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LIGHT IS FINALLY SHED ON THE TAXATION OF CAPITAL GAINS OF PORTUGUESE REAL ESTATE FUNDS

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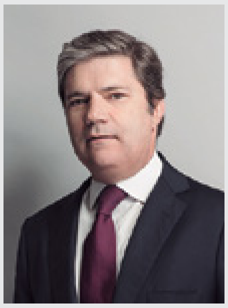

On 19 May 2020, the Secretary of State for Tax Affairs issued Instruction 107/2020-XXII, in response to a request for a binding information from a Portuguese taxpayer relating to the regime applicable to capital gains derived by Portuguese UCITS (which include investment vehicles in the form of funds, special investment companies, and the new exchange-traded Portuguese REIT, the SIGI). The taxpayer at issue is a real estate investment fund that was engaged in the trading of immovable property.

Ever since the tax regime of investment funds was reformed in 2015, with a view to aligning it with the international standard of neutralizing taxation at the level of fund and shifting it to the *"exit taxation method"*, the treatment of income from real estate development and trading activities derived by funds was still lacking full clarification by the Portuguese Tax Authority (*"PTA"*) , thus impacting certainty in the tax treatment of several sources of real estate income, from construction or rehabilitation projects to the mere resale of properties. The bulk of that tax regime is laid down in Article 22 of the Portuguese Tax Benefits Statute ("EBF"), where, under the heading Collective Investment Undertakings and by reference to the concepts of rental income and capital gains (and also dividends, interest and the like) enshrined in the Portuguese Personal Income Tax Code (*"IRS"*), an almost general exemption for income derived by investment funds has been established.

It was the scope of the concept of capital gains that was under discussion by practitioners and by professionals involved in the management of investment funds. The interpretation issue revolved around the qualification of income arising from real estate development and trading activities by investment funds and whether or not such income would fall within the purview of the concept of capital gains foreseen in article 10 of the Portuguese IRS Code. In fact, the latter rule comprises windfall gains, which have an incidental character and do not derive from a purposeful activity, whereas income from real estate development and trading activities by REITS is, by nature, one of their core income sources.

Although the spirit and the scope of the investment fund tax reform appeared clearly to point to a general exemption on income arising from real estate trading and development, before the aforesaid Instruction the possibility of the PTA challenging that interpretation and seeking to tax such income in the general terms could not be ruled out. The Instruction expressly clarifies that the exemption applies to any disposals of real estate, irrespective of whether they result from a purposeful investment or not. With this clarification and the recent approval of the new Portuguese REIT regime, the investment fund tax regime achieves a much desired stability and the level of competitiveness that appears to have been sought by tax reform since its inception.

Presently, investors in Portuguese real estate have a wide range of competitive and flexible closed-end and open-end investment vehicles at their disposal, which can either adopt a corporate form with fixed or variable capital or a contractual (fund) form. They can also choose to incorporate a Portuguese REIT (ie.,*"Sociedade de Gestão e Investimento Imobiliário"* or "SIGI") to secure contributions from sizeable institutional investors and obtain, in exchange, a greater degree of liquidity and transferability through the listing of its shareholdings, either in the Portuguese stock market or anywhere within the EU or the EEA. A SIGI can also be created through the conversion of existing property joint stock companies (with variable or fixed capital).

The tax framework for all these investment vehicles is unified in articles 22 and 22-A of the EBF and is characterized by a comprehensive exemption regime, comprising rental income, income from capital investments, such as dividends, interest, royalties, gains from derivatives, and also income deriving from resale of property and development or promotion activities, either regarding new construction or rehabilitation projects. An exemption is also foreseen in relation to the Municipal Surcharge (*"Derrama Municipal"*) and the State Surcharge (*"Derrama Municipal"*) which, when combined, can reach the heights of 10,5% of the net income in the top marginal tax brackets of 35 million euro. However, in the particular case of a SIGI, there is a temporal restriction for capital gains: they will be exempt only when the property being sold has been held for lease activities (the law seems not to require that an actual leasing has taken place) for at least three years.

For non-resident investors individuals or entities, income distributed by or derived through the redemption of units by these investment vehicles, is subject to a reduced 10% flat rate of income tax collected either by withholding or by autonomous declaration. It is noteworthy that the rule at issue expressly qualifies such income as real estate income even when distributed by real estate investment companies, thus compromising the possibility to apply even more beneficial regimes applicable to dividends like the Portuguese participation exemption regime (which, anyway, would never be applicable to shareholdings of less than 10%).

By shedding light on a crucial aspect of the tax regime of real estate investment funds, we can say that the Portuguese Government has now finalized its most needed revamping. This is good news for Portuguese investors in Portuguese real estate but also to investors keen on diversifying their investments geographically and for those wishing to allure investors from different locations. Via a Portuguese investment platform, they can now invest in Portugal or elsewhere, achieve tax neutrality on Portuguese sourced income while ensuring minimum tax leakage on income distributions and, if they opt to create a SIGI, they can even trade its securities in more liquid markets than the Portuguese and further capitalize their investments. ■