* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

\+ **INCOME TAX APPEAL NO. 442/2007**

Reserved on: 13th February, 2012

% **Date of Decision:** 17th April, 2012

COMMISSIONER OF INCOME TAX DELHI-VI
...Appellant
Through Mr. Sanjeev Sabharwal, Sr. Standing Counsel.

VERSUS

THE INSTALMENT SUPPLY LIMITED .....Respondent
Through Nemo.

CORAM:
HON'BLE MR. JUSTICE SANJIV KHANNA
HON'BLE MR. JUSTICE R.V. EASWAR

SANJIV KHANNA, J.:

This appeal by the Revenue in the case of Installment Supply Limited, the assessee pertains to the assessment year 1994-95. The impugned order passed by the Income Tax Appellate Tribunal (Tribunal) in ITA No.1156 /Del/2002 is dated 22nd September, 2006.

2. The present appeal was admitted to hearing vide order dated 15th September, 2010 and the following substantial question of law was framed:

> "Whether the ITAT was correct in law in deleting addition of Rs.39,33,333/- made by the Assessing Officer by disallowing claim of

> depreciation in respect of assets allegedly leased to M/s. H.C.L. Hewlett Packard Ltd.?"

3. In view of what was highlighted during the course of arguments, we are inclined to reformulate the substantial question of law mentioned above and the same should reads as under:

> "Whether the Income Tax Appellate Tribunal has rightly examined the facts and the issue in question while allowing the appeal of the assessee and holding that the addition of Rs.39,33,333/- towards depreciation of assets leased to HCL Hewlett Packard Limited should be allowed?"

We had heard counsel for the parties on the said question.

4. The assessee is a company and for the assessment year 1994-95 had filed its return of income on 30th November, 1994 declaring income of Rs.6,09,610/-. The return of the assessee was not taken up for scrutiny and no notice under Section 143(2) of the Income Tax Act, 1961 (Act, for short) was issued within the prescribed time. Subsequently, information was received from Additional Director of Income Tax (Investigation) that a bio gas plant purchased from and leased back to Western Pacques (India) Limited, Pune was not to be found at the site, where it was stated to be installed. Accordingly, notice for reopening

was issued on 28th July, 1995. In response, the assessee filed a return declaring same income and the proceedings continued.

5. Subsequently, on 30th March, 1998, the assessee made a declaration under the Voluntary Disclosure of Income Scheme, 1997(VDIS, 1997). In this declaration, the assessee withdrew its claim and offered for taxation depreciation claimed on the assets purchased from and leased back to Western Pacques (India) Limited. The assessee withdrew the claim of depreciation on the assets purchased from Agritech Hatchem and leased to Alpha Engineers. These transactions were treated as finance transactions and the amount of depreciation was reduced by recovery of the principal amount and included as income from lease rentals. The total income voluntarily disclosed under VDIS, 1997 was Rs.1,06,46,076/-.

6. The Assessing Officer noticed that the assessee had claimed that they had purchased 1614 items/parts of computer systems etc. for Rs.40 lacs from HCL Hewlett Packard Ltd. and these items/parts were again leased back to the same company on 23rd February, 1994. The assessee had claimed that cost of each of the said items, was less than Rs.5,000/- and accordingly they were entitled to 100% depreciation as a lessor. The

Assessing Officer observed and held that the aforesaid lease cannot be treated as a bona fide transaction. The assessee was not interested in acquiring a large number of small spare parts and then lease them. It was observed that the transaction was a finance transaction, but had been given colour of a lease transaction. The assessee had advanced Rs.40 lacs to HCL Hewlett Packard Limited and had agreed to receive back this amount along with the interest over a period of six years, but the item/parts were described as a lease property. He relied upon decision of the tribunal in the case of ***Goel Gases Private Limited***, ITA No. 8105/Del/1992, A.Y. 1989-90, decided vide order dated 22nd October, 1993.

7. The CIT(Appeals) affirmed the said decision after recording that the items included spare parts of computers, printers, networking and items like key board, RAM, logic cards, adapter cards, power supply etc. It was observed that these spare parts purchased and leased back could not function as an independent machine. The assessee had not submitted details how these spare parts were leased back to HCL Hewlett Packard Limited. In the absence of the details, the normal presumption would be that the HCL Hewlett Packard Limited

would have utilized the spare parts in manufacture of computers etc. or manufacture of machines sold by them. It was held that the alleged lease agreement was a collusive device to avoid payment of tax. The CIT(Appeals) also held that the title was never transferred to the assessee.

