IN THE INCOME TAX APPELLATE TRIBUNAL
MUMBAI SPECIAL BENCH "G", MUMBAI

Before Shri D Manmohan (V.P.), Shri R.S.Syal (A.M.), and Shri R.S.Padvekar (J.M.)

ITA No.6566/Mum/2002 : Asst.Year 1998-99
ITA No.606/Mum/2003 : Asst.Year 1999-2000

M/s.IndusInd Bank Limited 8th Floor, Tower One, One Indiabulls Centre 841 Senapati Bapat Marg Elphinstone Road (West) Mumbai – 400 013. **PAN : AAACI1314G.**	Vs.	The Addl.Commissioner of Income-tax Special Range – 15 Mumbai.
(Appellant)		(Respondent)

Appellant by : S/Shri H.P.Mahajani & D.S.Mainkal
Respondent by : Shri Pavan Ved (CIT-DR)

Date of Hearing : 01.03.2012		Date of Pronouncement : 14.03.2012

O R D E R

Per R.S.Syal (AM) :

The Hon'ble President of the Income Tax Appellate Tribunal, on a reference made by a Division Bench, has constituted this Special Bench by posting the following questions for our consideration and decision :-

"1. Whether, on the facts and in the circumstances of the case and in law, the agreement in question could be called "financial lease agreement"?.

2. Whether on the facts and in the circumstances the lessor is entitled to depreciation on assets leased by it in the event of the transaction being held as a financial lease in the light of the judgment of the Hon'ble Supreme Court in the case of Asian Brown Boveries Ltd. reported in 54 Taxman 512 (SC)".

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2. Briefly stated the facts of the case for the A.Y. 1998-99 are that the assessee bank filed its return claiming depreciation of ₹25,70,03,293. The Assessing Officer observed that there was substantial variation between the amount of depreciation as per books of account and that claimed in the computation of income. Such variation was found mainly due to 100% depreciation claimed on leased assets to the tune of ₹9,72,74,434 during the year. This depreciation was in addition to the claim of depreciation in respect of certain other assets leased in earlier years. The Assessing Officer observed that the claim of depreciation on assets leased up to assessment year 1997-98 was disallowed by him making a detailed discussion in the assessment order passed for assessment year 1997-98. Following the same, he disallowed depreciation on the assets leased prior to the year in question. In the present special bench we are concerned only with the depreciation on the asset claimed to have been leased during the current year. The particulars of such asset purchased and claimed to have been leased out during the year have been tabulated in para 2.4 of the assessment order in which it has been noted that - the Name of supplier is Thermax Limited; Name of the Lessee is Indo Gulf Fertilisers and Chemical Corporation; the Description of asset is boiler, Lease agreement is dated 04.09.1997; Cost of the asset is ₹19.45 crore; and Depreciation claimed in this year is ₹9.72 crore. On being called upon to substantiate the allowability of depreciation allowance on this lease transaction entered into with Indo Gulf Fertilisers and Chemical Corporation on 04.09.1997, the assessee furnished copy of Lease agreement, Purchase bills, Details of payment made to the supplier and also the details of Delivery challans. The assessee claimed that since he was the rightful owner of the asset, therefore, claim for depreciation was allowable. The Assessing Officer did not accept the assessee's contention for the reasons which can be summarized as under:-

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i. The assessee never got the possession of the asset, which is boiler in this case. It was a case of full payout.
ii. The risk and rewards incidental to the ownership vested with the lessee.
iii. The entire transaction was on paper for the purpose of claiming depreciation by the assessee.
iv. The lease was for a fixed term and after the expiry of the lease period, the asset was sold back to the lessee.
v. The assessee's only concern was to recover the periodic lease rentals. It was not interested in user of the asset in any manner.
vi. The documents of transaction are important but not conclusive to decide the case of the assessee. An in-depth study of the documents with inquiries showed that substance of the transaction was devoid from its form.
vii. A finance lease is analogues to outright purchase of an asset which is financed by the borrower from the lessor.

3. In the light of the above summarized position and the reasons so given in detail in the assessment order, the A.O. came to hold that the assessee was not the owner of the asset and hence ineligible for depreciation. He disallowed the depreciation to the tune of ₹9.72 crore. The assessee's alternative contention that if depreciation on the leased asset was to be disallowed by treating it as a loan transaction, then the capital recovery embedded in the lease rentals should not be charged to tax, was accepted by the A.O. in all fairness by restricting the net disallowance to ₹6,42,07,759. The facts for the A.Y. 1999-2000, in so far as the question before the special bench is concerned, are exactly similar. The assessee claimed depreciation for ₹.9.72 crore at half of the cost of the asset in A.Y. 1998-99 on the ground that it was leased out for a period of less than six months. The remaining amount of ₹.9.72 crore of the depreciation was claimed in the A.Y. 1999-2000. The AO disallowed such depreciation in the succeeding year also by

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following the view taken by him in the immediately preceding year. The first appeals for both the years did not change the fortune of the assessee on this issue. It will not be out of place to mention that another assessee, namely, Axis Bank was permitted, on request, to intervene in the Special Bench. However no one has appeared on its behalf.

4. We have heard the rival submissions and perused the relevant material on record in the light of precedents relied upon. We are taking up the facts for the A.Y. 1998-99 for decision, in respect of which the leading orders have been passed by both the authorities below. The assessee claimed to have leased out boiler to Indo Gulf Fertilizers by maintaining that it was the owner of the asset and hence entitled to depreciation. The case of the Revenue is that it is not a case of operating lease and hence the asseesee lessor cannot be granted depreciation.

I. WHETHER PRESENT AGREEMENT IS OF OPERATING OR FINANCE LEASE

5.1 In order to decide the controversy, we need to appreciate the true meaning and purport of the term `lease'. Section 105 of the Transfer of Property Act, 1882 defines lease. It provides that "a lease of immovable property is 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 transferor by the transferee, who accepts the transfer on such terms." From the above definition it can be seen that the fundamental characteristic of any lease is to separate the "use" from "ownership" of the assets. As per the above section 105 of TPA a person owning the asset, called the `lessor', provides the asset for use for a certain period of time to another called the `lessee' for some consideration. In the present commercial world, there are different types of leases such as finance lease, operating lease, deferred lease, skip lease, sale and

lease back etc. Presently we have been called upon to concentrate only on the finance and operating lease, as the assessee is claiming it to be a case of operating lease, whereas the Revenue has held the lease agreement as a finance lease.

5.2 As per Guidance note on Accounting for Leases, `Finance lease' means: `A lease under which the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset. `Operating lease' has been defined to mean : ` A lease other than a finance lease'. The phrase `fair value' as used in the definition of `Finance lease' has been further defined to mean : `The amount for which an asset could be exchanged between a knowledgeable, willing buyer and a knowledgeable, willing seller in an arm's length transaction.' The Explanation further elaborates the definition of `Finance lease' by providing that : "A lease is classified as a finance lease if it secures for the lessor the recovery of his capital outlay plus a return on the funds invested during the lease term. Such a lease is normally non-cancellable and the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset.' The learned AR has invited our attention towards clause 28 of this Guidance note which provides that the recommendations of this Guidance Note shall apply to all assets leased during the accounting periods beginning on or after 1st April, 1995. It was put forth that the assessee entered into the instant lease transaction during the previous year relevant to the assessment year 1998-99 and hence this Guidance Note shall be relevant for determining the distinction between the operating and finance lease in the years in question. From the above Guidance note we can understand the ambit of finance lease in a generic sense to mean a lease under which the lessor secures the recovery of his capital outgo plus a return on such funds during the lease term and the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair

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value of the leased asset. Another highlight of such a lease is that it is normally non-cancellable.

5.3 Accounting Standard (AS) 19 issued in 2001 explains that `A lease is an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time.' In this Accounting Standard a `Finance lease' has been defined as : `a lease that transfers substantially all the risks and rewards incident to ownership of an asset' and `Operating lease' as `a lease other than finance lease'. Para 6 of this Accounting Standard provides that a lease is classified as finance lease if it transfers substantially all the risks and rewards incident to ownership. Title may or may not eventually be transferred. Para 8 of this AS illustrates certain situations normally leading to a lease being classified as a finance lease, as under :-

> *"(a) the lease transfers ownership of the asset to the lessee by the end of the lease term;*
>
> *(b) 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 the option becomes exercisable such that, at the inception of the lease, it is reasonably certain that the option will be exercised;*
>
> *(c) the lease term is for the major part of the economic life of the asset even if title is not transferred;*
>
> *(d) at the inception of the lease the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset; and*
>
> *(e) the leased asset is of a specialized nature such that only the lessee can use it without major modifications being made."*

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5.4 Para 9 of this AS further sets out certain indicators of situations which individually or in combination could also lead to a lease being classified as finance lease, as under:-

> *"(a) if the lessee can cancel the lease, the lessor's losses associated with the cancellation are borne by the lessee;*
>
> *(b) gains or losses from the fluctuation in the fair value of the residual fall to the lessee (for example in the form of a rent rebate equaling most of the sales proceeds at the end of the lease); and*
>
> *(c) the lessee can continue the lease for a secondary period at a rent which is substantially lower than market rent."*

5.5 On a perusal of the meaning of operating lease and finance lease from the Guidance note and Accounting Standard 19 above we find there is not much difference between the two. Operating lease has been defined in both as a lease other than finance lease. And when we examine the meaning of `Finance lease' as per Guidance note along with Explanation given in para 4, it turns out that its scope is almost the same as that given in the AS 19. Rather the AS simply elaborates the concept of finance lease as given in the Guidance Note without making any qualitative addition to or subtraction from that.

5.6 At this juncture it would be relevant to note the case of *Asea Brown Boveri Limited v. Industrial Finance Corporation of India [(2006) 154 Taxman 512 (SC)]*. This judgment has been rendered u/s 10 of the Special Courts (Trial of Offences Relating to Transactions in Securities) Act, 1992. The facts of the case are that IFCI carried on the business of financing money to various buyers. Vide agreement dated 4th December, 1990, ABB Ltd. entered into lease agreement with M/s. Fairgrowth Financial Services Limited. Pursuant to the letter of offer dated 26th July, 1990 under this lease finance agreement, ABB Ltd. had taken lease finance of total 57 cars out of which one car was foreclosed, leaving 56 under lease finance.

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ABB Ltd. deposited security amount on 56 cars. As per the terms of lease finance agreement, ABB Ltd. was required to pay 25% of the purchase price of the car as security deposit on understanding between the parties that the cars were to be transferred to ABB Ltd. at the end of initial lease period of 5 years. Due to certain illegal transactions, M/s. Fairgrowth Financial Services Limited became a notified party. The Central Government appointed IFCI as the Custodian over the properties belonging to Fairgrowth. ABB Ltd. continued to make payments to IFCI in place of Fairgrowth as per lease finance agreement. ABB sent a communication to IFCI clarifying that they would be entitled under the agreement to the amounts on account of security deposit and interest thereon at the time of buy back or purchase of leased asset. Certain amount was paid by ABB Ltd. to IFCI which squared up the liability for payment and demanded that the said 56 cars be transferred in its favour by IFCI which had taken over the properties of Fairgrowth. The Special Court refused to treat the transaction between ABB and Fairgrowth as one of lease finance and instead treated it to be a transaction of lease only i.e. ABB Ltd. holding 56 cars as lessee of Fairgrowth. The Hon'ble Supreme Court, after analyzing the meaning of finance, finance lease and operating lease in great depth, directed to deliver the possession of cars to ABB Ltd. In reaching this conclusion, the Hon'ble Summit Court thoroughly analyzed the concepts of `Finance lease' and `Operating lease' in the light of Dictionary of Accounting & Finance by R. Brockington ; a book on Lease Financing & Hire Purchase by Dr. J.C.Verma ; and another Book on Lease Financing & Hire Purchase by Vinod Kothari. The features of `Finance lease' as given in the latter book, have been reproduced as under :-

"1. The asset is use-specific and is selected for the lessee specifically. Usually, the lessee is allowed to select it himself.

