

# *Real Estate Going Global Portugal*

*Tax and legal aspects of  
real estate investments  
around the globe*

*2012*

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# ***Contents***

Contents .....	2
Real Estate Tax Summary – Portugal.....	3
Real Estate Investments – Portugal .....	5
Contacts.....	28

**All information used in this content, unless otherwise stated, is up to date as of 29 June 2012.**

# Real Estate Tax Summary – Portugal

## General

Foreign corporate entities and real estate funds may invest in properties located in Portugal by setting up or acquiring local companies, such as joint stock companies (*Sociedade Anónima (SA)*), private limited liability companies (*Limitada (Lda)*), partnerships (*Sociedades em Nome Colectivo ou Sociedades em Comandita*), or by means of the direct acquisition of the legal title of such properties. In the latter case, such investments can be either made through a branch, i.e. a Permanent Establishment (PE), or as a passive investor, without a branch.

## Rental income

Net rental income is taxed at the 25% main Corporate Income Tax (CIT) rate, plus a local surtax, *derrama municipal*, which is levied by several municipalities in Portugal, of up to 1.5% of taxable profit, not considering any tax losses carry forward. An additional surtax, *derrama estadual*, a state surtax that is also levied in two tax brackets: the first, with a 3% rate, applicable to the part of taxable profits between EUR 1.5m and EUR 10m, and the second with a 5% rate, applicable to the part of taxable profits that exceeds EUR 10m.

The final tax rate for a company may increase to 26.5% and ultimately it can go up to 31.5%, if local and state surtaxes are due.

Resident companies and branches, i.e. PEs of non-resident companies, are allowed to deduct interest, depreciation charges (if the investment property is booked at cost) and other property expenses such as taxes and duties paid. Taxation is levied on an accrual basis. Under certain conditions, these expenses should be added to the property's acquisition cost. Tax depreciation charges are not allowed in case of investment property booked at fair value.

Non-resident companies carrying out passive investments, in general, may not be deemed to have a PE in Portugal. Therefore, in general terms, they are not allowed to deduct interest and depreciation charges, being only entitled to deduct maintenance and repair expenses when actually paid and properly documented. Taxation is levied on a cash basis. Net rental income will be taxed at the income tax rate of 15%.

## Depreciation

In case the company opts for booking the investment property at cost, it should be depreciated for taxation purposes, at a 2% rate annually for flats or apartments, offices and commercial property and at a 5% rate annually for industrial buildings. Depreciation is calculated under the straight-line method.

Land cannot be depreciated for tax purposes.

The property should also be subject to an impairment test and if any loss is accounted for, its acceptance for tax purposes is subject to the fulfilment of strict tax exceptional devaluation requirements.

If any impairment loss related to the property is recognised and not deductible for tax purposes in the year on which it is accounted for, considering that it is an asset that is subject to depreciation, the impairment's tax deductibility would be deferred for the remaining useful life of the property, meaning, the respective amount will be eventually recovered for CIT purposes.

No tax depreciation charge is allowed in case the company opts for booking the investment property at fair value. Any variations on the fair value of the property will be accounted for in the company's profit and loss account. These variations are not relevant for taxation purposes.

## Capital gains on the sale of property

Capital gains arising on the sale of property by tax resident companies and PEs of non-resident companies are taxed at the 25% main CIT rate. The final tax rate for a company may increase to 26.5% and ultimately it can go up to 31.5%, if local and state surtaxes are levied.

According to the reinvestment relief mechanism, 50% of the net annual capital gains arising from the sale of fixed assets owned for at least one year are considered for taxation purposes. For that, the sale proceeds must be reinvested in the acquisition of other fixed assets. This regime also applies where the proceeds from the sale are partially reinvested, with the necessary adaptations.

Any capital gain arising from the sale of property located in Portugal when owned by a non-resident entity without PE in Portugal is taxable at a rate of 25%.

## Loss carryforward

Since 2012 tax losses can be carried forward for 5 years. The carryforward period for tax losses generated in 2010 and 2011 was of 4 years and before 2010, of 6 years. Losses can be used to offset net operating income and capital gains realised on the sale of property located in Portugal.

The deduction of tax losses is limited to 75% of the taxable profit of the year, with the possibility of carrying forward the remaining 25% in future years within the established carry forward period (5, 4 or 6 years).

Nevertheless, the company loses the right to keep on carrying forward the tax losses in the year when either of the following changes occur: (i) if the object, purpose of the company, as stated in its articles of association is changed (formal test) or if the nature of its activities is substantially changed (substance test); or, (ii) if there is a change of at least 50% of the share capital or the majority of the voting rights of the company.

The Portuguese Tax Administration may nevertheless authorise otherwise upon a request submitted by the company before proceeding with any of such modifications.

# Real Estate Investments – Portugal

## Direct investments in Portuguese property

Corporate and individual investors planning to invest in property located in Portugal may opt between various ways to structure such investment. Basically, they can opt between a direct acquisition and an indirect acquisition (i.e. a purchase of shares in a company owning property in Portugal). The main tax issues arising from direct investments are addressed in this section. Another way to structure investment is through real estate funds incorporated under Portuguese law.

### Tax aspects

Whatever the status of the owner of property in Portugal, whether an individual or a corporate entity, resident or non-resident, the taxable basis of income derived from property will be determined according to Portuguese domestic tax law.

Similarly, with respect to indirect taxes, the Portuguese Property Transfer Tax (IMT) and VAT rules may apply on any property transaction in Portugal.

### Corporate tax

#### Resident companies

Under Portuguese tax law, companies that have their head office or place of effective management in Portugal qualify as Portuguese residents for tax purposes, and are therefore subject to Portuguese (CIT) on their worldwide income.

The taxable income of Portuguese resident companies is subject to a main CIT rate of 25%, plus a local surtax, *derrama municipal*, which is levied by several municipalities in Portugal, of up to 1.5% of taxable profit, not considering any tax losses carry forward. An additional surtax, *derrama estadual*, is also levied in two taxation brackets: the first, with a 3% rate, applicable to the part of taxable profits between EUR 1.5m and EUR 10m, and the second with a 5% rate, applicable to the part of taxable profits that exceeds EUR 10m.

The final tax rate for a company may increase to 26.5%, and ultimately, it can go up to 31.5%, if both *derrama municipal* and *derrama estadual* are due.

The basis of the taxable income of Portuguese resident companies investing in property is the gross income realised on the property, less allocable expenses and depreciation (if booked at cost). Allocable expenses include repair, maintenance, renovation and similar costs, and interest expenses on loans taken out to finance the respective acquisition. Tax depreciation charges are not allowed in case of investment property booked at fair value.

