UNIT 6 : LEASE FINANCING AND HIRE-PURCHASE

UNIT STRUCTURE

6.1 Learning Objectives

6.2 Introduction

6.3 Concept of Leasing

6.4 Features of Lease

6.5 Classification of Lease

- 6.5.1 Financial Lease
- 6.5.2 Operating Lease
- 6.5.3 Sale and Lease Back Lease
- 6.5.4 Leverage Lease

6.6 Advantages and Limitations of Lease

6.7 Legal Aspect of Leasing

6.8 Hire Purchase: Meaning and Features

6.9 Differences between Leasing and Hire-Purchase

6.10 Installment Purchase: Meaning and Features

6.11 Differences between Hire-Purchase and Installment Purchase

6.12 Legal Aspect of Hire Purchase

6.13 Let Us Sum Up

6.14 Further Readings

6.15 Answers to Check Your Progress

6.16 Model Questions

6.1 LEARNING OBJECTIVES

After going through this unit you will be able to:

- explain the concept of lease financing, hire purchase and installment purchase
- discuss types of lease financing
- describe the essential features of lease financing, hire purchase and installment purchase
- explain the legal aspects of lease financing and hire purchase.

6.2 INTRODUCTION

In this unit we will get inputs on major asset financing service prevalent in industrial sector i.e. leasing.

Suppose, we are going to establish a tea factory .First of all we require land, building and machinery which involves investment of huge funds. We do not have the entire fund required for setting up the factory. Now, what we can do is that we can go to a leasing company, get the machinery on lease without buying them. For that we need to pay an amount monthly to the leasing company which is called rental. This system is called lease. The same is done for the existing company also which go for expansion of their business. In case of existing companies, they may have the required fund but if they pay the entire amount from their earning, it will put a pressure on the current year's earning resulting in reducing profit. Hence, companies go for alternative financing of assets like leasing. Let us discuss the concept of "lease".

6.3 CONCEPT OF LEASING

A lease may be defined as a contractual arrangement or transaction in which a party (lessor) owing an asset or equipment provides the asset for use to another or transfer the right to use the equipment to the user (lessee) over a certain or for an agreed period of time for consideration in the form of a periodic payment (rentals) with or without a further payment (premium). At the end of the period of contract (lease period), the asset or equipment reverts back to the lessor unless there is a provision for the renewal of the contract. The above definition reveals that leasing essentially involves the divorce of ownership from the economic use of an asset or equipment. It is a device of financing the cost of an asset. Lease financing is thus a device of financing or money lending. Lease financing is available for land, buildings, industrial equipments etc.

As we have already discussed that in leasing, the user company does not own the machinery or the equipment leased; yet for all practical purposes the user has virtually all rights over the machinery. The main

difference between leasing and term loan are: a finance company called the leasing company arranges to buy a piece of machinery or equipment (usually in consultation with and prior approval of the lessee) and the leases the machinery on long term to the lessee.

The lessee pays the lease rental whereas in a term loan the borrower is expected to pay the interest as well as the repayment of the loan amount. The lessee does not own the equipment and hence cannot claim the depreciation and investment allowances on the relative machines. However, the lease rental would normally include repayments towards principal and interest and the entire rental may be written off as eligible expenditure from profits for income tax purpose.



LET US KNOW

Lease has been in practice since time immemorial in various forms. Evidence trace the evolution of leasing during the Sumerian and Greek civilization where leasing of land, agricultural tools, animals and ships took place. Equipment leasing is found to be used in large scale during the post second world war era by the European rail companies. Since then the leasing gained popularity and during late 19th century, the leasing practice was rapidly used in USA especially among the rail road operators who took rail cars and locomotives in lease. Leasing in India is of recent practice. It is in 80's when the leasing practice was started in India. Today leasing has become a very common and popular means of assets financing for large scale manufacturing facilities, power and infrastructural equipments and construction equipments. Other common equipment leasing includes plant and machinery, office equipment automobiles ships and aircrafts. Leases are used to finance such items as computers, commercial aircrafts, construction equipment machine tools and medical equipment.

