Article

Understanding Sale and leaseback

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Article

Understanding Sale and lease back:

Sale and lease back (SLB) is a subset of leasing; a special case of application of leasing technique. Lease is a preferred mode of using the asset without having to own it. In case of leases the lessee does not own the asset but acquires the right to use the asset for a specified period of time and pays for the usage. The twist in SLB transactions is that the lessee has an existing asset which it wants to leverage on instead of acquiring the same in the process the lessee does away with the ownership of the asset yet continues to enjoy the usufructs arising out of the asset. As was the intent of putting to use the asset when the ownership of the asset resided in the lessee in the first place, SLB allows the lessee to detach itself with legal ownership yet continuing to use the asset as well. In effect there is no movement of asset however through paper transactions there is a change in the title of the asset.

SLB is not a modern day innovation and has been prevalent across countries for decades now. In U.S sale and lease back for real estates have been used as a means for secured financing. In U.K, practice of bills of sales is similar to SLB. In India too, SLB has been used particularly for lessor tax-shelters.

Motivations of Parties:

As is evident from the mechanics of SLB above, SLB results in taking the asset off the books of the lessee (in case of true leases) and results in upfront cash which could be used for paying off existing liabilities. Hence this does not impact the existing lines of credit the lessee may be availing otherwise. Also for an entity that has high on-balance sheet leverage can replace it with off-balance sheet lease liability and the finances raised can be used to pay off the existing liabilities as well. SLB may bring about a financial advantage as well wherein a high cost debt can be substituted with a low cost lease liability.

Further, once the asset is sold and taken off the books of the lessee, the lessee is able to account for an immediate accounting profit without having to pay tax on it instantly. As under the block concept of depreciation, when the lessee sells the capital assets, the sale proceeds including the profits on sale are allowed to be deducted from the block of assets and hence there is no immediate tax on the accounting profits. The tax is paid in a staggered manner in the form of reduced claim for depreciation.

Also typically the asset is recorded on historical costs which may be lower than the intrinsic value of the asset. SLB sometimes allows the entities to unlock the appreciation in value. However it is not always necessary that the asset would have appreciated value. In some cases the asset may have become junk completely.

Most of the assets considered for SLB have been used by the lessee for a substantial period of time and the value of the physical assets may be insignificant. Hence SLB is sometimes referred to as junk financing. Also it is significant to note that the proceeds of

sale of the assets by the lessee can be utilised for any purpose of the entity. In such cases mostly the lessor would look at the credit worthiness of the lessee than really considering the asset's value. The very fact that sale and lease back offers off balance sheet leverage may actually be subject to misuse and quite often than not is. In conventional lending, the amount financed is typically a proportion of the asset or is asset based. In case of sale and lease back since the exposure is on the lessee the value of the asset is not important and the funding is on the entire value of the asset instead of a proportion of it.

Last but not the least, SLB may sometimes lead to tax benefits as well (we shall see this in detail in the sections below). This has been one of the major drivers of SLB transactions in India and has its own pitfalls as well. One of the major pitfalls to SLB is the danger of excess leveraging; the lessee may tend to overvalue the asset. Considering that SLB is a mode of asset-backed lending but the asset has may not have much value and the lessee may exercise discretion on the application of funds poses threat of misuse of the product.

From the lessor's perspective the lessor may see SLB as a good mode of financing where the lessee's credit worthiness is good and he need not look at the asset for lending. In essence, while the lessor lends against the asset, but the asset may be junk for all practical purposes, hence lessor's exposure in SLB is completely on the lessee.
Considering the structure of SLB, which comes across as a money circulation device the biggest threat is that of the tax officer holding the lease as invalid or challenge the purchase price of the asset. If the transaction in substance comes across as a sham the tax officer may classify the transaction as a loan instead of a lease.

Legal issues in SLB:

The very thrust of doing sale and lease back transaction is the engineering behind doing such transactions. In India the over-aggressive use or misuse of sale and lease back transactions in the early 90s left lessor's with burnt fingers, made tax officers highly apprehensive of such shady transactions and lead to the downfall of the entire market.