8. On further appeal, the tribunal has reversed the findings of the Assessing Officer/CIT(Appeals), inter alia, recording as under:

> "7.6 The next objection of the learned CIT(Appeals) is that the spare parts were not capable to function independently as a machine. It was pointed out by the learned counsel for the assessee that each item is excisable and is covered within the definition of machine. The learned counsel made reference to the decision of Hon'ble Supreme Court in the case of CIT Vs. Mir Mohammad Ali (1964) 53 ITR 165 and submitted that the term "machinery" and 'installed' should not be taken in narrow sense. After going through the decision of Hon'ble Supreme Court in the case of Mir Mohd. Ali (supra), we find force in the submission of the assessee.
>
> 7.7 We have also examined the lease agreement. On going through this agreement, it is found that the conditions of a valid lease are fully satisfied. The assessee has also proved necessary conditions for claiming depreciation which are: (1) that it was owner of the assets leased out; and (2) that the assets were used for business purposes. Although the

> departmental authorities have applied the ratio of decision in the case of McDowell (supra) but the transaction of lease has not been declared as non-genuine or sham transaction. There is nothing on record to show that the lease transaction entered into by the assessee was sham transaction. So far as the decision in the case of Goyal Gases Pvt. Ltd. (supra) is concerned, in that case the transactions were found to be merely paper transactions whereas in the present case the transactions are not merely paper transactions. The lease was not only for one year but for five years and was for a valid consideration."

9. In addition, the tribunal also observed that the CIT(Appeals) was not right in holding that the title in the computer parts was not passed on to the assessee. Tribunal has relied on invoice dated 26th February, 1994 issued by HCL Hewlett Packard Limited and observed that this invoice had not been taken into consideration.

10. With regard to claim of depreciation, it was observed that when the business of the assessee was leasing, the actual use and the fact how the asset was being used by the lessee, was not relevant. The exact reasoning given by the tribunal reads as under:

> "7.8 So far as the issue of user of the leased assets is concerned, the learned CIT(Appeals) has taken a technical view. In the case of Multican Builders Ltd. Vs. CIT

(2005) 278 ITR 142, after making reference to the decisions in the cases of CIT Vs. Oriental Coal Co. Ltd. (1994) 206 ITR 682 (Cal.); CIT Vs. Geo Tech Construction Corpn. (2000) 244 ITR 452 (Ker.); CIT Vs. Kanoria General Dealers P. Ltd. 159 ITR 524 (Cal.); and Hindustan Gas and Industries Ltd. Vs. CIT 79 Taxman 151, the Hon'ble Calcutta High Court has concluded as under:

> "From the above discussion, it is clear that the claim of depreciation is not dependent on the actual use or the asset being put to use. It is dependent on the question of being used for the purpose of the business. When the leasing is the business, giving of a vehicle in lease even if it may not be used by the lessee on the date of the agreement but from the date of registration of the vehicle or thereafter even then it would be an use for the purpose of the leasing business of the assessee. It is the use of the vehicle by the lessor for the purpose of his business, which is material. It is the use of the vehicle for the purpose of leasing which is material."

11. We have elucidated and reproduced the relevant reasoning given by the tribunal. The real issue and question involved in the present case is, whether or not the agreement in question was a finance agreement or an operating lease. The aforesaid question cannot be decided by merely looking at the

title of the agreement itself or the nomenclature given to the said agreement. The terms and conditions mentioned in the agreement may be relevant but we have to also take into account the surrounding circumstances as well as the type and nature of the asset. It is this aspect which has been ignored and not given due credence.

12. The two types of transactions i.e. finance agreement and operational lease are different. Explaining this difference in ***Asea Brown Boveri Limited versus Industrial Finance Corporation of India and Others***, (2004) 12 SCC 570 it has been observed:

> "**13.** What is a lease finance? According to *Dictionary of Accounting & Finance* by R. Brockington (Pitman Publishing, Universal Book Traders, 1996 at p. 136):
>
> > "A finance lease is one where the lessee uses the asset for substantially the whole of its useful life and the lease payments are calculated to cover the full cost together with interest charges. *It is thus a disguised way of purchasing the asset with the help of a loan*. SSAP 23 required that assets held under a finance lease be treated on the balance sheet in the same way, *as if they had been purchased and a loan had been taken out to enable this*."
> >
> > (emphasis supplied)
>
> **14.** In *Lease Financing & Hire Purchase* by Dr. J.C. Verma (4th Edn., 1999 at p. 33), financial lease has been so defined:

"Financial lease is a long-term lease on fixed assets, it may not be cancelled by either party. It is a source of long-term funds and *serves as an alternative of long-term debt financing*. In financial lease, the leasing company buys the equipment and leases it out to the use of a person known as the lessee. It is a full payout lease involving obligatory payment by the lessee to the lessor that exceeds the purchase price of the leased property and finance cost.

