IN THE CUSTOMS, EXCISE AND SERVICE TAX APPELLATE TRIBUNAL
SOUTH ZONAL BENCH AT CHENNAI
[COURT III : Division Bench B1]

Appeal Nos.: ST/650 & 651/2012

[Arising out of Order-in-Original Nos. LTUC/271 & 272/2012-C dated 30.08.2012 passed by the Commissioner, Large Taxpayer Unit, Anna Nagar, Chennai.]

M/s. Sundaram Finance Ltd. , **: Appellant**
No. 21, Patullas Road,
Chennai – 600 002

Versus

The Commissioner of C.Ex. & Service Tax, **: Respondent**
Large Taxpayer Unit, Chennai

Appearance:-
Shri. P. C. Anand, Consultant
for the Appellant

Shri. K. Veerabhadra Reddy, ADC (AR)
for the Respondent

CORAM:
Hon'ble Ms. Sulekha Beevi C.S., Member (Judicial)
Hon'ble Shri Madhu Mohan Damodhar, Member (Technical)

Date of Hearing: 26.02.2019

Date of Pronouncement: 18.03.2019

Final Order Nos. 40530-40531 / 2019

Per Bench :

Brief facts are that the appellant is a Non-Banking Financial Company and is into the business of financing purchase of commercial vehicles, cars, houses and also provide services of software solutions, business process outsourcing, hire-purchase and leasing including equipment leasing, etc. The appellants thus mainly provide the service of "Banking and other Financial Services" for which they have *inter alia* obtained registration. They were allotted Large Taxpayer Unit Registration in 2012.

2.1 Financial Leasing Services including equipment leasing and hire-purchase by a body corporate was included as a taxable service under the category of Banking and Other Financial Services under Section 65(10) of the Finance Act, 1994 from 16.07.2001 vide Notification No. 04/2001-ST dated 09.07.2001. Subsequently, on introduction of new definition and re-alignment of Section 65 of the said Act, "Banking and other Financial Services" are now defined by Section 65(12) of the Finance Act, 1994.

2.2 Immediately, Writ Petitions were filed by the Association of Leasing and Financial Services Companies before the Hon'ble High Court of Madras against the levy of service tax on leasing/hire purchase transactions, as being *ultra vires* the provisions of Articles 14, 19(1)(g), 265, 366, (29A), Entry 54, List-II, Schedule VII of the Constitution of India and also being beyond the legislative competence of Parliament. The Writ Petition was admitted and the Hon'ble High Court had granted a stay. The Equipment Leasing Association (India), of which the appellant is a member, filed similar petitions and were granted stay by the Hon'ble High Court. Hence, the appellants neither declared the taxable value of the hire-purchase and leasing services nor did they pay the appropriate service tax.

2.3 Subsequently, the prayers in all the related Writ Petitions were disposed of by a common Order dated 09.06.2009 by dismissing the Writ Petitions. Against such decision of the Hon'ble High Court, the appellants filed SLP (C) No. 23161 of 2009 before the Hon'ble Supreme Court along with a Stay Petition. The Hon'ble Supreme Court vide Order dated 26.10.2010 upheld the constitutional validity of the levy. After the aforesaid decision of the Hon'ble Apex Court, the appellants paid applicable service tax of Rs. 8,17,11,538/- on hire-purchase and leasing transactions. They also filed ST-3 returns in April 2011.

3.1 However, it is the case of the Department that even though the appellants have discharged their service tax liability on Financial Leasing activities, the appellants did not discharge service tax on certain leasing transactions which they claim to be Operating Lease transactions. That they did not reflect the said income received from Operating Leasing transactions in their ST-3 returns.

3.2 Instead, letter dated 29.03.2010 was issued by the appellants stating that Financial Lease is different from Operating Lease and that Operating Lease would not fall within the meaning of Financial Leasing Services as defined in the Finance Act, 1994.

