* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

Reserved on: 09.11.2017
Pronounced on: 21.02.2018

\+ **ITA 378/2004**

COMMISSIONER OF INCOME TAX, DELHI …. Appellant
Through: Sh. Rahul Chaudhary, Advocate.

versus

M/S. MGF INDIA LTD. .... Respondent
Through: Sh. Satyen Sethi, Sh. Arta Trana Panda and Ms. Gargi Sethee, Advocates.

\+ **ITA 76/2007**

COMMISSIONER OF INCOME TAX, DELHI …. Appellant
Through: Sh. Rahul Chaudhary, Advocate.

versus

M/S. MOTOR AND GENERAL FINANCE LTD. .... Respondent
Through: Sh. Satyen Sethi, Sh. Arta Trana Panda and Ms. Gargi Sethee, Advocates.

CORAM:
HON'BLE MR. JUSTICE S. RAVINDRA BHAT
HON'BLE MR. JUSTICE SANJEEV SACHDEVA

MR. JUSTICE S. RAVINDRA BHAT

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1. The Revenue's appeal under Section 260A of the Income Tax Act ("the Act") had urged several questions of law. On 12.01.2016, this Court framed the following questions:

(i) whether the lease equalization charges can be deducted while computing book profit; and

(ii) whether the provisions for non-performing assets are liable to be adjusted while computing book profit under Section 115JA of the Act.

2. The assessee's commercial activity centers on leasing assets and the resultant income from it. In terms of lease agreements it enters into, ownership of the assets continues to vest with the assessee and the assets are shown in the balance sheet under the head "Fixed Assets". On this account, it claims depreciation. However, while preparing profit and loss account, it does not credit the full amount of lease charges; some amounts are set apart to be carried over to the lease equalization reserve; only the balance amount is credited to the profit and loss account. In the relevant year (AY 1998-99) the assessee credited ₹ 15,38,13,310/- as lease charges. The footnotes below the schedule reflect that this amount is the net of the lease equalization reserve. The total amount carried over to the lease equalization reserve is ₹ 6,24,96,982/-. This was added in its total income while computing its return; however, in the course of assessment proceedings, the assessee, by its letter of 23.03.2001 contended that as it was lease equalization charge, the sum (offered for taxation) should be withdrawn and that this position was based on legal opinion. The Assessing Officer (AO) considered the assessee's submissions and after analyzing the materials reasoned that the Act does not distinguish between a finance lease and operating lease, because the legal ownership of the underlying asset continues unchanged. Therefore, the charges (towards lease) received by the owner should be taxed as a whole and no artificial provision can bifurcate such amounts. It was further held that lease equalization could not fall within any allowable deduction or expense as it was a provision similar to depreciation and that the assessee incurred no liability of any nature. The AO added back the amount. The

assessee's appeal was rejected by the CIT(A). In the body of its reasoning, the CIT's observations and findings were accepted by the Income Tax Appellate Tribunal (ITAT); however, it proceeded to note that similar claims had been allowed in the past; relief was accordingly granted on this ground.

3. This Court had, in *Commissioner of Income Tax v Virtual Soft Systems* 2012 (341) ITR explained the concept of lease equalization fund as follows:-

> *"14.3 Lease rental in monetary terms is a sum total of: the financing charge and the amount embedded in it in the form of the capital sum. What the assessee needs to do, while offering for tax income derived from lease is, to separate the financing charge from the amount recovered towards capital, that is, the capital recovery amount. The financing charge is determined by applying the IRR to the net investment made in the asset. The assessee also needs to provide for depreciation, on the capital value embedded in the lease rental. The fourth element which is the lease equalization charge is the result of the adjustment, which the assessee has to make whenever, the amount put aside towards capital recovery is not equivalent to the depreciation claimed by the assessee. The assessee, may claim depreciation based on the provisions of the IT Act or, may even adopt the method of depreciation provided under the Companies Act. In the event, the depreciation claimed is less than the capital recovery, the difference is debited in the profit and loss account in the form of lease equalization charge, and similarly if, for any reason the depreciation claimed is more than capital recovery then, the difference is credited, once again, in the form of lease equalization charge to the profit and loss account. Therefore, the assessee in effect debits or credits its profit and loss account with a lease equalization charge depending on whether or not the depreciation claimed is, less or more than the capital recovery. The capital recovery can be known, as is evident, on deduction of financing charges from the lease rentals. In sum and substance, lease equalization charges is a method of re-calibrating the depreciation claimed by the assessee in a given accounting period. The method employed by*

the assessee, therefore, over the full term of the lease period would result in the lease equalization amount being reduced to a naught, as the debit and credits in the profit and loss account would square off with each other. Hence, the contention of the revenue that it is a claim in the form of a deduction which cannot be allowed, as there is no provision under the I.T. Act is, in our view, a complete misappreciation of what constitutes a lease equalization charge. In our opinion, as long as the method employed for accounting of income meets with the rudimentary principles of accountancy, one of which, includes offering only revenue income for tax, we cannot find fault with the assessee debiting lease equalization charges in the AYs in issue, in its profit and loss account. This represents true and fair view of the accounts; a statutory requirement under Section 211 (2) of the Companies Act. As explained by us above, the rationale is that over the entirety of the lease period the said debit would work itself out."