Capital gains realised on the sale of property are treated as part of the company's taxable income for CIT purposes. Capital losses realised are fully deductible. Capital gain or loss realised corresponds to the difference between the sale price, net

of inherent charges, and acquisition cost, net of impairment losses and accumulated tax depreciation charges.

Please note that when the sale price of the property is lower than its tax registration value, the seller must either: (i) adjust the annual CIT return for the amount corresponding to the positive difference between the tax registration value and the amount stipulated in the sale agreement; or (ii) prove to the Portuguese Tax Administration that the price of the transaction was effectively lower than the tax registration value of the building, by, e.g. giving evidence that the construction costs were actually lower than those established by law. In this case, the Portuguese Tax Administration may have free access to the bank accounts of the seller as well as that of its managers on the date the sale occurred.

To exclude inflationary gains made on the disposal of tangible fixed assets held in the company's balance sheet for at least two years, the acquisition cost of these assets is multiplied by the official monetary devaluation index that is published annually.

According to the reinvestment relief mechanism, only 50% of the net annual capital gains arising from the sale of fixed assets owned for at least one year are considered for taxation purposes. For that, the sale proceeds must be reinvested in the acquisition of other fixed assets. This regime also applies where the proceeds from the sale are partially reinvested, with the necessary adaptations.

Given a final corporate tax rate of 25% (or 26.5% if *derrama municipal* is levied or 31.5% if both surtaxes are levied), then the capital gain arising from the sale of the fixed asset when the reinvestment relief is adopted attracts an effective tax rate of 12.50% (or 13.25% or 15.75%, depending on the surtaxes) corresponding to 50% of the capital gain.

Nevertheless, in order to benefit from this regime, companies must state in their tax return, corresponding to the tax year when the assets are sold, that they intend to reinvest the proceeds.

If the reinvestment does not take place, an adjustment will have to be made to taxable income for the year subsequent to the year of the sale, corresponding to the amount of the non-taxed capital gain multiplied by 1.15. Late assessment interest will accrue. If no tax is due in the year of the sale because of tax loss carry forward, accumulated losses are adjusted accordingly.

Portugal changed its accounting rules applicable to statutory accounts (SNC) to be in line with the International Financial Reporting Standards. The new rules are in force since 1 January 2010.

According to the SNC, property classified as investment property may be valued according to the following criteria:

- Cost model subject to depreciation and impairment; or
- Fair value model.

The main features for tax purposes of the cost model are:

- Depreciation: The property will be subject to annual depreciation, which is deductible for tax purposes (up to a maximum of 2% per year), except the part regarded as land.

The CIT rules do not require that the amounts to be claimed for tax purposes are accounted for as costs in the same tax period; however, the tax rules prevent the accumulated depreciation claimed at the end of each tax year exceeding the accumulated accounting depreciation and impairment losses accounted for in prior years.

- Impairment loss: Property should also be subject to an impairment test, and if any loss is accounted for, its acceptance for tax purposes is subject to the fulfilment of strict tax exceptional devaluation requirements.

If any impairment loss related to the property is recognised and not deductible for tax purposes in the year in which it is accounted for, considering that it is an asset that is subject to depreciation, the impairment's tax deductibility would be deferred for the remaining useful life of the property, meaning, the respective amount will be eventually recovered for CIT purposes.

- Future sale of the property: In such case, the computation of any capital gain results from the difference between the sales value minus the acquisition price (net of any accumulated tax-deductible depreciation charges and impairment losses that have already been considered as deductible for tax purposes).

The main features of the fair value model for tax purposes are:

- Depreciation: Tax depreciation is not allowed.
- Fair value variations: Any variations on the fair value of the property will be accounted for in the company's profit and loss account. These variations are not relevant for taxation purposes.
- Future sale of the property: In such case, the computation of any capital gain results from the difference between the sales value minus the acquisition price (without considering any variation on the fair value of the property because it has not been accepted for tax purposes), meaning that the 'loss' for tax purposes of the annual depreciation amount will be recovered at this stage through the computation of a lower capital gain (or higher capital loss).

For completeness, according to the Portuguese Company Law, any impact on the company's net profit of year derived from the application of the fair value model is not subject to dividend distribution to its shareholder, until it becomes effectively realised, i.e. any gain on the fair value of properties may only be distributed to shareholders when the property is effectively sold.

In case the company opts to account for the investment property by the cost model, with the exception of land, property is depreciable. The original acquisition cost of property, i.e. the acquisition cost, plus related expenses such as registration duties, brokerage fees, notary and architect's fees, is the basis for tax depreciation. The cost of acquisition also includes irrecoverable VAT.

By contrast, as a general rule, interest derived from loans contracted for the acquisition of tangible fixed assets, and foreign exchange differences related to tangible fixed assets

arising either from actual payments, are not considered as part of the acquisition cost. Notwithstanding this, where the construction works last more than one year, interest can be capitalised.

For tax purposes, depreciation of property should be charged to the P&L account on a straight-line basis, according to the rules and rates laid down in the tax law, which defines maximum specific rates to be used for each type of fixed asset. The declining balance method cannot be used for buildings. No depreciation for tax purposes is allowed for goodwill.

Depreciation rates for property may vary between 2% and 5%, depending on the type of the property, e.g. 2% annually for flats or apartments, offices and commercial property; 5% annually for industrial buildings or hotels. Land and the capitalised expenses related to it cannot be depreciated. If the land value is not known or determinable, it is deemed to account for 25% of the acquisition cost of the property.

Since 2012, tax losses, i.e. accounting losses adjusted to comply with tax law criteria, can be offset by taxable income arising in the following 5 years. The carry forward period for tax losses generated in 2010 and 2011 was of 4 years and before 2010, of 6 years. The deduction of tax losses is limited to 75% of the taxable profit of the year, with the possibility of carrying forward the remaining 25% in future years within the established carry forward period (5, 4 or 6 years).

Nevertheless, the company loses the right to keep on carrying forward the tax losses in the year when either of the following changes occur: (i) if the object, purpose of the company, as stated in its articles of association, is changed (formal test) or if the nature of its activities is substantially changed (substance test); or (ii) if there is a change of at least 50% of the share capital or the majority of the voting rights of the company.

This holds true unless the Portuguese Tax Administration, upon a request submitted to the Ministry of Finance before proceeding with any such modifications, authorise otherwise.

### *Non-resident companies*

Under Portuguese corporate tax law, distinction has to be made between non-residents with a PE, and non-residents without a PE located in Portugal.

