

Legal and Regulatory Aspect of Lease Financing in India

Dr. Hena Naaz

PhD, Department of Commerce, Aligarh Muslim University, Aligarh, India

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*Corresponding Author

Email: henaalig@gmail.com

ABSTRACT

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 sales aid in marketing their products. Laws and regulations applicable to lease financing are discussed in this paper. Though there is no special law which is applicable to such transactions, the few important laws governing the leasing transaction are: Indian Contract Act 1872, The Transfer of Property Act 1882, The Income Tax Act 1961, and the Central Sales Tax Act 1957. The main objectives of these regulations are to safeguard public interest, to enforce discipline in the growth and functioning of NBFCs and to separate good companies from bad ones and viable companies from the unviable ones.

1. Introduction

Without the legal definitions and clarifications the economic advantages that Leasing may present to borrowers, vis-a-vis conventional bank financing, would be hard to realize. A sound framework of fiscal equity and enabling regulatory environment is indispensable for the continued growth of the leasing industry [4]. Leasing is popularly known as hiring agreement in which lessor conveys to the lessee the right to use the asset in return for rental regular interval of times. Hiring transactions in India are class of bailment in contract law. The business of lease is governed by the universal rule of contracts trading with bailment dealings. Contracts law, being universal law, is codified in the Indian Contracts Act 1872 but is enriched by the past of precedents from both English and Indian magistrates. Particularly, the general law of contracts in India is based largely on the British legal ideology, which has by and large been accepted as applicable to India. Consequently, the principal sources of appropriate law on lease agreements are sections 148 to 171 of the Indian Contracts Act trading with bailment [10].

2. Concept of lease financing

The International Accounting Standards No.17 defines lease as "an arrangement whereby the lessor conveys to the lessee in return for rent the right to use the asset for an agreed period of time" [17].

Wikipedia defines "lease as a contract calling for the lessee (user) to pay the lessor (owner) for use of an asset" [14]. Whereas Investopedia defines lease as "a legal document outlining the terms under which one party agrees to rent property from another party. A lease guarantees the lessee (the renter) use of an asset and guarantees the lessor (the property owner) regular payments from the lessee for a specified number of months or years. Both the lessee and the lessor must uphold the terms of the contract for the lease to remain valid" [3]. There is a great potential for growth in Indian leasing sector by an estimate of annual expansion of 25 to 30% in the coming years, even though it is from low starting point.

There is a wide scope for expansion in vehicle leasing especially in the car financing [1].

3. Laws of Lease Financing in India

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 apply to all such transactions. The few important laws governing the leasing transactions are discussed below. The relevant laws for leasing are as follows:

3.1 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. especially 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 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 is accomplished, be returned, or disposed of according to directions of the person delivering them" [8]. The person who delivers the goods is called bailor and the person to whom the goods are delivered is known as Bailee.

Liabilities of Lessee

The liabilities of a lessee under contract of lease are similar to that of a bailee. These are as under [8].

1. **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 responsible care to protect the goods.

2. **Not to make unauthorized 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 unauthorized act in relation to the goods, if the lessee does anything which is not permissible under the lessee agreement, the agreement is immediately determined and the lessor may recover the possession of the goods.
3. **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 been accomplished.
4. **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.
5. **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.
6. **To insure and repair the goods:** A lease 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:

1. **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.
2. **Peaceful possession:** In a lease agreement the lessee is allowed only the possession of the goods to make economic use of the goods.
3. **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.
4. **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.

3.2 The Transfer of Property Act, 1882

Real estate leasing is regulated under the provisions of the Transfer of the Property Act. Real estate or immovable property has been defined to include land, benefits arising out of land, 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. The important provisions of the Act relating to lease are mentioned below [15].

i. Duration of Lease (Section 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 the 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 (Section 110)

Where the lease term is expressed as commencing from a particular day, in computing the terms of lease, such day shall be excluded

iii. Lease Agreement and the Registration (Section 107)

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 a oral agreement accomplished by delivery of possession.

iv. Rights and the Liabilities of the Lessor (Section 108)

Unless there is the contract or local usage to the contrary, the lessor has the following rights and the liabilities [8].

- 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 the 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 the Liabilities of the Lessee (Section 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 time after notice, any repairs which he is bound to 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 is bound to pay or tender, at the proper time and place, the premium or rent due to the lessor.
- g) 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.
- h) 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.
- i) The lessee must not erect any permanent structure in the property without lessor's consent.
- j) The lessee must put the lessor into possession of the property on determination of the lease.

3.3 Tax Aspect of Leasing

Leasing can be used as a vehicle of transferring the investment related tax shields from the lessee to the lessor and the former can share a portion of tax benefits accruing to the latter through a reduction in lease rentals. Specifically, both interest expenses and lease payments are tax deductible. Thus, a firm that finances its operation with debt or leases reduces its taxable income [5].

Income Tax 1961

Income 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. Whereas financial lease is treated under 'Business' head.

