Impact of Covid -19 on Rental Agreements - Direct and Indirect Tax Issues

Date: June 29,2020

Advocate K. Vaitheeswaran **Nikitha Vaitheeswaran**

The year 2020 has been a challenging one so far. The outbreak of the nightmare inducing Coronavirus has brought the world to its knees. The shutdown of life as we know it, has far reaching consequences worldwide. The World Health Organisation has declared this outbreak as a pandemic and the fast spreading virus has led to a global economic standstill. India has come up with various legal and regulatory reforms to combat this crippling and steep decline in economic progress whilst permitting the carrying on of certain business activities. However, numerous cities in India continue to impose stringent restrictions, which albeit necessary, only further serve to hinder economic performance. Theatres, shopping malls, business houses, complexes, retail outlets, restaurants, among others, remain closed. This raises a complete new set of questions such as the ability of the lessee to pay rent on these properties when there is negligible to no income arising from these properties.

While the initial stages of the lockdown were characterised by debates on the concepts and interpretations of the doctrine of frustration, impossibility of performance, force majeure clauses or provisions of transfer of property law, it has now evolved and moved onto discussions where landowners want to negotiate and reduce rent, permit waivers of rent, deferrals, etc. This article aims to cover the tax implications of this.

Indian Contract Act

The Doctrine of Waiver is enshrined in Section 63 of the Indian Contract Act, 1872. Section 63 states that "*Every promisee may dispense with or remit, wholly or in part, the performance of the promise made to him, or may extend the time for such performance, or may accept instead of it any satisfaction which he thinks fit.*"

Section 62 deals with the effects of novation, recession, and alteration of contract and provides that *"If the parties to a contract agree to substitute a new contract for it, or to rescind or alter it the original contract need not be performed."*

Any negotiation of contractual terms or modifications of rentals in the form of reduction, or deferral or waiver would fall within the scope of Sections 62 and 63 mentioned above. Wherein the parties to a contract consent to alter the contract or dispense with whole or part performance of obligations, such waiver of performance of promise is valid. When the alteration of the terms of the contract result in modification of the rental obligations, or in some cases result in waiver, then, there is less income or no income or deferment of income. The Income Tax and GST implications are quite complex.

Rental Income - The category debate

Rent payable by a tenant to a landlord may be assessed either as Income from House Property, Income from Business and Profession or as Income from other sources depending upon a number of factors. The issue whether a property falls under one head of income or the other is one that has been hotly debated from time immemorial. The Supreme Court in the case of ***Shambu Investment P Ltd v. CIT [2003]*** ***[TS-5004-SC-2003-O] (SC)***,concurred with the view of the High Court which had held that the primary use of property is the relevant factor in determination of assessability of income under the various heads. The assesse had let out some portion of commercial space for use as table space with facilities like power, water and other common amenities and contended that the taxability of the income was in the nature of business income. After applying the test of primary use, it was held that the assessment of the income as business income was incorrect.

The Supreme Court in the case of ***Karanpura Development Co. Ltd. Vs. Commissioner of Income Tax (1962)*** ***[TS-11-SC-1961-O]*** held as under:

Ownership of property and leasing it out may be done as a part of business, or it may be done as land owner.

Whether it is the one or the other must necessarily depend upon the object with which the act is done. It is not that no company can own property and enjoy it as a property, whether by itself or by giving the use of it to another on rent. Where this happens, the appropriate head to apply is 'income from property', even though the company may be doing extensive business otherwise. But a company formed with the specific object of acquiring properties not with the view to leasing them but to selling them or turning them to account even by way of leasing them out as an integral part of business, cannot be said to treat them as landowner but as trader. In deciding whether a company dealt with its properties as owner, one must see not to the form which gave to the transaction but to the substance of the matter. Where a company acquires properties which it sells or leases out with a view to acquiring other properties to be dealt with in the same manner, the company is not treating them as properties to be enjoyed in the shape of rents which they yield but as a kind of circulating capital leading to profits of business which profits may be either enjoyed or put back into the business to acquire more properties for further profitable exploitation.