2. The risks and rewards incident to ownership are passed on to the lessee. The lessor only remains the legal owner of the asset.

3. Therefore, the lessee bears the risk of obsolescence.

4. The lessor is interested in his rentals and not in the asset. He must get his principal back along with interest. Therefore, the lease is non-cancellable by either party.

5. The lease period usually coincides with the economic life of the asset and may be broken into primary and secondary period.

6. The lessor enters into the transaction only as a financier. He does not bear the costs of repairs, maintenance or operation.

7. The lessor is typically a financial institution and cannot render specialized service in connection with the asset.

8. The lease is usually full-pay-out, that is, the single lease repays the cost of the asset together with the interest."

5.7 On making painstaking examination, the Hon'ble Apex Court has summed up the features of finance lease as under :-

"In our opinion, financial lease is a transaction current in the commercial world, the primary purpose whereof is the financing of the purchase by the financier. The purchase of assets or equipment or machinery is by the borrower. For all practical purposes, the borrower becomes the owner of the property inasmuch as it is the borrower who chooses the property to be purchased, takes delivery, enjoys the use and occupation of the property, bears the wear and tear, maintains and operates the machinery/equipment, undertakes indemnity and agrees to bear the risk of loss or damage, if any. He is the one who gets the property insured. He remains liable for payment of taxes and other charges and indemnity. He cannot recover from the lessor, any of the abovementioned expenses. The period of lease extends over and covers the entire life of the property for which it may remain useful divided either into one term or

divided into two terms with clause for renewal. In either case, the lease is non-cancellable."

5.8 The learned AR strongly objected to the lower authorities rejecting assessee's claim of depreciation on leased assets under the Income-tax Act, 1961 (hereinafter also referred to as the `Act') by taking support from the proposition laid down in the case of *Asea Brown Boveri Limited (supra)*. He argued that this case has been decided under the Special Courts (Trial of Offences Relating to Transactions in Securities) Act, 1992, which is an altogether different enactment, not in *pari materia* with the Act. He submitted that there is no definition of operating lease or finance lease under the Act so as to mark distinction between the two. Referring to Direct Tax Code Bill, 2010, the learned AR stated that clause 314(101) specifically defines finance lease to mean a lease transaction satisfying certain conditions as expressly provided. He further referred to clause 37(4) of the Code in which it has been provided that a business capital asset shall be deemed to be owned by the person if he is lessee in terms of a financial lease. In the absence of any such definition under the Act, the learned AR contended that it would be unfair to characterize the lease under consideration as a finance lease. It was urged that no relevance should be attached to the judgment in ABB Ltd. for the reason that the *ratio* of each case is required to be considered and examined within the parameters laid down under that particular Act under which such judgment has been delivered. He submitted that in contrast to the position under the Act and in consonance with the DTC Bill, 2010, the relevant provision in the context of service-tax precisely defines financial leasing services. He also took us through Maharashtra Value Added Tax Act, 2002, in which the definition of `Sale' covers within its scope a delivery of goods on hire purchase or any system of payment by installments. He reemphasized that the final decision of any judgment should be confined to that very statute alone under which it is rendered and should not be

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applied in other statutes. On the basis of such reasoning it was insisted that importing the *ratio decidendi* from the case of *Asea Brown Boveri Limited (supra)* to the Income-tax Act, 1961, was wholly improper.

5.9 The contention of the learned AR that the meaning assigned to the finance lease by the Hon'ble Supreme Court in *Asea Brown Boveri Limited (supra)* should not be considered under the Income-tax Act, in our considered opinion, is wholly bereft of any force. There is no doubt that the case of *Asea Brown Boveri Limited (supra)* has been decided by the Hon'ble Supreme Court in the context of Special Courts (Trial of Offences Relating to Transactions in Securities) Act, 1992. This Act consists of sections 1 to 15. Section 2 contains definitions of the words etc. used in this Act. It is pertinent to note that there is no definition of `lease' much less operating or finance lease under that Act. Thus it becomes clear that the Hon'ble Supreme Court in that case considered and decided the concept and ambit of operating and finance lease in a general manner without reference to any specific provisions of that Act. Position prevailing under the Income-tax Act is identical inasmuch as here also no definition of `operating lease' or `finance lease' has been given. It is unlike the provisions of Service-tax or the Direct Tax Code Bill, 2010 wherein specific definition has been given to finance lease. The Hon'ble Supreme Court, on consideration of relevant aspects of the matter, has laid down guiding principles for deciding as to whether a particular lease is operating or finance. The meaning to the finance lease so ascribed by the Hon'ble Supreme Court in the case of *Asea Brown Boveri Limited (supra)* is of universal application except where it has been otherwise defined in any statute. In such a situation we do not find any reason to observe departure from the general concept of finance lease as laid down by the Hon'ble Supreme court in *ABB Limited (supra)* under the Income-tax Act, 1961.

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5.10 There is no dearth of judicial precedents holding that the general meaning of a word or phrase or expression as assigned by the Hon'ble Supreme Court under one enactment without reference to any specific provision therein is binding under another enactment which again does not specifically define such word or phrase or expression. One such case is the judgment of the Hon'ble jurisdictional High Court in *Avinash Bhosale v. Union of India & Ors. [(2010) 322 ITR 381 (Bom.)].* In that case the petitioner was carrying dutiable goods on which duty was not paid. He was arrested by the Directorate of Revenue Intelligence. The bail was granted. The Directorate of Revenue Intelligence moved the Magistrate seeking judicial custody of the petitioner and also prayed for grant of permission by the Court to retain the passport of the petitioner with a view to facilitate further investigation. The Directorate of Revenue Intelligence also challenged the order granting bail to the petitioner by filing criminal application in the High Court. The High Court allowed the said application and cancelled the bail granted to the petitioner. The petitioner moved the Hon'ble Supreme Court. The order passed by the Hon'ble High Court was set aside. During the course of investigation, the Directorate of Revenue Intelligence had retained the passport of the petitioner. He moved the Additional Chief Metropolitan Magistrate seeking permission to go abroad and also sought direction against the DRI for return of the passport. As no decision was communicated to the petitioner, the petitioner filed petition before the Hon'ble Bombay High Court. The petitioner relied upon a judgment rendered by the Hon'ble Supreme Court in the case of *Suresh Nanda v. CBI [(2008) 3 SCC 674]* holding that Passport Act is a complete code in relation to impounding of the passport and even a Court exercising powers u/s 104 of Criminal Procedure Code has no authority to impound a passport. While interpreting the term "documents" appearing in section 104 of the Criminal Procedure Code, the Hon'ble Supreme Court held that the term "documents" cannot be read so widely as to include passport. In the opposition it was contended by the learned Solicitor General that

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section 23 of the Passport Act itself provides that the provisions of FERA etc. are in addition to and not in derogation of the provisions of the Passport Act. By relying on section 37(3) of FEMA, it was submitted that the power and authority of DRI includes the powers which are conferred on Income-tax authorities u/s 131(3) of the Income-tax Act, 1961 which provide for seizure as well. Rejecting this contention, the Hon'ble Bombay High court held as follows : "What is to be borne in mind is that the *apex court* was dealing with power of a court to impound a document and, in that context, *held that "document" does not include a passport*. Section 131 of the Income-tax Act vests power in regard to search and seizure in the authorities under the Income-tax Act. The authority has been vested with power to seize documents. While interpreting section 104 of the Criminal Procedure Code, which categorically deals with power of the court to impound documents, it is held that document does not include a passport. *If by an interpretative process the apex court has held that even a court cannot impound a passport, then, it would be highly inappropriate to interpret the term "documents" used in section 131(3) of the Income-tax Act, so as to enable the executive authorities to impound the passport.*"

5.11 From the above judgment of the Hon'ble jurisdictional High Court, it is apparent that when the Hon'ble Supreme Court has interpreted or explained a particular term or phrase under one enactment, it cannot lie in the mouth of the lower authorities to interpret such term or phrase in a different manner under another enactment unless the context of such other enactment otherwise requires. Coming back to the facts of the instant case, it is noticed that the Hon'ble Supreme Court in the case of *Asea Brown Boveri Limited (supra)* has given a meaning to the concept of "finance lease". Further such meaning has been given without any definition of finance lease in the Special Courts (Trial of Offences Relating to Transactions in Securities) Act, 1992. When we advert to Income-tax Act, 1961,

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here again we find that no definition has been given to the "finance lease". In such a situation we are not only empowered but also duty bound to consider and apply such meaning of finance lease given by the Hon'ble Supreme Court under the Income-tax Act, 1961.

5.12 The contention of the learned AR that the Direct Tax Code Bill, 2010 specifically defines the concept of financial lease which is absent under the Income-tax Act, 1961 and hence no artificial meaning should be given to the finance lease under the present Act, is sans merit. The obvious reason is that the Direct Tax Code Bill, 2010 is not providing anything contrary or in contradistinction to the provisions under the present Act in so far as this issue is concerned. The concepts of finance and operating lease, which are implicit under the Income-tax Act, 1961 have been made explicit under the Direct Tax Code Bill, 2010. In view of the foregoing reasons we are of the considered opinion that this contention raised by the learned AR is incapable of acceptance. The same is, therefore, jettisoned.

5.13 It is interesting to note that the Hon'ble Supreme Court once again in the case of *Association of Leasing & Financial Services Companies v. Union of India & Ors. [2010-(SC2)-GJX-0838-SC]* considered the controversy pertaining to validity of sections 65(12) and 65(105)(zm) of the Finance Act, 1994 seeking the levy of service tax on leasing and hire purchase. The Association contended that the levy of service tax under these sections on financial leasing services including equipment leasing and hire purchase was beyond the legislative competence of Parliament. Rejecting this contention and dismissing the appeal, the Hon'ble Supreme Court held that the imposition of service tax relating on financial leasing services including equipments leasing and hire purchase is within the legislative competence of the Parliament. In coming to this conclusion the Hon'ble Supreme

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Court noticed the distinction between `finance lease' and `operating lease' as under:-

