# All About Taxation Of Leasing Business

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**Now leasing transactions are subject to service tax also, though, at present levy is on limited category of lessors. The article presents an overview of the controversy surrounding the issue, line of judicial thinking, evolvement of law and resultant tax planning avenues to properly plan affairs of business.**

Taxation of leasing transactions under Indirect Tax laws has been a subject of litigation in past. Leasing of assets is not a transaction of sale as is understood in common parlance. Therefore separate dedicated sections in the Sales Tax laws of states are inserted to tax consideration flowing out of such transaction and such tax is levied in the name of 'Tax on transfer of right to use'. To finally settle the dispute between tax authorities and assesses about taxing of leasing transactions, it required amendment in constitution and Central sales Tax Act.

## Constitutional Provisions

To understand the whole issue, it is important to have a quick view of various provisions of Constitution, from where taxing powers of Centre and States are controlled.

**Article 265** of the Constitution provides that "No tax shall be levied or collected except by authority of law"

Article 265 requires that—-

(i) there must be a law

(ii) the law must authorize the tax; and

(iii) the tax must be levied and collected according to the law.

It has been held by courts that the authorization made by the statute to levy a tax must be expressed. Taxing power cannot be derived from the delegation of mere regulating power.

**Article 245** of the Constitution provides that "Subject to the provisions of this constitution, Parliament may make laws for the whole or any part of the territory of India, and the legislature of a state may make laws for the whole or any part of the state."

**Article 246** provides that:

a) Parliament has exclusive power to make laws with respect to

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any of the matters enumerated in List I in the seventh schedule

b) Subject to a above, Parliament as well as Legislature of any state have power to make laws with respect to any of the matters enumerated in List III

c) Subject to a and b above, Legislature of any state has exclusive power to make laws for such state with respect to any of the matters enumerated in List II.

## Controversy and enactment of Central Sales Tax Act

Until 1955, lot of confusion prevailed over powers of states to levy tax on Inter State Transactions. In 1955, Supreme Court, in the case of *Bengal Immunity Company Ltd.* Vs. *State Of Bihar* [1955] 6 STC 446 held that What is an inter-State sale or purchase continues to be so irrespective of the State where the sale is to be located. The site of sale or purchase is wholly irrelevant as regards its inter-State character. Until parliament by law made in exercise of the powers vested in it by the then clause (2) of article 286 provides otherwise, no state can impose or authorize the imposition of any tax on sales or purchases of goods when such sales or purchases take place in the course of inter-State trade or commerce.

After the above decision of Supreme Court certain recommendations were made by the Tax Inquiry Commission, proposing certain amendments in the Constitution relating to levy of sales tax. The Aforesaid recommendations were accepted and as a result of which parliament passed the Constitution (Sixth Amendment) Act, 1956 whereby following amendments (so far it relates to levy of Sales Tax) were made.

1) In list I of the Seventh Schedule, entry 92-A was added, which read as "Taxes on the sale or purchase of goods other than newspapers, where such sale or purchase takes place in the course of inter-state trade or commerce."
2) Words "subject to the provisions of entry 92-A of list I" were added to entry 54 of list II
3) Sub-clause (g) to clause 1 of article 269 was added.

**In absence of definition of the word "Finance leasing" in the relevant Act, true character of a lease viz. Finance/Operating leasing should be determined on the basis of definitions provided in AS-19 issued by ICAI.**

Further a new clause 3 was added to article 269, combined affect of which was that Central Government got the power to assign taxes levied and collected on Inter state sales or purchase and also to enact law to determine, when a sale or purchase will be deemed to be in the course of Inter state trade.

Consequent to amendment in article 269 enumerated in 3 above, article 286 was also amended, whereby deeming fiction of Inter state sales or purchase being considered to be sale within state was done away with. Central Government also assumed powers to enact law to formulate principals as to when a sale or purchase will be deemed to be in the course of import in or export out of India.

Above amendments cleared the way for Central Government to pronounce a comprehensive law to levy tax on Inter State Transactions, according to which the Central Sales Tax Act was enacted, which came into being on 21.12.1956.

