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### Lessee not entitled to deduction for lease rental but to depreciation, and set-top box entitled for depreciation at 60%

The Chandigarh Bench of the Indian Income-tax Appellate Tribunal (ITAT) gave its decision on facts that lessee is not entitled to deduction for lease rental but is entitled to depreciation and that set-top box is entitled for depreciation at the rate of 60%, as applicable to computers

#### Facts of the case:

- Fastway Transmission P. Ltd (the taxpayer)<sup>1</sup> is a company engaged in the business of multi-system operators and digital cable services.
- The taxpayer had entered into a financial lease agreement with CISCO Capital System India Pvt. Ltd. (CISCO) for supply of set-top boxes (STB) and head ends. CISCO is a Non-Banking Finance Company (NBFC) registered with the Reserve Bank of India (RBI) providing different types of loans on assets / equipment to its customers.
- The taxpayer gave the STBs to its consumers on hire purchase basis. It collected refundable security deposit equal to the cost of the STBs and charged monthly rent from the consumers for three years. After the expiry of three years, the STBs became the property of the consumer, the security deposit was forfeited, and the taxpayer offered the same as its income.
- During the course of the audit proceedings, the Assessing Officer (AO) noted that with respect to the principal portion of the lease payment, the taxpayer had:
  - Capitalised it in the books of accounts, on the basis that the transaction with CISCO was of finance lease for accounting purposes; and
  - Claimed it as a revenue expenditure in the income-tax return.
- The AO after analysing various clauses of the agreement between the taxpayer and CISCO:
  - Treated the principal portion of lease rent payment as capital expenditure and allowed depreciation at 15% (as applicable for plant and machinery);
  - Rejected the alternate contention of the taxpayer that STBs were eligible for depreciation at the rate of 60% as applicable for computers.
- The Commissioner of Income-tax Appeals [CIT(A)] upheld the AO's order.

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<sup>1</sup> Fastway Transmission (P.) Ltd. v. ACIT [2020] 116 taxmann.com 427 (Chandigarh – Trib.)

- Aggrieved by the CIT (A)'s order, the taxpayer filed an appeal before the Chandigarh Bench of the Income-tax Appellate Tribunal (ITAT).

### Decision of the ITAT:

- The ITAT noted that the following two issues had emerged in the case under consideration:
  - Whether the principal component of lease rental was revenue expenditure, eligible for deduction, or capital expenditure, eligible for depreciation?
  - In case the STBs qualify as capital asset, then what would be the rate of depreciation (i.e. 15% or 60%)?

### Issue 1: Whether the principal component of lease rental was revenue expenditure eligible for deduction or capital expenditure eligible for depreciation?

- The ITAT noted that unlike the accounting standards, the Income-tax Act, 1961 (ITA) did not differentiate between different types of lease transactions (i.e. an operating lease and a finance lease). Under the ITA, in all lease transactions, the owner of the asset is entitled to depreciation (if the asset is used in the business) and the ownership was to be determined based on the terms of the contract.
- The ITAT relying on the case of Tuticorin Alkali Chemicals and Fertilizers Ltd v. CIT<sup>2</sup> held that accounting standards cannot override the provisions of the ITA. The ITAT also relied on the case of Kedarnath Jute Manufacturing Co. Ltd. v. CIT<sup>3</sup> case wherein it was held that entitlement for deduction would depend upon the provisions of the ITA and not the books of account.
- The ITAT relied on the case of Sundaram Finance Ltd. v. State of Kerala And Another<sup>4</sup> and held that the terms of the agreement in light of the surrounding circumstances were relevant to determine the true effect of a transaction. The nomenclature given to a transaction by the parties was not sacrosanct or determinative of the nature of the transaction.
- The ITAT analysed various clauses of the lease deed in the case under consideration and noted that:
  - The taxpayer selected the equipment and CISCO's role was only to finance the purchase of the STBs;
  - The taxpayer used the STBs for its entire expected economic life and paid back the entire cost of the STBs over the lease period;
  - The taxpayer exercised all rights of ownership over the asset and the risk of loss, damage, etc. was borne by the taxpayer;
  - The taxpayer could not cancel / terminate the lease and return the asset before the end of the lease term;

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<sup>2</sup> Tuticorin Alkali Chemicals and Fertilizers Ltd. v. CIT [1997] 93 Taxman 502 (SC)

<sup>3</sup> Kedarnath Jute Manufacturing Co. Ltd. v. CIT [1971] 83 ITR 363 (SC);

<sup>4</sup> Sundaram Finance Ltd v. State Of Kerala And Another" 1966 AIR 1178, 1966 SCR (2) 828

- The title of the asset was retained by CISCO for security purposes.
- In view of the above, the ITAT held that:
  - The arrangement between the taxpayer and CISCO was that of a loan / finance arrangement;
  - The taxpayer could claim deduction for interest paid as revenue expenditure; and
  - The taxpayer would need to treat the STBs as capital assets entitled to depreciation.

## Issue 2 – Rate of depreciation for STBs (i.e. 15% or 60%)?

- The ITAT held that the rate of depreciation under the ITA and the rules thereof were provided taking into consideration the general or approximate age of the asset and the speed at which it depreciated.
  - Similar type of assets irrespective of their quality, make or the material used therein, were placed under the same category with same / equal depreciation rate (e.g. all type of buildings except purely temporary erections, etc.).
- The ITAT noted that intelligent electronic devices and computer hardware / software were placed under the same category and mentioned together for certain assets qualifying for the 80% depreciation rate<sup>5</sup>. Accordingly, the ITAT held that a clue could be taken from the same that intelligent electronic devices (such as STB) were identical to computers not only in their architectural design but also in their functioning.
- The ITAT held that STBs formed part and were attachment of the computer systems and were not mere information appliances attached to the TV on the following basis:
  - The STBs were essential to provide broadcasting / D2H services offered by the taxpayer to the consumers;
  - The STBs were part of the setup essential to transmit, decode and send the audio / video signal to the television;
  - The STBs were useless if not connected with main server system.
- Considering the nature of STBs, their architecture, their components, their functions and also their average life, the ITAT held that STBs qualified under the category of computer for the purpose of determination of rate of depreciation.
- Additionally, the ITAT relying on the TRAI notification<sup>6</sup>, noted that the usual economic life of STBs was three years, after which the consumer became the owner of the STBs. Further, it noted that the taxpayer recovered rent for 3 years and the security deposit towards STBs was forfeited / appropriated to the taxpayer (on the consumer becoming owner of the STBs). Accordingly, the ITAT held that:

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<sup>5</sup> The 80% rate has now been revised to 40%.

<sup>6</sup>TRAI notification No. 1-19/2012-B&CS dated 27-3-2013

- Considering that the total receipt relating to the STB taxpayer was accounted as receipt / income by the taxpayer, the corresponding expenditure / depreciation could not be delayed / postponed beyond the date of sale of STBs to the consumers.
- Rate of depreciation has to be commensurate with life of the asset and lower rate of depreciation (viz. 15% as held by Revenue) would extend the depreciation claim beyond the life of the asset.
- In view of the above, the ITAT held that the taxpayer with respect to STBs was entitled to depreciation at 60% as applicable to computers.

**Comments:**

- This ruling affirms the following principles:
  - Accounting standards cannot override the provisions of the ITA.
  - The terms of the agreement in light of the surrounding circumstances were relevant to determine the true effect of a lease transaction.
  - The rate of depreciation if not expressly specified, has to be decided after taking into consideration all relevant facts
- The depreciation rate for computers has now been revised to 40%.



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