Depreciation Allowance on Leased Assets

The salient provisions of the Income Tax Act, 1961 relating to depreciation allowance as stated in Section 32 are as follows [16].

1. 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.
2. Depreciation on a business asset is allowed as a tax deductible expense if the asset is owned by the assessee and the asset is used by the assessee.
3. 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% of the depreciation computed as per the provisions of the Act.
4. 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%, 40% and 100%. In the case of

office buildings, the rate of depreciation is 10%. 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. Table 1 shows the different rates of depreciation which are applicable on leased assets in India.

Table 1.
Rates of Depreciation on the Leased Assets

Leased Assets	Rate of Depreciation
Motor cars	20%
General plant or machinery	25%
Lorries, buses or taxies plying on hire, aero planes, moulds used in plastic or rubber factories	40%
Bottles and crates	50%
Computers	60%
Pollution control devices, energy saving devices, renewable energy devices, rollers in flour mills, gas cylinders etc.	100%

Source: Kothari, V. (n.d). Rates of Depreciation. Retrieved from <http://www.india-financing.com/indo4.html> [11].

Sales Tax and Leasing

The Sales Tax Act, 1957 is concerned with the levy and collection of sales tax on interstate sale of goods. Sales tax laws are enacted by the state legislatures. With the enactment by the Indian Parliament of the Constitution (46th 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 considerations. Presently the states of Andhra Pradesh, Bihar, Goa, Gujarat, Haryana, Himachal Pradesh, West Bengal and certain other states have amended their existing sales tax laws to provide for levy of tax on lease rentals. Central government can impose tax on sale or purchase of goods in the course of interstate trade or commerce, outside the territory of a state and in the case of import into and export out of India [9].

A state Government can impose tax on sale or purchase of goods within the state. Lease transaction can attract sales tax in three stages i.e. the purchase of an asset by the lessor for the purpose of leasing it out to the lessee, 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 consideration and the sale of the asset at the end of the lease period [8].

3.4 Central Sales Tax Act (Import/Export of leases)

Article 286 (1b) of the constitution prohibits state legislatures for 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. Further the introduction of unified goods and service tax has resolved the disallowance on the part of input tax credit among the various tax components such as Central sales Tax, VAT and service tax and has largely reduce the level inefficiencies in the taxation norms for leasing transactions [13].

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 as follows [12].

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 occasion such export or is affected 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 occasion such import or is affected 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.

4. 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.

Policy of the Government

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.

Investment Allowance

First Leasing Company pointed out that conditions under Section 32A requires to be fulfilled by anyone 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[6].

Policy of Reserve Bank of India

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 51% of shareholding. Investment in share of subsidiaries with leasing companies should not exceed 10% of the banks paid up share capital and reserves i.e. net worth. Leasing companies have been permitted to accept deposits in the ratio 10:1 of their net worth for a minimum period of six months and a maximum period of 36 months. Leasing

companies can pay a maximum interest of 15% per annum. These leasing companies must maintain liquid assets of at least 10% of total deposits outstanding on any day [7].

5. Audit of Lease Financing Company

The essential points which must be covered while auditing the lease financing companies are

- i. To verify the lease agreement entered into with the lessee with respect to the equipment which is given on lease to the lessee.
- ii. To verify that the accounting standards related to Accounting for Leases issued by the Institute of Chartered Accountant of India (ICAI) has been compulsory followed or not by lessor and lessee companies.
- iii. The auditor should determine that the NBFCs has an satisfactory system for ensuring that the assets have been effectively insured by the lessee and the continuous maintenance of the leased assets is also being carried out by the lessee.
- iv. The auditor should also ascertain whether the NBFC has an ample appraisal system for extending equipment lease financing.
- v. The auditor should also determine that there is a satisfactory system for continuous physical verification of the assets and should also ensure proper installation of assets [2].

6. Conclusions

Indian Financial markets, especially in recent times, are in a state of revolution which is evident by the rapid growth in number of leasing companies of different kinds. The accounting profession in India needs to take note of this revolution because so far no specific guidelines and standards as such have been evolved regarding lease financing in order to make corporate reporting practices more meaningful and objective. Therefore, a time has now come to lay down clear guidelines in respect of accounting methods and presentation thereof to prevent such large issues from the decision of individual companies and that ultimately results difficulties in application of tax laws and other related regulations. These guidelines are also necessary to check the mushrooming growth of new leasing companies in India.

7. Suggestion

Laws and Regulations of lease financing should ensures that the final accounts of individual companies shows a true and fair picture of the company and any of the balance sheet financing is also brought to the notice of all concerned. At this juncture, the newly formed Accounting Standard Boards should now take the initiative to formulate and release the guidelines and standards as soon as possible in consultation with the company law board, Reserve Bank of India, the Institute of Cost and Works Accountants of India etc. The important point to remember while releasing such guidelines is, the practice of such guidelines should be made mandatory in case of all companies involved in lease financing if necessary by bringing the suitable amendments to existing laws relating to companies and tax laws.

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