The legal validity of SLB was discussed by the U.S Supreme Court in the landmark ruling of *Frank Lyon and Company*[1]. In Frank Lyon's case the bank took the building on lease back. Under the lease terms the bank was liable to pay rentals periodically and had the option to purchase the building at various times at a consideration based on its unexpired exposure. The bank took possession of the building in the year it was completed and the lessor claimed deductions on depreciation, interest on construction loan, expenses related to sale and lease back and accrued the rent from the bank. The Commissioner of Internal Revenue denied the claims of the petitioner on the grounds that the petitioner was not the owner of the building and the sale and lease back was a mere financing transaction. The Hon'ble Court held that –

[1] **435 U.S. 561 (1978);** http://supreme.justia.com/cases/federal/us/435/561/case.html

> *Where, as here, there is a genuine multiple-party transaction with economic substance that is compelled or encouraged by business or regulatory realities, that is imbued with tax-independent considerations, and that is not shaped solely by tax-avoidance features to which meaningless labels are attached, the Government should honor the allocation of rights and duties effectuated by the parties; so long as the lessor retains significant and genuine attributes of the traditional lessor status, the form of the transaction adopted by the parties governs for tax purposes.*

The fundamental principle of judicial interpretation of contracts is that the Court should be concerned with the real substance of the transaction rather than the form of the same. If there are reasons to believe that the form of the transaction and its real substance are not mutually corroborative, the Court must not be swayed by the form of the transaction nor by the nomenclature that the parties have given to it.

In India too, the sanctity of SLB transactions have been questioned often; sometimes the transactions have come out clean while in some cases, SLBs were considered sham.

In case of *Indian Management Advisors and Leasing P Ltd* vs. *Dy. Commissioner of Commercial Taxes*[2], the Delhi Tribunal did not rule out the possibility of sale and lease back transaction being a genuine transaction. In case of *CIT* vs. *Punjab State Electricity Board*[3], the Punjab and Haryana High Court has held the SLB transaction to be clean and genuine transaction. Punjab State Electricity Board (the assessee) sold energy saving devices and took the assets back on lease and claimed a deduction for lease rent paid. The Assessing Officer and the CIT (Appeals) disallowed the claim on the ground that the transactions were "sham". However, the Income Tax Appellate Tribunal upheld the plea of the assessee and remarked that,

> *"It cannot be said that any and every attempt of tax planning is illegal/ illegitimate or that every transaction or arrangement which is perfectly permissible under the law, having the effect of reducing the tax burden on the assessee cannot simply be discarded because it is the businessman/ assessee who is to take a decision in view of its business expediency."*

The High Court held that, *"Merely because tax liability was reduced could not be conclusive of arrangement being sham of a device."* It was observed that the assessee was entitled to arrange his affairs to reduce the tax liability without violating the law, relying on *UOI Vs Azadi Bachao Andolan*[4]. Tax planning is legitimate as far as it works within the periphery of law; colourable devices and dubious methods are what the law seeks to discard.

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[2] 51 ITD 566, http://indiankanoon.org/doc/704667/
[3] http://itatonline.org/archives/index.php/cit-vs-punjab-state-electricity-board-punjab-haryana-high-court/
[4] AIR 2004 SC 107

In *CIT* vs. *High Energy Batteries (India) Limited*[5], High Energy Batteries (the assesee) purchased an igni-fluid boiler from its sister concern and on the same day leased it back. The AO & CIT(A) held the sale and lease back arrangement to be a sham & camouflage for a loan by the assessee to the sister concern and rejected the assessee's claim for depreciation. However, the Tribunal allowed the claim on the ground that the transaction was not a "sham". The Madras High Court dismissed the appeal of the Department and held that: though the machinery was embedded and was in possession of the seller, the assessee took constructive delivery of the machinery and the law recognizes constructive delivery as the acceptable mode of delivery and possession. There was no material on record to show that the sale was a sham transaction and so its genuineness cannot be questioned. As regards the lease, the fact that some part of the funding came from Wipro Finance & that the lessee paid directly to Wipro in satisfaction of the assessee's obligation does not make the agreement a sham because it is a matter of pure commercial understanding between the parties as to the modalities of lease rental payment: *"it is a matter of pure commercial understanding between two parties under the agreement to decide as to the modalities of lease rental payment."* To invoke the theory of tax evasion, the Revenue must have sufficient evidence to the effect of showing an understanding on an agreement between the parties, not to be so in fact.