"In this connection, as and by way of illustration we need to give an illustration which brings out the distinction between a "finance lease" and "operating lease". A finance lease transfers all the risks and rewards incidental to ownership, even though the title may or may not be eventually transferred to the lessee. In the case of "finance lease" the lessee could use the asset for its entire economic life and thereby acquires risks and rewards incidental to the ownership of such assets. ***In substance, finance lease is a financial loan from the lessor to the lessee.*** *On the other hand an operating lease is a lease other than the finance lease. Accounting of a "finance lease" is under AS-19, which as stated above, is mandatory for NBFCs. It is a completely different regime. According to Chitty on Contract, a hire-purchase agreement is a vehicle of instalment credit. It is an agreement under which an owner lets chattels out on hire and further agrees that the hirer may either return the goods and terminate the hiring or elect to purchase the goods when the payments for hire have reached a sum equal to the amount of the purchase price stated in the agreement or upon payment of a stated sum. The essence of the transaction is Bailment of goods by the owner to the hirer and the agreement by which the hirer has the option to return the goods at some time or the other. Further, in the bailment termed "hire" the bailee receives both possession of the chattel and the right to use it in return for remuneration to be paid to the bailor. Further, under the head "equipment leasing", it is explained that it is a form of long-term financing. In a finance lease, it is the lessee who selects the equipment to be supplied by the dealer or the manufacturer, but the lessor [finance company] provides the funds, acquires the title to the equipment and allows the lessee to use it for its expected life. During the period of the lease the risk and rewards of ownership are transferred to the lessee who bears the risks of loss,*

destruction and depreciation or malfunctioning. The bailment which underlies finance leasing is only a device to provide the finance company with a security interest [its reversionary right]. If the lease is terminated prematurely, the lessor is entitled to recoup its capital investment [less the realizable value of the equipment at the time] and its expected finance charges [less an allowance to reflect the return of the capital]. In the case of hire-purchase agreement the periodical payments made by the hirer is made up of :
(a) consideration for hire
(b) payment on account of purchase"

5.14 Thus it is apparent that the broader guidelines laid down by the Hon'ble Supreme Court in the case of *ABB Ltd* have been reiterated in the latter case of *Association of Leasing & Financial Services Companies v. Union of India & Ors.* On a fair reading of the aforenoted two judgments rendered by the Hon'ble Supreme Court in the light of the Guidance Note and the AS 19, we can draw the following broad features of finance lease :-

- Such a lease is non-cancellable and there is a fixed obligation on the lessee for payment of lease money. In case lease is terminated prematurely by the lessee, the lessor is entitled to recover his investment with expected interest.
- Such a lease is always for a fixed period, which period is decided by taking into consideration the economic life of the asset.
- The initial lease period is settled in such a way so as to fully recover the investment of the lessor together with interest thereon.
- Lessor is always interested in the recoupment of his investment with interest in the shape of rentals over the period of lease and not the asset or its user.

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- It is the responsibility of the lessee to bear all costs of insurance, repairs and maintenance and other related costs and expenses for the leased equipment.
- Though the equipment is chosen by the lessee but the payment to the supplier is made by the lessor. Thus it is the lessee who chooses the assets, takes delivery, enjoys the use of the asset, bears its wear and tear. It is the lessee who becomes the real owner of the asset.
- It is the lessee who pays taxes etc. in relation to such asset.
- The risks and rewards incidental to the ownership vest with the lessee.
- The features of bailment are absent in such a lease.
- The lessor simply holds the title of asset as his security till his investment and interest thereon is recouped. The lessor is only symbolic owner during the period of lease and on the expiry of lease period, even such symbolic ownership also comes to an end.

5.15 Now we will proceed to examine the nature of present lease agreement which was entered into on 4th September, 1997 between the assessee and M/s. Indo Gulf Fertilizer & Chemical Corporation Limited, a copy of which is available at pages 91 onwards of the paper book, to determine whether or not it substantially satisfies the conditions of finance lease.

a. Lease agreement is non-cancellable and there is fixed obligation on lessee

Clause 19 reads as under:-

"(c) "FIXED PERIOD"

*The **"Fixed Period" of the Lease** as defined in Lease Summary Schedule hereof, which is **non-cancelable** by the Lessor and / or the Lessee except as provided in Clause 18.1 hereof."*

From the above clause it is apparent that lease is for a fixed period which is non-cancelable by the lessor and / or lessee except as provided in clause 18.1. Clause 18.1 reads as under:-

> *"On the occurrence of any of the events specified below, the **Lessor shall be entitled**, without prejudice to any other rights or remedies which the Lessor may have under this Lease or otherwise in law and **notwithstanding any subsequent Termination acceptance of lease rentals**, to terminate this Lease, without any notice except as specified in 18.1.2 hereof and at any time **after the occurrence of such event.**"*

Clauses 18.1.1 to 18.1.6 of the Agreement speak of the inability of the lessee either to pay lease rentals or to neglect to perform any breach of the agreement etc. Clause 18.2 stipulates that on termination of this lease pursuant to clause 18.1, the lessor as per clause 18.2.1 shall be entitled to remove and repossess the equipment and clause 18.2.2(i) stipulates that in addition to lessor's right under clause 18.2.1, the **lessor shall be entitled to recover from the lessee `the entire amount of lease rentals for the fixed period of lease'**. The lessee is not only liable to pay to the lessor all arrears of lease rentals up to the date of pre-mature termination of the lease but also such further amount for the then expired residue, the amount which the lessee would have been otherwise bound to pay to the lessor had the lease continued. These clauses indicate that the lease agreement is non-cancellable and there is fixed obligation on the lessee for payment of lease rental for the entire lease period of seven years notwithstanding the fact that lease may be cancelled pre-maturely.

b. Lease period is fixed to sufficiently recover the cost of asset plus interest

This lease is valid for a period of 7 years. It is pertinent to note that the cost of the leased asset is ₹19.45 crore and during the period of said 7 years the assessee, as per the Synopsis given by the learned AR, has recovered lease rentals of ₹27.95

crore comprising of the full principal amount and and also interest of ₹8.18 crore. When we compare the cost of the asset vis-à-vis lease rental over the period of lease period, it becomes absolutely clear that the period of lease is equal to or very close of the economic life of the asset and the assessee has recovered its principal amount along with interest within the lease period of 7 years. In order to ensure that there is no difficulty in recovering the cost of the asset plus interest over a period of 7 years, the assessee has obtained post-dated cheques towards lease rentals.

c. Sale of asset to lessee at the end of lease period at a pre-determined price.

It is further relevant to note that it has been decided between the assessee and Indo Gulf that the asset would be sold to the latter at the end of the lease period at a fixed residual value equal to 1% of the cost of the asset. This pre-determined residual value clause has been inserted to ensure that the assessee must necessarily part with its formal ownership of the boiler at the end of the lease period so that the lessee becomes absolute legal owner apart from the existing real owner. It can be noticed from the Synopsis given by the ld. AR that on 29.03.2005 i.e. at the end of the lease period the asset was sold for a consideration of ₹19,45,489 (which is exactly equal to 1% of the purchase price) to M/s.Hindalco Industries Limited. The learned AR submitted that M/s. Hindalco Industries Limited took over Indo Gulf Fertilisers and Chemical Corporation, the hitherto lessee. It, therefore, shows that the boiler which was leased out to Indo Gulf Fertilisers and Chemical Corporation remained with it even after the expiry of the lease period.

d. Repairs and Insurance of the boiler is sole liability of the lessee

Clause 7 of the agreement stipulates that the lessee shall install, use and operate the equipment carefully and maintain the same in good working condition and repair at its cost and expenses. It is further relevant to note that the entire liability towards

insurance has been cast on the lessee and not the assessee-lessor. Clause 8.1 of the agreement clearly provides that the equipment shall be insured in the joint names of the lessor and lessee but the insurance premium shall be paid by the lessee alone. Clause 8.3 is quite relevant, the relevant portion of which is reproduced as under:-

> *"8.3 Notwithstanding anything herein contained in 8.2 above the Lessor may at its option agree that any insurance receipts recoverable under the said insurance shall be applied at the option of the Lessor:*
>
> *(i) in making good the damage, or*
> *(ii) in replacing the Equipment to which the terms of this Lease shall apply.*
> *(iii) In appropriating all the outstanding dues of the lessee and the principal outstanding (as per CRR method) under the lease. Any shortfall / surplus available after adjusting all the dues would be on lessee's account.*
>
> ……
> *provided that in the event of irreparable loss or damage to the Equipment as a whole the Lessor shall be entitled to terminate this Lease and to retain any insurance receipts by the Lessor in respect thereof. All insurance claims received by the Lessor would be adjusted towards the dues of the Lessee."*

From the above clause it can be observed that if the lessor receives any insurance claim it shall be applied by him towards dues of the lease. It is obvious for the reason that since the liability to pay insurance premium has been fastened on the lessee, it is but natural that if any insurance claim is received by the lessor from the insurance company because of joint insurance policy, the lessor will be liable to return such amount to lessee or adjust the amount so received towards lease rentals etc. It indicates that the onus of paying the insurance premium in respect of the boiler has been put on the lessee and not the lessor.

e. It is the lessee who has to choose the equipment.

The lessor has no role in the selection of equipment or supplier or to settle other terms and conditions including warranties etc. In this regard Clause 15.1of the agreement is relevant which reads as under:-

> *"The **Lessor hereby appoints the Lessee as its agent to inspect and receive delivery and installation of the Equipment** from the Acceptance of manufacturer. By accepting the Equipment, Lessee shall be deemed to have examined the Equipment and to have found it complete, in proper order and condition and entirely fit for its purpose and the **Lessee does not and will not, at any time, have any claim against the Lessor in respect of or arising out of the Equipment.**"*

From the above clause it is apparent that not only the equipment to be leased shall be finalized by the lessee but it is the lessee who has undertaken to inspect and receive the delivery and installation of equipment directly from the manufacturer. It is the responsibility of the lessee to ensure that the equipment so received is complete in all respects and in case any deficiency is found later on, it would be the lessee who will be responsible for this.

f. Lessee to pay all taxes and obtain necessary licences and permissions

In this regard it is relevant to note clause 9 of the agreement, the relevant part of which is as under:-

> *"9.1 The **Lessee shall** during the period of this Lease and till the Equipment is delivered back to the Payment of Lessor in good working order and condition (fair sales tax and wear and tear accepted) **bear all imposts, rates and charges other charges and all other duties, taxes other charges and penalties as may as may be levied from time to time by the Government or any other authority pertaining to or in respect of this Lease** and pay the same on demand by the Lessor.*

> *9.2 The Lessee agrees that the transaction covered by this Lease is not understood to be a sale eligible to tax under the existing sales tax laws. If, however, by reason of any amendments of any law, Central or State, this transaction is held to be eligible to tax, as a sale or otherwise, either in whole or in part, or any input or material or equipment used or supplied in executing of or in connections with the Lease are eligible to tax, the* ***Lessee shall pay such tax immediately upon the same becoming payable or reimburse the same to the Lessor*** *in addition to the lease rentals payable under the Agreement.*
> …….
>
> *9.4 The* ***Lessee shall punctually and duly pay*** *or cause to be paid* ***all rates, taxes licence fees, surcharges, registration charges and other outgoings payable in respect of the Equipment*** *or the storage, installation, use or operation thereof or of the premises where the same is kept and on demand produce to the Lessor all receipts and other evidence of such payments.*
>
> *9.5 The* ***Lessee shall obtain and keep effective all necessary licences, permissions and consents*** *for the storage, installation and use and operation of the Equipment and furnish the same to the Lessor on demand."*

From the above clauses it is easily deducible that it is the sole responsibility of the lessee to pay all the taxes in connection with the equipment. Such liability extends not only to the taxes paid at the time of purchase of the equipment but also throughout the lease period. Though such transaction has been understood as not being covered under the existing Sales-tax Law but it has been agreed that in case sales-tax becomes payable on this transaction under any circumstance, it will be the liability of the lessee and not the lessor. In case lessor is forced to pay such sales-tax, he shall be entitled to recover it from the lessee. Further all rates and taxes, licenses, fees, surcharge, registration charges etc. in respect of equipment shall be paid by the lessee. It is important to note that apart from paying all taxes, it is the lessee who shall be responsible to obtain and keep alive all necessary licenses, permissions etc. in connection with installation and usage of the equipment. It is,