PEs of non-resident entities are subject to similar CIT rules to those applicable to Portuguese resident entities. Hence, the basis for the taxable income of entities investing in Portuguese property is the gross income, including capital gains realised on the property, minus allocable expenses and depreciation (if applicable). For non-residents without a PE in Portugal, income derived from property located herein will be subject to CIT as follows:

- Capital gains realised on the disposal of property will be subject to a 25% CIT rate.
- Rents received will be subject to a provisional 16.5% withholding tax (WHT), where the entity paying the income is required to have accounts and bookkeeping. The tax withheld corresponds to an advanced payment on account of the final tax due, with a final rate of 15% applicable. Tax refunds for the difference are allowed. Where the rents received are paid by entities not required to have accounts and bookkeeping, no provisional WHT is levied.

- When owned by an entity resident for tax purposes in a tax haven, according to a list published by the Government (tax haven entity), unused property or property not allocated to an economic activity is always deemed to be let and, consequently, generating rental income. For tax purposes, the deemed annual gross rental income is one-fifteenth of the tax registration value. This rule is not applicable where the tax haven entity is able to demonstrate that the property is not used by an entity domiciled in Portugal and is indeed vacant.

## Personal income tax

### *Resident individuals*

Individuals resident in Portugal are liable for personal income tax on family income arising worldwide.

Tax resident status in Portugal applies when an individual stays an aggregate of more than 183 days in Portugal in a given calendar year, or, if on 31 December the individual possesses a home in the country, and it can be assumed that this will be used by the person as a place of habitual residence or abode.

An individual that transfers its tax residency to a tax haven country or jurisdiction is also deemed to be tax-resident in Portugal in the year of the transfer and in the following four years, unless the individual is able to prove that there are good reasons for that transfer, such as the carrying out of a temporary activity for a Portuguese company.

The general principle is that resident individuals investing in property located in Portugal are subject to personal income tax on the income allocated to the property. Nevertheless, a distinction has to be made between individuals carrying out a business undertaking, and individuals owning properties outside the scope of a business undertaking.

In the former case, the taxable income is determined under the rules applicable to Portuguese resident companies (see section, '*Direct investments in Portuguese property*' – '*Corporate tax*'). Tax losses arising from the business undertaking can be carried forward to offset profits arising from the same business undertaking within the subsequent 5 years.

Taxable income is subject to progressive tax rates, which vary between 11.5% and 46.5%, depending on the respective tax bracket.

In the case of individuals obtaining income from property located in Portugal, which does not qualify as profits of a business undertaking, these are subject to personal income tax as follows.

Capital gains realised on the disposal of property is equal to the difference between sales price and purchase price. Duly documented improvement expenses, incurred in the previous five years, plus costs inherent to the disposal are added to the purchase price. In order to exclude purely nominal or inflationary gains, the purchase price is multiplied by the official monetary devaluation index.

The annual net balance between capital gains and capital losses should be included in the annual income tax return, and is subject to tax at rates varying between 11.5% and 46.5%, depending on the annual taxable income. Nevertheless, 50% of the capital gains are not subject to tax, except if the counterpart is resident in an offshore country.

The concept of property rent is defined by the tax law in very broad terms and includes, among other items, fees for services provided in relation to leased property, lease of equipment, fixtures and fittings installed in the leased property, etc.

Tax is withheld, or not, depending on the tax status of the entity paying the rent. While rents paid by companies, entrepreneurs or independent professionals required to have accounts are subject to a 16.5% provisional WHT, no provisional WHT applies in the case of rents paid by non-professional individuals.

Where applicable, the tax withheld constitutes an advanced payment on account of the final tax due, at rates varying from 11.5% to 46.5%, depending on the annual taxable income. Tax refunds are allowed.

### *Non-resident individuals*

Non-resident individuals are subject to personal income tax on the capital gains arising from the sale of property located in Portugal, at the autonomous rate of 25%.

Rental income for non-resident individuals is subject to an autonomous rate of 16.5%.

Residents from another country of the European Union (EU) or of the European Economic Area (EEA) may opt to have their capital gains or rental income taxed at the same rates as Portuguese residents, i.e. 11.5% and 46.5% (for residents in the EEA, the country must have a tax information exchange in place with Portugal).

To calculate the applicable tax rate, the individual's worldwide income is taken into account, as for Portuguese resident individuals.

All other Portuguese-sourced income is subject to similar rules as those for resident individuals (see section, *'Direct investments in Portuguese property' – 'Personal income tax'*).

Double tax treaties concluded by Portugal grant Portugal the right to tax income derived from property located in Portugal.

### **Property taxes**

#### *Property transfer tax (Imposto Municipal sobre as Transmissões Onerosas de Imóveis or IMT)*

IMT is levied on the transfer of ownership of property located in Portugal at the rate of 6% for the acquisition of residential property above EUR 550,836. However, for dwellings acquired for own residential purposes, the 6% rate only applies for dwellings above EUR 574,323. The IMT rate is 5% for rural land and 6.5% for other urban properties and other onerous acquisitions. When an entity acquiring a property located in Portugal is tax-resident or domiciled in a tax haven, the IMT rate is 10%, except in case of individuals.

IMT is applied to the higher of the purchase price or the official tax registration value, appraised under the annual local property tax (IMI) rules. This tax is borne by the acquirer, whether resident or non-resident.

In relation to the acquisition of residential property, the tax rate may be reduced if the acquisition price does not exceed a certain amount, which is updated every year. Full exemption is also available for lower amounts (in 2012 less than EUR 92,407).

For IMT purposes, we list below several actions that are deemed transfers of property:

- Promissory sale or exchange of property agreements in which the economic ownership transfer of the properties occurs.
- Letting of property for more than 30 years.
- Direct acquisition of at least 75% of the share capital of private limited liability companies, general partnerships, or limited partnerships that own property.
- Irrevocable powers of attorney related to property acquisitions or share capital of limited liability companies in the conditions stated above.
- Transfer of contractual position foreseen in promissory sale agreement.

Several exemptions from this tax are available, in particular, for the following situations:

- Operations qualifying as restructuring or cooperation projects, upon previous request, which are:
  - Mergers
  - Split-ups or spin-offs through transfer to a newly established company of all the assets of other companies, which are allocated to a technically independent business, provided that the transferor ceases to engage in the corresponding activity.
  - The acquisition by an existing company, under certain conditions, of all the assets of other companies, which are allocated to a technically independent business, provided that the transferors cease to engage in the corresponding activity.

