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A RECENT EU CASE ON UCITS AND PORTUGUESE REITS: THE TAX OUTLOOK FOR FOREIGN INVESTMENTS IN THESE VEHICLES MAY HAVE BECOME EVEN BRIGHTER

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When, in the beginning of 2015 the current special tax regime of UCITS (including financial investment and real estate funds) was introduced, few would have guessed that it would have the success and stability it has displayed up to the present day. The previous regime, besides raising some practical difficulties in its application and being somewhat incoherent, was founded on a tax paradigm that was not aligned with the international standard.

In fact, up until 31 December 2014, Portuguese REITs were subject to income tax, but were not taxed as "normal" corporate taxpayers but more like individual investors who see the different categories of income they receive being liable to tax at different rates. The idea behind the scheme was indeed to mimic the investments made by individuals, rendering the option to invest personally or through a regulated investment vehicle as neutral as possible. As the REITs were taxed, the owners of the participating units were, as rule, exempt. From a pure internal perspective, this scheme worked well within the aforesaid neutrality perspective. However, for cross-border investments it lacked coordination with the tax systems of the majority of the investors' domiciles, as it normally generated overlapping levels of taxation. That is, even though a foreign investor (either corporate or individual) would not be taxed in Portugal upon an income distribution, the same would not happen with the fund's income and, most probably, with the foreign investor in his state of residence, who would be receiving fully taxed income from a non-corporate fund and probably would not benefit from any underlying tax credit for taxes paid by the fund.

This overall picture changed dramatically in 2015. The new system of taxation of UCITS (including REITs) enshrined in article 22 of the Tax Incentives Statute ("TIS"), shifted the taxation to the investor by foreseeing an exemption for the main types of income derived by those vehicles, namely rental income, capital gains and dividends from real estate companies. but avoided establishing an overall exemption. As to distributions, it opted not to impose any tax withholding on Portuguese-domiciled corporate investors (which add back income received from funds to their taxable profits as ordinary profit), but, apparently to avoid losing all the tax revenue previously generated by funds and achieve a minimum level of the income channeled to foreign investors, it laid down a 10% withholding tax for cross-border distributions.

The importance of the 2015 changes stemmed not only from the modification of the taxation of the flows of income but, most notably, from the enlargement of the types of entities that could take advantage of the new regime, thereafter encompassing regulated real estate companies with fixed capital ("SICAFI") or variable capital ("SICAVI"), which, for legal purposes, are corporations. This, of course, makes all the difference in terms of tax status, namely vis-à-vis tax treaties and EU Directives.

Furthermore, in 2019, a new Decree-Law (19/2019) enacted the legal regime of the SIGIs (*"sociedade de investimento e Gestão imobiliária*), joint stock companies with a flexible legal regime that must, within a year from being registered, be admitted to trading in a regulated market or selected for trading in a multilateral trading system operating in Portugal or any other Member State of the EU or EEA. With specific free-float rules, incompatibilities, and stringent income distribution thresholds, the SIGI regime is especially attractive for private banking investments and for direct investments by small investors.

For foreign investors, the mutation of Portuguese funds to flow-through vehicles in terms of tax was a big step forward in their competitiveness and in the overall attractiveness of real estate investments in Portugal. But one recent decision by the CJEU may have the potential to tear down the only corporate tax barrier that was still standing for foreign investors in Portuguese REITs, ie. the 10% withholding tax on income distributions.

On 17 March last, the Court of Justice of the European Union (CJEU) delivered its judgment on the Allianzgi-Fonds Aevn Case (C-545/19), where it concluded that the withholding tax (WHT) applicable in Portugal to dividends paid to non-resident undertakings for collective investment in transferable securities (UCITS) is incompatible to European Union (EU) law, namely the free movement of capital.

The case was referred to the CJEU due to the different level of taxation of dividends paid to domiciled UCITS versus non-domiciled UCITS. Whereas dividends distributed to resident UCITS enjoy a full exemption from dividends received, dividends paid to foreign UCITS are subject to a 25% final WHT rate. The Portuguese Government (backed by the Attorney General) justified the restriction on the basis that Portuguese UCITS, unlike foreign ones, were taxed quarterly on their overall net assets, including dividends that have not yet been distributed, by means of a stamp duty. Furthermore, dividends received by a non-resident UCITS with corporate form could be exempt from WHT in Portugal, but only if they are taxed in the State of residence at a rate greater than 60% of the corporation tax rate applicable in Portugal. That was not the case of Allianzgi-Fonds Aevn (a German UCITS) since Germany – unlike Portugal – deems a UCITS to be a tax flow-through entity.

The CJEU's view was the opposite. First, it remarked that that the Portuguese tax framework led to a discriminatory tax treatment on the distribution of dividends to non-resident UCITS, as Portuguese UCITS may also be tax exempt and thus the situations are objectively comparable.

The reasoning of the CJEU diverged with the view upheld by the Advocate General, in that it sustained that the stamp duty levied on net assets is not comparable to an income tax for the purpose of assessing the existence of a restriction on the free movement of capital. Therefore, according to the CJEU, the discriminatory treatment allowed by the Portuguese legislation (which considers only the place of residence of the UCITS), is not accompanied and justified by an objective difference in the situations of resident and non resident entities. In addition, the CJEU stated that even if it would be possible to compare the stamp duty to a tax on dividends, resident UCITS could still avoid the payment of this tax by distributing the income immediately to their investors (that is to say, prior to the quarterly stamp duty taxation).

This decision may be very relevant as far as the 10% WHT on cross-border fund distributions is concerned, if we consider that no such rate exists in internal distributions to funds owning the units or shares from which those distributions derive. Thus, in light of this jurisprudence, it has become very difficult to justify that a foreign REIT investing in a Portuguese REIT may be disadvantaged in relation to a Portuguese REIT in the same conditions. ■