Although it started late in India, leasing witnessed a very rapid growth during last few decades. Industrialization and the advent of multinationals in India have augmented the growth further. The

financial sector reform has paved the path for the financial innovation resulting in these types of services. Leasing is expanding both in public and private sectors. The major private sector leasing companies operating in India are Sundaram Finance Ltd, Ashok Leyland Finance Ltd, Kotak Mahindra Finance Ltd and Tata Finance Ltd. Apart from these; many public sector banks have floated their finance and leasing arms. Some of them are Infrastructure Leasing and Financial Services Ltd promoted jointly by Central bank of India, HDFC and UTI, PNB Financial Services, Industrial Reconstruction Bank of India etc.

6.4 FEATURES OF LEASE

The basic features of a lease are-

- There are essentially two parties associated in the leasing; the Lessor (owner of the asset) and the Lessee (user of the asset).However, in some cases a third party called Lender or financer is involved when the Lessor thinks it to be necessary.
- The asset- a vehicle, an aircraft, a machine, a computer, a building, etc can be a subject of leasing.
- Lease contract is done for a specified period; may be for long term(called finance lease) or for short term(called operating lease)
- Lessee has to pay a consideration to the lessor for using the asset. This is called rentals.
- At the end of the lease period, the contract may be renewed or the asset may be sold to the lessee or the asset may be reverted to the owner.



CHECK YOUR PROGRESS

Q 1: Who are the parties involved in lease agreement?

.....

.....

Q 2: State two features of lease agreement.

.....

.....



ACTIVITY 1

Visit two Finance companies of your choice and identify various items for which they provide lease financing.

.....

.....

.....

.....

Now, we have a fair idea about the concept of leasing .Let us now proceed to discuss a little more about it.

6.5 CLASSIFICATION OF LEASE

An equipment lease transaction can differ on the basis of (i) the extent to which the risks and rewards of ownership are transferred. (ii) number of parties to the transactions (iii) domicile of the equipment manufacturer, the lessor and the lessee and so on.

Leasing can be classified in to the following types: (i) Financial lease, (ii) operating lease, (iii) sale and lease back arrangement (iv) Leverage Lease

6.5.1 Financial Lease

Finance lease or Financial lease sometimes called the capital lease means a long term lease which transfers the ownership of an asset to the lessee by the lessor with a substantial part of risks and rewards of ownership .As per Financial Accounting Standards Board (FASB) of the USA, the lease can be classified as financial lease , if the term of lease exceeds 75 percent of the useful life of the asset or if the present value of the minimum lease payments exceeds 90 percent of the fair market value of the asset, at the inception of the lease.

The basic features of the financial lease are –

(a) The lessor does not provide for the repair and maintenance service, insurance of the asset and these have to be borne by the lessee;

(b) These contracts are not cancelable;

(c) They are fully amortised (i.e., the lessor receives rental payments which are equal to the full price of the lease equipment plus return on the investment);

(d) Lessee has the obligation to pay the rental irrespective of the suitability of the asset once agreed to take it on lease;

(e) The lessee enjoys the option to purchase the asset at a price which is lower than the fair market value at the end of the lease period.

Now, let us go through the steps of a lease finance transaction. They are –

- The lessee (the intending buyer) selects the equipment according to his requirement, from its manufacturer or distributor.
- The lessee negotiates and settles with the manufacturer or the distributor, the price, the delivery schedule, installation, terms of warranties, maintenance and payment etc.
- The lessor purchases the equipment either directly from the manufacturer or distributor (under straight forward leasing) or from the lessee after the equipment is delivered (under sale and lease back).
- The lessor leases out the equipment to the lessee. The lessor retains the ownership while lessee is allowed to use the equipment. A finance lease may provide a right or option to the lessee to purchase the equipment at a future date, however this practice is rarely found in India.

6.5.2 Operating Lease

Operating lease is defined as a short-term cancelable lease which transfers the ownership of the asset to the lessee without transferring risk and reward of the ownership unlike the finance lease. Operating leases, sometimes called service leases, provide for both financing and maintenance. An important feature of operating leases is that the frequently contain a cancellation clause, which gives the lessee the right to cancel the lease before the expiration of the basic agreement. Let us discuss the features of an operating lease

- An operating lease is generally for a period significantly shorter than the economic life of the leased asset. In some cases, it may be even on hourly, daily, weekly or monthly basis.
- Since the lease periods are shorter than the expected life of the assets , the lease rental are not sufficient to totally amortise the cost of the asset
- Operating lease normally include maintenance clause requiring the lessor to maintain the lease asset and provide services such as insurance, support staff, fuel etc.