The sub-leases were granted, because the assessee-company wanted, as a matter of business, to turn its rights to account. The assessee-company opened out, and developed the areas, and then granted these sub-leases with an eye to profit. In the circumstances, the nature of the business was trading within the objects of the company and not enjoyment of property as landowner. There was also no sale of its fixed capital at a profit. The High Court rightly answered the question against the assessee-company.

In the case of ***Chennai Properties and Investments Ltd. Vs. CIT (2015)*** ***[TS-238-SC-2015-O]***, the main objective of the assessee, as stated in the Memorandum of Association, is to acquire the properties in the city of Madras (now Chennai) and to let out those properties. The assessee had rented out such properties and the rental income received therefrom was shown as income from business in the return filed by the assessee. The Supreme Court held that letting of the properties is in fact is the business of the assessee and the assessee therefore, rightly disclosed the income under the Head Income from Business. It cannot be treated as 'income from the house property'.

The Madras High Court in the case of ***PSTS Heavy Lift and Shift Ltd. Vs. Deputy Commissioner of Income Tax*** has held that the amended definition under Section 22 of the Income Tax Act, 1961, now defines the 'Income from House Property' as the annual value of property, as determined under Section 23 of the Act, consisting of buildings or lands appurtenant thereto of which the assessee is the owner, other than such portions of such property, as he may occupy for the purposes of any business or profession carried on by him, the profits of which are chargeable to income tax, shall be chargeable to Income Tax under the head 'Income from house property'. Thus, even the amended definition intends to tax the notional income of the self-occupied portion of the property to run Assessee's own business therein as business income. Therefore, the other rental income earned from letting out of the property, which is the business of the Assessee itself, cannot be taxed as Income from house property. Moreover, the Heads of Income do not exist in silos or in watertight compartments under the Scheme of tax and thus, these Heads of Income, as we have noted above, are fields and heads of sources of income depending upon the nature of business of the Assessee. Therefore, in cases where the earning of the rental income is the exclusive or predominant business of the Assessee, the income earned by way of lease money or rentals by letting out of the property cannot be taxed under the Head 'Income from house property', but can only be taxed under the Head 'Income from business income'.

Income from House Property

Section 22 of the Income Tax Act, 1961 charges income tax on the 'annual value' of property owned by the assessee. The House of Lords in the case of ***Governers of Rotunda Hospital Vs. Coman*** , held that although the tax under this head is a tax on income, it is not a tax upon rents but upon the inherent capacity of the heridament to yield profit.

In the current Covid scenario, where the landlord has no income arising out of property that is let out, is the assessment of rental income correct? In the case of ***CRP (India) Pvt Ltd Vs. Asst. CIT (ITA No.97/Chny/2018) / [TS-8042-ITAT-2019(CHENNAI)-O]*** , the assessee had let out an industrial shed for rent to its subsidiary which was incurring persistent losses, upon non-recovery the said rent was waived off and it was not offered to tax in the return of income filed. The ITAT Chennai held that the rent payable by the tenant by waiver would amount to application of income and it cannot be construed as overriding title. It further held that "*merely because the tenant in this case happened to be the subsidiary/joint venture company incurring persistent losses and the rent was waived, cannot be reason not to tax the amount due from tenant*". It observed that the rental income accrued to the assessee on accrual basis, assessee may treat it as capital contribution and it does not act as an estoppel for taxation of rent on receipt/accruals.

In my view, the application of the principles set out in this was based on those facts and circumstances. In this period of forced lockdown, where businesses are mandated by law to remain closed, can there be a notional assessment of rental income when there is mere passive possession of property and no actual

income?

Under the provisions of the Income Tax Act, 1961, if any property is let out and was vacant during the whole, or any part of a year, and owing to such vacancy the actual rent received or receivable by the owner, in respect thereof is less than the amount for which the property might reasonably be expected to let out; then the taxable income from such property can be claimed at the reduced amount. This benefit of being allowed to offer a lower rental income is referred to as Vacancy Allowance. In the case of ***Sachin R. Tendulkar Vs. DCIT, (I.T.A. No. 3755/Mum/2016)*** ***[TS-7836-ITAT-2018(MUMBAI)-O]*** , the assessee was allowed deduction as a vacancy allowance due to his inability to find tenant by ITAT Mumbai.

