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Court : Income Tax Appellate Tribunal ITAT Delhi

Decided On : Feb-17-2006

Judge : N Vasudevan, N Saini

Appellant : Goodwill India Ltd.

Respondent : Dcit

Judgement :

1. ITA No. 2977/Del/02 is an appeal by the assessee and ITA No.3227/Del/02 is an appeal by the Revenue and both these appeals are directed against the order dated 7.5.02 of CIT(A)-XV, New Delhi relating to the assessment year 97-98. ITA No. 2912/Del/02 is an appeal by the assessee while 3228/Del/02 is an appeal by the Revenue and both these appeals are directed against order dated 6.5.02 of CIT(A)-XV, New Delhi. ITA No. 1712/Del/02 is a appeal against the order dated 19.2.02 of CIT(A)-XV, New Delhi relating to the assessment year 98-99. All these appeals were heard altogether and involve identical issued. They were heard altogether and are being disposed of by this consolidated order.

2. The only issue for consideration in the three appeals filed by the assessee is with regard to the addition made by the Assessing Officer on account of lease equalization charges. The facts with regard to the lease equalization charges claimed as deduction by the assessee, which was disallowed by the Revenue authorities are as follows. The assessee is a company which is engaged in the business of leasing and hire purchase. In respect of the assets which it had granted on lease to the customers, the assessee reflected them as fixed assets in

its balance sheet. In other words, the assessee was the owner of the assets which were given on lease. As owner of the assets, the assessee claimed depreciation on the assets. The lease charges received by the assessee was shown as a receipt in the Profit & Loss Account. The assessee had however deducted from the lease charges certain amounts carried over to lease equalization reserve and only the balance has been credited to the P&L account. In the notes to the accounts, the system of deducting lease equalization reserve from the lease charges received has been explained as follows: Lease Rentals are accounted for as per the terms of the lease agreements. However, in compliance with the Guidance note issued by the Institute of Chartered Accountants of India, the differential between the capital recovery component comprised in lease rentals and depreciation referred to in Note 4(a) above is carried as "Lease Equalization" and shown as a deduction from Lease Rentals" in the Profit and Loss account for all assets acquired on or beginning from 1st April, 1995 and the same has not been done for assets acquired upto 1st April, 1995.

3. To understand the stand of the assessee it is necessary to explain the manner in which the assessee arrives at the lease equalization charges. When the assessee gives the assets on lease it computes the lease rent payable monthly or annually by taking into consideration the interest for the entire period of lease and spreads over the cost of the asset and the interest, to the entire period of lease. The assessee also claims depreciation as per the Income Tax Act but as at the end of the lease period, the assessee does not recover the full cost of the assets in the form of depreciation. This is illustrated by the assessee as follows:

(Assuming that an assets has been financed for a period of 3 years @ 15%)
 Cost of asset : Rs. 100
 Interest (finance charges) @ 15% for 3 years: Rs. 45 -----
 Gross Lease Rents : Rs. 145 (To be spread over -----lease period of 4. The assessee has also given farther illustration explaining basis on which the lease equalization charges are determined for the period of lease of an asset.)

1) Capital cost	100	_____	_____
2) Financial charges	45	_____	_____
c) Lease equalization	12	12	_____
d) Lease rental	(33 + 15)	48	_____
Third year	c) Lease equalization	19	19
	d) Lease rental	(34 + 15)	49

5. The Revenue authorities have, however, not accepted this claim made by the assessee. The Assessing Officer in the order of assessment for assessment year

98-99 has explained this system and has given the following reasons for not accepting the same.

The method of accounting is further explained by way of an illustration given below: The various accounting entries in the books of the lessor and the computation of income would be as per the table given below:

	Year 1st	2nd	3rd	4th	Total
Capital balance outstanding	1000	800	570	305.52	350
Lease rent received	350	350	350	1400	350
Finance charges	150	120	85.5	45.825	401.34
Capital recovery component[(2)-(3)]	200	230	264.5	304.18	998.75
Depreciation charged in the books	100	100	100	100	400
Lease equalization charge [(4)-(5)]	100	130	164.5	204.18	598.77
Amount credited to P&LA/c[(2)-(6)]	250	220	185.5	145.83	801.38
Depreciation as per Income Tax Rules	400	240	144	86.4	870.49
W.D.V. carried forward to next year	600	360	216	129.6	1105.2
Profit as per books [(7)-(5)]	150	120	85.5	45.825	401.31
Income offered to tax [(7)-(8)]	-150	-20	41.5	59.425	-69.08

