

Supreme Court upholds deduction for lease equalisation charges – takes note of ICAI's Guidance Note on leases

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In brief

In a recent decision¹, the Supreme Court of India (SC) has upheld the order of the Delhi High Court² (HC) allowing bifurcation of lease rental income into capital recovery and finance income based on the Guidance Note issued by the Institute of Chartered Accountant of India (ICAI). Accordingly, the SC has also upheld the deduction claimed by the taxpayer for lease equalisation charges debited to the Profit and Loss account (P&L a/c).

In detail

Facts

- The taxpayer an Indian Company which had leased an asset on a finance lease filed its return of income claiming a deduction for lease equalisation charges against its lease rental income. The taxpayer had followed the Guidance Note (dated 20 September, 1995) issued by ICAI when accounting for leases.
- As per the Guidance Note, lease rentals under finance lease is shown separately under "Gross Income" in the P&L a/c. The Guidance Note prescribes that against this lease rental income a matching annual charge is debited to the P&L a/c. The annual lease charge should have been calculated by first

deducting the annual lease rental with the finance income for the period (i.e. capital/ principal sum recovery). This net annual lease charge would comprise of two items – i) Depreciation on the asset leased and ii) Lease equalisation charge/ credit. When the depreciation for the period was less than the net annual lease charge (capital recovery), then the difference was to be debited to P&L a/c as lease equalisation charge. In the *vice versa* situation, the difference was to be credited to the P&L a/c i.e. lease equalisation credit.

- The tax officer (TO) disallowed the deduction claimed by the taxpayer for such lease equalisation

charges debited to the P&L a/c.

- On appeal, the Commissioner of Income-tax (Appeals) [CIT(A)], upheld the disallowance made by the TO.
- Aggrieved, the taxpayer preferred an appeal before the Income-tax Appellate Tribunal (Tribunal), which held in favour of the taxpayer and set aside the CIT(A)'s order.
- Aggrieved by the order of the Tribunal, the Revenue preferred an appeal before the Delhi HC, which dismissed the appeal and upheld the Tribunal's order.

Issue before the Supreme Court

Whether the deduction for

¹ Civil Appeal Nos. 4358 to 4376 of 2018

² ITA Nos. 216, 398, 403, 404 and 680 of 2011(Delhi HC)

lease equalisation charges from lease rental income could be allowed under the Income-tax Act, 1961 (Act) on the basis of the Guidance Note issued by the ICAI?

Revenue's contention

- The lease equalisation charge is a deduction debited to the P&L a/c in addition to depreciation claimed in the books, to make the sum of both equal to the capital recovery.
- Thus, it is merely an artificial calculation to bifurcate the lease rental into the components of capital recovery and interest.
- The entire lease income constitutes the income of the taxpayer.
- There is no concept of deduction for lease equalisation charge under the Act.

Taxpayer's contention

- It is a settled principle that a Guidance Note issued by the ICAI carries great weight and the adoption of the method prescribed in such Guidance Note for computing real income under the Act cannot be disregarded by the TO unless such action calls for rejection of the books³.
- The lease equalisation charge is nothing but a method adjusting the depreciation claimed in the books of accounts to represent the taxpayer's real income by

adopting an accounting methodology approved by the ICAI.

Supreme Court's decision

- First, the SC, referred to the relevant section of the Companies Act, 1956 (relevant for the year under consideration) and the SC decision in the case of Punjab Stainless Steel Industries⁴, acknowledging the significance and relevance of Guidance Notes issued by the ICAI. The SC observed that the ICAI's Guidance Note on Accounting for Leases reflects the best practices adopted by accountants throughout the world and it was not disputed that the body of experts develop accounting standards after extensive study and research.
- Second, after examining the relevant paragraphs of the Guidance Note, the SC noted that the Guidance Note captures "real income" by separating the lease rentals into elements of capital recovery (representing repayment of the principal amount) and finance income, which was in the nature of a revenue receipt. Accordingly, the SC clarified that the method prescribed in the Guidance Note was a valid method of capturing real income based on the substance of finance lease transaction.
- Thus, the SC observed that if such bifurcation (between capital recovery and finance

income) were not performed, the taxpayer would be assessed for income-tax not merely on revenue receipts but also on non-revenue items, which was contrary to the principle, scheme and spirit of the Act. Accordingly, the SC upheld that the taxpayer was entitled to such bifurcation.

- Lastly, the SC did not agree with the plea of the Revenue that the lease equalisation deduction was unallowable, as there was no such express provision in the Act. The SC clarified that the Act did not bar the application of such Guidance Note and that in absence of internal aid in the Act, it was obvious that for computing a fair and real income liable to tax under the Act, the taxpayer must take recourse in the Guidance Note prescribed by the ICAI.

The takeaways

The SC has re-affirmed the principle that only real income in the nature of revenue receipts can be taxed under the Act. Importantly, the SC also has upheld the principle that a taxpayer can take recourse to the Accounting Standards/ Guidance Notes issued by the ICAI to compute taxable income under the Act, when not in conflict with any other provisions of the Act.

Let's talk

For a deeper discussion of how this issue might affect your business, please contact your local PwC advisor

³ Section 145(3) of the Act

⁴ CIT v. Punjab Stainless Steel Industries (2014) 15 SCC 129 (SC)

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