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therefore, abundantly borne out that the lessee has been made responsible to pay all taxes and obtain all the licenses and permissions in connection with the equipment.

g. Elements of bailment missing

Operating lease can be well equated with the bailment. Section 148 of the Indian Contract Act, 1872 defines `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 otherwise disposed of according to the direction of the person delivering them'. Section 151 of the Indian Contract Act provides that in all cases of bailment, the bailee is bound to take as much care of the goods bailed to him as a man of ordinary prudence would, under similar circumstances, take of his own goods of the same bulk, quantity and value as the goods bailed. Section 152 with the title `Bailee when not liable for loss, etc. of the thing bailed', which is quite relevant, provides that : "The bailee, in the absence of any special contract, is not responsible for the loss, destruction or deterioration of the thing bailed, if he has taken the amount of care of it described in section 151". On a conjoint reading of the above relevant sections of the Indian Contract Act, it clearly emerges that the duty of the bailee to take care of the goods under bailment is equal to that a man of ordinary prudence takes. Taking such care of goods bailed excludes special care on account of the reasons beyond the control of bailee. It is simple and plain that if during the period of bailment, the item bailed is destroyed due to natural calamity etc. which is obviously beyond the control of bailee, no responsibility for such loss can be put on him. The bailee, in the absence of any special contract, can never be saddled with a liability towards the loss occurring to the goods bailed for the reasons absolutely beyond his control. That is the reason for which operating lease can be equated with bailment because it is the lessor who is responsible for the loss of goods during the lease period arising due to no fault of the lessee. For example, if a motor car is leased for a period of a week and during such period earthquake

occurs causing immense loss to the car, in such a situation the lessee cannot be held responsible for the loss to the motor car. It is so because the occurrence of earthquake is a factor that surpasses the prescription of section 151 of the Contract Act, being the care which a man of ordinary prudence would under similar circumstances take of his own goods. In such a case it will be the lessor who will bear such loss. With this background let us turn to the terms of the agreement to ascertain whether the present lease can be equated with bailment. Clauses 13 and 14, which assume significance in the present context read, as under:-

> *"13. The* ***Lessee shall bear the entire loss of or damage Destruction or to or the destruction of the Equipment or any of damage to the its integral parts due to any reason or cause Equipment whatsoever*** *or due to its or any of its parts being rendered unfit for use or operation for any reason whatsoever and no such loss of or damage to or destruction of the Equipment or any of its parts shall impair / release or discharge the Lessee of its obligation to duly pay the lease rentals and observe and perform the terms and conditions herein contained. In the event of such loss or damage, the Lessee shall after obtaining the Lessor's prior consent in that behalf, at his (Lessee's) cost, replace the Equipment or the parts thereof as the case may be of Equipment or parts thereof of the same or like design and make, which in the opinion of the Lessor, are in good working order and condition and in all respect, comparable to the one to which loss / damage occurred or which are rendered unfit for the use or operation…….*
>
> *14. The* ***Lessee shall indemnify and keep indemnified the Lessor, at all times, against any loss or seizure of the Equipment under distress, execution or other legal process or destruction or damage to Third Party Claim the Equipment by fire, accident or other cause, from any claim or demand arising out of the storage, installation, use or operation of the Equipment or any risk or liability for death or loss of limb of any person whether employee of the Lessee or of third party and hold the Lessor harmless, against all losses, damages claim penalties, expenses, suits, or proceedings of Whatsoever nature*** *made, suffered or incurred consequent thereupon and for this purpose take out such workmen's compensation third party insurance*

cover as may be necessary, customary to the practice in the business carried on by the Lessee or as may be directed by the Lessor, in that behalf."

From the above clauses it can be seen that it is the lessee who has been made absolutely responsible to bear the loss due to damage or destruction of the equipment for any reason whatsoever. The responsibility of the lessee is not restricted only to taking "as much care as a man of ordinary prudence would" as warranted under section 151 of the Contract Act, but complete in all respects extending to all situations. Any loss occurring to the equipment or its parts, while taking due care or otherwise, is the solitary liability of the lessee. Even if the loss arises due to any natural calamity such as fire, accident, or in any manner whatsoever, it is the lessee who shall bear such loss. It is further imperative to note that it is not only the liability put on the lessee to bear the loss to equipment under any circumstance, but clause 14 of the agreement also mandates that the lessee will be liable even for the damages to third parties towards any loss caused due to equipment. Thus it is manifest that the element of bailment is completely missing in the instant agreement.

h. Risks and Rewards

We have noticed above that in the case of finance lease, risks and rewards of the ownership vest with the lessee and not the lessor. Various rewards of ownership of an asset can be illustrated as under:-

(a) right to exclusively use the asset.

(b) right to prohibit anybody else from using the asset or sharing the benefits of appreciation;

(c) right to prohibit anybody from transferring the asset;

(d) right to claim damages, warranties, etc. from the supplier;

(e) right to claim any subsidies or other benefits or concessions attached

to ownership of the asset etc.

Turning to the instant lease agreement it can be observed that it is the lessee alone who has the right to use the asset not only during the period of lease of seven years but after that also as the agreement itself provides for sale of the boiler to Indo Gulf after the expiry of the lease period at a pre-determined value of 1% of the cost of asset. The assessee cannot cancel the lease period at his option and repossess the asset at any time. It is only the lessee who has to decide about the user of the asset. He has got the exclusive right to use the asset. Irrespective of the fact whether the boiler is used or not or even kept idle for a fairly long period, the assessee cannot compel him in any manner either to use the boiler or return it. Whether there is any appreciation or depreciation in the value of boiler, it is only the lessee who has to share the benefit or take the risk. The assessee-lessor has no authority whatsoever to lease out the boiler to anybody else during or after the lease period of 7 years. Any other benefit such as the right to claim damages, warrantees, etc. from the supplier also vest with the lessee alone. The assessee can in no case claim any subsidiary or other benefit attached to the ownership of boiler.

Now let us illustrate various types of risks attached to the ownership of an asset:-

(a) loss due to idle capacity;
(b) loss due to technical obsolescence of the asset;
(c) loss due to the asset not being fit for the purpose or merchantable;
(d) loss due to damage in transit;
(e) loss due to damage during installation or operation;
(f) liability to pay any taxes attaching to ownership of the asset;
(g) liability due to any statutory offences committed because of ownership, use or operation of the asset.

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It is amply borne out from various clauses of the lease agreement as discussed above that any loss occurring due to obsolescence of the boiler shall be borne by the lessee alone. In no way the assessee-lessor can be compelled to share the loss from the technical obsolescence of the boiler. Further if the boiler is not found to be fit for use it is the lessee alone who is responsible. Clause 13 of the agreement as extracted above clearly shows that the lessee shall bear the entire loss of damage or destruction to the equipment. Further clause 15.1 of the agreement also clearly stipulates that the lessor appoints the lessee to inspect and receive the delivery and installation of the equipment. Clause 15.3 of the agreement makes it abundantly clear that : "The Lessor shall not be responsible for any direct, indirect or consequential loss to the Lessee or third party arising from any delay in delivery and / or installation of the Equipment either by the action of the manufacturer or otherwise however or by reason of any delay in the commencement of the Lease". It is relevant to note clauses 16.5 and 16.6, as reproduced below, which make it absolutely clear that the assessee shall in no way be responsible to the lessee for any loss, damage arising from the transportation and delivery of the equipment, lease of the equipment, its storage, installation, or its failure to operate from performing or otherwise howsoever.

> *"16.5 The* ***Lessor shall in no way be liable or responsible to the Lessee for any liability, claim, loss, damage of any kind or nature whatsoever arising from the transportation and delivery of the Equipment, lease of the Equipment, its storage, installation, use of operation or its failure to operate or perform or otherwise howsoever.***
>
> *16.6 No manufacturer, dealer or supplier by whom the Equipment was or is to be supplied, is or shall be deemed to be the agent of the Lessor for any purpose and* ***no liability shall attach to the Lessor for any conditions, warranties*** *or representations made by such dealer or supplier or persons in their employment".*

The above clauses make it clear that any loss to the boiler even in the transit shall be borne by the lessee and not by the assessee-lessor. It is further important to note clauses 9.1 and 9.2 of the agreement as extracted above to the effect that the lessee shall bear all rates, taxes and other charges and if by any reason whatsoever any further statutory liability arises, it shall be the lessee alone who shall pay such taxes and if the lessor has already paid it shall be reimbursed to him.

From the above, it becomes clear that the risks and rewards of the ownership of the asset vest with the lessee and the assessee-lessor is not entitled to any reward or liable for any risk attaching to the boiler.

5.16 The above discussion in the light of the relevant clauses of the agreement fairly indicates that all the criteria of finance lease are fully satisfied in this case. Lease agreement is non-cancellable for a period of seven years and thereafter the leased asset has been pre-decided to be sold at 1% of the original cost to the lessee. While deciding the lease rental and the period of lease, the assessee's investment has been duly taken into consideration to ensure that the full cost of the asset leased out by the assessee together with interest is recouped within the said period of seven years. It is the sole responsibility of the lessee to bear repairs and maintenance cost and also insurance premium. Boiler has been chosen by the lessee who has taken the delivery of it. It is the lessee who has to pay all the taxes. Features of bailment are completely absent. The risks and rewards incidental to the ownership are vested with the lessee. What the assessee as a lessor owns is not any asset but the contracted stream of payments in the shape of lease rental covering its entire investment plus interest. Such lease rentals have been ensured by way of the assessee taking post-dated cheques for the entire lease period. On the other hand what the lessee has got is not just a rented boiler but a fixed non-terminable agreement under which it is obliged to pay the rentals. These factors strongly

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indicate that whereas the lessee is the actual or real owner, the lessor-assessee is only nominal or symbolic or the so-called perceived owner.

5.17 Here it is important to note the underlying basic distinction between advancing a simple loan and finance lease. Where as financing is genus, finance lease is its species. In the case of a loan simpliciter, the lender only advances loan without acquiring even a nominal title in the asset against which loan is given. It has been noted above that a lease contemplates a lessor, a lessee and the asset which is leased. In that view of the matter, the very nature of finance lease pre-supposes that existence of the lender as a lessor. The essence of finance lease and loan simpliciter is same, that is, to advance money to the borrower by the lender. To provide sanctity to the finance lease, the lessor acts as a nominal or symbolic owner. If the element of lessor as a nominal owner is removed, the transaction of financing will go out of the ambit of `finance lease' and fall with in the overall category of advancing simple loan. That is why there has to be necessarily some nominal owner of the asset in a case of finance lease.

5.18 The learned Counsel for the assessee invited our attention towards certain clauses of the agreement which in his opinion go to prove that it is a case of operating lease and not finance lease agreement.

i. The preamble of the agreement provides that the *lessor has agreed to purchase and let on lease the equipment to the lessee* subject to the conditions stated in agreement. As per the learned AR it is the lessor who agreed to purchase the boiler ; in fact purchased; and thereafter let it on lease to the lessee.

ii. As per clause 3.4 the *lessee shall not claim depreciation* but it shall be the *lessor who will be entitled to claim such allowances*. It was argued that only an

owner of an asset can claim depreciation. Since the agreement unequivocally states that the depreciation shall be claimed by the lessor and not the lessee, it was put forth that it showed the lessor as the real owner.

iii. Clause 3.5 of the agreement clearly mandates that `*the lessee is not the owner of the Equipment'*.

iv. Clause 5 states that lessee shall affix a name plate or other *mark on the equipment identifying the sole and identification exclusive ownership thereof of the lessor* and not allow or permit the same to be removed or defaced.

v. Clause 6 states that the *lessee acknowledges, confirms and declares that it holds the equipment as a mere bailee of ownership of the lessor.*

vi. Clause 8.2 provides that the lessee shall give to the lessor immediate written intimation on receipt of any claim arising under insurance policy.

vii. Clause 11 provides that the *lessee shall not make any alteration, addition or improvement to the equipment* or change the condition thereof *without the prior written consent of the lessor.*

viii. Clause 12 states that the lessee shall not transfer, assign or otherwise dispose off or perpetuate to allow or create any lien, charge etc. in any manner to part with the possession of the equipment.

ix. Clause 14 provides that the lessee shall indemnify and keep indemnified the lessor at all times against any loss or the seizure of the equipment.