The Hon'ble High Court held that mere fact that what had been purchased had been leased out to the vendor or that vendor had undertaken to pay the hire charges on behalf of the assessee to the hire purchase company does not per se lead to a conclusion that the transaction is a sham one.

In a similar case of *CIT* vs. *Rajasthan State Electricity Board*[6], the sale and leaseback transaction was questioned as mere financing however the Rajasthan High Court found the transaction to be genuine and allowed lease rentals for deduction.

In a more recent ruling of *First Leasing Company Ltd* vs. *Assistant Commissioner of Income Tax*[7], the sanctity of a sale and lease back transaction was being discussed. The Madras High Court held that merely because sale and lease back (SLB) agreement provided for deduction of lease instalments from current consumption charges, it cannot be construed that the transaction is not a sale and leaseback but a mere loan transaction; merely because the assets were eligible for 100% depreciation does not mean that the transaction was doubtful. The Madras High Court held that as long as the SLB transaction was legally tenable in law and there was no reason to doubt the transaction depreciation would be allowed to the leasing company (assessee).

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[5] http://itatonline.org/archives/index.php/cit-vs-high-energy-batteries-india-ltd-madras-high-court-sale-lease-back-transactions-are-not-sham-transactions/; http://india-financing.com/Sale_and_lease_back_transaction_CIT_vs_High_Energy_Batteries_India_Limited.pdf

[6] (2006) 204 CTR (Raj) 415

[7] http://www.taxmann.com/topstories/101010000000087952/madras-hc-accepts-a-novel-sale-and-lease-back-transaction-allows-lessor-to-claim-depreciation-on-let-out-asset.aspx

In case of *CIT* vs. *Cosmo Films Limited*[8], Cosmo Films Limited (the assessee) purchased equipment from the Haryana State Electricity Board (HSEB) which was already installed at HSEB's Thermal Power Station at Faridabad and immediately thereupon leased the said equipment back to the HSEB on certain terms and conditions. The Assessing Officer rejected the claim of assessee for 100% depreciation, viewing that the transaction was not a case of purchase and lease back of equipment, but was a pure financial and loan transaction. The CIT (Appeals) rejected this order followed by the Income Tax Appellate Tribunal. In the Delhi High Court, it was contended on behalf of the revenue that the transaction in question was merely a finance lease transaction, wherein all the risks and rewards incidental to ownership are transferred to the lessee. Therefore, the transaction is not a sale and leaseback transaction, but a finance lease and as such relying on *Asea Brown Boveri Ltd v. Industrial Finance Corporation of India*[9], the assessee (lessor) was not entitled to depreciation on the equipment.

On a plain reading of the sale deed, the Delhi High Court observed that the property in the said equipment passed on to the assessee as the documents themselves indicate that HSEB conveyed and transferred its title, interest rights and privileges in the equipments sold completely and irrevocably in favour of the assessee. Perusing other clauses of the sale deed and the lease agreement, the Court concluded that the ownership of the equipment was of the assessee and that after the said transfer, the lease was entered into and the said equipment was leased back to the HSEB.

The Court expressed its consonance with the view taken by the Orissa High Court in *Industrial Development Corporation of Orissa Limited v. Commissioner of Income-tax and Others*[10] that the Court would have to find out as to what was the real intention of the parties in entering into the sale and lease agreement and that such intention has to be gathered from the words in the said agreement in a tangible and in an objective manner and not upon a hypothetical assessment of the supposed motive of the assessee to avoid tax. Also, the revenue could discard such transactions only if there are materials or evidence before it to show that the intentions of the parties are different from what has been incorporated in the sale and lease back agreements and that the transaction is really a sham and dubious transaction and is a colourable device.

