CHAPTER III
RBI AND OTHER REGULATORY BODIES GUIDELINES AND IMPACT:

The Accounting Standard on lease accounting AS19 issued by ICAI is effective from 1st April 2001 and according to this, finance leases to be capitalized in the books of the lessee. Most of the leases in India are financial leases and by capitalization of the lease by the lessee means that the leased asset will be reflected in the books of the lessee as the lessee's fixed asset, with a corresponding liability equal to the discounted value of lease rentals. In the books of the lessor, lease appears as a current asset.

According to notification of CBDT F.No.225/186/2000 ITA, Government of India, under the Income-Tax Act, in all leasing transactions if the same is used in the business, under Section 32 of the Income -Tax Act 1964, the ownership of the asset is determined by the terms of contract between the lessor and the lessee. It mentioned about the New accounting standard on 'leases' issued by the Institute of Chartered Accountant of India', which mentioned about, the capitalization of the asset by the lessee in financial lease transactions. But, the accounting standard will have no implication on the allowance of depreciation on assets under the provisions of Income Tax Act.

Thus in terms of accounting standards, the leased asset is deemed to be owned by the lessee, who is though not it's legal owner, only. However, Section 32 will continue to allow depreciation to the legal owner of the asset, which is the lessor. In other words, the lessor will claim depreciation while the lessee will capitalize and depreciate the asset for accounting purposes on the lessee's books.

In case of Sale and leaseback transactions, the allowability will be examined based on whether the transaction can be regarded as a colourable device or sham. For other lease transactions, the CBDT circular leaves the matter to be investigated by the assessing officer.

And for sale and lease there is no tax benefit.

The CBDT circular of 9th February is completely silent on the tax treatment for the lessees. Under the current prevailing law, the lease rentals as paid by the lessee
are accounted as expenses by him, and are claimed as fully expenses for tax purpose.
Under the new accounting standards, the lessee will not expense out the rentals for accounting purposes; he will be required to split the two and report only the interest fraction of the rentals as expense.
Presumably, as the CBDT holds that the accounting standard will not be relevant for tax purposes, a lessee may not be debiting the full amount of rentals for accounting purposes, but nevertheless, will claim the rentals as expenses for tax purposes, as he does today. At the same time, a lessee might be capitalizing and depreciating the leased asset for accounting purposes, but will not do the same for tax purposes. In other words, a lessor will depreciate what he does not account for, and a lessee will not depreciate what he accounts for.

THE MAT MATTER;
While the CBDT circular on tax depreciation will be relevant for tax computation, it is the accounting standard which is relevant for minimum alternative tax (MAT) purposes, as MAT is imposed on book profits. In other words, for MAT purposes, it is the lessee who will depreciate the asset and apportion the rentals into interest and principal, with only the former going to revenue statement.

RBI GUIDELINES:
RBI, having considered it necessary in the public interest, and being satisfied that, for the purpose of enabling the Bank to regulate the credit system to the advantage of the country, it is necessary to issue the directions relating to the prudential norms as set out, in exercise of the powers conferred by Section 45 JA of Reserve Bank of India Act, 1934(2 of 1934) and of all the powers enabling it in this behalf. These directions are known as Non-banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 which came into force from that time. According to 13(ii) of Non-Banking Financial Companies Prudential Norms (Reserve Bank) Directions, 1998 the provisions of paragraph 10 and 12 of
these directions shall not apply to (a) a loan company (b) an investment company (c) a hire purchase finance company and (d) an equipment leasing company which have NOF of rupees twenty-five lakh and above but not accepting/holding public deposit.

NBFCPN, 1998 10 deals with requirement of Capital Adequacy.
11 deals with Loans against NBFC’s own shares prohibition.
12 deals with concentration of credit/investment.

The above exceptions by RBI will give a little fresh breather for leasing companies. Otherwise practicing the above norms for leasing business is tough.

According to Section 2 (1)(xii) of RBI Act, Non performing Asset means
(a) An asset, in respect of which interest has remained past due for six months.
(b) A term loan inclusive of unpaid interest, when the installment is overdue for more than six months or on which interest amount remained past due for six months.
(c) A bill which remains overdue for six months.
(d) The interest in respect of a debt or the income on receivables under the head ‘other current assets’ in the nature of short term loans/advances, which facility remained overdue for a period of six months.
(e) Any dues on account of sale of assets or services rendered or reimbursement of expenses incurred, which remained overdue for a period of six months.
(f) The lease rental and hire purchase installment, which has become overdue for a period of more than twelve months.

Income Recognition: In respect of lease asset, where lease rental are overdue for more than 12 months, the income shall be recognized only when lease rentals are actually received. The net lease rentals taken to the credit of profit and loss account before asset become non-performing and remaining
unrealized shall be reversed. (i.e. the lease rentals in respect of non-performing lease asset shall not be given credit in the Profit & Loss account.

Accounting Standards:

Accounting Standards and Guidance Notes issued by Institute of Chartered Accountants of India shall be followed insofar as they are not inconsistent with any of these directions.

Amendment text of rule 8(2) as amend on 30th June, 2000.

