Legal Briefing
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RENTAL INCOME REDUCTIONS IN THE CONTEXT OF COVID-19

As a result of the public health crisis caused by COVID-19, on 14 March 2020, RD 463/2020 of 14 March was published in the Official State Bulletin (**"BOE"**), declaring a state of alarm for the management of the health crisis caused by COVID-19 (the **"RDEA"**). This RDEA establishes a series of temporary measures of an extraordinary nature to protect the health and safety of citizens, contain the spread of the disease and strengthen the public health system.

Sections 1, 3, 4 and 5 of Article 10 of the RDEA provided for the suspension of the commercial activity of numerous cultural and recreational establishments, other activities and hotel and restaurant activities during the state of alarm. As a result, except for activities and supplies declared essential, almost all commercial premises have been seriously affected by this measure: some have had to close their premises completely, some have had to remain partially open for activities considered essential by the RDEA, and others have had to adapt their business model to provide home delivery only.

A few days later, availing of the authorisation contained in Article 10.6 of the RDEA under Order SND/257/2020, of 19 March, the Minister of Health declared the suspension of the opening to the public of tourist accommodation, including hotels and similar accommodation, short-stay accommodation, campsites, caravan parks, and other similar establishments in any part of the national territory of Spain.

Subsequently, with the approval of RDL 10/2020, of 29 March, which governs recoverable paid leave for employed persons who do not provide essential services, in order to reduce the mobility of the population, new limitations on activity were introduced. The latter limitations are no longer in force as of Monday 13 April, but those established prior to RDL 10/2020 remain in force.

Due to the difficult circumstances involved in sustaining structural costs in a context of stagnating, or severely reduced, activity and the uncertainty of subsequent recovery, many tenants, in order to maintain the viability of their businesses, are asking their landlords to take measures aimed at maintaining the viability of their businesses that involve the reduction, suspension or deferment of the payment of rent. In this briefing, we will refer to cases of total or partial waiver of rent as "reductions" *("bonificaciones")*. Deferral cases are treated differently from the cases referred to above.

The purpose of this briefing is to analyse the main tax implications of rent reductions for landlords.

1. Implications for corporate income tax

In general terms, it must be assumed that any reduction in rent can be considered a gift *("liberalidad")* insofar as the parties could be departing from an agreement that for them is legally binding (Article 1091 of the Civil Code ("CC"). Although such a reduction will not normally entail an expense for the landlord, but rather a reduction in income, this does not change its categorisation as a gift.

However, given that the aforementioned Article 1091 of the CC establishes that the obligations arising from the contracts *"must be fulfilled in accordance with them"*, it will first be necessary to determine whether the lease contracts include clauses of *force majeure* or others that can be understood to have been activated with the current situation, in which case it will be necessary to comply with what was agreed by the parties in those contracts. In other words, it would not be possible in such cases to analyse the tax deductibility of the gift since, given that such a clause has been duly agreed by the parties at the time of signing the lease, there would not be any gift, but rather strict compliance with the contract.

Another interpretation that could lead to the same conclusion would be that resulting from the doctrine of *"rebus sic stantibus*" or hardship, although, as analysed by this firm in the corresponding legal briefing[1], the application of this doctrine is very rare.

In the absence of *force majeure* clauses or interpretations with a similar effect in the contract, the general rule applicable to gifts, established in Law 27/2014, of 27 November, on Corporate Income Tax (**"CIT Law"**), should be applied, particularly with respect to those regulating deductible expenses and timing allocation criteria *("imputación")*.

Regarding income deferrals, these will not entail lower taxable income (if anything, they could be higher if interest is applied), but in some cases a different temporary allocation. This is because in cases where the deferral granted is greater than one year or the possible failure to apply interest on the debit balances has a significant effect, in the application of the accounting fair image principle the landlord must recognise the implicit financial asset by reducing the rental income accordingly. Consequently, it is possible that income that would normally have been taxed in 2020 may be deferred to subsequent years. Each specific situation should be analysed in the light of Article 11 of the CIT Law. The question arises as to whether, in cases where the effect is substantial, it would be appropriate to resort to the mechanism provided for in Article 11(2) of the CIT Law.