6.5.3 Sale and Leaseback Lease

Under this type of lease, the owner of an equipment/ asset sells it to a leasing company (lessor) which leases back to the owner (lessee). A classic example of this type of leasing is the sale and lease back of safe deposits vaults by banks under which banks sell them in their custody to a leasing company at a market price substantially higher than the book value. The lease company in turn offers these lockers on a long-term basis to the bank. The bank sub-leases the locker to its customers. The lease back arrangement in sale and lease back type can be in the form of finance lease or operating lease. This type of lease enables the lessee to use the sales proceeds in productive projects and meet the rental of the lease using them.

6.5.4 Leverage Lease

Leverage lease is a form of lease where lessor acquires the asset/ equipment by borrowing funds from a third party. The lender to this leased asset is called the loan participant. Loan participant gets an assignment of the lease which gives the right to the rentals to be paid by the lessee. Further a first mortgage on the leased assets is also entitled to the loan participant. Another party called trustee is also associated with this type of lease to look after the interest of the lessor and the loan participant. The rental payments of the lease are routed through the trustee. On receipt of the lease rental, the trustee remits the debt service component to the lender (loan participant) and the balance to the lessor. Leverage lease is applied in case of those assets which require a huge amount of funds, i.e., aircrafts, ships etc.

6.6 ADVANTAGES AND LIMITATIONS OF LEASE

Now, let us discuss about the advantages of leasing. Advantages of leasing may be discussed from the lessee's point of view and from the lessor's points of view.

Lease financing has following advantages to the lessee:

- **Financing of capital goods:** Lease financing enables the lessee to have finance for huge investments in land, building, plant, machinery, heavy equipment etc. up to 100 percent without requiring any immediate down payment. Thus , the lessee is able to commence his business virtually without making any initial investment (of course he may have to invest the minimal some of working capital needs)
- **Additional source of finance:** Leasing facilitates the acquisition of equipment, plant and machinery without the necessary capital investment, and thus has a competitive advantage of mobilizing the scare financial resources of business enterprise. It enhances the working capital position and makes available the internal accruals for business operations.

- **Less costly:** Leasing as a method of financing is less costly than the other alternatives available.
- **Ownership preserved:** Leasing provides finance without diluting the ownership or control of the promoters. As against it, other modes of long term finances, for example, equity or debentures normally dilute the ownership of the promoters.
- **Avoids conditionality:** Lease finance is considered preferable to institutional finance, as in the former case, there are no strings attached. Lease financing is beneficial since it is free from restrictive covenants and conditionality, such as representation on the board, conversions of debt into equity, payment of dividend etc which usually accompany institutional finance and term loans from bank.
- **Simplicity:** Lease finance is simple to negotiate and free from cumbersome procedure with faster and simple documentation. As against it, institutional finance and term loans require compliance of covenants and formalities and bulk of documentation causing procedural delays.

Lease financing has following advantages to the lessor-

- **Full security:** The lessor's interest is fully secured since he is always the owners of the leased assets and can take repossession of the asset if the lessee fails to pay rentals. As against it , releasing an asset secured against a loan is more difficult and cumbersome
- **Tax benefit:** The greatest advantage for the lessor is the tax relief by way of depreciation. If the lessor in high tax bracket he can lease out assets with high depreciation rates and reduce his tax liability substantially. Besides, the rentals can be suitably structured, to pass on some tax benefit to the assessee.
- **High profitability:** The leasing business is highly profitable since the rate of return is more than what the lessor pays on his borrowing. Also the rate of return is more than in case of lending finance directly.
- **Trading on equity:** Lessor usually carries out the operations with greater financial leverage i.e., they have a very low equity capital and use a substantial amount of borrowed funds and deposits. Thus, the

ultimate return on equity is very high.

