

Lease equalisation charges leading to determination of ‘real income’ of the lessor allowable for tax purposes: SC

Summary

The Supreme Court (SC)¹ has upheld the tax deductibility of lease equalisation charges from the lease rental earned by a taxpayer in the course of a finance lease transaction. The lease equalisation charges were reduced from the rental amount by the taxpayer in accordance with the Guidance Note on Accounting for Leases² issued by the Institute of Chartered Accountants of India (ICAI). The SC has also held that there is no express bar in the Income-tax Act, 1961 (the Act) regarding the application of accounting standards issued by the ICAI.

Facts of the case

- The taxpayer leased out certain assets on a finance lease. In its books of accounts, it followed the Guidance Note on Accounting for Lease and claimed a deduction of lease equalisation charges apart from depreciation as prescribed. The lease equalisation charges were claimed as deductible along with depreciation in the tax computation.
- The tax officer disallowed the claim made in the ROI and added it to the income of the taxpayer. The disallowance was upheld by the first appellate authority.
- On further appeal, the Income Tax Appellate Tribunal (ITAT) agreed with the taxpayer’s contentions, which were also upheld by the High Court (HC).
- Aggrieved with the HC order, the Revenue Department filed an appeal in the SC.

¹ CIT vs. Virtual Soft Systems Ltd. [TS-205-SC-2018]

² GN (A) 10 (Revised 1995)

Revenue's contentions

- Lease equalisation charges were claimed in the Profit and Loss (P&L) account in addition to the depreciation already claimed in the books so as to make it equal to capital recovery. Therefore, this was an artificial calculation which bifurcated lease rental into the capital recovery and interest components.
- There is no concept of deduction regarding lease equalisation charges under the Act.

Taxpayer's contentions

- The Guidance Note issued by the ICAI carries great weight, and the adoption of such accounting prescribed cannot be disregarded by the tax officer unless such action falls within the scope of relevant provisions³ of the Act.
- Lease equalisation charges were nothing but a method of adjusting the depreciation claimed in the books of accounts enabling the taxpayer to represent its real income by adopting an accounting methodology approved by the ICAI.

SC ruling

- When a recognised body of accountants like the ICAI publishes certain materials for its members after due deliberation and consideration, they can be relied on. In this regard, the SC relied on one of its earlier decisions⁴.
- Taking into consideration relevant provisions⁵ of the Companies Act, 1956, the SC stated that according to those provisions, accounting standards prescribed by the ICAI shall prevail until accounting standards are prescribed by the central government.⁶
- Rejecting revenue's stand that bifurcation of the lease rental is an artificial calculation, the SC held that the method of accounting as derived from the ICAI's Guidance Note is a valid method of capturing real income based on the substance

³ Section 145(3) of the Income-tax Act, 1961

⁴ CIT vs. Punjab Stainless Steel Industries [2014] 364 ITR 144 (SC)

⁵ Section 211(3C) of the Companies Act, 1956

⁶ The Companies Act, 1956 vide Companies (Accounting Standards) Rules, 2006 had prescribed the accounting standards which continue to be applicable even under the Companies Act, 2013, except on companies which have transitioned to Ind AS Accounting Standards issued vide Companies (Accounting Standards) Rules, 2015.

of a finance lease transaction. The rule of 'substance over form' as a fundamental principle of accounting was applicable in the said case.

- Lease equalisation is an essential step in the accounting process to ensure that only real income from the transaction in the form of revenue receipts is captured for the purposes of income tax. Further, there is no express provision under the Act which bars the bifurcation of lease rental.
- Based on the aforesaid observations, the SC upheld the order of the HC allowing the bifurcation of lease rental as prescribed by the ICAI stating that the application of such accounting method was valid under the Act.

Our comments

The decision of the Apex Court giving finality to the tax treatment of lease equalisation charges is a positive step, and it also reaffirms the applicability of the accounting standards issued by the ICAI for determination of 'real income' for the purpose of tax computation.

It is important to note that this Guidance Note is not applicable for assets leased on or after 01 April 2001. In respect of such assets, either Accounting Standard (AS) 19 Leases or Indian Accounting Standard (Ind AS) 17 Leases is applicable. Under AS 19 as well as Ind AS 17, assets given on a finance lease are de-recognised and finance income is recognised based on a pattern that reflects a constant periodic rate of return on the net investment. Thus, a finance lease under AS 19 or Ind AS 17 does not require any lease equalisation adjustment.

Further, lease equalisation is prescribed for accounting of an operating lease where relevant. In this regard, while the SC decision does indicate that lease equalisation reflects 'real' income, one would need to evaluate its applicability in case of operating lease transactions.



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