3.3 The Department was of the view that there was no difference in respect of Financial Lease and Operating Lease offered by the appellant as per the terms of contracts except for the clause relating to return of the asset to appellant at the end of the tenure in the case of Operating Lease. Further, whatever risks and rewards clause were built into the leasing contracts were the same for Financial and Operating Leases. It therefore appeared that the Operating Lease entered into by the appellant is only a misnomer and that they are actually Financial Leases, which are subject to levy of service tax.

4. Show Cause Notices were issued proposing to demand service tax along with interest and also for imposing penalties. After due process of law, the Original Authority confirmed the demand along with interest and also imposed penalty. Aggrieved, the appellants are now before the Tribunal.

5.1 On behalf of the appellant, Ld. Consultant Shri. P.C. Anand appeared and argued the matter. He submitted that the appellants had discharged the entire service tax liability on Financial Leases.

The present demand is in respect of Operating Lease and no service tax is leviable on such activities. He adverted to the definition of Banking and Other Financial Services for the period from 16.07.2001 to 09.09.2004, as amended from 10.09.2004 to 30.06.2007 as well as the period after 01.07.2007. In all these definitions, there is no levy on the activity of Operating Lease transactions; there is a clear difference between Financial Lease and Operating Lease.

5.2 He explained that in order to treat a lease agreement as a Financial Lease, it should satisfy all the four sub-clauses to the Explanations in the definition of "Banking and Other Financial Services" after 01.07.2007. Since the lessee under the lease agreements does not have either the right or option to own the asset at the end of the lease period, the fourth sub-clause of the Explanation would not apply to the disputed transactions, which are in the nature of Operating Lease.

5.3 Further, the Accounting Standards (AS-19) issued by the Chartered Accountants of India defines the term "Financial Lease" as "a lease that transfers substantially all the risks and rewards incident to ownership of an asset." The difference between the two types of leases was summarized by the Ld. Consultant, as under :

Finance Lease	Operating Lease
Lessor will purchase the asset as required and allow lessee to use that asset during the lease period	The ownership of the asset is retained by the lessor during and after the lease term and in the agreement, there is no option or entitlement for purchasing the asset at the end of the lease period.
During lease, while the lessor is the title holder of the asset, the lessee effectively owns the asset with risk and reward of ownership transferred to him.	The lessee has only the right to use the asset; the risk and reward/benefit of ownership remains with the lessor; and it is the lessor who pays for the maintenance and insurance of the asset, there is no transfer of risk and reward of ownership to the lessee.
The lessor recovers a large part or all of the cost of the asset plus interest from the rent paid by the lessee.	Payment of lease rent by the lessee are considered as operating expenses and shown in his profit and loss account statement.
The lessee has the option to purchase the asset or entitlement for purchase of the asset at the end of the lease period.	The option is denied and if at all it may be considered and the valuation thereof is fixed by the lessor.
While the lessor shows the asset leased in his balance sheet as “receivable”, the lessee is considered to be the owner of the asset for the purpose of income tax and therefore claims depreciation expense and interest expense.	The lessor is the owner of the goods so leased.

5.4 The intention of the legislature was to tax only those Financial Leasing Services which satisfy all the four conditions cumulatively and not any other financial transaction relating to a moveable asset. The lease agreement would clearly show that the transactions are in the nature of Operating Lease, which fall outside the definition. In the case of Operating Lease, the lessee sometimes such as executives using the car, offers to buy the asset and the appellants consider effecting sale to them. Such buyers obviously do not stand in the shoes of the lessee who had originally taken the asset on lease. He relied upon the High Court decision in the case of ***M/s. Association of Leasing & Financial Service Companies Vs. Union of India – 2010 (20) S.T.R. 417 (S.C.)*** wherein the two concepts of Financial Lease and Operating Lease have been discussed and it was held that only Financial Leasing activity would be liable to service tax.