Limitations of leasing

Lease financing suffers from certain limitations which may be discussed as under-

- **Restrictions on use of equipment:** A lease arrangement may impose certain restriction on use of the equipment, or requires compulsory insurance etc. Besides, the lessee is not free to make additions or alteration to the lease assets to suit his requirement.
- **Limitation of financial lease:** A financial lease may entail a higher payout obligation, if the equipment is found not useful and the lessee opts for premature termination of leased agreement. Besides, the lessee is not entitled to the protection of express or implied warranties since he is not the owner of the asset.
- **Loss of residual value:** The Lessee never becomes the owner of the lease asset. Thus, he is deprived of the residual value of the asset and is not even entitled to any improvements done by the lessee or caused by inflation or otherwise, such as appreciation in value of leasehold land.
- **Double sales-tax:** with the amendment of sale tax law of various states a lease financing transaction may be charged to sale tax twice, once when the lessor purchases the equipment and again when it is leased to the lessee.



CHECK YOUR PROGRESS

Q 3: State two advantages and two disadvantages of lease.

.....

.....

Q 4: Mention two features of finance lease.

.....

.....

6.7 LEGAL ASPECT OF LEASING

There is no legislation which is exclusively meant for leasing transactions. However, various provisions of a number of laws/ Acts / directions are applicable to lease. In the following paragraphs, we will the main provisions of different Acts/ laws which are very common.

Indian Contract Act, 1872

The provisions relating to bailment in the Indian Contract Act cover equipment leasing agreement. Since an equipment lease transaction is regarded as a contract of bailment, the obligation of the lessor and the lessee are similar to those of the bailor and the bailee as defined by the provisions of the Indian Contract Act. The special provisions of Indian Contract Act relating to leasing are:

- The lessor is required to deliver the asset to the lessee with all legal documents enabling him to use the asset.
- The lessor must ensure the peaceful possession of the lessee during the tenure of the agreement.
- The lessor must disclose to the lessee about the faults, defects and risks (if any) of the assets leased failing which the lessor has to compensate the loss arising out of that.
- The lessor (Bailor) must ensure that the asset leased is fit and usefull for the lesee(bailee).
- The lessee has the obligation to pay the lease rentals as specified in the lease agreement, to project the lessor's title,
- Take reasonable care of the asset, and the lesse must not use the asset for unauthosied purpose.
- The lessee has to return the leased asset on the expiry of the lease, or when the agreement is terminated.

Competition Act

The lease contract also comes under the purview of Restrictive Trade Practices Act, now Competition Act. According to this Act, the following practices considered to be restrictive-

- Use of leased assets in certain purposes

- Binds the lessee to use a certain types of machinery manufactured by the Lessor
- Binds the lessee to buy the accessories and spare parts from the lessor only.

Foreign Exchange Management Act

Certain provisions pertaining to holding of assets in India by NRIs, restriction of payment on imported assets, restrictions in sending assets to outside on lease or hire purchase etc are appended in the FEMA which cover lease transactions involving foreign party or currency.

Motor Vehicle Act

Under Motor Vehicle Act the lessor of a lease contract is considered as the dealer and the lessee is considered as the owner for the purpose of registration, even if the legal ownership remains with the lessor.In this the lessor is treated as financier of the assets.

Indian Stamp Act

The leasing contracts are subject to the provisions of Indian Stamp Act for the payment of stamp duty creating a right or liability in monetary terms.

Income Tax Act, 1961

Income Tax Act 1961 provides for implications and offers tax benefits both to the lessor and the lessee the provisions are:-

- Lessor can deduct the amount of depreciation of the leased assets from his taxable income.
- Where leasing constitutes the business or main activity of the assessee (lessor), income from the lease is taxable under the head Profits and Gains from business and profession. In other cases, the income from lease is taxed as income from other sources.
- While computing the income of lessor from leasing, certain expenses are allowed as deductible expenses to determine the taxable income. These include-
  – Depreciation
  – Rent, taxes, repairs and insurance
  – Preliminary expenses

– Interest on borrowed capital

– Bad debts

– Expenses incurred in the furtherance of trade/business

– Entertainment expenses

– Travel expenses

- Lease rentals are considered as a normal business expenditure of lessee as per the Income Tax Act.
- Income Tax Act allows the lessee to deduct the expenses associated with the leased assets such as repairs and maintenance, insurance, finance charge and so on.