This reasoning finds acceptance also in the Karnataka High Court's judgment in *Commissioner of Income tax v. Weizmann Finance* [2013] 357 ITR 74 (Karn), where it was held as follows:

"9. In the instant case, the assessee is in the business of long term finance. In order to carry on the said business, a debtor, who needs the assistance, has to make an application in writing. To consider the said application before granting loan, the assessee collects processing charges. After the debtor is found to be eligible to grant loan, agreements are entered into and thereafter loan is advanced. The amount has to be repaid with interest within 7 years period for repayment of the loan. The agreement also contains the stipulation that the amounts are not paid periodically as agreed to, the debtor has to pay penal interest. If the debtor chooses to repay the amount and fore close before the agreed period, then not only he has to pay the loan amount plus interest, he has also to pay additional interest, as he is not entitled to the benefit in respect of lower rate of interest, which was spread over the period of 7 years.

All these amounts, which are paid by the debtor to the assessee, have a direct nexus with the business, which he is carrying on. All these incomes are derived from the business, which he is carrying on. It is also on record except this long term finance business, the assessee is not carrying on any other business much less any short term finance business. Therefore, all these categories of incomes which the assessee is receiving as a direct nexus with the long term finance and therefore section 36(1)(viii) of the Act is attracted. Therefore, we do not see any merit in these appeals. Accordingly, the first substantial question of law is answered in favour of assessee and against the Revenue."

4. The Revenue argues through its counsel, Mr. Rahul Chaudhary, that the AO and the CIT(A) justifiably rejected the assessee's argument. The assessee could not rely only on the Guidance Note issued by the ICAI with respect to accounting for leases, in deciding what was the income. Whether a particular deduction ought to be allowed or disallowed, has to be in accordance with provisions of the Act. The Revenue argued that the debit made to the profit and loss account by the assessee in the assessing year concerned, towards lease equalization charge, was rightly disallowed by the AO as there was no provision in the Act supporting such deduction. Furthermore, there was no determination by the AO, whether the lease transactions were finance or operating leases.

5. Mr. Chaudhary urged that the claim for deduction of lease equalization charges is an artificially created one and that the true picture in the case of finance lease will emerge only when the lease agreement is over. The assessee's arguments and claims do not show how it would deal with a situation in a case where the lease is suspended without the full term having been completed. It was also submitted that on expiry of the lease period

alone the lease assets are transferred and it cannot be said that till such only would it be necessary to have a lease equalization reserve. In this connection, the Revenue 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 Act.

6. It was next 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 counsel such contingent liability cannot be allowed as a deduction. It was submitted that these aspects were not considered in *Virtual Soft Systems (supra)* and *Weizmann (supra).* Learned counsel relied on *Manipal Finance Corporation Ltd v. Assistant Commissioner of Income Tax* 2014 49 Taxmann.com 353 (Karnataka).

7. Mr. Satyen Sethi, learned counsel for the assessee argued that this Court's judgment in *Virtual Software (supra)* has been accepted by most High Courts, i.e. Gujarat High Court, Karnataka High Court etc. Reliance was placed on *Prakash Leasing Ltd. v. Commissioner of Income Tax* (2012) 208 Taxman 464 (Karn); *Commissioner of Income Tax v. Indian Railway Finance Corp. Ltd* (2014) 362 ITR 548; *Commissioner of Income Tax v. ICICI Ventures Funds Management Co. Ltd* 2015 234 Taxman 569 (Karn); *Commissioner of Income Tax v. Pact Securities and Financial Services Ltd* (2015) 374 ITR 681 (AP & T) and *Commissioner of Income Tax v. Sun Pharmaceutical Industries Ltd.* 2016 (240) Taxman 686 (Guj). Counsel submitted that the amount is nothing but the difference between the statutory

depreciation on rentals and the recovery of cost of capital. Therefore, merely because it entered in the P&L account, did not make any difference. At any rate, it could not be treated as a reserve. Therefore, ITAT was justified in directing deletion of the said amount.