5.5 Leasing activity as entered into by the appellant is in the nature of Operating Lease and therefore there is no liability to pay service tax. To support his arguments, he relied upon the decision in the case of ***C.C.E. & S.T., New Delhi Vs. M/s. Lease Plan India Ltd. - 2018-TIOL-550-CESTAT-DEL.***

5.6 Countering the allegation of the Department that all the leases are actually in the nature of Financial Lease and is merely stated to be Operational Lease by the appellant, Ld. Consultant submitted that the accounts maintained would clearly show the difference between Financial Lease and Operating Lease. He referred to the financial statements of the appellant-company and submitted that the Financial Leases are shown as current assets whereas Operational Lease is shown under the category of fixed asset. This is because in Operational Lease the ownership of the equipment/machinery/vehicle leased out is retained by the appellant-company. After the lease period, the moveable property has to be returned to the appellant, who has the right to sell the same to third parties. Occasionally, the lessee himself, as stated earlier, approaches to buy the moveable property and even then, it is sale to a third party since such person, after termination of the lease, is no longer a lessee. In the case of Financial Lease, after the lease period, when the payments have been made fully, the lessee is entitled to own the vehicle.

5.7 He referred to the Master Lease Agreement and submitted that Clause 21 of the agreement refers to the residual value in the case of Financial Lease agreement, while in the case of Operating Lease agreement, it refers to delivery of equipment on termination of the lease. In the Financial Lease, the residual value is fixed at the time when the lease agreement is signed while in the Operating Lease, in as much as the equipment will be sold to the person as chosen by the lessor, the lessee is directed to return or deliver the goods to the lessor in good condition. That the agreement would establish that the transactions on which demand has been raised are in the nature of Operating Lease.

6.1 Ld. AR Shri. K. Veerabhadra Reddy appearing on behalf of the respondent supported the findings in the impugned Order. He submitted that the definition of "Banking and Other Financial Services" when introduced with effect from 16.07.2001 itself, included the activity of Financial Leasing Services. The amendment brought forth with effect from 10.09.2004 mentioned the words "Financial Leasing Services including equipment leasing and hire-purchase". After 01.07.2007, an Explanation was added in the definition so as to give clarity to the term "Financial Leasing". It was stated therein that if four Clauses of the Explanation are satisfied, the lease would be a Financial Lease. In the transactions impugned in the Show Cause Notices, the fourth Sub-Clause of the Explanation is present. The said Sub-Clause states that "the lessee is entitled to own or has the option to own the asset at the end of the lease period after making the lease payment."

6.2 From paragraph 22 (2.1) of the impugned Order wherein the Master Lease Agreement has been examined by the Original Authority, it is evident that the transactions are in the nature of Financial Leasing. In paragraph 27 of the impugned Order, the Commissioner has correctly analyzed the issue. In all the agreements, it is seen that the risk is with the lessor. This Clause of 'risk' is similar in the case of Financial Lease agreements as well as the disputed Operating Lease agreements. Therefore, the lease transactions are in the nature of Financial Lease and not Operating Lease.

7. Heard both sides.

8. The appellant, as a Non-Banking Financial Company, has been entering into agreements in the nature of leasing of equipment, vehicles, etc. It is not disputed that they have discharged their entire tax liability on the lease agreement, which they believed to be Financial Leases. The present dispute is with regard to the Show Cause Notices with respect to the agreements/transactions which according to the appellant fall under the category of Operating Leases. Thus, our main endeavor would be to find out the nature of leasing in such transactions.

9.1 Before appreciating the facts, it would be relevant to extract the definition of "Banking and Other Financial Services" as amended with effect from 01.07.2007, which contains the Explanation as to what is a Financial Lease :

> *"[(12) "Banking and Other Financial Services" means —*
>
> *(a) the following services provided by a banking company or a financial institution including a non-banking financial company or any other body corporate [or commercial concern], namely :—*
>
> *(i) financial leasing services including equipment leasing and hire-purchase;*

*[**Explanation**. — For the purposes of this item, "financial leasing" means a lease transaction where —*

(i) contract for lease is entered into between two parties for leasing of a specific asset;

(ii) such contract is for use and occupation of the asset by the lessee;

(iii) the lease payment is calculated so as to cover the full cost of the asset together with the interest charges; and

(iv) the lessee is entitled to own, or has the option to own, the asset at the end of the lease period after making the lease payment;]

(ii) to (ix) ...."