Sales Tax Act

Leased transactions are also covered by certain provisions of Sales Tax Act. These provisions are following.

- While purchasing equipment by the lessor, the normal sales tax is applicable.
- Sale tax is payable on the annual taxable turnover (aggregate lease rentals) of the lessor.
- Lessor with an annual taxable turnover beyond the specified limits must seek registration as 'dealer' under the local sales tax law.
- Surcharge, additional surcharge, additional sales tax is levied on turnover exceeding a specified limit or turnover.



ACTIVITY 2

Which type of lease would be suitable for acquisition of the following assets or equipments? Justify.

Computer .....

Aircraft .....

Truck .....

Car .....

6.8 HIRE PURCHASE: MEANING AND FEATURES

Now let us discuss another asset financing service of similar kind, called hire-purchase. A hire purchase can be defined as a contractual arrangement under which the owner lets his goods on hire to the hirer and offers an option to the hirer for purchasing the goods in accordance with the terms of the contract.

Features of Hire Purchase system

The following are the important features of hire- purchase system:

- Hire- purchase agreements are agreements to sell goods. It is not a contract of sale although it resembles a sale. The sale takes place at a future date on the fulfillment of certain conditions.
- Possession of goods under hire- purchase system is transferred from the seller to the buyer on signing the agreement.
- Although the possession of goods under the hire- purchase system remains with the buyer, the ownership of such goods remain with the hire seller till the payment of the last installment.
- The hire- purchaser agrees to pay cash price of the goods along with interest in periodical installments which may be monthly, quarterly, half- yearly or yearly.
- Installments paid by the hire- purchaser are treated as the hire charges till the payment of the last installment.
- The hire- vendor has the right to repossess the goods if the hire-purchaser makes default in the payment of any installment.
- The hire- purchaser has a right to terminate the agreement, after giving at least fourteen day's notice in writing, and thereby return the goods bought under hire- purchase system.

6.9 DISTINCTION BETWEEN LEASING AND HIRE-PURCHASE

Many a times people confuses between the leasing and hire purchase contract. Both leasing and hire-purchase provide a source of financing fixed assets. However, the two are not similar on many accounts.

Let us discuss the following points of distinction between leasing and hire purchase -

Point of Difference	Leasing	Hire-Purchase
1. Ownership	Ownership is not transferred to the lessee	Ownership is transferred to the hirer on payment of last installment.
2. Tax Deductibility	Entire lease rentals are tax-deductible expenses	Only the interest component and not the entire installment is deductible.
3. Depreciation and other allowances	Cannot be claimed by the lessee	Can be claimed by the hirer.
4. Salvage Value	Lessee cannot realize salvage value of the asset on the expiry of the lease of life of the asset.	Hirer can realize salvage value of the asset after payment of last installment.

6.10 INSTALLMENT PURCHASE: MEANING AND FEATURES

Installment purchase indicates the type of purchase under which the price of the goods and the interest on the price are paid by the buyer by periodical installments. Under this system the buyer acquires the title of the goods and the possession thereof as soon as the transaction is completed. This system hardly differs from a contract of sale except that payment of the price of the goods is spread over a number of installments and that each installment includes interest.

Features

The main features of an Installment purchase arrangement are as follows:

- **Credit sale**: It is a credit sale where payment is made in installments.
- **Transfer of ownership**: The title in the goods passes from the seller to the buyer when the transaction is completed.
- **Payment of interest**: Every installment includes interest on unpaid

balance.

- **Non-return of goods**: The buyer has no option to return the goods once they are purchased.
- **No right of possession**: the seller has no right to repossess the goods if the buyer fails to pay the installments. However, he can sue the buyer for the unpaid balance.