The acquisition of property bound for resale may also benefit from IMT exemption, if the acquirer is able to demonstrate to the tax administration that it is acquiring the property for resale and is acting in a normal and usual basis, i.e. on a business basis. For this purpose, the acquirer should demonstrate that it has made at least one transaction in the previous year, i.e. either acquired property for resale or sold property previously acquired for resale. If no transaction has been made by the acquirer in the previous year, IMT will have to be assessed and paid, although the acquirer may be entitled to claim later from the tax administration the tax paid on the acquisition. For this purpose, the same property has to be sold within three years, and the new purchaser may not acquire it for resale again.

### *Stamp duty*

As a general rule, stamp duty is levied on the transfer of property ownership at 0.8%. The taxable basis is the purchase price, or the tax registration value appraised under IMI rules.

However, if the transfer of property is subject to VAT (by means of waiving the VAT exemption), it is not subject to stamp duty.

### *Annual local property tax (Imposto Municipal sobre Imóveis or IMI)*

IMI is the municipal tax levied on the ownership of property. The tax is due by the owner of the property on 31 December of each year.

IMI is levied on the definitive assessed tax registration value of land and buildings located within each municipality. New assessment rules have been in force as of 1 December 2003 (with further changes from 1 July 2007) in order to adjust the tax basis of the buildings.

According to the IMI rules, the tax registration value of the urban properties will also be adjusted. In case of property intended for commercial, industrial and services the tax registration value is updated annually, based on the official monetary devaluation index. The remaining property (e.g., for residential purposes) is updated on a triennial basis, based on 75% of the official monetary devaluation index.

IMI taxable basis is calculated in accordance with the tax registration value of the property and the corresponding rates are:

- Rural property – 0.8%.
- Urban property appraised under the *Contribuição Autárquica* rules – 0.5% to 0.8%.
- Urban property appraised under the IMI rules – 0.3% to 0.5%.
- Tax resident in a tax haven owning urban property in Portugal, except for individuals – 7.5%

The applicable rates for urban property held by either Portuguese residents or non-residents (but not residents from a tax haven), can be tripled annually in the event that the building is unoccupied for over one year or in ruins.

Several IMI exemptions are available. Among others, we highlight the following:

- Houses or flats considered as permanent places of abode.
- Buildings qualified as historical property.
- Property owned by open-ended or publicly offered close-ended real estate funds and pension funds established under Portuguese law.
- Property acquired by property trading companies under certain conditions.

This tax is allowed as a deduction in the computation of corporate tax, for companies owning and using land or buildings for their business undertaking.

### *Special tax (Contribuição Especial)*

Literally translated as special tax, *Contribuição Especial* may be defined as a contribution due to extraordinary benefits, or externalities, arising from works of general or public interest, or when the activity carried out by one entity causes higher public expenditure in the services or facilities that have to be provided by the state or municipalities. In summary, this tax is levied on the increased worth of land capital.

Major infrastructure works have been undertaken in Lisbon and its outskirts, including the *Circular Regional Interna de Lisboa* (CRIL), or Lisbon inner ring-road, the *Circular Regional Externa de Lisboa* (CREL), or Lisbon outer ring-road, the train crossing on the first bridge across the river Tagus and new subway lines extending to Lisbon's outskirts. The construction of a second bridge across the river Tagus, and the area around the EXPO 1998 site are also of great relevance for the city. This tax also applies as a result of infrastructure work undertaken in Porto and its outskirts.

From a tax standpoint, it is considered that the underlying values of properties deemed to be close to these infrastructure works have increased substantially, simply because they now benefit from them. The *contribuição especial* is a tax on this valuation rise.

In general, this tax is levied on the increased value of farmland when construction is undertaken. However, it also applies to the increased value of construction plots, or development land, as well as areas resulting from the demolition of already existing buildings. Nevertheless, a special tax only applies when the relevant land is located in a parish that is referred to in the Special Tax Statute.

Special tax is applicable over a 20-year period, and it cannot be levied twice on the same property, being an one-off tax. Equivalent or similar taxes or impositions, such as capital gain charges (*encargos de mais-valias*), which is a charge levied by the municipalities due to the licensing process, should also not be levied on properties located in the areas subject to the special tax.

### *Urban rehabilitation*

The Portuguese Urban Rehabilitation Regime provides tax incentives for the rehabilitation of properties that started on or after 1 January 2008 and are concluded by 31 December 2020.

The property subject to rehabilitation must fulfil certain requirements related to its lease status or its physical location.

In broad terms, this regime includes several tax incentives. Among others we highlight:

- Possible IMI exemption for urban property subject to rehabilitation, applicable for a period of five years which may be renewed for a subsequent period of five years.
- Possible IMT exemption for the acquisition of urban property considered a permanent place of residence destined for urban rehabilitation. It must be the first transaction of the building after the rehabilitation and the building must be located in an urban rehabilitation area.
- Income obtained by both individuals and corporate investors and derived from the units held in the referred funds is subject to a WHT rate of 10% for income tax purposes.

Several particularities apply in the case of tax-exempt entities and non-residents.

### *Value added tax (VAT)*

#### *General*

In accordance with the Portuguese VAT code, operations subject to IMT are VAT-exempt. As a result, the transfer of property subject to IMT is, as a general rule, exempt

from VAT. Although there are some exceptions, the leasing of property is also a VAT-exempt operation under the Portuguese VAT code.

Contrary to what happens in other EU Member States, Portuguese VAT provisions do not distinguish between new and second-hand or old property properties.

Besides, the basic concepts of the Portuguese VAT system, such as taxable persons, nature of goods, supply of goods and services, are in line with the Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, and the Portuguese VAT regulations are, therefore, comparable to those applicable in other EU Member States.

The supply of goods and services are the main target transactions, being, in principle, subject to VAT. Any operation not falling within the supply of the goods concept (and that implies any sort of payment or contribution, either in cash or in kind), qualifies as a supply of services, meaning this is a residual concept.

For civil law purposes, the transfer of legal ownership, or other rights on property, is submitted to specific contractual and registration formalities typified in the law. VAT legislation transposed this concept in order to qualify property transactions.

As for services related to property, the definition is unclear, and has to be ascertained on a case-by-case basis. The most common transaction falling within the scope of services is the leasing of property.

The place of supply of property, including the settlement, transfer, assignment, or yield of rights *in rem* (i.e. beneficial ownership), is the Portuguese territory whenever the property concerned is located in Portugal. As a result, Portuguese VAT should be charged. This is also applicable to installation and assembling supplies of property, although simplification measures are applicable when the supplier is a non-resident entity with no PE herein.