(Emphasis added)

The first three Clauses are almost common to both Financial Leasing as well as Operating Leasing. The arguments revolve around the fourth Clause.

10.1 The Hon'ble Apex Court in the case of *M/s. Association of Leasing & Financial Service Companies (supra)* has analyzed the difference between Financial Lease and Operating Lease. The relevant portion of the said judgement is reproduced as under :

*"**21.** To sum up, NBFCs essentially are loan companies. They basically conduct their business as loan companies. They could be in addition thereto in the business of equipment leasing, hire purchase finance and investment. Because NBFCs are basically loan companies, they are required to show the assets leased as "receivables" in their balance sheets. That, the activities of hire-purchase finance/equipment leasing undertaken by NBFCs come under the category of "para banking". **That, in substance a finance lease, unlike an operating lease, is a financial loan (assistance/facility) by the lessor to the lessee.** That, in the bailment termed "hire" the bailee receives both possession of the chattel and the right to use it in return for remuneration. **On the other hand, equipment leasing is long term financing which helps the borrower to raise funds without outright payment in the first instance.***

Here the "interest" element cannot be compared to consideration for lease/hire which is in the nature of remuneration (consideration) for hire. ***Thus, financing as an activity or business of NBFCs is different and distinct from operating lease/hire-purchase agreements in the classical sense. The elements of the finance lease or loan transaction are quite different from those in equipment leasing/hire-purchase agreements*** *between owner (lessor) and the hirer (lessee).* ***There are two independent transactions and what the impugned tax seeks to do is to tax the financial facilities extended to its customers by the NBFCs under Section 66 of the 1994 Act (as amended) as they come under "banking and other financial services" under Section 65(12) of the said Act.*** *"The finance lease" and "the hire-purchase finance" thus squarely come under the expression "financial leasing services" in Section 65(12) of the Finance Act, 1994 (as amended)."*

(Emphasis supplied)

Earlier the same judgement of the Hon'ble Supreme Court accepted the accounting methodology as propounded in the Accounting Standards (AS-19) of the Institute of Chartered Accountants of India:

"18. *The Institute of Chartered Accountants of India (ICAI) has also issued AS-19 "Accounting for Leases". It is mandatory in respect of financial leases executed on or after April, 2001. It inter alia provides for capitalization of finance lease assets in the books of the lessee instead of lessor. The lessor [NBFC] is required to show the assets leased only as receivables in its balance sheet instead of as fixed assets. The implication of the above AS-19 for the NBFC prescribed by RBI vide amendments to the 1998 Directions is that all financial leases would now be accounted like hire-purchase transactions [See Manual of NBFCs 9th Edition Page 268]. Similarly, under the RBI Guidelines dealing with accounting for investments, NBFCs having not less than 60% of the total assets in lease and hire purchase and deriving not less than 60% of their total income from such activities can be classified as hire purchase/equipment leasing companies. All these circulars and guidelines issued by RBI are relied upon only to show that equipment leasing and hire-purchase are activities undertaken as business by NBFCs which are regulated as para banking activities by the RBI under the provisions of the 1934 Act. They are regulated not only to protect depositors but also customers [See Section 45-I(c)(iii)(i)]. The above activities are financing activities encompassed under Section 45-I(c)(i) which in turn* *constitutes "rendition of services to its customer(s)" which is the taxable event under Section 65(105)(zm) of the Finance Act, 1994 (as amended). Apart from NBFCs, even banks through their subsidiaries with the approval of RBI can undertake equipment leasing, hire-purchase business and financial services. These are not direct lending activities. However, RBI treats them as services or facilities. The financial facilities are extended by way of equipment leasing or hire-purchase finance subject to approval of RBI.*