Financial lease has been defined by International Accounting Standards Committee as 'a lease that transfers substantially all the risks and rewards incident to ownership of an asset. Title may or may not eventually be transferred'. *Lessor is only a financier and is not interested in the assets*. This is the reason that financial lease is known as full payout lease where contract is irrevocable for the primary lease period and the rentals payable during which period are supposed to be adequate to recover the total investment in the asset made by the lessor."

(emphasis supplied)

15. According to *Lease Financing & Hire Purchase* by Vinod Kothari (2nd Edn., 1986 at pp. 6 & 7), a finance lease, also called a capital lease, is nothing but a loan in disguise. It is only an exchange of money and does not result in creation of economic services other than that of intermediation. The learned author has quoted T.M. Clark, one of the most authentic writers on the subject who defines lease and operating lease in the undergoing words:

"A financial lease is a contract involving payment over an obligatory period of specified sums sufficient in total to amortise the capital outlay of the lessor and give some profit.

* * *

An operating lease is any other type of lease — that is to say, where the asset is not wholly amortised during the non-cancellable period, if any, of the lease and where the lessor does not rely for his profit on the rentals in the non-cancellable period."

16. The features of the financial lease, according to the learned author are 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 specialised service in connection with the asset.

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

17. 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 equipments

> 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."

13. The aforesaid distinction has been again highlighted by the Supreme Court in ***Association of Leasing and Financial Service Companies versus Union of India***, (2011) 2 SCC 352 with reference to service tax imposed under Section 65(12) and 65(105)(zn) by Finance Act, 2001, which underwent some changes by Finance Act, 2004 and 2007. Referring to the difference between the two agreements/transactions, the Supreme Court has held:

> **"34.** 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.

35. 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 (see Paras 36.242 and 36.243). 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 (see Para 32.045). 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 realisable value of the equipment at the time) and its expected finance charges (less an allowance to reflect the return of the capital) (Para 32.057). In the case of hire-

purchase agreement the periodical payments made by the hirer are made up of:

(*a*) consideration for hire, and

(*b*) payment on account of purchase.

36. To sum up, NBFCs essentially are loan companies. They basically conduct their business as loan companies. They could be in addition thereto in the business of equipment leasing, hire-purchase finance and investment. Because NBFCs are basically loan companies, they are required to show the assets leased as "receivables" in their balance sheets. That, the activities of hire-purchase finance/equipment leasing undertaken by NBFCs come under the category of "para banking". That, in substance a finance lease, unlike an operating lease, is a financial loan (assistance/facility) by the lessor to the lessee. That, in the bailment termed "hire" the bailee receives both possession of the chattel and the right to use it in return for remuneration. On the other hand, equipment leasing is long-term financing which helps the borrower to raise funds without outright payment in the first instance. Here the "interest" element cannot be compared to consideration for lease/hire which is in the nature of remuneration (consideration) for hire."

14. The aforesaid distinction was elucidated earlier also in a litigation in which the assessee was involved (see In re ***Instalment Supply (P) Limited versus Union of India and Others***, AIR 1962 SC 63 and ***Instalment Supply Limited versus STO***, (1974) 4 SCC 739).

15. In ***Sundaram Finance Limited versus State of Kerala***, AIR 1966 SC 1178 it was observed as under:

"**24.** 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 statute, power to go behind the documents and to determine the nature of the transaction, whatever may be the form of the documents. An owner of goods who purports absolutely to convey or acknowledges to have conveyed goods and subsequently purports to hire them under a hire-purchase agreement is not estopped from proving that the real bargain was a loan on the security of the goods. If there is a bona fide and completed sale of goods, evidenced by documents, anterior to and independent of a subsequent and distinct hiring to the vendor, the transaction may not be regarded as a loan transaction, even though the reason for which it was entered into was to raise money. If the real transaction is a loan of money secured by a right of seizure of the goods, the property ostansibly passes under the documents embodying the transaction, but subject to the terms of the hiring agreement, which become part of the buyer's title, and confer a licence to seize. When a person desiring to purchase goods and not having sufficient money on hand borrows the amount needed from a third person and pays it over to the vendor, the transaction between the customer and the lender will unquestionably be a loan transaction. The real character of the transaction would not be altered if the lender himself is the owner of the goods and the owner accepts the promise of the purchaser to pay the price or the balance remaining due against delivery of goods. But a hire-purchase agreement is a more complex transaction. The owner under the hire-purchase agreement enters into a transaction of hiring out goods on the terms and conditions set out in the agreement, and the option to purchase exercisable by the customer on payment of all the instalments of hire arises when the instalments are paid and not before. In such a hire-purchase agreement there is no agreement to buy goods; the