Declared objects of the Central sales Tax Act, 1956 reads as under: -

"An Act to formulate principles for determining when a sale or purchase of goods takes place in the course of inter-state trade or commerce or outside a state or in the course of import into or export from India, to provide for the levy, collection and distribution of taxes on sale of goods in the course of inter-state trade or commerce and to declare certain goods to be of special importance in inter-state trade or commerce and specify the restrictions and conditions to which state laws imposing taxes on the sale or purchase of such goods of special importance shall be subject."

## Controversy about taxing leasing transactions

Sales tax laws of Central and State Governments proceeded on the footing that the expression 'sale of goods' having regard to the rule as to broad interpreta-

tion of entries in the legislative list, would be given a wider connotation. However, Supreme Court, in *state of Madras* Vs.*Gannon Dunkerly & Co. (Madras) Ltd.* [1958] 9 STC 353/ AIR 1958 SC 560 held that the expression 'Sale of goods' as used in the entries in seventh schedule to the Constitution has the same meaning as in the Sale of Goods Act, 1930.

By a series of subsequent decisions, the Supreme Court, on the basis of the Gannon Dunkerly's case, held various other transactions which resemble, in substance, transaction by way of sales, to be not liable to sales-tax. These included transaction of leasing.

**In the current era of business restructuring, there are several instances where running plants as a whole are leased out. A care should be taken to clearly list the items fastened to earth permanently in lease agreement and lease rent should be fixed in two parts viz. for land, building and items permanently fastened to them and other. There is no Sales Tax liability on former.**

The various problems connected with the power of the states to levy a tax on the sale of goods and with the Central Sales Tax, 1956 were referred to the Law Commission of India. The Commission considered these matters in their sixty-first report and, recommended *inter-alia* certain amendments in the Constitution if as an administrative policy it is decided to levy tax on transactions of the nature mentioned in the preceding paragraphs.

Consequent to above, The Constitution (Forty-Sixth Amendment) Act, 1982 was enacted by virtue of which, among other amendments, clause 29-A was inserted in Article 366, which provided for definition of term "tax on the Sale or purchase of goods" Such definition reads as under: -

"Tax on sale or purchase of goods' includes-

a) a tax on the transfer, otherwise than in pursuance of a contract, of property in any goods for cash, deferred payment or other valuable consideration;
b) a tax on the transfer of property in goods (whether as goods or in some other form) involved in the execution of a works contract;
c) a tax on the delivery of goods on hire-purchase or any system of payment by installments;
d) a tax on the transfer of the right to use any goods for any purpose (whether or not for a specified period) for cash, deferred payment or other valuable consideration;
e) a tax on the supply of goods by any unincorporated association or body of persons to a member thereof for cash, deferred payment or other valuable consideration;
f) a tax on the supply, by way of or as part of any service or in any other manner whatsoever, of goods, being food or any other article for human consumption or any drink (whether or not intoxicating), where such supply or service is for cash, deferred payment or other valuable consideration.

And such transfer, delivery or supply of any goods shall be deemed to be a sale of those goods by the person making the transfer, delivery or supply and a purchase of those goods by the person to whom such transfer, delivery or supply is made."

After above amendments in Constitution, way was paved clear to levy tax on transactions of transfer of right to use, and several states made suitable arrangements by way of enactment of new law or modification to existing laws to levy tax on such transactions.

## Local Sales Tax Vs. Central Sales Tax

Several State Governments tried to bring within the purview of their taxing power, transfer of right to use the goods, in case goods in question are used by the lessee within their state irrespective of the fact that the contract of transfer of right to use has been executed outside the state or sale has taken place in the course of an inter-state trade or goods have been delivered to the lessee outside the state.

However, the Supreme Court in the case of *20th Century Finance Corp. Ltd.* Vs. *State of Maharashtra* 119 STC 182, has taken note of such attempt and has

quashed such attempts as violative to the constitution.