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x. Clause 18.1.1 provides that if the lessee fails to pay rentals on the dates given in the supplementary lease schedule, the lessor has right to terminate this lease.

5.19 In the light of the above clauses, the learned AR vehemently argued that there was a clear mandate in the lease agreement that it is the assessee who is the real owner of the equipment and hence it should be considered as a case of operating lease and not a finance lease.

5.20 In view of the fact that the ld. AR has lodged a strong claim to consider the present agreement as that of operating and not a finance lease, it is imperative to understand the distinction between the two as under :-

a. In the case of an operating lease, the lessor provides the asset for use for a certain period of time to the lessee for rent. On the expiry of such lease period, the lessor has to inevitably repossess the asset. On the other hand, a case of finance lease is in essence an arrangement for borrowing. The role of lessor is limited to that of financier only.

b. In operating lease, it is the lessor who bears the loss and obsolescence of the asset leased, whereas in case of finance lease it is the lessee who always bears such loss.

c. In the case of an operating lease, the lessor remains the owner of the asset throughout the lease period and thereafter also , whereas in a finance lease it is the lessee who becomes the real owner. The lessor's title over the asset is only symbolic to serve as security for the rentals, which are nothing but the return of his investment with interest.

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d. Operating lease is cancellable, whereas finance lease is always non-cancellable. In a case of finance lease, the lessor is interested in lease rentals and not the asset.

e. In the case of an operating lease, substantial risks and rewards of ownership of the asset remain with the lessor, whereas in the case of finance lease these *ab initio* vest with the lessee.

f. In the case of an operating lease, the fixation of lease rental bear no symmetry with the economic life of the asset and the possibility of the asset reverting back to the lessor can never be ruled out. However in the case of a finance lease, the lease period is ordinarily equal to the economic life of the asset and lease rentals are fixed in such a way so as to recover the investment with interest during the lease period itself. The possibility of the asset reverting back to the lessor is never there.

g. In the case of an operating lease, the asset is ordinarily common use utility whereas in case of finance lease the asset is normally selected by the lessee himself so as to suit his particular requirements.

h. Normally an operating lease is non payout whereas a finance lease is full payout. Full payout lease means that the lessor recovers the full value of the leased asset plus the finance cost over the period of first lease. Full payout lease is peculiar to finance lease. On the other hand, a non payout lease is one where the lessor is not interested in recovering his principal investment plus interest from one lessee only because he may lease out the same asset over and over again. Though no single lease recovers the principal amount plus interest component of the lessor

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but all the leases taken together make it a full payout. That is why the non payout lease is peculiar to operating lease.

5.21 From the above points of distinction between operating lease and finance lease, the salient features of operating lease have become glaring. Now let us ascertain as to whether the above clauses, claimed by the ld. AR as amply proving it to be a case of operating lease agreement, do in fact prove it so. In an earlier para we have observed that this lease agreement fully satisfies all the characteristics of finance lease. The position which, therefore, emerges is that some clauses of the agreement tend to give impression of this being an operating lease whereas the others largely indicate it to be a finance lease. How to resolve the conflict? In order to decide as to whether the instant lease agreement be characterized as operating or finance lease, we need to take shelter of the doctrine of pith and substance. This rule stipulates that if there is some overlapping in the contents of the clauses of an agreement, then it becomes necessary to examine the pith and substance of the agreement. It can be done by seeing as to whether it predominantly satisfies the conditions of operating lease or finance lease. The crux is that we should find out the substance of the agreement.

5.22 We have highlighted the broad features of operating lease such as, the lease is cancellable; the lessor provides services, maintenance and insurance; total of all the lease payments by the lessee does not provide for the recovery of the investment with interest. Further the operating lease generally covers the asset which can be needed by different users so that the lessor may make available to one lessee after another.

5.23 Now let us try to find out the substance of the extant lease agreement as to whether it predominantly satisfies the conditions of an operating lease. On reading

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the lease agreement as a whole, we find that except for naming the lessor as owner at some places in the agreement and inserting certain cosmetic clauses to give the colour of operating lease, there is nothing in substance which satisfies the inherent requisites of operating lease. It can be observed that the lease is not cancellable prior to the expiry period of seven years. The cost of repairs and insurance is to be borne by the lessee. Sum total of the lease rentals by the lessee recoups the amount invested by the lessor plus interest. There is a clause that after the expiry of seven years period, the boiler will be sold to the lessee at predetermined value. It is the lessee who has to bear the loss due to obsolescence. All the risks and rewards vest with the lessee. When we consider the cumulative effect of all the factors for and against the operating lease, it can be easily found out that if one has to choose between the finance lease and operating lease, there can be no difficulty in reaching the irresistible conclusion that it is a case of finance lease agreement. In pith and substance this agreement is nothing but a finance lease.

5.24 Our view is fortified by the RBI Circular No.FSCBC 18/24-01-001/93-94 dated 14.02.1994 which *inter alia* deals with equipment leasing. It is needless to say that this circular is binding on the assessee bank. Para 1(i) of it provides that the activities like equipment leasing, hire purchase and factoring services should be undertaken only by certain selected branches of the Bank. Para 1(ii) which is relevant for our purpose reads as under:-

> *"(ii)* ***These activities should be treated on par with loans and advances*** *and should accordingly be given risk weight of 100 per cent for calculation of capital to risk asset ratio. Further, the extant guidelines on income recognition, asset classification, asset classification and provisioning would also be applicable to them."*

Paras 1(v) and (vi) which are also relevant read as under:-

> *"(v)* ***Banks undertaking equipment leasing*** *departmentally should follow prudential accounting standards. The* ***entire lease rental should not be taken to the bank's income account****. It would be recognized that* ***lease rentals comprise two elements a finance charge*** *(i.e. interest charge)* ***and a charge towards recovery of the cost of the asset.*** *The* ***interest component alone should be taken to the income account****. The* ***component representing the replacement cost of the asset should be carried to the balance sheet in the form of a provision for depreciation****.*
>
> *(vi) As a prudent measure,* ***full depreciation should be provided for during the primary lease period of the asset****. The period of lease should not normally exceed five years. In exceptional cases, lease period not exceeding 7 years may be fixed in respect of lease transactions covering assets of Rs.1 crore and above, as the recovery of cost may not be possible in a period of 5 years."*

5.25 On perusal of the above paras of the above circular it becomes patent that the equipment leasing activity should be treated by banks "*on par with loans and advances*". The further contents of para 1(ii) which provides that the guidelines on income recognition, asset classification and provisioning would also be applicable to them, make it clear that the activity of equipment leasing should be considered as an act of advancing loans and advances. It is so for the reason that the guidelines on income recognition and asset classification etc. as referred to herein, are applicable to loans and advances. Further para 1(v) provides that the entire lease rental should not be taken to the bank's income account. Only the interest component being the finance charge should be taken to the income account and the second component being charge towards recovery of the cost representing the replacement cost of the asset should be carried to the balance sheet in the form of a provision for depreciation. Para 1(vi) states that as a prudent measure full depreciation should be provided for during the preliminary lease period of the asset. It is impermissible to read para 1(vi) of the Circular in isolation to support the contention that the RBI permits claiming depreciation on the leased assets. It is

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in fact not so because the Circular as a whole treats the activity of equipment leasing as that of loans and advances and the reference to full depreciation in para 1(vi) should be read in juxtaposition to para 1(v) which talks of the second component of the lease rental being the replacement cost of the asset. When we read this Circular in entirety, there remains no doubt that the activity of equipment leasing has to be considered by a bank on par with the loans and advances.

5.26 In view of the above circular we do not find any scope for argument that the instant lease agreement be treated as that of operating lease. Since the loans and advances encompass finance lease, naturally such type of equipment leasing cannot be given any name other than the finance lease. Here it is relevant to note that the assessee claimed depreciation on leased asset and also showed full amount of lease rental as income in contravention of para 1(v) of the afore noted RBI Circular. When the Assessing Officer concluded that the instant lease cannot be characterized as finance lease, the assessee requested the A.O. that in case the depreciation on the leased asset to assessee is not to be granted by treating it as a loan transaction, then the capital recovery embedded in the lease rental should not be charged to tax. This issue has been discussed in para 2.30 of the assessment order. Acceding to the assessee's request, the Assessing Officer excluded the portion of capital recoveries from the rental income. Thus it can be observed that the action of the A.O. is fully in consonance with the RBI Circular which states that in case of equipment leasing the entire lease rental should not be treated as bank's income but only that component of such lease rental which represents finance charges i.e. interest should be recognized as income alone.

5.27 We, therefore, approve the view taken by the authorities below in coming to the conclusion that the lease agreement under consideration is that of finance lease and not operating lease.

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II. WHETHER DEPRECIATION ADMISSIBLE IN CASE OF GENUINE FINANCE LEASE

6.1 The learned Counsel for the assessee took his argument further by contending that even if it is treated as a case of finance lease still the claim of depreciation to the assessee-lessor cannot be denied. Relying on the judgment of the Hon'ble Supreme court in *CIT v. Shaan Finance Pvt. Ltd. [(1998) 231 ITR 308 (SC)],* he stated that the Hon'ble Supreme Court has allowed investment allowance u/s 32A to an assessee engaged in the business of leasing of machines. It was argued that there is no difference between the conditions for grant of investment allowance vis-à-vis depreciation insofar as the user of equipment is concerned. It was thus stated that the very act of the assessee in leasing the equipment to Indo Gulf Fertilisers and Chemical Corporation should be treated as the user of the leased asset. Since both the conditions of section 32, being the ownership and user of the asset, have been satisfied by the assessee in the instant case, he urged that there can be no question of denying depreciation to the assessee. He further invited our attention towards a Circular of CBDT mandating that an integrated approach should be adopted so that the depreciation is not denied to both the parties. It was put forth that since the lessee had not claimed any depreciation, the assessee's right to such depreciation on the leased asset cannot be justifiably denied. Per contra, the ld. DR relied on the orders of the authorities below in support of his contention that the depreciation has been rightly not allowed.

6.2 We have heard the rival submissions on this issue and perused the relevant material on record. In the earlier part of the order we have held, on the perusal of terms and conditions of the agreement, that it is an agreement of finance lease and not operating lease. Now the question which looms large is - Whether any depreciation can be allowed to lessor in case of a genuine finance lease ?

