INVESTING IN PROPERTY IN PORTUGAL

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CONTENTS

INTRODUCTION

Following the end of Portugal's bailout programme by the European Union (EU), the International Monetary Fund (IMF) and the European Central Bank (ECB), which lasted from May 2011 until June 2014, foreign investors are now looking at Portugal with different eyes.

As part of the bailout programme, Portugal implemented an ambitious privatisation programme and made other reforms to reduce its public debt, attract foreign investment and foster competition in closed or semi-closed sectors.

Foreign investment showed some positive signs in 2014 pushed by the success of the privatisation programme, increased activity in private sector, M&A and investments in residential and commercial real estate.

The golden visa programme which gives foreign investors the possibility of obtaining a Portuguese visa provided they invest a minimum of €500,000 is probably the main factor in attracting investment in medium-size properties, especially in the residential market.

Still price and yield in the current market conditions remain interesting, as local banks and corporations holding large real estate investments are looking to dispose or monetize real estate assets.

The recently announced quantitative easing measures adopted by the ECB which will increase liquidity in the financial markets are likely to renew investors' appetite for real estate assets in Europe.

The Portuguese real estate market now offers very interesting opportunities, as the country emerges from its worst crisis in the last thirty years, with good valuation opportunities.

This paper summarises certain legal and regulatory issues affecting the investment in property in Portugal.

1. Overview of the Portuguese economy

1. OVERVIEW OF THE PORTUGUESE ECONOMY

1.1. Key information

Capital: Lisboa

Mainly District Capitals: Porto, Coimbra, Aveiro, Leiria

Area: 92,152 Km2

Population: 10,338,539 (10,427,301)

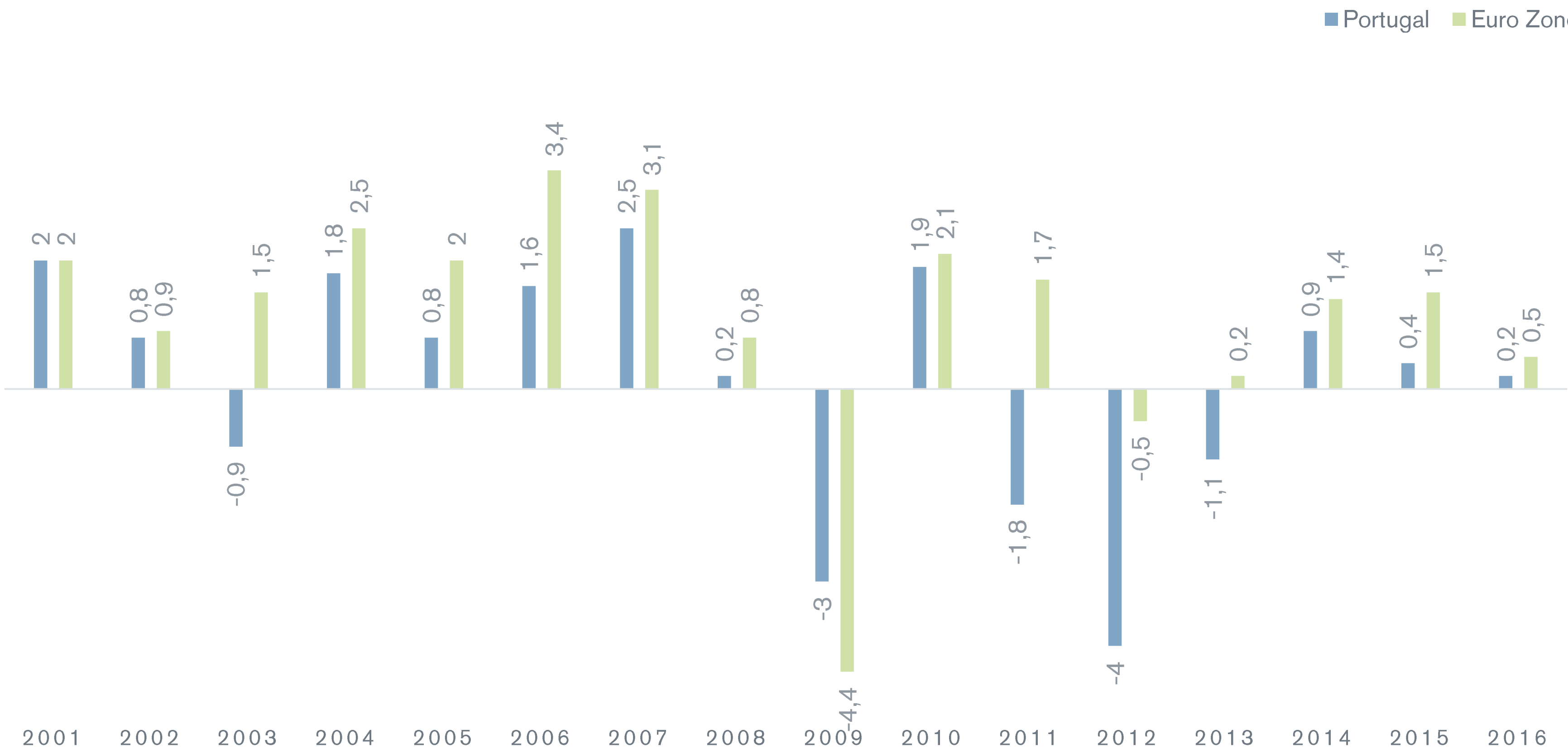
Working Population: 4,484,000 (4,497,466)