Where the property consisting of any building or land appurtenant thereto is held as stock-in-trade and the property or any part of the property is not let during the whole or any part of the previous year, the annual value of such property or part of the property, for the period upto two years from the end of the financial year in which the completion certification was obtained shall be considered as nil. Section 23(5) was amended by Finance Act, 2020 to increase from one year to two years. However, given the huge inventory held by developers and the impact of Covid on real estate markets, even two years may not be adequate and changes are warranted.

Section 23(1)(a) provides that the annual value of any property shall be deemed to be *"the sum for which the property might reasonably be expected to let from year to year"*. In the current scenario, where carrying on of business operations in the lockdown is prohibited, can it be said that the actual rent value that might reasonably be expected does not exist? Can any other property under similar circumstances be reasonably expected to be let from year to year? If nothing is done this issue will have to be settled by the Supreme Court 2 decades from now. The solution is to amend the law and tax only rent actually received or realised. Tough times calls for pragmatic and practical solutions and it is time to dispense with the notional income theory at least in the case of rentals. Alternatively it would be prudent for the Government to consider amending the law to permit a deduction in computation of rental income for the period of lock down in case the landlord has waived the rent for the said period or the tenant has not paid the rent.

Income from Business

Section 28 of the Income Tax Act, 1961 charges income tax on income from the head of profits and gains of business or profession carried on by assessee. The term income has been interpreted through various case laws. The concept has to be applied depending on various facts and circumstances and no straight jacket formula can be evolved as held in ***CIT Vs. Balarampur Commercial Enterprises*** ***[TS-5298-HC-2003(CALCUTTA)-O]*** ***(Cal)*** . In the case of ***CIT Vs. Industrial Credit and Development Syndicate Ltd.,*** ***[TS-5192-HC-2006(KARNATAKA)-O]*** ***(Kar)*** it was held that where the amount was shown as a surplus in the profit and loss account when the assessee did not actually receive any income, it would not constitute income under Section 2(24).

In ***State Bank of Travancore Vs. CIT (1986)*** ***[TS-13-SC-1986-O]*** ***(SC)***, it was observed that it is the 'real income' which has really accrued or arisen to the assessee that is taxable and this has to be ascertained by taking the probability or improbability of realisation in a realistic manner. In terms of when income is actually accrued, the Supreme Court in the case of ***Godhra Electricity Vs. CIT, (1997)*** ***[TS-5046-SC-1997-O]*** , held that a claim for increased rate of electricity which was not received due to litigation did not result in accrual of income. The Supreme Court held that Entries were not conclusive as long as recovery was not possible.

Where in a contract between parties the contract is renegotiated and the rentals are waived, does the income still accrue or is it taxable? The Calcutta High Court in case of ***Shri Kevalchand Bagri Vs. ITO*** ***[TS-5489-HC-1989(CALCUTTA)-O]*** held that 'interest income may have accrued according to the mercantile system of accounting but in our view such issue has to be viewed in the context of commercial and business reality of the situation.'

I n ***CIT Vs. Neon Solutions Private Limited (2016)*** ***[TS-5483-HC-2016(BOMBAY)-O]*** ***(Bom)***, the respondent assessee requested a waiver of interest on debentures as it was facing financial difficulties. The board of directors also passed a resolution to waive interest on the same. The AO passed an assessment order for the interest due. The Tribunal held that an item would be regarded as accrued income only if there is certainty of receiving it and not when it has been waived. The High Court affirmed the decision of the Tribunal and held that non-recognition of income when the realisation was uncertain was consistent with the Guidance Note and Accounting Standards of the ICAI.