In case of *CIT* vs. *The Installment Supply Ltd*[11], Instalment Supply Limited had purchased parts of computer system from HCL Hewlett Packard Limited (HCL) and leased it back to them. The assessee claimed 100% depreciation as a lessor and that the cost of each of the items was less than Rs. 5,000/-. The assessing officer held that the transaction was not *bona fide* as the assessee-lessor could not have been interested in acquiring spare parts and leasing them. Moreover, the assets included spare parts of computers, printers, logic

[8] http://www.indiankanoon.org/doc/1070529/
[9] AIR 2005 SC 17, http://www.indiankanoon.org/doc/1163314/
[10] 268 ITR 130 (Ori)
[11] http://www.india-financing.com/Lease_case_Law.pdf; http://itatonline.org/archives/index.php/cit-vs-the-instalment-supply-ltd-delhi-high-court-difference-between-finance-lease-operational-lease/

cards, adapter cards, power supply, etc and these assets could not function as independent machine. Further the assessee-lessor did not even provide for the details of the spare parts leased back to HCL. The presumption drawn was that HCL in all probability may have used those parts to manufacture computers and further sold them as well. The assessing officer alleged that the transaction was a device to avoid payment of tax.

Income Tax Appellate Tribunal (Tribunal) relying on the case of *CIT vs. Mir Mohammad Ali*[12] had reversed the findings of the assessing officer, considering force in the submissions of the assessee-lessor in the transaction on the pretext that the assets were owned by the assesee and the agreement captured all necessary conditions to satisfy the case to be a valid lease.

The High Court observed, "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" and the question cannot be decided by merely looking at the title of the agreement or the nomenclature given to the said agreement. The terms and conditions mentioned in the agreement may be relevant but the surrounding circumstances & type and nature of the asset have also to be considered. The High Court placed reliance on the judgment taken in *Asea Brown Boveri Limited vs. Industrial Finance Corporation of India and Others*[13] and *Association of Leasing and Financial Service Companies vs. Union of India*[14] and remanded the matter to the Tribunal since the real issue was not considered by the Tribunal in the right perspective. Further, the substantial question of law was decided in favour of the revenue and against the assesee; the Court held the transactions to be mere financing arrangements.

Accounting Issues

The accounting treatment for sale and lease back transactions comes from accounting standard 19 on leases (AS 19). AS 19 states that the accounting treatment for sale and lease back transaction depends on the type of lease involved. Para 48 to 55 of the standard illustrates the accounting mechanics of SLBs. The relevant extracts are reproduced below –

> *"48. If a sale and leaseback transaction results in a finance lease, any excess or deficiency of sales proceeds over the carrying amount should not be immediately recognised as income or loss in the financial statements of a seller-lessee. Instead, it should be deferred and amortised over the lease term in proportion to the depreciation of the leased asset.*

[12] (1964) 53 ITR 165
[13] (2004) 12 SCC 570
[14] (2011) 2 SCC 352

50. If a sale and leaseback transaction results in an operating lease, and it is clear that the transaction is established at fair value, any profit or loss should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.

52. For operating leases, if the fair value at the time of a sale and leaseback transaction is less than the carrying amount of the asset, a loss equal to the amount of the difference between the carrying amount and fair value should be recognised immediately

54. Disclosure requirements for lessees and lessors apply equally to sale and leaseback transactions. The required description of the significant leasing arrangements leads to disclosure of unique or unusual provisions of the agreement or terms of the sale and leaseback transactions.