It was held that State legislatures are not competent to enact law imposing tax on transactions of transfer of right to use any goods that take place in the course of inter-state trade or commerce. First because of entry 54 of list II itself, which gives power to legislate to states subject to entry 92A of List I and again by virtue of clause (1) of article 286, which imposes certain restrictions as to imposition of tax on sale or purchase of goods.

It was further held that in cases where goods are not in existence or where there is an oral or implied transfer of the right to use goods, such transaction may be effected by delivery of goods; in such cases the taxable event would be on the delivery of goods i.e. the State in which goods are delivered for use by lessee.

The delivery of goods may be one of the elements of transfer of right to use, but that would not be condition precedent for a contract of transfer of the right to use goods. Where a party has entered into a formal contract and the goods are available for delivery irrespective of the place where they are located, the situs of such sale would be where the property in the goods passes, namely, where the contract is entered into. Where the goods are when the right to use them is transferred is of no relevance. Also, where the goods for use were delivered is also of no relevance.

It was found that Article 366(29A)(d) allows levy of tax not on use of goods but on the transfer of the right to use goods.

Thus a clear distinction was made by above judgment, about situs of such deemed sale in cases (1) where goods were not in existence before execution of contract for transfer of right to use (2) where transfer of right to use was through an oral or implied contract and (3) where goods were in existence before execution of contract for transfer of right to use.

It was further held that a deemed situs of sale can only be fixed by the appropriate Legislature (parliament) by creating a legal fiction to tax such transactions in case of inter state transactions.

Supreme Court, more than once has held that in taxing laws, it is must to have substantive law and liability can not be imposed by fiction of law. This position was affirmed in *India Carbon Ltd.* Vs. *State of Assam* [1997] 106 STC 460, after which Central Sales Tax Act was amended in 2000 to expressly provide for levy of interest, though with retrospective effect.

Though amendment to Central sales Tax Act was due, immediately after 46th amendment to Constitution in 1982, it is not clear, what prevented Government to amend the Act accordingly. It was only after decision in 20th Century Finance case, that the Act was amended to include transactions of transfer of right to use in the definition of sale. It is pertinent to note here that this amendment is prospective and therefore it can be safely concluded that neither Central Government nor State Governments were authorized to levy tax on such Inter State Transactions.

**It is now clear that there is no service tax liability on 'Operating leases' and 'Leasing transactions' where lessor is other than a Banking Company, Financial Institution, Non Banking Finance Company or any other body corporate.**

## Development after Supreme Court decision in 20th Century finance case

Despite judgment from apex court and consequent amendment to CST Act, controversy seems to be unabated, latest in the series being *TATA Elxsi Ltd.* Vs.*State Of Uttaranchal* [2004] 134 STC 403, wherein while dealing with controversy of tax on leasing transaction and after considering the decision in 20th Century case, court observed that in view of section 3(a) of the Act, to be regarded as Inter State Transaction, what is important is movement of goods. The movement and sale must have a direct link. Even if the movement of goods is not specified in the contract, if the movement of goods takes place incidental to the contract the transaction would be inter-State sale. Court distinguished between "non-existent goods" and "unascertained goods". What transpires from above is that ruling of Supreme Court holding event of taxation in case of non-existent goods at the place of delivery holds goods where transaction is about items made to order, and goods or ordered for manufacture after entering into transaction for lease. In cases, where goods are existing but unascertained,

liability to tax will have to be examined in the light of section 3(a) only and ruling in 20th Century case will not be applicable.

## Service tax on leasing transactions: A new twist

Section 65(12) read with section 65(105)(zm) & section 66 of Finance Act, 1994 prescribes for levy of service tax on Financial leasing services including equipment leasing and hire purchase by a body corporate. Sections 65(12) & 65(105) appears to be loosely drafted as can be seen from plain reading of section 65(105)(zm), where such service provided by a Banking Company or a Financial Institution including a NBFC has been covered in the definition of taxable service. Thus 65(105)(zm) do not include such service provided by a person other than mentioned in section. On the other hand, section 65(12), while defining the term "banking and other financial services", specifically includes such services provided by any other body corporate in addition to banking companies, financial institutions and NBFCs. Thus it is difficult to make out legislature intention and will lead to dispute between department and service providers. However, that anomaly has now been corrected by Finance (No.2) Act, 2004, whereby definition provided has been amended to include body corporates also. Leaving above ambiguity apart, it is clear that there is no service tax liability on

i) Operating leases
ii) Leasing transactions where lessor is other than a Banking Company, Financial Institution, Non Banking Finance Company or any other body corporate.