GDP: € 165,6 billion (€ 188,96 billion)

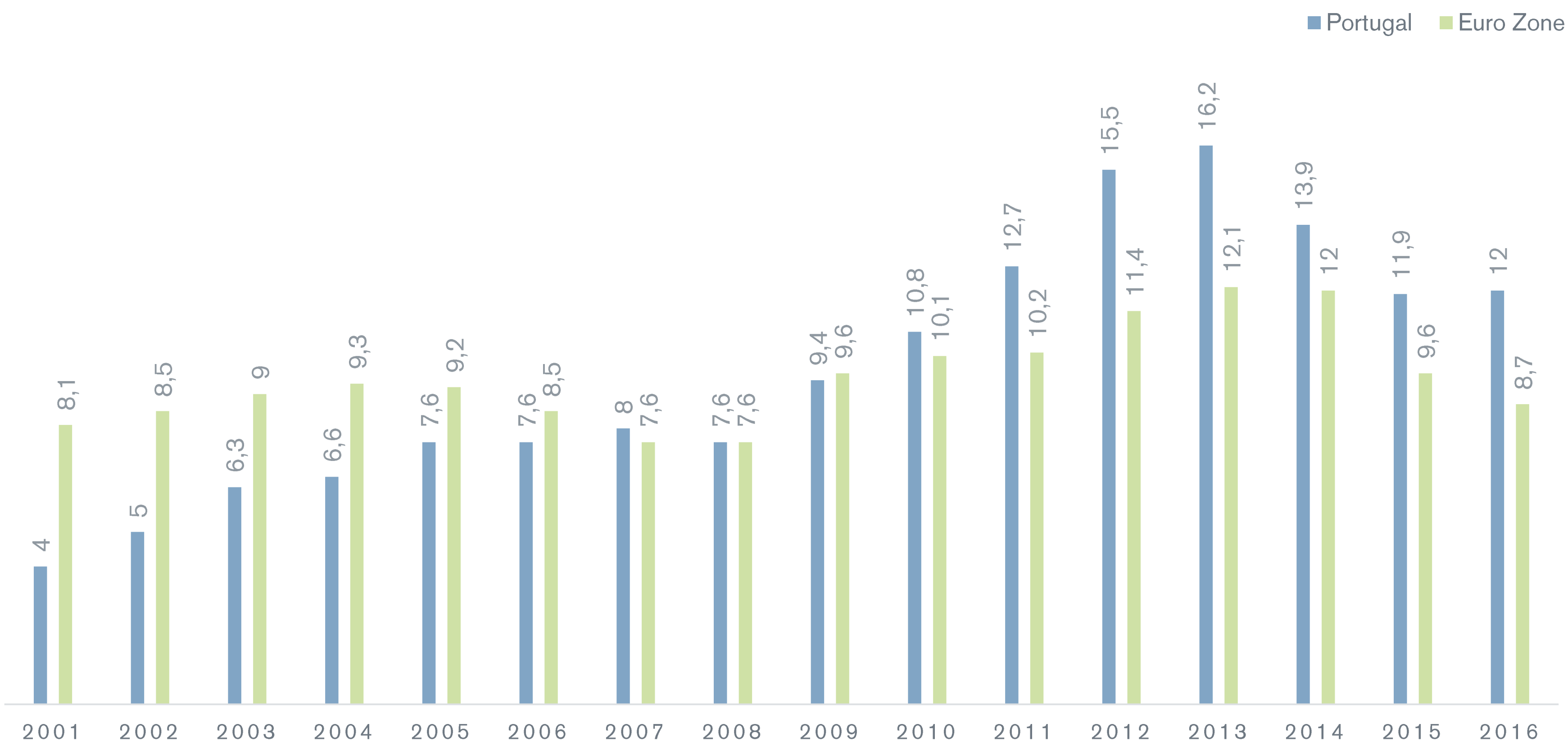
GDP per capita: € 19,492 (€20,100)