55. Sale and leaseback transactions may meet the separate disclosure criteria set out in ***paragraph 12 of Accounting Standard (AS) 5****, Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies."*

As per AS-5, Net Profit or Loss for the Period, Prior Period items and changes in Accounting Policies;

"*12. When items of income and expense within profit or loss from ordinary activities are of such size, nature or incidence that their disclosure is relevant to explain the performance of the enterprise for the period, the nature and amount of such items should be disclosed separately.*

14. Circumstances which may give rise to the separate disclosure of items of income and expense in accordance with paragraph 12 include:

xxxxxx

(c) disposals of items of fixed assets;

xxxx."

In case of financial leaseback transactions, the lessee's balance sheet will reflect both the asset and the liability to pay future lease payments while the lessor's balance sheet will reflect the lease rentals as receivables. The fact of sale of asset is not considered as there is no accounting sale of the asset.

In case of operating leaseback transaction, the lessee will record the lease rentals paid as an expense. The asset goes off the books and no liability is created. While in the books of the lessor, the asset will be shown as fixed asset and the lease rentals received will be recorded as income and the lessor will claim depreciation as an expense. The accounting treatment for sale and financial lease back and sale and operating lease back in the books of the lessor have been explained in the standard as follows:

a. **Sale and finance leaseback** – any excess or deficiency of sale proceeds over the carrying amount should be amortised over the lease term in proportion to the depreciation of the leased asset and should not be recognised upfront.

b. **Sale and operating lease back** – it is assumed that the transaction is done at fair value. The following is the accounting treatment:

   i. Any difference in the carrying amount and the fair value should be recognised upfront.

   ii. In case the sale value of the asset is more than the carrying amount, it should be amortised over the lease term.

   iii. In case the sale value of the asset is the same as fair value of the asset, this will not have any accounting impact.

   iv. In case the sale value of the asset is less than the fair value, there are two scenarios that may arise:

      1. Where the loss on sale value is compensated by future lease payments at below market price such loss should be deferred over a period of time.

      2. Where the loss on sale value is not compensated by the future lease payments, the same should be recognised upfront.

Taxation Issues

Direct Tax Aspect

The bone of contention in lease transactions is the depreciation claim. In case of operating leases while the depreciation claim by the lessor is mostly an established scenario, the depreciation claims in case of financial leases have been swinging like a pendulum in favour of lessor and lessee over years and several judicial pronouncements. For tax purposes, depreciation is calculated on the block of the assets and not on the written down value of each asset separately.

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Section 2(11) of the Income Tax Act, 1961 (IT Act) defines block of assets to mean

> *‘"block of assets" means a group of assets falling within a class of assets comprising—*
>
> *(a) tangible assets, being buildings, machinery, plant or furniture;*
>
> *(b) intangible assets, being know-how, patents, copyrights, trade-marks, licences, franchises or any other business or commercial rights of similar nature,*
>
> *in respect of which the same percentage of depreciation is prescribed.”*

The sale proceeds of the assets sold are deducted from the written down value of the block. In case of SLB transaction, assets are sold at higher than written down value, and the gain made on such a sale results in reduction in depreciable value of the block of assets. The reduction in depreciation will be allowed over a number of years. Similar would be the case in case the asset was sold at less than written down value, it sale consideration would be reduced from the block of the assets.

Section 43 (1) provides for treatment of sale and lease back transactions for tax purposes, the relevant extracts are reproduced below –

> *“Explanation 3.—Where, before the date of acquisition by the assessee, the assets were at any time used by any other person for the purposes of his business or profession and the Assessing Officer is satisfied that the main purpose of the transfer of such assets, directly or indirectly to the assessee, was the reduction of a liability to income-tax (by claiming depreciation with reference to an enhanced cost), the actual cost to the assessee shall be such an amount as the Assessing Officer may, with the previous approval of the Joint Commissioner, determine having regard to all the circumstances of the case.”*
>
> *“Explanation 4A.*—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 *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.”

Explanation 3 and 4A of Section 43 (1) restricts the consideration at which the lessor purchases the assets to written down value of the asset as appearing in the books of the lessee before it was sold and taken back on lease. The explanation explicitly states that the sale value for such sale and lease back transactions will be ignored and depreciation will be allowed on the first seller's depreciated value. Take, for instance, A (lessor) purchased machinery for Rs. 150 crores from B (selling lessee), though the WDV in the books of B is Rs. 100 crores. A can claim depreciation on Rs. 100 crores and not on Rs. 150 crores.