hirer being under no legal obligation to buy has an option either to return the goods or to become its owner by payment in full of the stipulated hire and the price for exercising the option. This class of hire-purchase agreements must be distinguished from transactions in which the customer is the owner of the goods and with a view to finance his purchase he enters into an arrangement which is in the form of a hire-purchase agreement with the financier, but in substance evidences a loan transaction, subject to a hiring agreement under which the lender is given the license to seize the goods.

25. A few illustrative cases decided by the Courts in England, which do not import complications arising from the Bills of Sale Act, 1878, and the Hire Purchase Act, 1938, may be briefly noticed. In *Re Watson Ex parte Official Receiver in Bankruptcy* it was held that in adjudging the true nature of a transaction purporting to be a sale of personal chattels, followed by a hiring and purchase agreements, whereby the vendor agreed to hire the chattels from the purchaser and to pay quarterly sums for such hire until a certain amount was paid, when the chattels were to become again the property of the vendor, and power was given to the purchaser to take possession of the chattels on default of payment, the form of the transaction cannot be given undue importance. The Court held that no sale or hiring of the chattel was intended, the object in truth being to create a security for a loan of money to the supposed vendor from the supposed purchaser. The transaction was therefore one of loan. Lord Esher, M.R., observed at p. 37:

> "…. when the transaction is in truth merely a loan transaction, and the lender is to be repaid his loan and to have a security upon the goods, it will be unavailing to cloak the reality of the transaction by a sham purchase and hiring. It will be a question of fact in each case whether there is a real purchase and sale complete before the hiring agreement. If there be such a purchase and sale in fact and afterwards the

goods are hired, the case is not within the Bills of Sale Act.

The document itself must be looked at as part of the evidence; but it is only part, and the Court must look at the other facts, and ascertain the actual truth of the case."

16. Majority further elucidated and explained the legal position as under:

"**28.** In the light of these principles the true nature of the transactions of the appellants may now be stated. The appellants are carrying on the business of financiers: they are not dealing in motor-vehicles. The motor-vehicle purchased by the customer is registered in the name of the customer and remains at all material times so registered in his name. In the letter taken from the customer under which the latter agrees to keep the vehicle insured, it is expressly recited that the vehicle has been given as security for the loan advanced by the appellants. As a security for repayment of the loan, the customer executes a promissory-note for the amount paid by the appellants to the dealer of the vehicle. The so-called "sale letter" is a formal document which is not made effective by registering the vehicle in the name of the appellants and even the insurance of the vehicle has to be effected as if the customer is the owner. Their right to seize the vehicle is merely a licence to ensure compliance with the terms of the hire-purchase agreement. The customer remains qua the world at large the owner and remains in possession, and on condition of performing the covenants has a right to continue to remain in possession. The right of the appellants may be extinguished by payment of the amount due to them under the terms of the hire-purchase agreement even before the dates fixed for payment. The agreement undoubtedly contains several onerous covenants, but they are all intended to secure to the appellants recovery of the amount advanced. We

> are accordingly of the view that the intention of the appellants in obtaining the hire-purchase and the allied agreements was to secure the return of loans advanced to their customers, and no real sale of the vehicle was intended by the customer to the appellants. The transactions were merely financing transactions."

17. In view of the aforesaid position, we feel that the matter has not been examined and considered by the tribunal from the right perspective, the real issue and controversy has not been examined. The tribunal has not considered the legal position to reach its conclusion.

18. In these circumstances, we answer this substantial question of law mentioned above in negative, i.e., in favour of the Revenue and against the assessee. An order of remand is passed directing the tribunal to examine the controversy a fresh in the light of what has been stated above and without being influenced by the earlier order. The appeal is disposed of. In the facts of the case, there will be no order as to costs.

-sd-
(SANJIV KHANNA)
JUDGE

-sd-
(R.V. EASWAR)
JUDGE

APRIL 17th, 2012/VKR