If the asset is transferred at a residual value say, Rs. 100/- at the expiry of lease, there would appear a profit of Rs. 100/- in the books of assessee as the full value of asset has already been written off from the books in the form of depreciation and Lease Equalization Charge. However, the computation of income would remain unaffected because the profit on sale of depreciable asset is not chargeable to tax and the sale consideration, i.e. Rs. 100/- would be reduced from the value of Block of assets.

From the illustration given above, it is clear that only a part of the lease rent received is recognized as income and credited to the profit and loss account and part of it is carried to the balance sheet. This method of accounting is applicable to the lease transaction in the nature of "Finance Lease". This method is based on the presumption that in the case of Finance Lease the entire lease charges received does not constitute the income and part of it is attributable to the recovery of a capital investment. Under this method the total of the accumulated depreciation and accumulated lease equalization charge at the end of the lease period is equal to the cost of the asset, i.e. the asset is fully written off from the balance sheet at the expiry of lease period.

Under the income tax Act, no distinction is drawn between the "Operating Lease Transaction" and "Finance Lease Transaction". In case of lease transaction, the ownership of the asset remains with the lessor and, accordingly, depreciation is also claimed by lessor.

Since the ownership of the assets remains with the lessor, the entire amount received by the lessor constitutes its income. For the purpose of income tax, the method of computation of total income can not be changed because of the change in method of accounting due to the new guidelines prescribed by the Institute of Chartered Accountants of India. In fact, it has already been clarified in Para 27 of revised guidance note on accounting for leases that specific treatments for determining taxable income would have to be in accordance with provisions of taxation laws; such treatment may differ from the recommendation contained in the guidance note.

The above illustration clearly brings out that the new method of accounting results into serious anomalies while computing the total income. In the illustration, the total expenditure made by the lessor on acquisition of capital asset is Rs. 1000/- and the total money received in the form of lease rent is Rs. 1400/- and in addition to this an amount of Rs. 100 is received as residual value of asset by the lessor. Thus, there is net income of Rs. 500/- over the period of lease. But as per the method of accounting followed by the assessee, the total income offered to tax, over the period of lease, is (-) Rs. 69.08 i.e. loss of Rs. 69.08. This situation is totally unacceptable.

If we analyse the reasons little more carefully, it is not difficult to appreciate that how such anomaly has arisen in computation of income. The basic concept of new method of accounting prescribed by ICAI is that the lessor should be able to write off the full value of asset during the period of lease itself, i.e. full deduction should be allowed to the lessor for the cost of asset against the total lease rent received. Under the old system of accounting, according to the rate of depreciation in companies Act, only a part of the total cost of the asset was written off in the form of depreciation and the balance was written off at the time of transfer of asset at the expiry of lease in the form of loss of sale of asset, i.e. the depreciation

provided in books was not sufficient to write off the asset during the lease period. Under this method the distribution profits as per books was uneven over the lease period having no regards to the overall implicit rate of return factored in the lease rent. In the initial years, very high profits appear in books and, finally, at the time of transfer of asset, loss appears in the books, i.e. there was over reporting of profits in the initial years and under reporting profits in the last year.

According to ICAI, the accounts drawn as per the old method did not represent true and fair picture of profits of lessor. Wherefore, the concept of lease equalization charge was introduced as a balancing charge in order to make up for lower rate of depreciation and to give more realistic estimate of profits in the books. In fact, Lease Equalization Charge is nothing but a provision charged in the books to create a reserve for the replacement of asset. Depreciation is also a provision to create reserves out of the profits to replace the asset after the end of its useful life.

However, under the income tax the rate of depreciation are much higher and normally substantial value of the assets is written off during the lease period itself. The amount of lease equalization charge depends upon the depreciation. Higher is the depreciation, lower is the amount of Lease Equalization charge. The very basis of calculation of Lease Equalization charge is linked with the depreciation rates. As mentioned above, the Lease Equalization charge is nothing but a provision similar to depreciation allowance.