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Allowability of depreciation is governed by section 32. The twin conditions of ownership and user of asset for the purpose of business are required to be cumulatively satisfied so as to allow depreciation. Let us examine as to whether the lessor satisfies the preliminary condition of being an owner of the asset in a case of finance lease. In the detailed discussion made above we have taken note of the salient features of finance lease by holding that it is the lessee who chooses the type of equipment, the model and other special features required. He then negotiates with the supplier about the delivery, installation and purchase price. The role of the lessor is only to provide finance. In a case of finance lease, the lessor recovers his entire investment together with interest during the lease period itself and such lease agreement is non-cancellable. It is the sole responsibility of the lessee to bear all costs of insurance, repairs and maintenance and also suffer any obsolescence loss. All risks and rewards incidental to the ownership of asset vest with the lessee alone. The title of the lessor in the asset is only symbolic, which serves no purpose other than a security for the recoupment of his investment with interest in the shape of lease rentals. Such nominal ownership also ordinarily ceases with the coming to an end of the lease period. As against the lessor's nominal or the so called perceived ownership, it is the lessee who is the actual and real owner of the asset.

6.3 In the case of *CIT v. Podar Cement (P) Ltd. [(1997) 226 ITR 625 (SC)]*, the assessee took the possession of flats after payment of the consideration. Such flats were let out to various persons. The assessee claimed that the rental income should be considered as "Income from other sources" and not "Income from house property" as it was not a "legal owner" of the property in the flat. This contention was rejected by the Assessing Officer. When the matter finally came up before the Hon'ble Supreme Court, it was observed that the liability u/s 22 is on a person who receives or is entitled to receive the income from the property in his own right. The

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requirement of the registration of sale deed in the context of section 22 was held to be not warranted. The Hon'ble Supreme Court, in reaching this conclusion also took into consideration the definition of owner given u/s 27(iii) to (iiib) containing the deeming provision about the treatment of a person as owner. In the light of these provisions the assessee was held to be owner of the property as it was he who was "*entitled to receive income from the property in his own right*". From the above judgment of the Hon'ble Supreme Court it can be observed that the charge u/s 22 has been held to be attracted on a person who is entitled to receive the income from the property in his own right *albeit* he may not be a legal owner of such property. At the same time it is equally true that while reaching this conclusion, the Hon'ble Supreme Court took into consideration the deeming provision contained in section 27(iii) to (iiib) as regards owner of house property. At this stage it will be relevant to consider the crux of the judgment reproduced as under:-

> *"We are conscious of the settled position that* ***under the common law, 'owner' means a person who has got valid title legally conveyed to him*** *after complying with the requirements of law such as the Transfer of Property Act, Registration Act, etc.* ***But, in the context of section 22 of the Income-tax Act, having regard to the ground realities and further having regard to the object of the Income-tax Act, namely, 'to tax the income',*** *we are of the view,* ***'owner' is a person who is entitled to receive income from the property in his own right.****"*

6.4 Once again the question of ownership of a property came up for consideration before the Hon'ble Supreme court, this time in the context of depreciation u/s 32 where there is no deeming provision like that of deemed owner u/s 27, in the case of *Mysore Minerals Ltd. v. CIT [(1999) 239 ITR 775 (SC)]*. The factual matrix of this case is that the assessee had purchased certain houses for the use of its staff. Part payment was made followed by delivery of possession. Actual conveyance was not executed in favour of the assessee. A claim for depreciation u/s 32 was made which was rejected by the A.O. on the

ground that the assessee was not the owner of the asset. When the matter came up before the Hon'ble Summit Court, it considered its earlier judgment in *Podar Cement (P) Ltd.* and described it "*as a trend settor"* in the concept of ownership. Assistance from the law laid down therein was taken by the Hon'ble Supreme Court in the latter case for adopting the meaning of the term "owned" as occurring in section 32(1) of the Act. Accepting the assessee's claim for allowing depreciation, the Hon'ble Supreme Court held as under:-

> *"In our opinion, the term "owned" as occurring in section 32(1) of the Income-tax Act, 1961, must be assigned a wider meaning. Anyone in possession of property in his own title exercising such dominion over the property as would enable others being excluded therefrom and having the right to use and occupy the property and/or to enjoy its usufruct in his own right would be the owner of the buildings though a formal deed of title may not have been executed and registered as contemplated by the Transfer of Property Act, the Registration Act, etc.* ***"Building owned by the assessee" the expression as occurring in section 32(1) of the Income-tax Act means the person who having acquired possession over the building in his own right uses the same for the purposes of the business or profession though a legal title has not been conveyed to him*** *consistently with the requirements of laws such as the Transfer of Property Act and the Registration Act, etc., but nevertheless is entitled to hold the property to the exclusion of all others."*

6.5 On analysing the above two judgments, it can be easily ascertained that the *ratio* laid down in the case of *Podar Cement (supra)* on the question of inclusion of income in the hands of the person who is entitled to receive income in his own right, has been applied on the question of allowing depreciation to a person who is entitled to hold the property to the exclusion of others though he is not a legal owner. There can be hardly any difficulty in finding an owner of a property when the person using the property in his own right as owner (i.e. real owner) also happens to be the legal owner. In such a case the real owner is both a *de facto* and also *de jure* owner of an asset. But the problem arises in

a case when there are apparently two simultaneous owners of the same property at the same time, viz, the *de facto* owner and *de jure* owner. Difference between the *de facto* owner and *de jure* owner has been highlighted by the Hon'ble Supreme court in the above two cases. The crux of these judgments is that in such a case it is the *de facto* owner, entitled to hold the property in his own right and entitled to receive income therefrom in his own right, who is to be treated as the real owner of the asset for the purposes of the Income-tax Act, unless stated otherwise in relevant provision, in preference to the one who is simply a *de jure* owner, not entitled to hold the property in his own right or to receive income therefrom in his own right.

6.6 The corollary which follows on consideration of the *Podar Cement (P) Ltd.* along with *Mysore Minerals Ltd. (supra)*, is that for the purposes of section 32(1) the word "owner" is to be assigned a wider meaning so that anyone in possession of such property in his own title exercising such dominion over the property as would enable others as being excluded there from and having a right in his own right would be the owner of building for the purpose of section 32(1) notwithstanding the fact that a formal deed of title may not have been executed and registered in his name. By applying the *ratio decidendi* of the judgment in the case of *Mysore Minerals Ltd.* to the facts of the present case, there hardly remains any complexity in deciding that it is the lessee who is the real owner of boiler. It is the lessee who is in possession of property exercising control over the boiler by excluding others including the assessee-lessor there from. M/s Indo Gulf has the right to use and to occupy the property in its own right. Apart from exercising complete control over the boiler and having full right to use, there is prior understanding with the lessor that after the expiry of the lease period the boiler will be transferred to it at a predetermined 1% value. The assessee-lessor has absolutely no control over the property during the lease period. It has no option to repossess the boiler either during the continuation of lease period or after that. All the risks and rewards attached to the property are that of the lessee. By no standard

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whatsoever the assessee-lessor can be described as the owner of the property. Thus whereas in a case of operating lease, the lessor is both *de facto* and *de jure* owner, in the case of finance lease, the lessee is *de facto* owner and the lessor is only *de jure* owner. We, therefore, hold that in case of a finance lease it is the lessee who is the owner of the property for all practical purposes entitled to depreciation as per law and not the lessor. When the lessor's so called symbolic ownership is pitted against the lessee's real ownership, one hardly encounters any trouble in finding out that it is the lessee who is the real owner.

6.7 The ld. AR has relied on certain decisions in which benefit of depreciation has been bestowed on the lessor of the asset in sale and lease back transactions. It is pertinent to note that Sale and lease back is a transaction in which the asset is transferred to the lessor first and the seller of the asset becomes lessee subsequently. It is in contradistinction to the finance lease in which there is no such transfer of the same asset first to the lessor. The asset is purchased by the lessee but the finance is provided by the lessor. The lessor holds only the symbolic ownership of the asset, which is in essence a security for the return of his investment. The position of depreciation in case of finance lease on one hand and on sale and lease back on the other, is quite different. Section 43(1) defines "actual cost" to mean `the actual cost of the assets to the assessee, reduced by that portion of the cost thereof, if any, as has been met directly or indirectly by any other person or authority…..'. Explanation 4A provides that : `Where before the date of acquisition by the assessee (hereinafter referred to as the first mentioned person), the assets were at any time used by any other person (hereinafter referred to as the second mentioned person) for the purposes of his business or profession and depreciation allowance has been claimed in respect of such assets in the case of the second mentioned person and such person acquires on lease, hire or otherwise assets from the first mentioned person, then, notwithstanding anything contained in

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Explanation 3, the *actual cost of the transferred assets, in the case of first mentioned person, shall be the same as the written down value of the said assets at the time of transfer thereof by the second mentioned person*'. From the prescription of Explanation 4A it can be observed that in a case of sale and lease back transaction, the legislature has itself provided that the actual cost of the asset in the hands of the first mentioned person (i.e. the lessor) shall be the same which is the w.d.v. in the hands of the second person (i.e. the lessee) at the time of transfer. Thus there is no prize for guessing that the legislature in its wisdom has treated the lessor as the owner of the asset in a case of sale and lease back transaction by specifically mandating that the written down value of the asset in case of the lessee shall be treated as the actual cost to the lessor. If there had been no intention of the legislature to allow depreciation to the lessor in case of sale and lease back, it would not have provided the meaning of `actual cost' in the hands of the lessor. As depreciation on asset is not to be disallowed to both the lessor and also lessee, in case of genuine sale and lease back of asset, the admissibility of depreciation in the hands of the lessor is beyond the pale of doubt. However, there is nothing in the language of this provision which extends its scope to finance lease as well. It has been noticed above that the position is quite different in so far as depreciation on the financially leased asset is concerned, whose features make the lessee as real owner and the lessor as only a nominal or symbolic owner. Thus various decisions relied upon by the assessee sanctioning the grant of depreciation to a lessor in a case of sale and lease back do not *per se* approve the grant of depreciation to the lessor in case of finance lease because of the inherent differences in the characteristics of both these types of leases.

6.8 To bolster his submission for allowing depreciation even in case of a finance lease, the ld. AR heavily relied on the judgment of the Hon'ble Supreme Court in *MCorp Global (P.) Ltd. VS. CIT (2009) 309 ITR 434 (SC).* In that case

there were two transactions of lease. The facts of the first transaction of lease dated February 15, 1991 were that during the year in question, the assessee lessor had bought 5,46,000 soft drink bottles from G. These bottles were directly supplied to C (the lessee) in terms of lease dated February 15, 1991. Vide assessment order dated March 28, 1994, the Assessing Officer found that C had received only 42,000 bottles out of the total of 5,46,000 bottles receivable by them from the assessee and that the remaining bottles stood received after March 31, 1991. Consequently, the Assessing Officer allowed depreciation only on 42,000 bottles and consequently disallowed the depreciation on remaining bottles. The CIT(Appeals) after formulating the "user test" remanded the matter to the Assessing Officer, who on remand held that all 5,46,000 bottles stood paid for and dispatched before March 31, 1991, and, therefore, the assessee was entitled to 100 per cent depreciation on all 5,46,000 bottles. This finding was given when the appeal was pending before the Income-tax Appellate Tribunal. The Revenue did not challenge this finding of the AO on remand. The Tribunal held that since it was only a financial arrangement and not a lease, hence, no depreciation could be allowed. The tribunal disallowed the entire depreciation on 5,46,000 bottles. The Hon'ble Supreme Court observed that when the AO had allowed depreciation on 42,000 bottles, it did not lie in the domain of the tribunal to disallow that depreciation as well because the tribunal has no power of enhancement. It was, therefore, held that the benefit of depreciation given to the assessee by the Assessing Officer in respect of 42,000 bottles out of 5,46,000 bottles could not have been withdrawn by the tribunal and to that extent alone the assessee succeeded. As regards depreciation on remaining bottles, the Hon'ble Summit Court observed that : `*in this case the Commissioner of Income-tax (Appeals) had remitted the matter to the Assessing Officer who on remand came to the conclusion that all 5,46,000 bottles stood sold before March 31, 1991. This finding of fact has become final. It has not been challenged*'.