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20. *According to Sale of Goods Act by Mulla [6th Edition] a common method of selling goods is by means of an agreement commonly known as a hire-purchase agreement which is more aptly described as a hiring agreement coupled with an option to purchase, i.e., to say that the owner lets out the chattel on hire and undertakes to sell it to the hirer on his making certain number of payments. If that is the real effect of the agreement there is no contract of sale until the hirer has made the required number of payments and he remains a bailee till then. But some so-called hire-purchase agreements are in reality contracts to purchase, the price to be paid by instalments and in those cases the contract is a contract of sale and not of hiring. It depends on the terms of the contract whether it is to be regarded as a contract of hiring or a contract of sale. A hire-purchase agreement partakes of the nature of a contract of bailment with an element of sale added to it. However, if the intention of the financing party in obtaining the hire-purchase and the allied agreements is to secure the return of the loan advanced to its customer the transaction would be merely a financing transaction. [See page 75]. The point which needs to be re-stated is that the funding activity undertaken by the financing party which could be in the form of loan or equipment leasing or hire- purchase financing, would be exigible to service tax if such activity falls in the category of "banking and other financial services" under Section 65(12) of the Finance Act, 1994. The financial transaction was earlier out of the tax net. In the process there are two different and distinct transactions, viz., the financing transaction and the equipment leasing/hire-purchase transaction. The former is exigible to service tax under Section 66 of Finance Act, 1994 (as amended) whereas the latter would be exigible to local sales tax/VAT. Funding or financing the transaction of equipment leasing and hire-purchase covers two different and distinct transactions. The activity of funding or financing by NBFC who is in the business of financing by giving loans, or equipment leasing or hire-purchase finance falls in the category of financial services rendered by NBFCs to their customers. It is an activity in relation to the hire-purchase or lease transaction. In this connection, as and by way of illustration we need to give an illustration* *which brings out the distinction between a "finance lease" and "operating lease". A finance lease transfers all the risks and rewards incidental to ownership, even though the title may or may not be eventually transferred to the lessee. In the case of "finance lease" the lessee could use the asset for its entire economic life and thereby acquires risks and rewards incidental to the ownership of such assets. In substance, finance lease is a financial loan from the lessor to the lessee. On the other hand an operating lease is a lease other than the finance lease. Accounting of a "finance lease" is under AS-19, which as stated above, is mandatory for NBFCs. It is a completely different regime. According to Chitty on Contract, a hire-purchase agreement is a vehicle of instalment credit. It is an agreement under which an owner lets chattels out on hire and further agrees that the hirer may either return the goods and terminate the hiring or elect to purchase the goods when the payments for hire have reached a sum equal to the amount of the purchase price stated in the agreement or upon payment of a stated sum. The essence of the transaction is bailment of goods by the owner to the hirer and the agreement by which the hirer has the option to return the goods at some time or the other [See para 36.242, 36.243]. Further, in the bailment termed "hire" the bailee receives both possession of the chattel and the right to use it in return for remuneration to be paid to the bailor [See para 32.045]. Further, under the head "equipment leasing", it is explained that it is a form of long-term financing. In a finance lease, it is the lessee who selects the equipment to be supplied by the dealer or the manufacturer, but the lessor [finance company] provides the funds, acquires the title to the equipment and allows the lessee to use it for its expected life. During the period of the lease the risk and rewards of ownership are transferred to the lessee who bears the risks of loss, destruction and depreciation or malfunctioning. The bailment which underlies finance leasing is only a device to provide the finance company with a security interest [its reversionary right]. If the lease is terminated prematurely, the lessor is entitled to recoup its capital investment [less the realizable value of the equipment at the time] and its expected finance charges [less an allowance to reflect the return of the capital] [para 32.057]. In the case of hire-purchase agreement the periodical payments made by the hirer is made up of :*

(a) consideration for hire

(b) payment on account of purchase."