Therefore, when the book profit, determined after providing Lease Equalization Charge, are further adjusted to give higher allowance of depreciation as per rates provided in Income Tax Rule. It leads to very distorted results, i.e. total computed in this manner does not at all comes anywhere near the real income of the assessee. The obvious reason is that the lease equalization charge is calculated on the basis of depreciation charged in the books but while calculating income depreciation is allowed at a much higher rate.

The assessee cannot be allowed both the benefits, to reduce Lease Equalization charge, calculated on the basis of depreciation as per Company Law, from its lease income and then claim higher depreciation as per Income tax Rules for

computing total income.

In any case, as mentioned above, the Income tax Act does not distinguish between finance lease and operating lease. Since the ownership of the asset remain vested with the lessor and depreciation is also claimed by the lessor the entire amount of lease rent received by the assessee is its income and there is no reason that why it should be reduced by any artificially determined provision, i.e. Lease Equalization Charge in this case. Income under the head "Profits and gains of business and profession" is to be computed under the provisions Chapter IV-D of the Income Tax Act and allowability of any deduction is governed by provisions of Section 30 to 37 of this Chapter. Under these provisions, the deduction is allowed for various expenses incurred by the assessee during the course of his business except for specific allowances, i.e.

Depreciation, Investment Allowance and Provision for bad debts in case of banks etc. By now it is clear that the Lease Equalization charge is not an expense incurred by the lessor but only a provision similar in nature to that depreciation. No liability of any nature whatsoever has been incurred by the assessee. It cannot be termed as repayment of capital or debt as no debtor/advance are appearing in the balance sheet. It is reduced from the Fixed assets, much the same way as depreciation. Under the Income Tax Act, no deduction is allowable for such provision.

There is another serious anomaly in the 'Method of accounting prescribed by the Institute of Chartered Accountants of India. These norms are applicable only to lessor and not to the lessee. Lessee would continue to account for the lease charges paid by it as per the existing system of accounting, i.e., it would claim the deduction for the full amount of lease charges paid by it without bifurcating them into two parts, i.e. Finance Charges and Capital recovery component, as is done in the case of lessor. As such, expenditure in the hands of one person is not reflected as the income of the other person. It is against the general principle of determination of income of the Income Tax Act. The expenditure in the hands of one person should normally constitute the income in the hands of other person.

In the case of a hire purchase transaction, the situation is totally different. The ownership of the asset passes over to the hiree and the depreciation is also claimed by it. The total amount paid by the hiree to the hirer is split into two parts viz, Finance charges and the capital payments and both, the hiree and the hirer, account for such payment on similar basis, i.e. in books of hiree also similar basis, i.e. in books of hiree also full amount of payment made to the hirer is also debited to the profit and loss account but only the part of it is debited and balance is accounted as a capital payment.

The method of accounting followed by the assessee, as per the guidance note of ICAI, cannot be adopted for the purpose of computation of total income under the Income Tax Act. It is now a well established principle that determination of income is not affected by the accounting entries made by the assessee. Another way to look at it is that since it is provision similar in nature to that of depreciation, though having different nomenclature, it should be added to the income alongwith book depreciation while computing total income. Therefore, total amount of lease charges received by the assessee (without reducing the amount of Lease Equalization Charge) shall be considered the income of the assessee.

The total amount of Lease Equalization Charge carried over to the balance sheet is Rs. 1,63,01,402/- as per the details given below: Lease Equalization upto 1997-98 2,52,92,623 For 1997-98 1.63.01.402 _____ Sale of Leased Assets 1.06.02.101 _____

6. The order of the Assessing Officer has been confirmed by the CIT(A) for all the three assessment years giving rise to the three appeals by the assessee. In assessment year 98-99 the profits of the assessee had been computed in accordance with the provision of Section 115-JA of the Act. In that year from the profits as per the P&L A/c the Assessing Officer had reduced the lease equalization charges thereby increasing the book profits as per Section 115-JA of the Act. In this year the question that would arise for consideration is as to whether the lease equalization charges can be said to be an amount set aside to provisions made for meeting liabilities, other than ascertained liabilities within the meaning of explanation to Section 115-JA of the Act. This was the basis on which the Assessing Officer and the CIT(A) added the lease equalization charges to the profits as per P&L account while arriving at the book profits in accordance

with the provisions of the Section 115-JA of the Act. The issue for consideration in the other two years would be as to whether the Revenue authorities were justified in making an addition equivalent to the amount of lease equalization charges which was claimed by the assessee as a deduction in computing its income.