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6.9 From the above judgment in respect of the first transaction of lease, it is evident that the Hon'ble Apex Court accepted the assessee's claim of depreciation on 42,000 bottles only on the ground that the tribunal has no power of enhancement inasmuch as when the AO had granted depreciation, the tribunal could not have taken it away. As regards the depreciation on remaining bottles is concerned, it was observed that the AO had himself allowed such depreciation in remand and such a finding became final because it was not challenged. This judgment has nowhere laid down that depreciation is allowable to lessor in case of finance lease. The finding is rather converse which is discernible from the following observations of the Hon'ble Supreme Court : `*There is one more aspect which needs to be mentioned. According to the impugned judgments of the High Court and the Tribunal, the transaction dated February 15, 1991, was a financial transaction and not a lease. If depreciation is to be granted for 42,000 bottles under the transaction dated February 15, 1991, then it cannot be said that 42,000 bottles came within the lease dated February 15, 1991, and the balance came within the so-called financial arrangement.'* From these observations the only inference that can be drawn is that depreciation to the lessor is allowable in case of an operating lease and not in any financial arrangement, which resembles with the finance lease.

6.10 There was also a second transaction of lease dated March 15, 1991 in that case before the Hon'ble Supreme Court in which the assessee lessor entered into a lease agreement with lessee A and such lessee entered into sub-lease agreement with U. The Assessing Officer came to the conclusion that the transaction dated March 15, 1991, was not proved by the assessee and, therefore, the assessee was not entitled to depreciation. He disallowed depreciation to that extent. This finding was accepted by the Tribunal and the High Court. Apart from claiming that it was a genuine transaction, the assessee also contended before the Hon'ble Supreme

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Court that that, if the said transaction was a financial arrangement, as held by the Department, then the assessee could be taxed only on interest embedded in the amount of lease rentals received from the lessee. Repelling both the contentions, Their Lordships held that the transaction dated March 15, 1991, was not proved. Therefore, the Assessing Officer was right in disallowing depreciation to that extent. From the above discussion it can be noticed that the reliance of the ld. AR on this judgment to canvass the view that depreciation should be allowed even in case of finance lease, is apparently misconceived.

6.11 Now we espouse the argument raised on behalf of the assessee about the applicability of the judgment in the case of *Shaan Finance Pvt. Ltd.(supra)*. In that case the question was about the grant of investment allowance u/s 32A. The assessee himself was not manufacturer of any article or thing. He purchased certain machines which were owned by him and later on hired to different persons for the purposes of their business of manufacturing. In respect of these machines, the assessee claimed investment allowance which was denied by the lower authorities. The Hon'ble Supreme court held the assessee to be entitled to investment allowance by holding that : "*when the business of the assessee is leasing of such machine, the machine so leased out are being used for the purpose of the assessee's business. The income by way of hire charges which the assessee receives is also taxed as business income of the assessee …….. The* ***hirer has not acquired any new asset****. The transaction of hire is, therefore, hiring of the machinery.* ***There is no extinguishment of any right of the owner in the machinery****. There is merely a license given to the hirer to use, for a temporary period, the machinery so hired*". From the above verdict of the Hon'ble Supreme Court it can be easily seen that it was a case of operating lease and not a finance lease. The hirer or the lessee in that case did not acquire any asset and further there was no extinguishment of any right of the lessor owner in the machinery. It was

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under such circumstances that the Hon'ble Supreme Court directed the granting of investment allowance u/s 32A. Thus it is obvious that there was no dispute *qua* the ownership of the asset in that case. It was only on the use of the asset. The ld. AR contended that the conditions for the grant of depreciation and investment allowance are more or less the same in the sense that both can be allowed only to the owner of the asset who uses it for his business. This judgment reiterates that the investment allowance, or for that purpose the depreciation allowance, can be granted to a person who is owner of the asset and is using it for his business. In that case the machines so hired were first purchased and then given on hire. Thus it can be seen that the act of the lessor in leasing the property to the lessee has been held to be satisfying the second condition of user of property. This judgment in no way decides the question of the lessor's ownership in the context of finance lease. Rather it was a case of operating lease. It is only when the first condition for the allowability of u/s 32(1), being the ownership of an asset is satisfied, that there can arise any question of considering the second condition, being user of asset for business purpose. In the instant case the assessee-lessor cannot be described as the actual and real owner of the property. His ownership is only nominal or perceived. Due to non-satisfaction of the first condition itself, being the ownership of property by the lessor, in our considered opinion, no depreciation can be allowed to the assessee u/s 32(1).

6.12 The learned AR also argued that the Board Circular talks of adopting an integrated approach in the case of leasing and in any case depreciation has to be allowed either to the lessor or to the lessee. It was argued that since the lessee had not claimed any depreciation, the lessor should be granted depreciation on the leased asset. We are in full agreement with the mandate of the Circular stipulating the grant of depreciation either to the lessor or to the lessee depending upon the nature of lease. However it is important to mention that the case under

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consideration is that of the finance lease in which the lessor-assessee, who claimed depreciation, is not the real owner of the asset in his own right. In such a situation the issue arises as to whether the lessor, who is not the real owner of the property, should be granted depreciation merely for the reason that the lessee had not claimed depreciation on the leased asset? In our considered opinion, the answer to this question can be given in negative and negative alone. The obvious reason is that it is only the right person entitled under law, who can get the benefit of depreciation allowance. Parties can not, in disregard to law, mutually decide as to who out of them will be allowed the depreciation and then offer such proposal to the AO for implementation. It is the duty of the AO to find out as to whether the assessee before him is entitled to depreciation allowance as per law or not. The mutual agreement between the parties is of no consequence. It is impermissible to allow depreciation to A when as per law it is only B who is so entitled to it. The fact that B has not claimed depreciation is inconsequential when the point for determination is the admissibility or otherwise of depreciation to A. The authority for this proposition can be found from none other than the Hon'ble Supreme Court in the case of *ITO v. Ch. Atchaiah [(1996) 218 ITR 239 (SC)]*. It has been categorically held in this case in the context of the Income Tax Officer that : "*He can, and he must, tax the right person and the right person alone. By "right person", we mean the person who is liable to be taxed, according to law, with respect to a particular income. The expression "wrong person" is obviously used as the opposite of the expression "right person". Merely because a wrong person is taxed with respect to a particular income, the Assessing Officer is not precluded from taxing the right person with respect to that income.*" The enunciation of law by the highest Court of the land makes it abundantly clear that only the right person should be taxed. To put it simply, if a deduction has not been allowed to a right person, it does not mean that the same deduction should be allowed to a wrong person. The judgment in the case of *Mysore Minerals (supra)* recognizes a person

as an owner who is in possession of property in his own right exercising such dominion over the property as would enable others being excluded there from. In a lease transaction also there can be only one owner of the asset, that is, either the lessor or lessee and not both of them or either of them at their discretion. Whereas in the case of operating lease, it is the lessor who is the real owner of the asset, but in case of finance lease, it is the lessee who is to be regarded as the real owner of the asset. *Ex consequenti* only the lessor can claim depreciation in case of an operating lease and the lessee in a case of finance lease. There is no question of deciding between the lessor and the lessee, as to who should be conferred the benefit of depreciation allowance. Adverting to the facts of the instant case, it can be seen that it is a case of finance lease agreement. The only and the inescapable conclusion which in our considered opinion follows is that the real owner of the leased property is Indo Gulf Fertilizer & Chemical Corporation Limited and not the assessee. We, therefore, decline to grant any depreciation to the assessee-lessor. However the lessee, if so advised, may take recourse to the legal remedy if any, for the grant of depreciation.

III. REALITY BEHIND PRESENT LEASE AGREEMENT

7.1 It is a settled proposition of law that the courts or for that purpose the authorities must have due regard to the reality of the transaction before taking a final decision on its true nature. If such reality behind the veil is different from the apparent form, then it is such reality which needs to be considered in preference over the form. Reality can be gathered from the intention of the parties and such intention, in turn, can be inferred from the facts and circumstances of the case rather than the way in which it has been presented. The nomenclature or a description given to a particular agreement cannot and should not be allowed to change the true nature of transaction. It is in fact the substance of the transaction rather than its form which matters. Thus the true effect of a transaction can be

determined by peeping in to the terms of the agreement seen in the light of the inherent intention of the parties and also the attending circumstances.

7.2 In the case of *CIT v. Panipat Woollen and General Mills Co. Ltd. [(1976) 103 ITR 66 (SC)]* the assessee entered into an agreement with S under which the latter was appointed as sole selling agent on the terms and conditions to finance the assessee-company to a particular extent and company agreed to pay 6% interest on the advance to be made by the agent and further agreed to pay 2% commission of net proceeds of sales. Before expiry of this agreement another agreement was entered into by the company with the agent under which the agent was to get 6% interest on all the advances made, 1½ % commission on net sales and 50% commission on sales from the worsted plant. The agent agreed to bear 50% of the loss incurred by the assessee from its remuneration. The agent advanced a particular sum and received 50% commission of the net profit of the worsted plant. The assessee claimed that the amounts paid to the agent were in the nature of commission. The A.O. disallowed the deduction by holding that it was actually a division of profits after the profits had come into existence. The Tribunal refused to accept the assessee's contention. It further held that the agreement dated 20th October, 1955 amounted to a joint venture for the distribution of profit. The Hon'ble High Court decided in favour of the assessee by holding that the payments amounted to a legitimate deduction. When the matter came up before the Hon'ble Supreme Court, it considered clause no.7 of the agreement which talked of commission at 1½ % on the net proceeds of sales of all goods and 50% commission of the net profit of the worsted plant. It was observed that the conduct of the agent in sharing half of the net profit did not appear to be consistent with the payments made to the agent for the services rendered. The clause regarding such payment was found to be peculiar to the agreement alone and it was held that : "*the Court in order to construe an agreement has to look to the substance or the essence of it*

rather than to its form. The party cannot escape the consequences of the law merely by describing an agreement in a particular form though in essence and in substance it may be a different transaction". Similarly in the case of *Controller of Estate Duty v. Aloke Mitra [(1980) 126 ITR 599 (SC)]* the Hon'ble Supreme Court has held that : "*In applying the Act to any particular transaction, regard must have to its substance, its true legal effect, rather to the form in which it is carried out*". The Hon'ble Supreme Court in *Sundaram Finance v. State of Kerala & Anr. [1966 AIR 1178]* has held that : "*The true effect of a transaction may be determined from the terms of the agreement considered in the light of the surrounding circumstances. In each case the Court has, unless prohibited by the statute, power to go beyond the document and to determine the nature of transaction, whatever may be the form of the document.*" Even Circular no.760 dated 13.01.1998 in the context of taxability of hire charges as interest under the Interest Tax Act, 1974, after taking note of the afore noted judgment of the Hon'ble Supreme Court in the case of *Sundaram Finance (supra),* requires the Assessing Officers to consider the question on merits after taking into account the terms of the agreement; the nature of the arrangement between the supplier of the asset, hire purchase company and the end user of the asset; and the intention of the parties which manifests itself in the fixation of the initial payment, the method of determination of hire purchase price etc. It has been provided in para 2 of the Circular : "*that in the case of transactions which are, in substance, in the nature of hire-purchase, the receipts of hire charges would not be in the nature of interest. On the other hand, if the transactions are in substance in the nature of financing transaction, the hire charges should be treated as interest subject to interest tax*".