8. This Court is of the opinion that the consistent view adopted in the various authorities - *Virtual Soft Systems (supra)* onwards is that in monetary terms, lease rentals are the sum total of financing charges and the amount included in it towards the capital sum. While offering for tax income derived from lease, a taxpayer has to separate the amount received towards capital, from the financing charge. The financing charge is determined by applying a separate formula to the net investment made in the asset. Depreciation too needs to be provisioned on the capital value fixed in the lease rental. Next is the lease equalization charge: it is described in *Virtual Soft Systems (supra)* as *"the result of the adjustment, which the assessee has to make whenever, the amount put aside towards capital recovery is not equivalent to the depreciation claimed by the assessee. The assessee, may claim depreciation based on the provisions of the IT Act or, may even adopt the method of depreciation provided under the Companies Act. In the event, the depreciation claimed is less than the capital recovery, the difference is debited in the profit and loss account in the form of lease equalization charge, and similarly if, for any reason the depreciation claimed is more than capital recovery then, the difference is credited, once again, in the form of lease equalization charge to the profit and loss account. Therefore, the assessee in effect debits or credits its profit and loss account with a lease equalization charge depending on whether or not the depreciation claimed is, less or more than the capital recovery."*

9. The Court also held that the capital recovery can be known, as is evident, on deduction of financing charges from the lease rentals. In sum and substance, lease equalization charges *"is a method of re-calibrating the depreciation claimed by the assessee in a given accounting period. The method employed by the assessee, therefore, over the full term of the lease period would result in the lease equalization amount being reduced to a naught, as the debit and credits in the profit and loss account would square off with each other."* Therefore, the Revenue's contention that the amount is unknown to the Act - as held in the decision, is a misappreciation of what constitutes a lease equalization charge. Therefore, as long as the method of accounting follows some established principles, one of which, includes offering only Revenue income for tax, we cannot find fault with the assessee debiting lease equalization charges in the AYs in issue, in its profit and loss account. It represents a true and fair view of the accounts, which is a statutory requirement under Section 211(2) of the Companies Act. For these reasons, the first question is answered in favour of the assessee and against the Revenue.

10. The second issue is whether the value of NPAs is to be adjusted while determining book profits under Section 115 JA of the Act. The assessee here argues that lease equalization is not a provision for diminution in asset value and is a mere adjustment entry. It was argued that in this case, since lease equalization was to the tune of ₹ 6,24, 96,982/- and debited to the profit and loss account, and since the lease charges shown in the P&L Account were the net amount of lease equalization charges, the gross block of fixed assets was simultaneously reduced by an amount of ₹ 9,08,03,993/- which was the

accumulated lease adjustment. Therefore, no adjustment was made which could be treated as being adjustment towards diminution in the value of assets. The assessee relies on *Commissioner of Income Tax v. Indian Railway Finance Corporation Ltd.* 2014 (362) ITR 548.

11. *Commissioner of Income Tax v. HCL Comnet Systems and Services Ltd.* 2008 (305) ITR 409 (SC) is an authority on the point that provision for diminution of an asset is not provisioning for a liability. This logic was followed in the case of *TVS Finance and Services Ltd., Jayalakshmi Estates v. The Joint Commissioner of Income Tax Special Range - XI* (2009) 318 ITR 435(Mad) by the Madras High Court. The Gujarat High Court in *Principal Commissioner of Income Tax-2 v. Sun Pharmaceutical Industries Ltd.* [2016] 240 TAXMAN 686 (Guj) followed this view (also applying *Virtual Soft Systems)* in the following terms:

> *"the lease equalization charge is a method of recalibrating the depreciation claimed by the assessee in a given accounting period. The method employed by the assessee, therefore, over the full term of the lease period would result in the lease equalization amount being reduced to a naught, as the debits and credits in the profit and loss account would square off with each other. Under the circumstances, the same is neither in the form of a reserve nor a deduction. The above view finds support in the decision of the Madras High Court in the case of TVS Finance and Services Ltd. {supra) wherein the court has held that lease equalization charge is not in the nature of a reserve, inasmuch as, the amount of lease equalization charge over a period of lease is equal to the difference between the quantum of principal recovered and the residual value."*

The view expressed by the Gujarat and Madras High Courts have also held that the lease equalization charges are not to be treated as adjustments

needing to be added back while computing book profits, under Section 115JA on account of Explanation 1. This Court is in agreement with that view. Accordingly the second question too is answered in favour of the assessee.

12. For the above reasons, the Revenue's appeal has to fail; it is dismissed.

S. RAVINDRA BHAT
(JUDGE)

SANJEEV SACHDEVA
(JUDGE)

FEBRUARY 21, 2018