If, on the other hand, the parties are applying a cancellation of rent or a similar measure, it will first be necessary to determine the accounting effect of that measure. Although such an assumption is not provided for in the Spanish National Chart of Accounts, we believe that the provisions of the IFRS (sections 18 et seq. of IFRS 15) could be taken into account, without

1 https://www.perezllorca.com/en/news/coronavirus-covid-19/special-information-briefing-covid-19-no-6-the-legal-consequences-in-the-civil-sphere/

prejudice to the fact that such standards are not applicable in Spain, not even subsidiarily as established by the ICAC (consultation no. 1 of BOICAC 74/2008). In accordance with these standards, the effect of the discount must be accrued over the life of the lease and the retroactive effect must be recognised as an expense when the "discount" is agreed. Again, in the case of accrual, perhaps the mechanism of Article 11(2) of the CIT Law could be considered to provide greater certainty.

Once the accounting treatment has been determined, it is appropriate to refer to the tax treatment. Specifically, in accordance with Article 15(e) of the LIS, expenses arising from gifts are not considered tax-deductible. However, a special rule is established for those expenses *"incurred in promoting, directly or indirectly, the sale of goods and the provision of services"* and *"those that are related to income"* which will be considered tax-deductible[2].

Until Law 43/1995, of 27 December, on Corporate Income Tax, only expenses necessary to obtain income were deductible. This was also the case regarding gifts. In the words of the Supreme Court, it required, referring to the latter, *"a true necessary relationship, so that it should be understood that the income could not be obtained without the expense"*[3], but since that law, this requirement does not exist and is replaced by that of direct or indirect promotion of income, or the relationship with it. It is important to take into account the change that has taken place and how the subsequent drafts of the gifts have confirmed the criterion of Law 43/1995. Thus, an interpretation by the tax authorities of that relationship should not lead to a requirement that the gift is necessary for the generation of income.

This does not mean that one should not be strict in the evaluation of the relationship, but quite the contrary. It will be the duty of the taxpayer to prove that the relationship exists. And in this regard, it will be necessary to consider, for example, whether agreeing on the same reduction for a business directly affected by COVID-19, such as a hotel, and another that is not (leaving aside the more generic and abstract impact that COVID-19 will have in general) can have the same tax treatment. It is possible that it can, but we will have to be extremely careful in analysing the circumstances that lead to that conclusion.

Finally, in the case of the total waiver of the rent, the possibility that the tax authorities may consider the market valuation rule provided for in Article 17.4.a) of the LIS to be applicable, which is provided for profit-making operations, cannot be excluded. The application of this rule would mean that the landlord would have to recognise income for the market value of the rent, while the tenant would recognise a corresponding expense. In our opinion, such a rule should not be applicable in this particular case, since there is no *animus donandi* on the part of the landlord. The waiver of rent is the result of an agreement reached by the parties in the context of a business relationship and is clearly in the economic interests of both parties. Another alternative which would lead to the same conclusion and which is mentioned below in relation to related-party transactions is that, in reality, it is possible that at this moment it is not possible to find

2 To this end, the deductibility of this type of item (gifts) *("liberalidades")* should be remembered.
3 STS of 10 February 2011.

comparisons which can be assessed given the peculiarity of the current situation or that rent cancellationis a feasible solution if we look at the present market environment.

2. Implications of the Value Added Tax and the General Indirect Tax in the Canary Islands

Impact on the tax treatment of possible reductions

As in the case of direct taxation, reductions in rent have their specific treatment for the purposes of Value Added Tax **("VAT")**. Thus, Article 12.3 of Law 37/1992, of 28 December, on Value Added Tax **("VAT Law")** establishes that *"Other services provided free of charge by the taxable person (...), provided that they are carried out for purposes other than those of the business or professional activity"* shall be considered self-consumption of services.

Thus, rent reductions could be classified as self-consumption if they were for purposes other than those of the landlords' business. We consider that the rent reductions granted to tenants for the maintenance of their business, given the extraordinary circumstances of forced closure and avoiding a breach of contract for the sake of maintaining the same, may be considered to be linked to purposes related to the activity, but it is advisable to consider the specific cases and, as indicated in relation to CIT, to be extremely careful in that analysis.

The practical implication of considering it as a self-consumption would be that the tax payers (in this case the landlords) should charge VAT on the amounts of that self-consumption (in our case on the reductions granted) and pay that VAT, which will not happen if the reductions are linked to the activity.

In the words of the Supreme Court, for a provision of services (a lease) to be considered self-consumption, *"The EU rule requires that the use of the goods or services provided free of charge be for purposes unrelated to the business activity (...). It is therefore meaningless to tax self-consumption when it takes place in the context of the taxable person's business activity and for his own purposes"*[4].