In absence of definition of the word "Finance leasing" in the relevant Act, true character of a lease viz. Finance/Operating leasing should be determined on the basis of definitions provided in AS-19 issued by ICAI.

As held by Supreme Court in *T.N.Kalyana Mandapam Association* Vs.*Union of India* [2004] 135 STC 480/267 ITR 9 Parliament has got the power to levy service tax by virtue of entry 97 of list I of the Seventh Schedule of the Constitution. List I is known as Union List i.e. by virtue of article 246, parliament has got exclusive power to make laws in respect of subjects listed in that schedule and states are not empowered to do so.

As per Ministry of Finance letter F.No. BII/1/2000-TRU, dated 09.07.2001 Annexure VII para 2.1-3 it is clarified that "Service tax in the case of financial leasing including equipment leasing and hire purchase will be leviable only on the lease management fee/processing fee/documentation charges (recovered at the time of entering into the agreement) and on the

## Lease as distinguished with temporary hire for use

Several times equipment/machineries etc. are given on hire for use by others temporarily. This situation often arises in large turnkey projects where contractors are allowed to use equipments owned by entrepreneurs for which charges are deducted while settling their bills.

Some times, several heavy equipment like road rollers, crains etc. are borrowed by nearby industries for temporary use.

A dispute often arises about the taxability of consideration for above. As held by Supreme Court in State of Andhra Pradesh and another Vs.Rashtriya Ispat Nigam Ltd. [2002] 126 STC 114, giving effective control to lessee is necessary to say that the transaction is a taxable lease transaction.

After decision of Supreme Court in State of Uttar Pradesh Vs. Union of India [2003] 130 STC 1, doubt was raised by certain circles of tax authorities as to applicability of ruling in Rashtriya Ispat Nigam Case (Supra).

However, Kerala High Court had occasion to deal with above situation in Alpha Clays Vs. State of Kerala [2004] 135 STC 107, wherein ratio of judgments of apex courts in both the above cases was examined and it was again affirmed by court that in order to attract tax particularly under the expressions "transfer of the right to use goods" there must be parting with the possession of the goods for the limited period of its use by the lessor in favour of lessee. So long as effective control of the goods is with the lessor, the rent received from the customer for use of the goods will not attract tax under the expressions "transfer of the right to use goods"

finance/interest charges (recovered in equated monthly installments) and not on the principal amount."

It transpires from above that a clear demarcation has been made between powers of Central and State so far taxability of finance leasing transactions is concerned. State government is empowered to collect tax on principal component of the transaction in the form of State Sales Tax or Central Sales Tax, whereas Central Government will levy and collect tax on interest component. This is in consonance with the federal taxing structure as envisaged in the Constitution.

As levy of service tax on leasing transaction began w.e.f.16.07.2001, it appears, above finer point of law is still unnoticed by many. Since the demarcation of Central and state powers has become clearer by clarification from ministry and again ruling of Apex court in T.N.Kalyana Mandapam case, a care should be taken to clearly bi-furcate principal and interest components in the agreement for lease itself and pay Sales tax only on principal component. This holds good even in cases where because of lessors being individuals, proprietorship or partnership firms there is no service tax liability.

**Section 65(12) read with section 65(105)(zm) & section 66 of Finance Act 1994 prescribes for levy of service tax on Financial leasing services including equipment leasing and hire-purchase by a body corporate.**

## Liability under Interest Tax Act

**For the purposes of Interest tax Act, leasing activity is not a financial activity and lease rentals earned by a company cannot be brought to tax under Act.** *Rajath Leasing & Finance Ltd.* Vs. *Jt.CIT* [2004] 89 ITD 289 (Rajkot)

## Tax Planning

Following aspects of tax planning emerges from above discussion.

