Basic tax treatment of lease transactions:

The tax treatment of lease transactions in India is based on whether the lease qualifies as a lease or not.

- If the transaction is treated as a lease, the lessor shall be eligible for depreciation on the asset. The entire lease rentals will be taxed as income of the lessor. The lessee, correspondingly, will not claim any depreciation and will be entitled to expense off the rentals.
- The tax-payer claiming depreciation should own the asset. No doubt, the lessor owns the asset, but it is not legal ownership alone that is sufficient; the lessor must establish himself to be the beneficial owner as well.

Tax Status of True Leases

Annual lease payments are tax deductible for the lessee if one crucial criterion is met: The IRS (Internal Revenue Services) must agree that a contract truly is a lease and not just an installment loan called a lease. Before embarking on a lease transaction, all involved parties should obtain an opinion from the IRS regarding the tax status of the proposed lease. The opinion of the IRS normally revolves primarily around the following general rules:

- The remaining useful life of the equipment at the end of the lease term must be the greater of 1 year or 20 percent of its originally estimated useful life.
- Leases in excess of 30 years are *not* considered to be leases for tax purposes.
- The lease payments must provide the lessor with a fair market rate return on the investment. This profit potential must exist apart from the transaction's tax benefits.
- Renewal options must be reasonable, that is, the renewal rate must be closely related to the economic value of the asset for the renewal period.
- If the lease agreement specifies a purchase option at the end of the lease period, the purchase price must be based on the asset's fair market value at that time.
- The schedule of lease payments should not be very high early in the lease and very low thereafter. Such a payment schedule suggests that the lease structure is being used merely to avoid taxes.
- In the case of a leveraged lease, the lessor must provide a minimum of 20 percent equity.
- Limited-use property (valuable only to the lessee) may not be leased.

Income Tax Aspect While the accounting standards addresses the companies act perspective, from the Income tax aspect, when the lessee incorporates both the asset and liability in the balance sheet and recognizes the depreciation expense in relation to the asset addition, the same is not allowed in the income tax act, due to the following reason:

1. the basic condition for claiming depreciation under income tax act is ownership and usage of asset, though the condition of usage of the asset is more or less settled issue, but the ownership of the asset under income tax act continues to be an point of debate.

2. As per the finance lease, the lessor is the owner of the asset legally and the lessee is only given a right to use the asset for a predetermined payment.

3. As per recent Supreme Court pronouncement also it is clear that only the lessor is eligible to claim depreciation on the leased asset, even though as per the companies act the asset is in the books of the lessee.

4. So as per the accounting standards, when the company discloses the lease to be an finance lease, the said depreciation as per the companies act is disallowed and no depreciation is allowed for the said asset in the income tax computation, as the asset is not legally owned by the lessee.

5. But the full finance charges paid by the lessee towards the assets will be allowed while computing the income tax. It is necessary to bear in mind this difference in the treatment of finance lease both in companies act and income tax act as it may cause hassle at the year end.

In case the asset is purchased by the lessee at the end of the lease term by making additional payment, the same shall be depreciated in the corresponding year under the income tax act as the ownership is transferred to the lessee.

- **Accounting in the books of Lessee in case of Finance Lease**

1. At the inception of lease, lessee will recognize the lease as assets or liability at an amount equal to the fair value of leased assets
2. Apportion the lease payments into finance charge and reduction in outstanding liability
3. Allocate finance charge to the periods during lease term
4. Pass journal entry for depreciation

- **Accounting in the books of Lessor in case of Finance Lease**

- Lessor to record assets in the books of account at an amount equal to net investment in Lease
- Record finance income based on pattern reflecting constant periodic rate of return
- If there is any reduction in estimated unguaranteed residual value then revise the income allocation over the remaining lease term. Reduction in respect to the amount to be recognized immediately.

- **Accounting in the books of Lessee in case of Operating Lease**

- Lease payment is recognized as an expense in the profit and loss account

- **Accounting in the books of Lessor in case of Operating Lease**

- Lessor should record assets in balance sheet under fixed assets
- Lease income to recognize in statement of profit and loss account
- Cost incurred including depreciation to be recognized in statement of profit and loss account