7. We have heard the submissions of the Id. counsel for the assessee and the Id. DR. Ld. counsel for the assessee after explaining the manner in which the lease equalization charges were worked out further brought to our notice the guidelines issued by the Institute of Chartered Accountants of India (ICAI) on the manner in which the accounting for leases in the books of lessor have to be made in the case of finance leases. It was highlighted by him that this method would ensure recognition of net income in respect of a finance lease at a constant periodic rate of return on the lessor's net investment outstanding in the lease. As per the guidelines of the ICAI, a lease under which the present value of the minimum lease payments at the inception of the lease exceeds or is equal to substantially the whole of the fair value of the leased asset is a finance lease. The Id.counsel for the assessee submitted before us that the transactions of the assessee in all these cases are a pure leasing transaction. His further submission was that as per the prudential norms issued by the Reserve Bank of India in exercise of its power conferred Under the RBI Act 1934, in the matter of accounting the NBFCs were required to follow the accounting norms to be followed by Non-banking Finance Companies (NBFC) such as the assessee, the assessee was required to follow the accounting standards and guidance notes issued by the ICAI. It was contended by the Id. counsel for the assessee that since the assessee was a non-banking finance company, it had to follow the prudential norms issued by the RBI. Since these guidelines were mandatory and had to be legally followed by the assessee, the said system of accounting should be applied even while computing Income under Income Tax Act. In this regard, the Id. counsel for the assessee submitted that in the context of provisions for bad and doubtful debts arising out of non-performing assets, the RBI had under the prudential norms applicable to NBFCs directed that such provisions will have to be claimed as a deduction. Under the Income Tax the Revenue authorities refused to recognize a claim for deduction on account of non-performing assets in the form of a provision. The Tribunal in the case of Hindustan Commercial Investment Trust Ltd. v. DCIT in ITA

No.1912/Del/02 had held as follows: The position, however, as we see it, is not as made out by the Taxing Authorities. Firstly, as per Section 45 JA of the RBI Act, the RBI has the power to determine the policy and give directions to all or any of the Non-Banking Financial Companies relating to the income recognitions and accounting standards, making of proper provision for bad and doubtful debts, capital adequately based on risk - for assets and credit conversion factors for off balance sheet items and also relating to deployment of funds by a Non-Banking Financial Company or a closure of Non-Banking Financial Company or Non-Banking Financial Companies generally, as the case may be. The section also specifies that Non-Banking Financial Companies shall be bound to follow the policies so determined and the directions so issued. The section also makes it clear that such policies have to be in public interest, or to regulate the financial system of the country to its advantage, or to prevent the affairs of any Non-Banking Financial Company being conducted in a manner detrimental to the interest of the deposits or in manner prejudicial to the interest of the Non-Banking Financial Company, Further, Section 45Q of the RBI Act is an overriding clause. This section is contained in Chapter III-B of the RBI Act and it provides that the provisions of Chapter III-B shall have an overriding effect, notwithstanding anything inconsistent therewith contained in any other law, for the time being in force or any instrument having effect by virtue of any such law. The Legislative intent is amply made clear in the said Section 45 Q. The provisions of Chapter III-B are to have overriding effect. As such, the directions issued by the RBI are to take precedence and the assessee is bound to follow the policy determined by the RBI and the direction issued by the RBI. The preamble of the RBI Act itself delineates the purpose for the wide powers given to the RBI Act, unambiguous terms. So far as regards determination of the policy for monetary, economic and physical policy of India, the provisions of the RBI Act, as discussed above, are clear and specific. Any other Act, including the I.T. Act, is subject to overriding mandate laid down in the RBI Act. As such, the assessee, by overriding statutory mandate, could not have ignored the provisions of Chapter III-B of the RBI Act and the Prudential Norms issued thereunder.

