates any requirement relating to the insurance, use or maintenance of the equipment, such violation can constitute an asset default. Under such circumstances the lease agreement may require the lessor to give a notice to the lessee allowing certain grace period to correct the default before exercising the remedies. Then default relates to insolvency of the lessee. Any insolvency, bankruptcy or re-organization proceeding which affects the lessee can give rise to a default under the lease whether or not the lessee has failed to make any rental payments or has committed a breach of the other covenants. As far as remedies are concerned, foreclosure and repossession of the leased asset can be the most useful remedy to the lessor. Remedies concerned to the lessee in the event of the
lessor committing an act of default. If the lessor commits a breach of the obligations, the lessee can terminate the lease agreement and claim damages. 

**Cancellability:** In case of short term operating leases, the lessee is generally entitled to cancel his obligation to pay the rental at any stage. However, the right of cancellation of the contractual obligation to pay the rentals cannot be valid in financial leasing. In finance leases, there is invariably a clause preventing the lessee to exercise the right of cancellation. Financial leases are always found to contain specific clauses making the lessee liable for continued rental payments despite loss or damage to the leased property. This may bring virtually the effect of debarring the lessee from any course of action against the lessor. The only situation in which the lessee is entitled to terminate the lease is where the leased property is not delivered by a specified date or in cases where, through no fault of the lessee, government regulations prohibit the operation of the leased property. Saving clauses to the above effect may be included in the lease contract allowing the lessee for early termination of the lease. In case of operating leases the flexibility of canceling the obligation to pay rental is provided for with a condition that the lessee must give a notice of 30 days or by setting forth relatively short initial terms.

**Warranties:** A troublesome issue that lessees often have to face is ensuring that the leased property is covered by the appropriate warranty to protect his interest as the user of the property. In an operating lease, or where the lessee deals with a specialized lessor and depends on the expertise of the later in selecting or manufacturing the leased asset, the contract should provide for express warranties. However, in the case of financial lease, the lessee cannot expect warranties with
regard to selection, quality, fitness, adequacy and maintenance of lease assets binding the lessor. In other words, the lessor invariably disclaims warranty to the lessee. Although the lessor’s warranties do not normally exist in a financial lease, there are certain warranties or assurances that may be reasonably expected to be made by lessor as that he has the authority to enter into lease contract, that the leased property will be paid for and will be free from lien and that the lessee’s use of the property will not be interfered with by either the lessor or any third party having claims on the lessor.

Technology Transfer: In case of an operating lease contract in which the lessee deals with a specialized lessor, it is possible that a degree of technology transfer will be involved in the deal. Indeed, most operating leases of equipments provide for some technical assistance by the lessor to the lessee. However, such provisions also require the lessee to keep the technical information confidential. The technical assistance may involve the lessor undertaking to train the lessee’s employees for effective use of the equipment. In actual practice however, it is presumed in a financial lease that the lessee has the necessary expertise and technological knowledge with respect to the equipment leased. For the lessee initiates continuing responsibility for repair and maintenance of the asset. If the lessee’s expertise is in doubt, the lessor as a financier assumes the risk of lack of expertise into account by increasing rental payments to compensate for such risks.

Supply or Purchase Contract: Normally a lease contract which embodies the transaction between lessee and lessor does not include the supplier or the manufacturer of the leased asset as a party. In financial leases the lessor enters into a
contract with the supplier or the manufacturer of the asset in accordance with the instructions and directions of the lessee who selects and specifies the asset. Even then, the purchase contract in respect of the asset is essentially between the lessor and the supplier or manufacturer. Thus, there is no formal contractual relationship between the lessee and the supplier. Hence, lease contracts include clauses providing for certain rights on behalf of the lessee regarding his expectations from the supplier. In many lease contracts, particularly finance leases, the lease ensures that, in addition to claims involving warranties, provision is made enabling him to proceed directly against the supplier for price adjustments and returns under certain circumstances.17

Regulatory Measures for Leasing

The various laws affecting the leasing business uncertainties are associated with the legal aspects of leasing which need to be classified at an early stage so that it could pave way for stable growth of leasing in right.

i) Policy of the Government: It has shown a positive and pragmatic attitude in the growth leasing industry. The government is convinced that leasing can be very useful for modernization ventures and trade of industrial equipments. Perhaps the government is interested in its rapid flourishing so that dependence on institutional borrowings by industries may wane. In 1984 a circular has been given by the ministry of finance as those leasing companies with a paid-up share capital of not less than Rs.1 crore be permitted to be listed on the stock exchanges that is the reason most of the leasing companies wish to raise their share capital Rs.1 crore and above.
ii) Investment Allowance: Investment allowance is still not clear and has never been an attractive incentive for leasing companies because most of the lease contracts are being written for a period of less than 8 years. Therefore the question of investment allowance invariably does not arise, but First Leasing Company pointed out that conditions under (Sec 32A) requires to be fulfilled by any one claiming investment allowance and called for the satisfaction of the following pre conditions: The assessee must own the asset, the asset should be brand new, the asset is to be wholly used for the purpose of the business of the assessee and the asset is to be placed in an industrial undertaking for the purpose of construction, manufacture or production of any article or thing.18

iii) Policy of Reserve Bank of India: Ever since the banking laws (Amendment) Act, 1983 was passed allowing the banks to enter into the field of leasing business, the market felt that many of the leasing companies would be wiped out as the banks are better equipped with resources and that these leasing companies can not stand in competition with the banks. In this regard the reserve Bank of India has cleared its policy on September, 1984. However, banks have been granted permission with the prior approval of the RBI, to set up subsidiaries for undertaking leasing and hire purchasing business. In these subsidiaries, banks must have a minimum of 51 percent share holding. Investment in share of subsidiaries with leasing companies should not exceed 10 percent of the banks paid up share capital and reserves i.e net worth. Leasing companies have been permitted to accept deposits in the ratio of 10:1 of their net worth for a minimum period of six months and a maximum period of thirty six months. Leasing companies can pay a maximum
interest of 15 percent per annum. These leasing companies must maintain liquid assets of at least 10 percent of total deposits outstanding on any day.\textsuperscript{19}
References


2 Ibid, p 60.


4 Sec. 3(26). The General Clauses Act.


7 Ibid.


13 (1989) 75 STC 217 (Bom)

14 (1968) 21 STC 212 (SC).


16 Ibid.


19 Prem Lal Joshi, Leasing comes of Age: Indian Scene, Amrita, Prakashan publishers.