Services connected with property such as leasing, repairs, etc. will also be considered located in Portugal if the respective property is located there. Other services, like engineering and architectural projects, will follow the same rule, provided they are related to a particular existing property. In the case of consultancy and advisory services not linked with a specific building, the place of supply will be the place where the recipient of the services has established their business.

The general rule of the Portuguese VAT code is that the taxable amount will be the consideration paid for the supply of goods or for the services rendered by the acquirer or a third party.

This value includes taxes, duties and other charges, exclusive of VAT. Ancillary and incidental expenses such as commissions, packing, transport, insurance and publicity costs, charged by the supplier to the acquirer, will also be included in the taxable amount, and are fully applicable in what concerns property supply.

### *Transfer of property (exemption waiver)*

As previously mentioned, the general rule in Portugal is that the transfer/leasing of property is VAT-exempt.

Nevertheless, in order to minimise the effects arising from this exemption, the relevant legal provisions allow a VAT-exemption waiver, with the VAT rate of 23% (on

the mainland), 22% (on Madeira island) and 16% (on the Azores islands) then applicable.

In order to qualify for the exemption waiver, several strict conditions need to be met. According to the VAT-exemption waiver regime on real estate transactions, there are three main types of conditions that need to be met:

- Conditions regarding the property:
  - The property (land for construction, building, or fraction of a building) is registered for tax purposes.
  - The property is registered in the name of the owner or landlord, and it cannot be residential property.
  - The sale or the lease agreement needs to cover the whole of the property unit.
  - The property unit is allocated to the undertaking of VAT-able transactions, i.e. those that give a right to deduct input VAT.
  - In the specific case of lease agreements, the annual rent should amount to at least one-twenty-fifth (1/25) of the acquisition price or construction cost of the property.
- Situations where it is possible to apply:

Once all conditions above are met, it is only possible to apply for the VAT-exemption waiver (charging VAT on the sale or lease agreement), if one of the following situations arises:

- In the first sale or letting following the construction of the property where it is possible to recover the total amount (or part) of the input VAT arising from the construction.
- In the first sale or letting upon major improvement works that increase the tax registration value of the property by more than 50%, when input VAT can still be recovered.
- In every subsequent sale or letting followed by a previous VAT transaction, when the property is still within the clawback period (in certain cases, VAT recovered may need to be paid back to the Government Revenue department, currently 20 years).

It is not possible to waive the VAT exemption in the case of subletting, except when the building is used for industrial purposes.

- Status of the parties

Regarding seller/landlord and the acquirer/tenant, respectively, being VAT taxpayers, both parties need to:

- Have VAT-able revenue exceeding 80% of total turnover. This rule may exclude the possibility of a waiver in the case of insurance companies, banks and

financial institutions, the State and municipalities in general, when using the property or letting of property.

- Having accounts prepared under local adopted accounting principles, as required by both personal and corporate income tax codes.

This means that entities that own property in Portugal which are considered non-resident without a PE in Portugal, are not able to apply for the VAT-exemption waiver, and are therefore not able to recover any input VAT.

The VAT-exemption waiver is requested on a transaction basis, in respect of each building/land sold or leased, through a request made by the seller/landlord to the Portuguese VAT administration on its internet website; and it has to be obtained prior to the signing of the sale or lease agreement.

Input VAT incurred with each operation or project, and with construction works, is deductible, from the moment the property is allocated to VAT-able operations, for a period of four years back from the date of each invoice issuance.

As mentioned, the transfer of property located in Portugal is, in principle, subject to IMT, and therefore VAT-exempt. Nevertheless, the VAT exemption can be waived, but that will have no consequences with regard to IMT, meaning that avoidance of this tax cannot be achieved by means of charging VAT on the transaction. As a result, if the option for taxation is exercised, both VAT and IMT will be levied, with VAT calculated upon the value of the transfer. If VAT is levied, stamp duty will not be due.

In the event of an acquisition of property, in principle, the VAT will be self-assessed by the acquirer, meaning that VAT will be charged and deducted, if and when possible by the acquirer of the property.

### *Right to deduct input VAT*

Mixed VAT-able entities, i.e. entities that carry out both taxable and exempt operations, are entitled to deduct VAT on the proportion of the taxable operations carried out, based on a specific method of calculation (pro rata method). This is where the numerator includes the operations with a right to deduct input VAT, exclusive of VAT, and the denominator the total amount of operations exclusive of VAT.

The fraction gives the percentage of deductible VAT, which is calculated on a yearly basis, based on the calculations of the previous year, i.e. the last VAT return, but must be adjusted at the end of each year.

Deduction per distinct activity, which allows the deduction of VAT on a separate basis for each taxable and exempt activity, is another VAT deduction regime available (allocation method), which requires separate accounts per activity. This regime is compulsory in the case of property activities, such as property developers.

Taxable persons are allowed to combine both VAT deduction regimes.

In the case of VAT-exemption waiver, reimbursement of total input VAT can only be claimed after the acquisition agreement or the definitive leasing contract is signed (in both cases prior VAT-exemption waiver certificates must be obtained).

The deduction of the VAT incurred by the seller/landlord related to each building, or unit thereof, must be made on a case-by-case basis in respect of each building sold or

leased. The VAT incurred in each building or land acquired or constructed can only be deducted within four years, counting from each invoice issuance date.

The seller/landlord is required to file periodic VAT returns from the moment the certificate is issued by the tax department.

VAT returns should be filed on a monthly or quarterly basis, depending on whether the annual turnover equals or exceeds EUR 650,000, being delivered to the VAT administration by the tenth day of the second subsequent month after the month when the chargeable events occurred. Quarterly returns have to be filed with the Portuguese Tax Administration by the fifteenth day of the second month after the respective quarter calendar ends.

VAT deduction on property is subject to a VAT claw back period of 20 years (10 years for properties acquired before 13 February 2001), during which certain occurrences may require VAT adjustments. The right to VAT deduction is attributed, provided the property is allocated to a VAT-able activity. Any modifications to this situation in the course of the 20 (10)-year period since the occupation of the property require adjustments of VAT on behalf of the revenue.

### *Foreign entrepreneurs*

Foreign entities that own Portuguese property, obtain income from such property and that do not have a PE in Portugal have to obtain a taxpayer number from the National Register Collective Body, and register with the Portuguese Tax Administration by filing a Statement of Beginning of Activity.

In this situation the foreign entity would not have to prepare accounts. This means that a foreign entrepreneur would not be able to waive the VAT exemption on the acquisition/sale of property, or on lease agreements, and is therefore unable to deduct input VAT on the acquisition of property (or VAT on construction costs).

If a PE exists in Portugal, besides the above-mentioned obligations, foreign entities are subject to registration with the Commercial Registry Office. From an accounting standpoint, the foreign entity must prepare accounts.