Lease and hire purchase assets

(2) The provisioning requirements in respect of hire purchase and leased assets shall be as under:

Hire Purchase:

(i) In respect of hire purchase assets, the total dues (overdue and future installments taken together) as reduced by

(a) the finance charges not credited to the Profit and Loss Account and carried forward as unmatured finance charges: and

(b) the depreciated value of the underlying asset, shall be provided for.

Explanation:

For the purpose of this paragraph

(1) the depreciated value of the asset shall be notionally computed as the original cost of the asset to be reduced by depreciation at the rate of twenty per cent per annum on a straight line method: and

(2) in the case of second hand asset, the original cost shall be the actual cost incurred for acquisition of such second hand asset.

Additional provision for hire purchase and leased assets:

(ii) In respect of hire purchase and leased assets, additional provision shall be made as under

(a) Where any amounts of hire charges or lease rental are overdue up to 12 months

Sub-standard assets:
(b) where any amounts of hire charges or lease rentals are overdue for more than 12 months but up to 24 months

Doubtful assets:
- © where any amounts of hire charges or lease rentals are overdue for more than 24 months but up to 36 months
- (d) where any amounts of hire charges or lease rentals are overdue for more than 36 months but up to 48 months

Loss assets:
- (e) where any amounts of hire charges or lease rentals are overdue for more than 48 months

(ii) On expiry of a period of 2 months after the due date of the lease instalment of hire purchase/leased asset, the entire net book value shall be provide for.

NOTES:
The amount of security deposits kept by the borrower with the NBFC in pursuance to the lease agreement may be deducted only against the provisions stipulated under clause (ii) above.

Submission of half yearly returns:

NBFCs including RNBFCs shall submit a half-yearly return within three months of the expiry of the relative half-year as on September and March every year, commencing from the half year ending March 31, 1998, in the form annexed hereto to the Regional Office of the Department of Non-Banking Supervision of the Reserve Bank of India under whose jurisdiction the registered office of the company is located as per Second Schedule to the Non-Banking Financial

RECOVERY OF LEASED ASSETS FROM A SICK UNDERTAKING:

In Kotak Mahindra Finance Limited Vs Deve Paints Limited, 1988 CLJ 24(b0m), the High Court interpreted section 22(1) of the Sick Industrial Companies Act and held that there is no bar in that section in repossessing leased assets as the said asset belonged to the leasing company and not to the lessee.

The noted section of the Sick Companies Act contains a restriction on any distress proceedings against the properties of the sick company. The distinction in case of leased properties is that the property belongs to the leasing company and not to the sick company.

In the BUDGET 2003-04 Service tax on banking and financial services remains the same in scope, except the rate has been increased from 5% to 8%. On leasing and asset based financing: there is no change. CST rates have been brought down to 2% but that will be effective only on implementation of VAT. The present system is as follows:

Under the sharing arrangement, all the CST collections are retained by the State concerned , States have been allowed to reduce the CST rates and also give tax exemptions. So as a general rule CST is 10% or such higher rate if the State charges a higher rate of tax on the local sale of the subject goods: or 4% with C Form, this could vary from State to State. But the State Government cannot increase the Central Sales Tax from 10/4% in any case. (No reference is made on CST Act amendment to include lease transaction),
Karnataka HC ruling on tax depreciation on leases:

There may not much of leasing happening in India as of now, but there is a lot happening on the Legislative and Judicial front - thanks to the vanished companies who filed cases and appeals when they were in business, and now find it no more worth spending money in legal fees for their near-sunk fortunes. Result: poorly argued cases before legal forums, and extreme rulings.

So, here is another big blow from the Karnataka HC - the ruling in Gowri Shankar Finance Ltd v. CIT 166 CTR 137. If the tax department follows this ruling, it would be hard for any lessor to claim depreciation on the leases being done in India.

In essence, this ruling holds that if the lessee after paying lease rentals is not required to return the goods to the lessor, the lease is not a true lease but an instalment payment plan on which depreciation will not be allowed to the lessor. The HC rules "ordinarily, the lessor is not entitled to claim depreciation on the assets leased by him because, in that case, the leased asset is used for the business/ profession of the lessee and that of the lessor." The facts in the case were almost representative of a usual lease in India, except that the assets in question were consumer durables. The HC narrates the facts: "The arrangements are made in such a way that if a customer sticks to the terms of the agreement, then, the entire amount including the lease rent gets paid before the expiry of the period of the lease and the ownership of the goods passes on from the assessee to the customers automatically. The customers are not required to return the goods to the assessee. It is like selling goods by way of installments". The HC goes on to say: "Had the assessee been leasing out the goods, then after the expiry of lease period the leased goods would be returned to the assessee for further leasing". "The goods never come back to the assessee for leasing them to any other person. Though the transaction was termed as a lease deed, in fact that was in the nature of hire-purchase/ instalment scheme".
It may be contended that in a lease, at the end of the lease period, the lessee is required to return the goods and there is no automatic transfer of title to the lessee. However, the ruling of the HC will put stress on the return of the goods to the lessor at the end of the lease period. Departmental enquiries will focus on the end-of-term treatment and it would be hard for the lessors to establish that they maintain effective control over the asset at the end of the lease term.