In analogous terms to that concluded in relation to CIT, there is no room for self-consumption when the lease contains *force majeure* clauses or other clauses that can be understood to have been triggered by the current situation.

If it is not self-consumption, the consideration of the reductions may be that of a *"discount or reduction"* (according to 78.Tres.2[9]) or a modification of the contract by mutual agreement. Whether we are dealing with one or the other is of no practical significance. In both cases, VAT does not affect the reduced amount (whether totally or partially), and there are no differences regarding the accrual and invoicing.

4 STS of 20 June 2012. ECLI

However, in both cases, the transaction must be properly documented. If it is considered that a modification of the contract is involved, it is necessary to make such a modification, which will require the agreement of the parties, which will preferably be in writing (although oral contracts are still valid under Spanish law), because evidence to this effect must be retained. This would be the most appropriate mechanism given the presumed importance of these reductions[5]. On the contrary, the discount or reduction should be stated on the invoice, but it would be advisable that there should also be some kind of communication and acceptance by both parties, to avoid the absence of a record of the reasonableness of the reduction made (risk of self-consumption).

Accrual and invoicing

Regarding accruals, this occurs when the rental income becomes due. It is then when the landlords (i) must issue the invoice on which they charge the VAT, and (ii) must pay the output VAT.

In view of the above, to the extent that the parties agree on any type of reduction that results in the corresponding rents not being collected (either permanently or temporarily), the VAT will not be due owing to the lack of enforceability of the payment.

In other words, the accrual of the transaction and, consequently, the issue of the invoice with the effect of the VAT payments will take place when the corresponding rental income becomes due.

In the event that there is an agreement whereby the tenant assumes the costs associated with the lease (i.e. property tax, taxes, community fees, supply costs, etc.), the corresponding invoice will be issued with the VAT payable on the sum of such costs.

3. Conclusions

While the wording of these rules is clear, it is not so clear that all the possible situations that landlords may have to face fall within them.

To ensure that such situations fall within the limits allowed by the applicable regulations and the doctrinal and jurisprudential interpretation for their consideration as deductible gifts (both in direct and indirect taxation), we recommend a detailed analysis of each case.

In this regard, it must be demonstrated that the rent reduction is related to the income earned by the landlord. This explanation will undoubtedly include proof of the advantages that the rent reduction will bring to the landlord. Among other issues, it could be argued that the economic survival of the tenant's business will have a direct impact on the maintenance of the lease contract and, indirectly, on the future income of the landlord, who will not have to terminate the contract and look for a new lease with the possible loss of income in this period. Additionally, this will be reinforced by the reasons that justify the impossibility or great difficulty that the tenant

5 Consultation of the Directorate-General for Taxation V 1327-09.

faces, temporarily, in paying the rent. This last aspect should be particularly noted because, although it seems that the current situation may justify it in a general manner, it is convenient to consider the specific case, since the reactions of the landlords to a business that is still open, another that has changed its business model (for example, home service) and another that has been forced to close down should not be identical.

Moreover, the rent reduction should preferably be agreed upon by the parties in a document. This agreement must include the terms and conditions under which the reduction will be granted, which need not be exhaustive, but it must include the basic rules for this purpose, without prejudice to subsequent modifications, depending on the development of the current situation.

In the event that the lease is considered a related-party operation for landlord and tenant, and therefore the application of the market value may be necessary, which in VAT terms will depend on the right to deduction of the parties, it must be noted that to determine said value, the special circumstances of this moment will have to be taken into account, so that if a landlord reduces the rent of third parties, that reduced rent to third parties can be considered the market value, without prejudice to the caveats of each case.

Finally, and regarding the need to provide taxpayers with security, we do not consider that a modification of the current regulations in relation to this specific area of rental income is essential, but it would be desirable to have a Resolution from the General Directorate of Taxes that addresses the issue raised in this Briefing. In this regard, a Consultation or Resolution that clarifies that Articles 15 e) of the CIT Law and 12. 3 of the VAT Law must be interpreted - under the protection of Article 3 of the Spanish Civil Code - taking into account both the social reality of the moment in which they are to be applied and the spirit and purpose not only of said articles but also in conjunction with the COVID regulations incorporated into the various Royal Decrees which, for some weeks now, have been governing the activity of this country, would provide security for the adoption of this type of measure, which is guided by the intention of maintaining the viability of the Spanish business sector.

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