This matter has been subject of judicial scrutiny in the case of 'TEDCO Investment & Financial Services (P) Ltd. v. DCIT (2003) 87 ITD 298 (Del). Our above view

finds support from the said decision also, which was cited before us by the Id counsel for the assessee.

The Id Commissioner (A) has clearly erred in not following the decision in 'TEDCO' (supra), which was cited and discussed before him.

As per the norms and guidelines issued by the RBI, where if any amount falls under the category of bad and doubtful debts, the assessee company has to account the same under the head of "Provision of Non-performing Assets". The assessee did accordingly.

The Id. Commissioner (A) was of the view that the conditions prescribed under Section 36(1)(vii) of the I.T. Act, were not complied with, and that the claim was in the nature of a contingent liability, the debts having not been written off in the accounts and the assessee having merely created a provision. However, in doing so, the Id. Commissioner (A) has erred in not taking into consideration the aforesaid arguments put forth by the assessee.

In view of the above, the grievance of the assessee by way of Ground No. 1 raised before us is justified and is accepted as such.

8. Further, reliance was also place on the decision of the Chennai Bench of the ITAT in the case of Overseas Sanmar Financial Ltd. v. JCIT in ITA No. 280 & 1527/Mds/99 laying down a similar proposition.

9. The submission of the Id. counsel for the assessee was that since the prudential norms of RBI read with the accounting standards/guidelines by ICAI in the matter of accounting for lease in the books of account of on NBFC, permit a deduction on account of lease equalization charges, the claim of the assessee should be allowed. In this regard, it was submitted that the accounting standards of ICAI referred to above, in the light of the NBFCs prudential norms issued by RBI, makes it obligatory for NBFCs to follow the accounting standards issued by ICAI, will have the force of law if read with the provisions of RBI Act. Strong reliance was placed on the decision of Tribunal referred to above in this regard.

10. The Id. DR, however, strongly opposed the plea raised by the Id.counsel for the assessee. His submissions were as follows: (a) The claim for deduction of lease equalization charges is an artificial created claim.

(b) The true picture in the case of finance lease will emerge only when the lease agreement is over. In this regard the Id. DR raised a query as to how the assessee will deal with a situation in a case where the lease is suspended without the full term having been completed.

(c)The Id DR also submitted that on expiry of the lease period alone the lease assets are transferred and it cannot be said till such time there would be only necessary to have a lease equalization reserve. In this connection, Id. DR submitted that in the event of sale by the assessee on expiry of the lease period, the assessee was entitled to reduce from the blocks and assets the value realized on sale of the assets and this will ensure the proper deduction that the assessee has to get in accordance with the provisions of the IT Act.

(d) It was submitted that the reserve created by the assessee is only to cover a loss, which may or may not occur in future and therefore has to be considered only as a contingent liability.

According to him such contingent liability cannot be allowed as a deduction.

(e) That the provisions of the I.T. Act alone are relevant for computing income for the purpose of taxation. The guidelines issued by ICAI are only for the purpose of ensuring disclosure of true and fair view of the state of affairs of the assessee. In any event it was submitted that the same will not have any binding force in view of the clause 27 of the very same norms relied upon by the Id. counsel for the assessee.

11. We have considered the rival submissions. The Tribunal in the case of Hindustan Commercial Investment Trust Ltd. (Supra) had held that in view of the provisions of the 45-JA of the RBI Act, the RBI has a power to determine the policy and give directions to all or any of the non-banking financial companies relating to income recognition and accounting standards to be followed. It has further been

held that in view of the overriding clause in Section 45-Q of the RBI Act, the said provisions are binding even on the income tax authorities while computing income for the purpose of taxation. The Tribunal had relied on the decision of the Delhi Bench in the case of TEDCO Investment and Financial Service Pvt. Ltd. (Supra). In the light of the above, we are of the view that the prudential norms issued by the RBI would be binding on an assessee and the assessee following such prudential norms would be entitled to claim in the income tax proceedings that the income determined in accordance of such guidelines should be the basis for determining income chargeable to tax under the IT Act also. It is, however, seen from the prudential norms issued by the RBI that the accounting standards prescribed by ICAI would apply to NBFC. A copy of the guidelines issued by ICAI in the matter of accounting for lease in the books of a lessor have been filed before us. In Clause 27 of such guidelines it is stated as follows: Clause 27. It is clarified that the specific treatments for determining taxable income would have to be in accordance with the provisions of taxation laws; such treatments may differ from the recommendations contained in the Guidance Note.

