

LEASING



WHY LEASING?

Micro, Small & Medium Enterprises (MSMEs)

The key aspect of any MSME, including Start-ups, is acquisition of assets like equipment, machinery etc. Further, in today's fast developing technological world "obsolescence" is another challenge which demands upgradation on a regular basis. Mechanisation and increased use of technology are required to ensure greater efficiency and transparency. All of this, needs capital investments which is a big challenge. Availing loans from banks and financial institutions often require collateral security by way of property, which again is an issue.

It is desirable to spread the capital investment for the above said purpose over a longer period and hence reduce the annual commitment towards the same. Intention is to match the commitment with the revenue generated every year without any cash flow mismatch.

Hence, leasing provides the right solution for any MSME to meet all the above said challenges.

Agriculture

With the increasing scarcity of labour and to ensure greater productivity, it is of utmost importance to encourage and promote farm mechanisation. For this, greater use of farm equipment is needed which require capital investments by the farmers.

Leasing is the best mode to enable farmers use the right equipment without making any capital investment

Leasing of Farm Equipment

Global demand for agricultural equipment is forecast to expand 7.0 percent per annum to \$216 billion in 2018, accelerating from the pace of the 2008-2013 period. Advances will be propelled by the increasing mechanization of farming operations in developing countries, with particularly sizable gains anticipated in China, India, and Brazil. Ongoing economic expansion, population growth, and rising per capita calorie intake in these and other developing nations will boost demand for food. This will not only place greater pressure on their agricultural sectors to become more efficient and productive, but it will also increase farm incomes, thus creating additional opportunities for machinery sales. In more developed markets such as the United States and Western Europe, growth in agricultural equipment demand will be driven by efforts to reduce inputs and maximize production capabilities

through the use of increasingly advanced high value precision farming technologies such as global positioning systems and yield monitors.

Reasons for leasing equipment is that it is only needed for a short period of time and the down time when you aren't using it is not costing you money in interest and other expenses. The most difficult thing about farming and agriculture is that your actions are always subject to the climate and the weather. This applies to all areas of agriculture, when to plant or harvest a crop or when to buy or sell livestock is always dependent on the weather conditions. This can be very difficult in some of the more extreme climates around the world. Leasing agricultural equipment makes it just that little bit easier for an agricultural business or company to survive. Often it is a dominant factor determining the sustainability of an agricultural enterprise

HOW LEASING HAS BEEN EFFECTIVELY USED IN OTHER COUNTRIES?

Russia's Leasing Industry

Leasing markets in Russia have demonstrated success in terms of developing enabling environments conducive to leasing

The leasing industry in Russia is characterized by different types of lessors, both private and government-owned. In the private sector, captive leasing companies or supplier-owned leasing companies, both Russian and foreign, are becoming more common. Foreign equipment suppliers, such as Caterpillar, John Deere, and Claas, play an increasing role in the Russian market. The captive leasing company model is effective in that the manufacturer and dealer network have a specialized knowledge of the client base, which permits stronger risk analysis. The suppliers are often geographically positioned closer to the lessees than in other leasing models.

There are also government-owned leasing companies, operating on either a commercial or non-commercial basis. The government-owned Rosagroleasing dominates the agricultural leasing sector

Legislative Reforms in Russia

IFC's Russia Leasing Development Group project in coordination with other key leasing stakeholders drafted amendments and framework agreements to resolve both internal contradictory provisions and contradictions that existed among the various legal acts. When the 2002 Federal Law "On Amendments and Addenda to the Federal Law on Leasing,"

passed, it substantially reduced the investment risks created from legal and tax uncertainties and established a stronger legislative base for the leasing industry to develop.

Four legislative reforms led to a more conducive environment for leasing in Russia. They include the following:

- Legislation that clearly defines a lease contract, leased assets, and responsibilities and rights of parties to a lease contract.
- Abolition of the law for licensing of leasing companies, which created a bureaucratic constraint rather than protection against illegal activities.
- A favorable tax policy that permits accelerated depreciation for leased property and expensing of lease payments.
- Abolishment of all turnover taxes on sales revenue.

There are no prudential regulations imposed on leasing companies in Russia. In fact, anyone can lease and registration is not required. Licensing of leasing activities created a bureaucratic bottleneck, which impeded industry development.