10.2 With this background of the legal provisions and precedents, let us now examine the facts. The lease agreement is produced before us. The relevant clauses are reproduced as under :

"Lease *3. The Lessor hereby lets on lease to the Lessee and the Lessee takes on lease from the Lessor, from the commencement date, the equipment described in the Schedule hereto/in the Schedule to the supplemental agreement.*

(i) The Lessee shall be solely responsible for taking/obtaining delivery and possession of the equipment leased under this agreement/supplemental agreement from the Manufacturers/Suppliers in accordance with the relative purchase orders, at the place specified therein.

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Ownership *8. The Lessee acknowledges, confirms and declares that it holds the equipment as a mere ballee of the Lessor and that it shall not have any proprietary right, title or interest in the equipment or any part thereof and shall at all times, protect and defend as ballee/licencee of the equipment the Lessor's absolute and permanent ownership right and title thereto and that he shall not at any time, advance or make any claim adverse to or in derogation of the Lessor's absolute and permanent ownership right and title. The Lessee further agrees and covenants that he shall not claim any benefits under the Tax Laws associated with the ownership of the equipment such as depreciation, investment allowance, etc.*

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21. DELIVERY OF EQUIPMENT ON TERMINATION OF THE LEASE :

a) Upon determination of the lease of the equipment granted hereunder, by efflux of time, unless a renewal is granted or agreed to, the Lessee shall, at its cost, forthwith, such determination, deliver or cause to be delivered to the Lessor at the place to be notified by the Lessor to the Lessee, the equipment in good order and condition (ordinary wear and tear being excepted).

b) Compliance with proper use: If anytime during the continuance of the lease, it appears to the lessor from the inspection carried out pursuant to Clause 14 hereof that the use to which the equipment/vehicle is being put is excessive, improper or unauthorized in terms of the lease, then it shall be lawful for the lessor to give notice to the lessee that the reasonable resale value of the equipment/vehicle is being prejudiced by such use of the equipment/vehicle by the lessee beyond the terms permitted under the lease and in such event, the lessor is entitled to increase the rentals payable by the lessee to the lessor or to *demand and recover from the lessee a lump-sum amount which the lessee agrees to pay to the lessor, without demur to ensure that the resale value is not prejudiced. The lessor shall also be entitled to prescribe a minimum sale price which the equipment/vehicle shall fetch on determination of the lease and any shortfall in the realization of the sale price occasioned by excessive, improper or unauthorized use as aforesaid shall be payable by the lessee without demur."*

10.3 The above Clauses, in particular Clause 8, shows that the ownership rests with the lessor (the appellant herein). Similarly, in Clause 21 it is stated that upon determination of the lease, the lessee has to deliver the equipment/vehicle to the lessor at the place notified. Thus, after determination of the lease in an Operating Lease, the lessee has to return the equipment/vehicle to the lessor. The lessee is not entitled to own or does not have an option to own the asset at the end of the lease period, which is the distinguishing feature between an Operating Lease and a Financial Lease.

11. Ld. Counsel for the appellant has also produced the financial statements of the appellant-company during the period 2010-11. As per Accounting Standards (AS-19), the Financial Lease is shown as current assets. Further, the Operating Lease is shown under the category of fixed assets. This is because, the equipment which are given on lease under the category of Operating Lease always remain in the ownership of the lessor (appellant-company).

12. We are therefore convinced that as per the documents, the transactions fall under the category of Operating Lease only. The allegation of the Department that the agreements are actually Financial Lease and that Operating Lease is only a misnomer, is factually wrong.

13. The issue as to whether Operating Lease is subject to levy of service tax has been analyzed by the Tribunal in the case of *M/s. Lease Plan India Ltd. (supra).* Following the said decision as well as after appreciating the facts, we are of the opinion that the allegation that the lease agreements are in the nature of Financial Leasing, is incorrect and hence, the demand cannot sustain. The impugned Order is set aside.

14. The appeals are allowed with consequential reliefs, if any, as per law.

*(Pronounced in open court on **18.03.2019**)*

(Madhu Mohan Damodhar)
Member (Technical)

(Sulekha Beevi C.S.)
Member (Judicial)

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