12. It is thus clear that even the ICAI is of the view that these provisions are meant only for recognizing the net income in respect of a finance lease at constant periodic rate of return on the lessor's net investment outstanding in the lease and are not to be considered while determining taxable income in accordance with the provisions of the Income Tax Act 1961. In view of the above, we are of the view that the claim made by the assessee cannot be accepted. In this regard, we are of the view that reasons given by the Assessing Officer in the assessment order for assessment year 98-99 are acceptable. As rightly held by him, such a claim is not recognized under the provisions of the Income Tax Act. The assessee can make its claim within the parameters of deductions allowed under Chapter IV D of the Income Tax Act, 1961 and the said provisions do not provide for any such deduction. The claim for such deduction in our view is artificial and cannot be allowed. Ld. counsel for the assessee had placed reliance on several decisions to emphasis the point that it is only the real income which has to be brought to tax. We are of the view that the method of debiting lease equalization charges is contrary to the theory of real income cannot override the express provision of the Act. The method in fact goes to reduce the income of an assessee. We have

already observed that the method followed by the assessee is not recognized by the Act.

Consequently, we uphold the order of the Revenue authorities and dismiss the grounds of appeal raised by the assessee in assessment year 97-98 and 1999-2000.

13. As far as assessment year 1998-99 is concerned, the question revolves around as to whether the lease equalization have to be added as profit as per the P&L account in view of the Clause (c) of Explanation to Section 115-JA of the Act. On this aspect, we find that the Tribunal in the case of MGF India Ltd., ITA No. 1143/Del/02 while considering a similar claim in the context of Section 115-JA has held that such an adjustment cannot be made. The Tribunal had referred to the decision of Hon'ble Supreme Court in the case of Apollo Tyres 255 ITR 273 (SC) and has held that such adjustments cannot be made while, determining income under Section 115-J of the Act. Respectfully, following the decisions of the Tribunal referred to above, we allow the appeal of the assessee. We are not convinced with the argument of Id.DR that the amount in question namely the lease equalization charges is an amount set aside to provisions for meeting liability other than ascertained liabilities. The lease equalization charge is not an amount set aside for meeting any liabilities which is unascertained. It is a recognized method for preparing Financial Statement of NBFC's. It is applicable while preparing Financial Statements under the Companies Act, 1956. The sum in question does not fall within any of the other Clauses (a) to (f) of Explanation to Section 115-JA. In view of the above, the claim made by the assessee for the assessment year 98-99 is allowed. In the result, ITA No. 2977/Del/02 and ITA No. 2912/Del/02 are dismissed while ITA No. 1712/Del/02 is allowed.

14. What remains consideration is the two appeals by the Revenue namely ITA No. 3227/Del/02 and ITA No. 3228/Del/02, the common issue for consideration in both these appeals is with regard to grant of higher rate of depreciation of leased vehicles and not allowing loss of sale of re-possessed stock. It is not in dispute before us that identical issue had come up for consideration before this Tribunal in assessee's own case in assessment years 94-95 and 98-99 in ITA No.

1202/Del/97 and ITA No. 2168/Del/05. This Tribunal in ITA No. 2168/Del/05 after following the decisions of the Hon'ble Delhi High Court in the case of CIT v. Bansal Credits Ltd. 259 ITR 69 was pleased to hold that the lease of the vehicles by the assessee was use by the assessee in the business of leasing and therefore the assessee was entitled to claim depreciation at a higher rate of 40%. As far as loss of sale on re-possessed stock of vehicle is concerned, the same was held to be allowable in assessee's own case for assessment year 93-94 and 95-96 in ITA No. 3232 & 3248/Del/98. Respectfully following the orders of the Tribunal referred to above, we dismiss the appeals of the Revenue.

15. In the result, ITA No. 2977/Del/02 and ITA No. 2912/Del/02 by the assessee are dismissed while ITA No. 1712/Del/02 by the assessee is allowed. ITA No. 3227 and 3228/Del/02 by the Revenue are dismissed.

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