Indirect Tax

The indirect taxes applicable to lease transactions would be as is applicable to sale nad lease back transactions as well. In case of sale and lease back there is a sale and leg and then a lease leg combined into on. When the asset is first sold to the lessor, the sale will be subject to central sales tax (CST) in case of interstate sale or VAT in case of intra state sale. Input tax credit is available under VAT laws of various States. But the same is available only if the dealer claiming the set-off fulfills certain conditions specified either in VAT Acts of the States or in their respective VAT Rules.

Thus, if the asset was subject to VAT at the time it was first sold to the lessee, the lessee can claim input tax credit at the time it is again sold by the lessee (assuming that the sale is a local sale). If the lessee has carry forward of input tax credit, the same can be set off against the VAT payable on sale of the asset.

Further, when the asset is taken back on lease, the lease rentals will also be subject to VAT. In case of the lessor who purchases the asset, the VAT paid on purchase is can be off-set similarly.

At the time of sale by the seller-lessee: When the seller lessee sells the asset to the prospective lessor; in effect the asset remains with the lessee only, and there is no movement of goods from one State to another. Therefore, *"The question of an SLB being an inter-state sale does not arise at all."*[15] Therefore, in any case the sale of the asset will be a local sale and chargeable to Value-added Tax (VAT, i.e. sales tax at State level only). What assumes significance here is the manner of acquisition of the asset by the selling lessee from the vendor, as discussed below:

i. Inter-State Purchase: In case the asset was acquired by way of an inter-state purchase, then the selling lessee must have paid Central Sales Tax (CST).

ii. Intra-State Purchase: In case the asset was acquired by way of an intra-state purchase, the VAT paid on the purchased asset can be claimed against the VAT paid on the sale of the asset.

[15] Vinod Kothari: *Sale and leaseback transactions: Walking once again on Achilles' Heels* http://india-financing.com/sale_and_leaseback_transactions.pdf

At the time of leaseback by the lessor: As there is no movement of assets, the leaseback will not qualify as inter-state sale; therefore, the lease will be an intra-state lease. The goods are with the selling lessee, so the State in which goods are situated will impose VAT. VAT will be charged on the lease rentals. Therefore, VAT paid by the lessor on the purchase of the asset is off-settable against the VAT charged on lease rentals. The VAT paid on lease rentals by the lessee is also off-settable.

Conclusion

In the heydays of leasing in India, sale and leaseback transactions had become popular amongst leasing companies and were equally misused by them, so much so that all sorts of sham transactions were undertaken in the garb of sale and leaseback which put to question the sanctity of such transactions in India.

During the 1996-98 period one of the most infamous cases was the sale and leaseback of electric meters by state electricity boards (SEBs). For SEBs it made perfect sense as it amounted to cheap borrowing by the cash starved SEBs who had practically no other source of borrowing. For leasing companies and others looking for a tax break, it was a perfect deal as there was 100% write off in case of assets costing Rs 5000 or less. Thus an electric meter will qualify for 100% deduction. Several SEBs had undertaken such transactions in those days. Obvious enough the sole motive was tax deduction no one would care about the value, quality, existence etc of the meters. In some cases, the asset was bought on 30th March to be used only for a day, assets revalued heavily at the time of sale to leasing companies etc.

Lease of non-existing assets such as electric meters, computers, glass bottles, tools, etc, lure of depreciation allowances caused the tax authorities to come down hard on sale and leaseback transactions calling them tax evading transactions. The whole fiasco of such sham transactions resulted in leasing going off the market completely.

The burns of the past continue to linger even after a decade and half since SLB transactions were completely written off. However with the revival of leasing industry in the last couple of years, sale and lease back seemingly is also making a come back but the riders from the past still holds good.