Clear and Favorable Taxation of Leasing in Russia

The main tax advantages to leasing are:

- (1) the flexibility to record an asset on either the balance sheet of the lessor or lessee,
- (2) accelerated depreciation of the asset up to a factor of 3, lowering profit and property taxes, and
- (3) the ability of lessees to fully expense leasing payments, lowering the taxable profit base. Lessees include lease payments in the cost of production, which lowers their profit tax payable.

Lower VAT taxes facilitate leasing industry growth. VAT has been lowered in Russia to 18 percent.

While all leasing payments in Russia are subject to VAT, the lessee can record VAT paid as a tax deduction and is entitled to government reimbursement within three months.

Leasing Provides Access to Finance Uzbekistan's SMEs

Uzbek Leasing has been a partner in the IFC Leasing Advisory Program in Central Asia since 2002 and has further strengthened its operational capacity. IFC has played a key role in the development of the leasing sector in Uzbekistan, helping to amend 11 pieces of legislation to facilitate leasing in the country. As a result of these regulatory improvements, targeted support at the company level, and increased awareness, the leasing market in Uzbekistan has grown by US\$220 million from 2001-2007. The Company's clients are private SMEs, whose growth is critical for the development of Uzbekistan's economy. With total assets of \$7.1 billion equivalent and declining banking penetration rates, the financing needs of the private sector, particularly SMEs, were not being met. Without access to term finance, SMEs are unable to implement investment plans and modernize existing facilities. Many small companies raised funds on the curb market, in cash, and often at significantly higher interest rates. Today Uzbek Leasing, which has IFC as one of its four shareholders, is one of the leading and most successful leasing companies in the country. Uzbek Leasing has served as a model that has led other leasing companies to launch operations in Uzbekistan

Leasing Helps Rwandan Coffee Farmers

The humble bicycle is helping boost the income and better the lives of 1,200 coffee farmers in Rwanda, thanks in part to IFC's leasing program in the country. Coffee is a major source of export income in Rwanda, a country that is still recovering from genocide and the resulting turmoil of the 1990s. Most of the country's 10 million people work in the agriculture industry or toil at their own small farms to survive. IFC, in partnership with a local subsidiary of an international nongovernmental organization, is expanding a program that allows local coffee farmers to lease durable, eight-gear bicycles with a specially fitted shelf to haul heavy loads. This enables farmers to bring their harvest to distant washing stations much faster, meaning the beans will be fresher and obtain a higher price at market. Some 1,200 farmers are now using the bicycles, which they purchase for about \$140 through a lease-to own program that was designed largely by IFC. Payments are made over the course of a year, ensuring that the cost does not bite deeply into the farmers' monthly income. IFC launched a leasing program in Rwanda in 2006. In a short time, it helped the country introduce a legal framework for leasing, guide banks through the process of developing leasing products, and raised awareness among businesspeople about the advantages of leasing equipment to expand production and profitability.

Yemen

In 2007, the president of Yemen formally signed the new leasing law that had been developed by the Central Bank of Yemen, drawing on IFC's advice. The law specifically establishes a clear set of rights and responsibilities for the parties of a lease and a new registry system for leased assets. In addition, it introduces speedy leased asset repossession procedures and sets out basic tax and accounting structures that create a level playing field between leasing and other types of financing, such as bank loans. Overall, the number and volume of leases in Yemen increased four-fold since IFC began working on the adoption of the law. The total leasing portfolio of all lessors at the middle of 2009 stood at USD56 million (an increase from USD13 million in just 18 months)

Tanzania

In April 2008, the Tanzanian Parliament endorsed the bill for the Financial Leasing Act. The creation of this law was the result of an IFC initiative sponsored by SECO (the Swiss State Secretariat for Economic Affairs) with the objective of stimulating capital investment and creating access to finance for local and international entrepreneurs, SMEs and corporates in Tanzania. IFC worked closely with several leasing companies during the drafting phase of this law and has continued their work with capacity building, including developing and presenting training programmes and seminars using international leasing experts and practitioners to present the information and share their knowledge with interested parties. By the end of 2008 the leasing market volume had grown to around USD100 million or 3% penetration in financing investment in the Tanzanian economy. This compares to around USD20 million or 1% penetration in 2005.