In ***CIT Vs. Shoorji Vallabhdas & Co., (1962)*** ***[TS-1-SC-1962-O]*** , the Hon'ble Court held as under -

"Income-tax is a levy on income. Though the Income-tax Act takes into account two points of time at which

the liability to tax is attracted, viz., the accrual of the income or its receipt, yet the substance of the matter is the income. If income does not result at all there cannot be a tax, even though in book-keeping, an entry is made about a 'hypothetical income', which does not materialise. Where income has, in fact, been received and is subsequently given up in such circumstances that it remains the income of the recipient, even though given up, the tax may be payable. Where, however, the income can be said not to have resulted at all, there is obviously neither accrual nor receipt of income, even though an entry to that effect might, in certain circumstances, have been made in the books of account."

Drawing inference from these decisions, it may be possible to take a view that when the landlord chooses to waive the rent payable by the tenant or the rent is re-negotiated resulting in rent not being payable for the lockdown period, or the rent becomes irrecoverable, no income can be said to accrue in the hands of the Landlord who is offering the income under business or other sources.

TDS

Section 194 I is relevant in this scenario. It reads as under -

194-I. Any person, not being an individual or a Hindu undivided family, who is responsible for paying to a resident any income by way of rent, shall, at the time of credit of such income to the account of the payee or at the time of payment thereof in cash or by the issue of a cheque or draft or by any other mode, whichever is earlier, deduct income-tax thereon at the rate of—

(a) two per cent for the use of any machinery or plant or equipment; and

(b) ten per cent for the use of any land or building (including factory building) or land appurtenant to a building (including factory building) or furniture or fittings:

In the context of a rental agreement where there is a waiver of rent, or deferral of rent, no income by way of rent is payable and hence Section 194-I should not apply. The Supreme Court in C***IT Vs. Eli Lilly & Co (India) Pvt. Ltd. (2009)*** ***[TS-124-SC-2009-O]*** has observed as under:

"Under the 1961 Act, total income for the previous year is chargeable to tax under Section 4. Section 4(2) inter alia provides that in respect of income chargeable under Section 4(1), income tax shall be deducted at source where it is so deductible under any provision of the 1961 Act. Section 192(1) falls in the machinery provision. It deals with collection and the recovery of tax. That provision is referred to in Section 4(2). Therefore, if a sum that is to be paid to the non-resident is chargeable to tax, tax is required to be deducted. The purpose of the TDS provisions in Chapter XVII-V is to see that the sum which is chargeable under Section 4 levy and collection of income tax, the payer should deduct tax thereon at the rates in force, if the amount is to be paid to a non-resident.

GST

The levy of GST in terms of Section 7(1) of the CGST Act, 2017 is on a supply for consideration. Section 2(31) of the CGST Act, 2017 defines 'consideration' as under-

"*consideration" in relation to the supply of goods or services or both includes--*

(a) any payment made or to be made, whether in money or otherwise, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government;

(b) the monetary value of any act or forbearance, in respect of, in response to, or for the inducement of, the supply of goods or services or both, whether by the recipient or by any other person but shall not include any subsidy given by the Central Government or a State Government:

Provided that a deposit given in respect of the supply of goods or services or both shall not be considered as payment made for such supply unless the supplier applies such deposit as consideration for the said supply;

Where the terms of the rental arrangement are revisited through an MoU or Supplementary Agreement and the rent for few months is identified as not payable or is waived or declared as rent free period then there is re-negotiation and restructuring of the consideration. The consideration payable for the entire year now stands reduced by factoring the relevant period where rent is waived or reduced. GST is on transaction value which is the price paid or payable and that would be the renegotiated rent for the year in question.

Therefore if the waiver or reduction is established, the consideration stands re-stated and GST will be payable only on the reduced consideration. Once the rent has been waived for a specific period, by entering

into a MoU by the parties involved, the liability to pay by the payer and the entitlement to collect by the payee ceases to exist.

In a situation where the rental obligations remain unchanged and it is only a case of the tenant refusing to pay or simply being in default, it would not be possible for the landowner to contend that GST is not payable. It is also a matter of irony that when the rentals are not realized, GST is still payable. Taking into account the plight of various property owners who are struggling post COVID, the only solution is for the Government to step in through a Removal of Difficulty Order to provide that GST would be payable on rent received or realised as against accrual.