If the use of the property is restricted to rental/leasing, and the exemption waiver option is not exercised, no further requirements will arise from a VAT point of view, apart from registration for VAT purposes. However, if the foreign entity wishes to deduct input VAT and to exercise the waiver option, it will be required to file monthly or quarterly VAT returns.

The reverse charge mechanism is applicable where the supplier of goods or services is not VAT-registered in Portugal and the supplier of the goods, uses for the supply, a VAT-registration number of an EU country. In those cases, the Portuguese VAT entity will account for the VAT due, and will do the corresponding deduction, if it is entitled to, on its own VAT return.

# Acquisition of a Portuguese property company

## *General*

Companies or individuals wishing to invest in Portuguese property may acquire the shares in a company owning property, rather than make a direct purchase of the property.

Given the fact that the company may have a tax history and contingent liabilities, it is generally advisable to conduct a due diligence review of the target company. In such a due diligence, corporate tax, VAT and the transfer tax position of the company should be checked. If necessary, the seller of the company should be asked for certain guarantees on the tax position of the company.

## *Tax aspects*

### *Corporate tax*

#### *Resident companies*

If shares in a company owning property are acquired by another company, the latter company must value the shares in the acquired company at the acquisition price.

Contrary to a direct purchase of property, the purchaser of the shares in a property company will not benefit from any step-up in the value of the property for taxation purposes, since for corporate tax purposes, the company owning the property must continue to value the property at the original acquisition price, even if booked at fair value. Hence, the fiscal book value of the underlying property will remain the same, and the annual depreciation (in case of being booked at cost) will be lower, compared to a direct purchase of property.

In the case of a dividend arising from substantial shareholdings, the beneficiary company may qualify for a special tax regime in accordance with which no WHT is levied on the payment of the dividend, and the dividend is fully exempt from corporate income tax when received.

For these purposes, besides the subsidiary being subject to corporate tax, the following conditions should also be met:

- **Holding level:** the parent company must have a direct shareholding of at least 10%.
- **Holding period:** the respective shareholding must be held for one consecutive year before being entitled to the exemption, or, since the incorporation date of the subsidiary, if this period is shorter, providing the same one-year holding period is observed.

Under the above-mentioned circumstances, no WHT will be levied, and the parent company will be allowed a full exemption from corporate income tax on dividends received, except when held for less than one consecutive calendar year before actual distribution, under which the WHT is levied. If the above conditions are not met, WHT will be levied.

The corporate income tax withheld constitutes an advanced payment on account of the final tax due by the company receiving the dividend.

In cases where dividends are paid either to a Portuguese holding company, i.e. *Sociedade Gestora de Participações Sociais* (SGPS), which has held the shareholding for at least one year, or within a fiscal unity, no WHT will apply.

Capital gains realised on the sale of shares are part of the company's taxable income, and are equal to the difference between transfer price and acquisition price of the shares. Only 50% of the negative balance between capital gains and capital losses arising on the sale of the shares is tax-deductible.

However, capital losses arising on the sales of shares are not tax-deductible if maintained for less than three years and the following applies:

- The shares were acquired to a related entity.
- The shares were acquired to a tax haven entity.
- The shares were acquired to an entity subject to a special tax regime.

Also, capital losses on the sale of shares are not tax-deductible if shares are sold to a related party or to a tax haven entity.

A company subject to corporate income tax may apply to the reinvestment relief mechanism. Therefore, capital gains arising from a 10% shareholding owned at least for one year should only be taxed for 50% of the gain, where the proceeds from the sale of the shares are reinvested in the acquisition of the share capital of a resident company, or in the acquisition, fabrication or construction of tangible fixed assets, non-consumable biological assets, or investment properties that are allocated to the entity's activity. This regime also applies where the proceeds from the sale are partially reinvested.

Given a final corporate tax rate of 25% (or 26.5% if *derrama municipal* is levied or 31.5% if local and state surtaxes apply), the adoption of reinvestment relief will result in an effective tax of 12.50% (or 13.25% or 15.75%) corresponding to 50% of the capital gain.

In order to benefit from this regime, companies must state in the tax return corresponding to the tax year when shares are sold where they intend to reinvest the proceeds.

If the reinvestment does not take place, an adjustment will have to be made to the taxable income of the second year after the year of sale, corresponding to the amount of the non-taxed capital gain multiplied by 1.15. Late assessment interest will accrue.

If no tax is due because of tax losses carry forward, accumulated losses are adjusted accordingly.

Please note that Portuguese holding companies (SGPS) have a special tax regime that concerns the taxation of capital gains generated from the sale of shares.

### *Non-resident companies*

Dividends distributed by a resident-affiliated company to a non-resident parent company are subject to a 25% WHT (or 30% if distributed to a resident in a country,

territory or region subject to a clearly more favourable tax regime, i.e., a tax haven entity).

Under the EU Parent-Subsidiary Directive, this rate can be eliminated where the EU parent company also qualifies for the Directive, meaning the non-resident parent company has to hold at least 10% of the share capital of the affiliated company resident in Portugal for one consecutive year.

Where the minimum holding period of one consecutive year is not observed, provisional WHT under domestic law is levied. Such provisional WHT may be refundable when the minimum holding period of one year is achieved.

The WHT rate may also be reduced, usually to 15% or 10%, under the tax treaties concluded by Portugal.

Capital gains arising from the sale of shares acquired before 1 January 2001 held in Portuguese resident property companies by non-resident companies is exempt in Portugal.

Capital gains arising from the sale of shares acquired on and after 1 January 2001 held in Portuguese property resident companies by non-resident entities is subject to 25% corporate income tax in Portugal. This tax may be avoided, depending on whether the non-resident entity is entitled to the protection of a tax treaty that does not give the right to Portugal to tax such capital gains.

## Personal income tax

### *Resident individuals*

Fifty percent of the annual net balance between capital gains and capital losses obtained by Portuguese residents arising from the sale of property is taxed through brackets with rates varying from 11.5% to the maximum marginal rate of 46.5%.

Capital gains arising from the sale of shares, including the ones held in the share capital of property companies is subject to taxation at the rate of 25%. Or if the individual opts to be taxed at marginal tax rates, such capital gains will be added to the remaining income and taxed through brackets with rates varying from 11.5% to a maximum of 46.5%.

The taxable gain is equal to the difference between the sale price and purchase price of the shares.

Dividends are subject to a 25% WHT. As of 1 January 2006, such a WHT corresponds to the final taxation of such income, unless the individual opts to include the respective amount within their overall income, in which case the tax withheld corresponds to an advance payment of the final tax due under the marginal rates applicable to the total income.