1. Study of rates of taxes on such transaction in different states is prerequisite before entering into such agreements. Agreement should be entered in the state, where tax rate is minimum.
2. A question may arise, whether agreement can be entered into a third state, i.e. where neither lessor nor lessee has its principal place of business. Answer to this appears to be positive. However, care should be taken to seek registration with tax authorities of that state, clearly mentioning the business of leasing as one of the nature of business.
3. In case of non-existent goods also, above care should be taken and delivery of goods should be planned accordingly as far as possible.
4. Principal and interest components should be bifurcated in agreement for each EQA in clear terms and Sales tax liability should be admitted on principal component only.
5. Levy of Sales tax is on goods. Under Sale of Goods Act, 1930 goods are defined to mean movable property/things. In absence of definition of term "Movable property" in the relevant Acts, shelter will have to be taken of General Clauses Act, 1897 according to which movable property shall mean property of every description except land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth.

In the current era of business restructuring, there are several instances where running plants as a whole are leased out. A care should be taken to clearly list the items fastened to earth permanently in lease agreement and lease rent should be fixed in two parts viz. for land, building and items permanently fastened to them and other. There is no Sales Tax liability on former. This view finds strength from the fact that plant is understood to be a combination of Land, building and machinery. Transaction of leasing of plant is inseparable in terms of Land & Building on one part and machinery on other part.

Concept of subject being immovable property holds good in the cases of sale and lease back transaction of heavy machinery also, where machinery is not removed from its foundations in earth and transaction is completed only by exchange of documents and cheques.

Some of the tips mentioned above, particularly 1

**The Finance (No.2) Act, 2004 has made a clear demarcation between powers of Centre and States so far taxability of finance leasing transactions is concerned. States are empowered to collect tax on principal component of the transaction in the form of State Sales Tax or Central Sales Tax, whereas Centre will levy and collect tax on interest component.**

1 & 2 may look crazy and there may be apprehension that tax authorities will not allow such planning looking to the observation of Apex Court in *Mcdowell And Co.* case 154 ITR 148.

In fact, issue of tax planning was raised during arguments in 20th Century Finance case, and apprehension was expressed that several lessors will shift their head office to neighbouring countries only to avoid sales tax. It was felt that parliament has ample power under article 246 of the constitution to plug such loopholes. So long there is no specific law preventing such transactions, taxpayer has every right to plan its affairs to minimize tax.

It is further to be noted that theory laid down in Mcdowell case has since been watered down substantially by Apex court itself by delivering judgment in *Union of India* Vs. *Azadi Bachao Andolan* [2003] 263 ITR 706/ 132 Taxman 373. It was held that an act which is otherwise valid in law cannot be treated non est merely on the basis of some underlying motive supposedly resulting in some economic detriment or prejudice to the national interest.

Judgments of Apex court in Mcdowell And Co. & Azadi Bachao Andolan case came up for consideration in *Industrial Development Corp. Of Orissa Ltd.* Vs. *CIT* in [2004] 137 Taxman 556 (Orissa). It was held that "If a transaction is otherwise valid in law and results in reduction of tax to an assessee, the same cannot be brushed aside on the ground that the underlying motive of entering into the transaction by the assessee was to reduce its tax liability to the State."

## Conclusion

Looking to the unabated hunger of the Government to generate resources to fund maintenance and development needs of the nation, new ways and means of taxing cannot be overruled. However, winners will be those, who can optimize their tax outgo by proper understanding of law and plan their affairs accordingly. This article tries to provide basic fuel to fire that planning process. ■

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### Corrigendum

In the article titled 'Regulating the NBFCs-Lessons from RBI' published in our October 2004, issue (page 414, 4th line) please read the figures as Rs. 2000/3000 million and not as printed. The error is regretted. The article was based on the author Shyamala Gopinath's address to Financial Sector Conference, Organized by World Bank in New Delhi on June 6, 2004.