WHY LEASING HAS SUFFERED IN INDIA?

Imprudent Taxation

Pre-GST Era – Multiple Taxation

Lease treated as a “Sale” - Levy of VAT on Lease Rental

46th Amendment to the Constitution of India in 1982, recognised lease and hire purchase as “deemed sale” activities. As a result the *entire lease rental / hire purchase instalment has been subject to the levy of VAT (earlier Sales Tax)*. The arrangement was working fine till 2001.

Lease also treated as a “Service” - Levy of Service Tax on the Interest Component of the Lease Rental

Union Budget 2001 included lease and hire purchase under the definition of “service” (part of banking and financial services). As a result, the interest component of a lease rental was also subject to the levy of service tax. Following aggressive representations made by industry bodies, Union Budget 2006 waived 90% of the interest component of lease rental from the levy of service tax.

Therefore 10% of the interest component of every lease rent/hire purchase instalment was subject to the levy of service tax, in addition to the levy of VAT on the entire lease rental/ hire purchase instalments.

Lease was also treated as a “Loan” – Levy of Interest Tax on the Interest Component of the Lease Rental

By treating the entire lease transaction as a “sham”, tax officials have gone on to treat lease as a “loan” and hence *raised interest tax demands (prior to it being abolished in 2006) on the interest component of the lease rent.*

GST – Provides No Incentive to Leasing

While the issue of multiple taxation has been solved by the introduction of GST, the GST regime does not “incentivise” leasing. As per the prevailing rates and norms, the GST rate on Lease Rentals is the same as the GST rate on normal sale of the asset.

It is imperative that in order to promote leasing the GST rate on lease rentals must be in the minimum slab i.e 5%

TDS And Withholding Tax on Lease Rental

As per Section 194-I, of the Income Tax Act, 1961 the definition of “rent” includes lease rent paid for any lease, sub lease, tenancy. As such, *the lessee is supposed to deduct TDS on the lease rent @ 2% for plant and machinery and 10% for furniture and fittings. This results in TDS on the principal amount (asset cost) also which is unjustified.*

As per Section 195 of the Income Tax Act, 196, in case of *cross border lease, the Indian lessee while paying the lease rental to a foreign lessor, is supposed to deduct the withholding tax. This discourages cross border leases.*_

Therefore, lease has been dealt a body below due to imprudent taxation as explained above. This makes “lease” unviable as compared to simple loan against hypothecation.

Dichotomy in Accounting and Taxation of Financial Lease

Accounting of Financial Lease is done as prescribed by Accounting Standard AS-19, issued by Institute of Chartered Accountants, India (ICAI). AS-19, requires the Lessee to capitalize the leased asset in his books and thus be eligible to claim Depreciation. Further, for Profit and Loss accounts, it is only the interest component of the lease rental that is treated as Income in the books of the Lessor and as a deductible expense in Lessee’s books.

However, Income Tax Act, being silent on the distinction between Financial and Operating Lease, mandates the Lessor, being the owner, to claim Depreciation. Further, CBDT vide its circular dt. February 09, 2001 had clarified that the Accounting Standard AS-19 will have no implication on the allowance of Depreciation of Assets in case of Financial Lease. As a result, for tax purposes, it is the lessor who claims Depreciation and also treats the entire lease rental (and not only the interest component) as his income. The same is treated as a deductible expense by the lessee. Honourable Supreme Court in its latest judgement in the matter had also ruled on similar lines.

This dichotomy in the system is the root cause for huge number of cases going in litigation.

Tax Officials View Lease with Suspicion

Experience has shown that tax officials across the country often view lease as a mode of tax evasion by the lessor, whereas the truth is that lease may only lead to tax deferral but certainly not evasion. Because of this suspicion, the tax officials treat the entire lease transaction as a sham and therefore deny depreciation benefits. In some cases depreciation is allowed only at a rate lower than the prescribed rates. Numerous cases are pending in various courts across the country on depreciation claims.

Therefore, the suspicious view of tax officials has not only led to harassment but also denial of depreciation benefits which is a key aspect of any lease transaction.