Since 2012, dividends paid or made available to resident individuals by non-resident entities residents for tax purposes in a tax haven, according to a list published by the Government, are liable to a tax rate of 30%, either by WHT or by the application of a special rate.

### *Non-resident individuals*

Capital gains arising from the sale of shares held by non-resident individuals in property companies resident in Portugal are taxed at a 25% flat rate. This taxation may be avoided, depending on whether the non-resident entity is entitled to the protection of a tax treaty that does not give the right to Portugal to tax such capital gains.

Dividends paid to non-resident individuals are subject to WHT at a standard rate of 25% (or 30% if distributed to a resident in a country, territory or region subject to a clearly more favourable tax regime). The WHT rate may be reduced, usually to 15% or 10%, under the tax treaties concluded by Portugal.

### **Property transfer tax (IMT)**

In principle, the acquisition of shares in a company owning Portuguese property does not qualify as an acquisition of property itself; it remains, therefore, outside of the scope of this tax.

However, an exception to this principle applies in cases where shares representing 75% or more of total share capital of an Lda company, of a general partnership, or of a simple limited partnership, owning property are acquired. (See section '*Investing in Portuguese property through a partnership*'.) In this case, the purchase of shares qualifies as a deemed purchase of property, with the tax levied on the fiscal value of the property in proportion to the shareholding transferred.

### **Value added tax (VAT)**

The acquisition of the shares in a company owning Portuguese property is not subject to VAT.

## **Investing in Portuguese property through a partnership**

### *General*

The term 'partnership' may be misleading for investors from most countries whose legal systems include similar types of business organisation, but according to which they are non-incorporated entities, i.e. are not considered as legal entities separate from their partners.

In fact, under Portuguese company law, partnerships are incorporated, meaning they have a legal existence separate from the partners, with several consequences at different levels, e.g. in the field of taxation, where the tax transparency regime is not automatically applicable on the grounds of the legal form adopted.

### *Tax aspects*

#### **Tax transparency regime**

Under Portuguese tax law, the tax transparency regime only applies in very strict cases to a few predetermined entities, not being automatically applicable on the ground of the legal form adopted.

In respect of investments in Portuguese property, companies qualifying as *Sociedades de Simples Administração de Bens*, i.e. companies that manage their own assets

passively, will qualify for the tax transparency regime, provided they do not have more than five shareholders in any day of the calendar year. These can be incorporated both under the form of an Lda or of an S.A. company.

In order to qualify as a *Sociedade de Simples Administração de Bens*, besides having as statutory purpose the management of its own assets, the following circumstances should also apply:

- The company's activity is restricted to the management of its own assets, owned on a permanent basis, so this can be regarded as a passive investment.
- Although the company may carry out other activities, the average of the income related to the passive activity of the three previous years should exceed 50% of the average of the total revenue of the company in the same period. In this case, the transparency regime is only applicable after the third year.

Under the tax transparency regime, the taxable income obtained by the transparent entity is not taxed at the entity level, being allocated to its partners on a proportional basis and taxed at their level.

For the purposes of the allocation of income to be made under this special tax regime, non-resident entities owning a share participation in a company subject to it are deemed to have a PE in Portugal to which the income is allocated.

## Investing in Portugal through a real estate fund

### *General*

#### Real estate funds and the management company

The sole purpose of real estate funds established under Portuguese law is to invest, according to a shared risk principle, funds obtained from investors. Assets are separate and autonomous from the unit holders, but are jointly owned by them. The fund is not a legal entity and it is ruled in the fund bylaws.

It is mandatory that they are managed by management companies, which must be incorporated as joint-stock companies (*Sociedades Anónimas, SA*), with an effective head office in Portugal. Its statutory objective should mainly be to manage one or more funds for the account of the respective unit holders.

#### Types of real estate funds

These funds are divided into investment units and can either be: (i) opened-ended, in which case the units are issued in a variable number; (ii) closed-ended, where the units are issued in a fixed number; (iii) semi close-ended, where the first two types coexist.

#### Regulatory aspects to be considered

The setting up of a real estate fund is subject to prior authorisation from the Portuguese securities market commission (CMVM) upon request of the management company. The Bank of Portugal and the CMVM are both responsible for the supervision of the fund and other related entities.

### Qualifying assets

The qualifying assets to these funds are: (i) urban properties or units divided into horizontal property and rural/farm land; (ii) investment units in funds; (iii) cash instruments, such as bank deposits, certificates of deposits; (iv) shareholdings in property companies under certain circumstances.

## *Taxation regime of real estate funds*

### Taxation at the real estate fund level

For corporate income tax purposes, real estate funds incorporated under Portuguese law are taxed under the tax neutrality principle, i.e. the investor should bear identical or similar taxation investing in it, as if it had directly invested in property.

The real estate funds are taxed on a cash basis. The net rental income is taxed at 20%. Expenses incurred with conservation and maintenance of the property are tax deductible. Since 2012, IMI is also tax deductible.

The net capital gain may be taxed at a final rate of 12.5%. Interest and depreciation charges are not tax-deductible, nor are any other expenses that are not directly related to the property such as, e.g. the management fee charged to the real estate fund. The tax is assessed and paid by the management company annually (April of the following year to which it refers).

Property acquired/owned by open-ended or publicly offered close-ended real estate funds that are set up and operate in accordance with the Portuguese law are fully exempt from IMT and annual IMI. Real estate funds are not exempt from stamp duty on the acquisition of property, levied at 0.8%. Stamp duty is not levied when VAT is charged on the transaction.

### Taxation at the unit holder level

Income paid by the real estate funds to taxable entities resident for tax purposes in Portugal is taxed at the level of the unit holders. These entities are entitled to recover the taxes paid by the real estate fund against their annual tax liability, with any excess refundable by the Government Revenue department.

Income paid to non-resident entities, without a PE in Portugal, is fully exempt from further WHT in Portugal, but a refund of the taxes paid by the real estate fund is not allowed.

## *Other real estate funds*

### Real estate urban rehabilitation investment funds

Real estate investment funds that:

- set up and operate in accordance with the Portuguese law between 1 January 2008 and 31 December 2012,
- whose assets are comprised of at least 75% by properties subject to urban rehabilitation and
- such properties are located in certain specific areas

are fully exempt from corporate income tax on all types of income (including rental income and capital gains). These may also benefit from IMT and IMI exemption.