6.11 DIFFERENCES BETWEEN HIRE-PURCHASE AND INSTALLMENT PURCHASE

Installment system differs from hire purchase system in many respects as shown below:

Points	Hire Purchase	Installment
1. Nature of contract	It is only an agreement to sale but the actual sale takes place in future	It is a contract of sale of goods and is completed when the parties enter into an agreement
2. Ownership of goods	The title in the goods passes from the seller to the buyer after the last installment is paid	The title in the goods passes from the seller to the buyer when the contract for sale is completed.
3. Right of lien on goods	The seller has a lien on the goods until he receives full payment	The seller has no lien on the goods as it is a contract of sale.
4. Disposal of goods	The buyer is not the owner; hence he cannot dispose off the goods till he pays the last installment	Since the buyer is the owner, he can dispose off the goods before the last installment is paid.
5. Controlling Act	It is controlled by the Indian Contract Act of 1872	There is no such Act to control these transactions.



CHECK YOUR PROGRESS

Q 5: State two differences between leasing and hire- purchase system.

.....

.....

Q 6: State two differences between hire- purchase and installment purchase system.

.....

.....

6.12 LEGAL ASPECT OF HIRE PURCHASE

Like leasing, there is no legislation exclusively for the governance of hire-purchase transactions. An effort was made to this direction by passing an Act named The Hire-purchase Act in 1972. However, the act has not been implemented so far. Now, in absence of any specific law, the hire-purchase transactions are governed by the provisions of the Indian Contract Act and the Sales of Goods Act. Other laws which provides for governance of hire-purchase transactions are Income Tax Act and Sales Tax Act.



ACTIVITY 3

Which among the Lease, hire-purchase and installment purchase will you chose for financing your asset and why? Justify.

.....

.....

.....

.....



6.13 LET US SUM UP

In this unit we have discussed the following points:

- Lease is a contractual arrangement in which the owner of an asset (lessor) provides the asset for use to another the right to use the asset to the user (lessee) for an agreed period of time in return for periodic payments (rental).
- At the end of the lease period the asset reverts back to the owner.
- The major players in leasing in India are independent leasing companies, other finance and investment companies, manufacturer-lessor, development finance institutions, in–house lessors and banks.
- Hire Purchase is the agreement whereby the hirer will pay to the owner of the goods an equal periodic installments spread over a period of time for using the goods.
- In case of Installment Purchase system, the buyer pays periodically the price of the goods along with interest to acquire the title and possession of goods.
- Both leasing and hire-purchase have emerged as a supplementary source of finance.



6.14 FURTHER READINGS

1) Pathak, Bharati V (2006). The Indian Financial System : Markets, institutions and services. New Delhi, Pearson Education Ltd.

2) Khan, M. Y. (2007). Indian Financial System. New Delhi. Tata McGraw Hill.



6.15 ANSWERS TO CHECK YOUR PROGRESS

Ans to Q No 1: i) Lessor- owner of the asset
ii) Lessee- user of the asset

Ans to Q No 2: i) Lease contract is done for a specified period.
ii) Lease contract separates the owner from the user of the asset.

Ans to Q No 3: Advantages:
i) Full security
ii) Tax benefit
Disadvantages:
i) Restriction on use of equipment
ii) Loss of residual value

Ans to Q No 4: i) The lessor does not provide for the repair, maintenance and insurance of the asset.
ii) The lessee enjoys the benefit of purchasing the asset at a lower price than the market value at the end of the market value.

Ans to Q No 5: i) In case of lease, ownership is not transferred from the lessor to the lessee.
In case of hire- purchase, ownership is transferred from the owner to the hirer of the asset after the last installment is paid.
ii) In lease, the lessee cannot claim depreciation and other allowances.
In hire- purchase, the hirer can claim depreciation and other allowances

Ans to Q No 6: i) Hire purchase is an agreement to sale but the actual sale takes place in future. Installment is an agreement of sale and is completed as soon as the parties enter into the agreement.
ii) In hire- purchase system, ownership is transferred after the last installment is paid. In installment system, ownership is transferred when the contract for sale is completed.



6.16 MODEL QUESTIONS

Q 1: Explain the concept of leasing and hire-purchase

Q 2: Why companies go for leasing rather than purchasing the equipment? Discuss.

Q 3: Differentiate between Hire purchase and leasing.

Q 4: Differentiate between Hire-purchase and Installment purchase.

Q 5: Classify lease financing and explain their specific features.

*** ***** ***