7.3 All the judicial pronouncements discussed in the foregoing para are clear pointer towards the fact that it is the substance of the transaction and not its form, which should be taken into consideration in deciding the true nature of a

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transaction. Same view has been reiterated by the CBDT in the above circular. Thus it follows that the authorities or for that purpose the Courts cannot decide an issue simply on the basis of form assigned by the parties to a transaction. Rather it becomes the duty of the authorities to the uncover the artificial layers of falsehood for finding out the bare reality of a transaction. This process can be undertaken by finding out the real intention of the parties emanating from the attending circumstances beyond the terms of agreement.

7.4 We again advert to the facts of the case. By considering various clauses of lease agreement it has been held above that such agreement is in essence of finance lease and not operating lease. This case has certain exciting facts which cannot be lost sight of. Copy of the lease agreement dated 4th September, 1997 is available in the paper book. The opening para of the lease agreement reads as under:-

> *"AND WHEREAS the **Lessor has agreed to purchase** and let on lease the Equipment to the Lessee upon and subject to the following terms and conditions."*

7.5 Further clause 15.1 provides that the *lessor hereby appoints the lessee as its agent to inspect and receive delivery* and installation of the equipment from the acceptance of manufacturer.

7.6 When we consider the above parts of the lease agreement dated 4th September, 1997, it becomes clear that the lessor agreed to purchase and let on lease the boiler to the lessee. A simple and plain reading of the above portions of the lease agreement makes it crystal clear that all the units of boiler were to be purchased on or after entering into this agreement on 4th September, 1997. On reading the above clauses, one can never contemplate that such boiler could have been purchased and leased to lessee even before entering into lease agreement. The

further clause that the lessor "*has agreed*" to purchase fairly indicates that the lessor and lessee have agreed on 4th September, 1997 to purchase and let on lease the equipment to the lessee. During the course of hearing the Bench required the ld. AR to place on record the sanction letter of the financial assistance by the assessee bank to Indo Gulf Fertilizers. A copy of such letter dated 26th May, 1997 has been submitted which was addressed by the assessee bank to the lessee stating that : "we refer to your request for lease equipment for ₹20.79 crore with a facility of ₹19.00 crore as per capitalization advance (within ₹20.79 crore) and are pleased to advance sanction of the same on the following terms and conditions". This sanction letter dated 26th May, 1997 also states that "Short Term Loan" of ₹19.00 crore was sanctioned by the assessee bank. On a pertinent query, the learned AR submitted that initially a short term loan was sanctioned to the assessee on 26th May, 1997, which was later on converted into lease by way of the agreement dated 04.09.1997. It is further relevant to note complete details of invoices with purchase price of separate units of boiler with the respective bill numbers, bill date, description and price etc. as per page no.1 of the paper book, which contain 45 entries mainly towards `Supply' and some others towards `Erection' and `Spares' and two towards some debit or credit notes. The total of this page at ₹19.45 crore is equal to the cost of the leased asset as depicted in the Synopsis of facts given by the learned AR. When we watchfully tread through page 1 of the paper book, it can be observed that the Supply of the units of the boiler started with the first invoice dated 24.01.1997. The second invoice is dated 25.01.1997 and third invoice is dated 31.01.1997. There are six invoices dated February 1997, thirteen dated March 1997 and one dated April 1997. In that way, 37 out of 45 invoices indicate the dates prior to the lease agreement dated 04.09.1997. In financial terms, out of the total cost of the leased asset at ₹19.45 crore the assessee made purchases approximately worth ₹.18.40 crore before the date of lease agreement itself. This fact casts a serious doubt on the genuineness of the lease agreement itself. When

around 95% of the purchase of units of boiler was made prior to the date of the lease agreement then how it could have been mentioned in the lease agreement that "*the lessor has agreed to purchase*" and let on lease the equipment to the lessee. The further fact that initially short term loan of ₹19.00 crore was sanctioned by the assessee to Indo Gulf Fertilizer & Chemical Corporation Limited which as per the learned AR's version was later on converted into lease, evidently destroys the theory of genuine lease. In fact, it amply proves that it was a case of mere loan granted by the assessee to the Indo Gulf Fertilizer & Chemical Corporation Limited and later on the lease agreement was formally executed to give such a loan transaction the colour of lease. Let us further consider the relevant part of clauses 3.3 and 3.4 of the agreement as under:-

> *"3.3 Under the applicable provisions of the Income Tax Act, 1961 and the rules made thereunder and the relevant Finance Act as prevalent at present, the Lessee would have been entitled to and could have claimed depreciation at the rates prescribed thereunder if it had bought the Equipment and was using and operating the same as the owner thereof.*
>
> *3.4 The Lessee shall not be liable for fair and normal wear and tear of the Equipment and the* ***burden of depreciation resulting from any such fair wear and tear shall fall upon the Lessor*** *who shall be entitled to claim from the Revenue all capital allowances in respect of the Equipment."*

7.7 From these clauses read with certain other clauses of the agreement, it can be easily noticed that the entire arrangement has been effected only to facilitate the assessee to claim the benefit of depreciation. There is apparent conflict in various clauses of the agreement as regards the liability of the lessor on one hand and the lessee on the other to bear normal wear and tear of the equipment. Whereas in clause 3.4 it has been categorically provided that the lessee shall not be liable for fair and normal wear and tear of the equipment, the other clauses as discussed

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above clearly put the burden of repairs and maintenance of the boiler on the lessee only. It can be further seen from clause 12 of Lease Summary Schedule which is reproduced below:-

> *"12. Repairs & Maintenance :*
> *At Lessee's cost who shall provide ongoing maintenance replace free of cost any component which are either defective or worn out due to wear and tear and keep the equipments in good condition."*

7.8 A bare perusal of various clauses of the agreement clearly transpires that this lease agreement has been entered into with the sole purpose of enabling the assessee to artificially fulfill the twin requirements of ownership and user of the asset so as to claim depreciation, to which it was not otherwise entitled as per law and thereby reduce its income in a *mala fide* manner. Though the parties have attempted to assign a form of operating lease to the transaction to enable the lessor to have the benefit of depreciation, but in fact the substance is that of a transaction of a simple advancing of loan, what to talk of even a finance lease.

7.9 The learned AR made one more interesting contention about tax neutrality. He stated that there can be no benefit to the lessor or the lessee by claiming depreciation in the wrong hands because the tax rates in both the cases are similar. He submitted that whether the assessee claims depreciation or the lessee, it is only single amount of depreciation that is going to be allowed and this transaction is over all tax neutral because of the similar rate of tax in the hands of the lessor and lessee. This contention of the ld. AR appears attractive at the first blush but, on closer examination, falls to the ground. It can be observed from the assessment order that the assessee filed its return declaring total income of ₹100.78 crore after claiming the said depreciation. On the other hand, the so called lessee i.e. Indo Gulf Fertilizer & Chemical Corporation Limited had accumulated brought forward

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losses and they filed loss return. This fact is apparent from para 2.21 of the assessment order. The learned AR was fair enough to concede that Indo Gulf Fertilizer & Chemical Corporation Limited had brought forward losses and there was no positive income for the year. The hard realities of the case cannot be lost sight of and the Tribunal cannot act as a mute spectator to this ongoing by ignoring the glaring reality which can be seen even with the naked eyes. The attending circumstances of the case run in complete contradistinction to the cloak of lease agreement which has been used by the assessee in connivance with Indo Gulf Fertilizer & Chemical Corporation Limited as a dubious way to mitigate the rightful tax liability. When we find that the tax neutrality argument as neutral in the facts and circumstances of the present case and also consider the other important fact that the assessee had already advanced loan to Indo Gulf Fertilizer & Chemical Corporation Limited for purchase of boiler much prior to the date of formal lease agreement, it can be appreciated without any difficulty that the so-called lease agreement is sham which was executed with the sole intention of allowing the assessee to claim depreciation in its hands as a measure of tax avoidance.

7.10 The law permits tax planning and not tax avoidance. If within the four corners of law a person arranges its affair in such a way that his overall tax liability is reduced, there cannot be any embargo on such tax planning. If however dubious means are adopted to reduce the incidence of tax by artificially inflating expenses or reducing income, it cannot be described as anything other than tax avoidance. The law permits only tax planning and not tax avoidance. When we consider the reality of the situation in the present case, it becomes abundantly manifest that a simple loan transaction was made to adorn the garb of lease to avoid the rightful tax due to the exchequer. We, therefore, refuse to accept the very genuineness of the so called lease agreement itself and hold that it is not even a case of finance lease. In our considered opinion, the authorities below were fully justified in

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refusing to grant depreciation to the assessee in both the years under consideration.

8. In view of the above discussion, we answer question no.1 in negative by holding that the agreement in question cannot be called as a financial lease agreement. It is so for the reasons discussed above that it is a simple case of advancing of loan by the assessee to the lessee and the so called lease agreement, in the facts and circumstances of the present case, has been attempted to be used as a device to reduce tax liability of the assessee. Accordingly, the second question is also answered in negative by holding that the assessee lessor is not entitled to depreciation.

9. We, therefore, sum up our conclusion as under:-

(i) If the conditions as laid down in the judgments of *Asea Brown Boveri Limited (supra)* and *Association of Leasing & Financial Services Companies (supra)* are satisfied in a lease agreement, it will be a case of finance lease and not operating lease.

(ii) Only the lessee can be treated as owner of the asset in case of a finance lease. It is he who is entitled to claim depreciation as per law. No depreciation can be allowed to the lessor in such a case of a genuine finance lease.

(iii) The facts and circumstances of the present case show that it was a case of mere advancing of loan by the assessee to Indo Gulf Fertilizers. There was, in fact, no genuine leasing of boiler, neither operating nor finance. In that view of the matter also no depreciation is admissible to the assessee-lessor.

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10. Before parting with this appeal, we record our deep appreciation for illuminating arguments put forth on behalf of the learned counsel from both the sides on the issue in appeal. Further we want to make it clear that the *ratio decidendi* of all the decisions relied on by both the sides has been duly taken into consideration while passing this order. However, we have desisted from specifically referring to certain cases relied on by both the sides in the present order either due to their irrelevance or of the repetitive nature.

11. Having answered both the questions in the above terms, we direct the listing of these two appeals before the Division Bench for disposing off the grounds of depreciation on loan to Indo Gulf Fertilizers in conformity with this order and other grounds as per law.

Order pronounced on this **day of March, 2012**.

Sd/-	Sd/-	Sd/-
(R.S.Padvekar)	**(D.Manmohan)**	**(R.S.Syal)**
Judicial Member	**Vice-President**	**Accountant Member**

Mumbai : **March, 2012.**
Devdas*

Order pronounced on **14th March, 2012**.

Sd/-	Sd/-	Sd/-
(R.S.Padvekar)	**(N.V.Vasudevan)**	**(R.S.Syal)**
Judicial Member	**Judicial Member**	**Accountant Member**

Mumbai : 14th March, 2012.

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Copy to :

1. The Appellant.
2. The Respondent.
3. The CIT concerned
4. The CIT(A)-XXXIII, Mumbai.
5. The DR/ITAT, Mumbai.
6. Guard File.

TRUE COPY. By Order

Assistant Registrar, ITAT, Mumbai.

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