## Real estate investment funds for residential letting

This new type of real estate fund (*Fundos de Investimento Imobiliário para Arrendamento Habitacional* – FIIAH) set out according to the Portuguese legislation, between 1 January 2009 and 31 December of 2013, may benefit from several tax benefits until 2020. Some of these benefits are:

- Corporate income tax exemption on all types of income.
- IMI exemption for properties that are part of the portfolio of the FIIAH.
- Property transfer tax exemption for acquisitions made under this regime by the FIIAH.

At the unit holder level:

- Personal and corporate income tax exemption on income distributed by the fund. This exemption does not apply to capital gains arising from the sale of such participation units.

Some tax benefits may also be applicable to individuals that sell their residential properties and subsequently sign a lease agreement for such property. Several conditions need to be met.

The above-referred tax regime and respective exemptions are not applicable to entities resident in a country or jurisdiction with a more favourable tax regime (listed tax havens).

## Investing in Portugal through *Sociedades de Investimento Imobiliário* (SIIMO)

### *General*

The *Sociedades de Investimento Imobiliário* (SIIMO) have been introduced in 2010. They are regulated investment vehicles for investing in property. As they are recent, there is no information about their actual use and practical experience about them.

The SIIMO are collective investment schemes adopting the legal form of a joint stock company (*sociedade anónima*), which can either be a fixed capital company (SICAFI) or a variable capital company (SICAVI), whose assets are managed, on a fiduciary basis, on the sole interest of their shareholders. SIIMO can be internally managed, or managed by an independent management company. Assets are entrusted to a depositary bank.

### *Regulatory aspects*

There is regulatory supervision of the SIIMO, the regulatory authority being the CMVM. The management company, if any, is governed by the banking law, is supervised by the Bank of Portugal and is only allowed to manage regulated funds.

Periodical financial reports are sent by the management company to the CMVM.

## *Taxation regime of SIIMO*

Tax neutrality also applies for SIIMO.

The SIIMO are taxed under the same rules as apply for real estate funds for both income and property taxes. SICAFI are taxed like a close-ended real estate fund and SICAVI are taxed like an open-ended real estate fund.

## *Financing the acquisition of Portuguese property*

### *Equity financing*

#### *Portuguese tax aspects*

Under Portuguese tax law, subscription and paying in of statutory share capital at incorporation as well as subsequent increases are not subject to stamp duty.

Registry fees, as well as other related expenses (e.g. contractual expenses), are due on this type of operation.

If the contributions of the shareholders are made in kind by means of a transfer of property to the company, property transfer tax, or IMT, will be levied under general rules. (See section '*Direct investments in Portuguese property*' – '*Property taxes*').

### *Debt financing*

#### *Portuguese tax aspects*

##### *Deductibility of interest*

The general principle regarding the acceptance of costs and expenditures as tax-deductible, is that these are necessary for the company's activity, or may be considered indispensable to generate the taxable profits and gains obtained by the company.

To this extent, interest and other financial expenses are, in principle, tax-deductible, provided they are established at arm's length. Nevertheless, interest arising from financing provided by shareholders can only be deductible to the amount that corresponds to the 12-month Euro Interbank Offered Rate (Euribor) plus a 1.5% spread, on the financing date. This limitation is not applicable to situations subject to transfer pricing rules and to some tax treaties.

##### *WHT on interest*

##### *Resident entities*

Interest received by Portuguese resident companies and individuals, arising from loans and paid by an entity taxable in Portugal, are subject to a 16.5% WHT, which assumes the nature of an advance payment of the final tax due. Interest from bank deposits are subject to a 25% withholding rate, also regarded as an advance payment for companies, but individuals can regard it as a final tax.

##### *Non-resident entities*

Interest received by non-resident companies and individuals, arising from loans and paid by an entity taxable in Portugal, are taxed at a 25% (or 30% if due to a resident in a country, territory or region subject to a clearly more favourable tax regime) flat withholding rate, in cases where the entity receiving the interest is resident in a country that has not signed a tax treaty with Portugal. Where the beneficiary is resident

in a country that has concluded a tax treaty with Portugal, the withholding rate may be reduced, in most cases to 10% and 15%.

Portugal has implemented the Interest-Royalty Directive, under which Portugal still levies WHT at until 30 June 2013 and nil afterwards. The minimum shareholding required is 25% and the definition of associated company is in line with the one set out in the Directive.

### Indirect taxes (stamp duty)

Stamp duty, which applies to a wide range of documents and acts, is also levied at different rates on different aspects/components of funding operations. In this respect, it is important to distinguish between those concluded with banks or other credit institutions, and those established with the company's shareholders. In the former case, stamp duty applies as follows:

- Principal lent or capital guaranteed, depending on the maturity, at 0.04% per month for funding up to one year, at 0.5% for funding with maturity varying from one year to less than five years, and 0.6% for five or more years.
- Commissions on guarantees, at 3%.
- Interest, commissions and other fees charged by banks or financial institutions, at 4%.

Shareholders' loans may also be subject to stamp duty, although several exemptions are available, depending on the specific terms and conditions of the transaction.

### *Debt/equity ratio*

When considering a company's funding provided by shareholders, special tax rules on thin capitalisation should be taken into consideration. Thin capitalisation rules apply in Portugal to entities taxable therein on their indebtedness towards non-resident related parties. A debt-to-equity safe harbour ratio of 2:1 applies. Indebtedness towards non-resident third parties (e.g. banks) but guaranteed or secured by non-resident related parties is also covered by thin capitalisation rules. Since 1 January 2006, the thin capitalisation rules are not applicable when the debt is obtained from a related entity resident for tax purposes in an EU Member State.

Interest arising from excessive non-resident-related party debt will be disallowed as a deductible tax expense, unless the taxable entity or company is able to demonstrate that its indebtedness level and capital structure is established at arm's length. However, the part of interest whose tax deductibility is disallowed under these rules is still subject to WHT as interest, and not as a deemed dividend.

For the purposes of the Portuguese thin capitalisation rules, related parties, qualifying equity and qualifying debt are defined as follows:

- Related parties are defined as under the same rules that apply to transfer pricing.

Qualifying equity, which will be relevant for these purposes will be the amount determined in accordance with the Portuguese generally accepted accounting principles, with the following exceptions:

- The part of the statutory share capital that has not yet been fully paid in.

- Technical or other revaluation of assets not covered by tax legislation.
- Adjustments resulting from the application of the equity method to account financial investments.

For qualifying debt, related parties' indebtedness is defined as any form of financial assistance given by the related parties to the Portuguese company. Two other forms of financial assistance are also considered:

- Balances outstanding more than six months, resulting from trading or commercial transactions.
- Non-resident third-party financing with recourse to related parties as defined under this legislation.

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