Currency: € / Euro (one euro is divided in hundred cents)

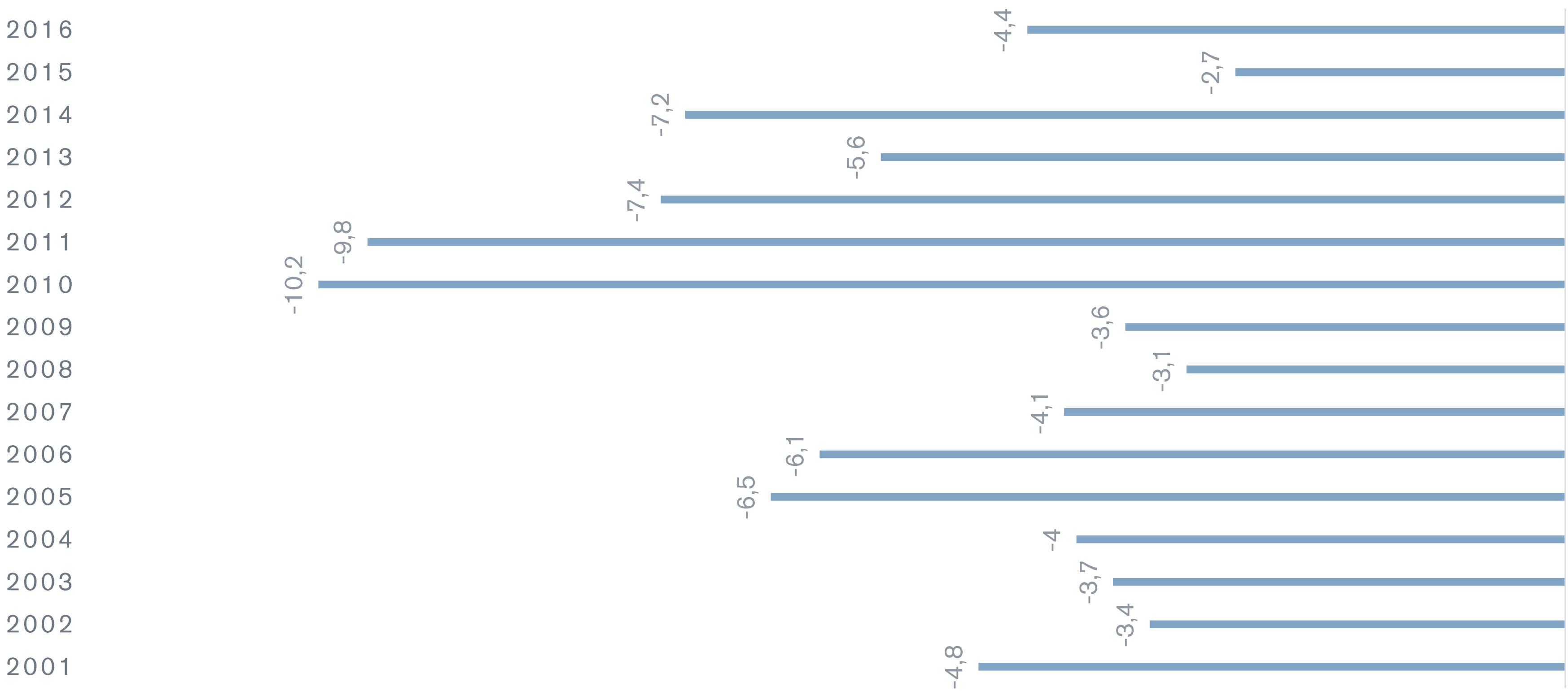
1.2. GDP growth



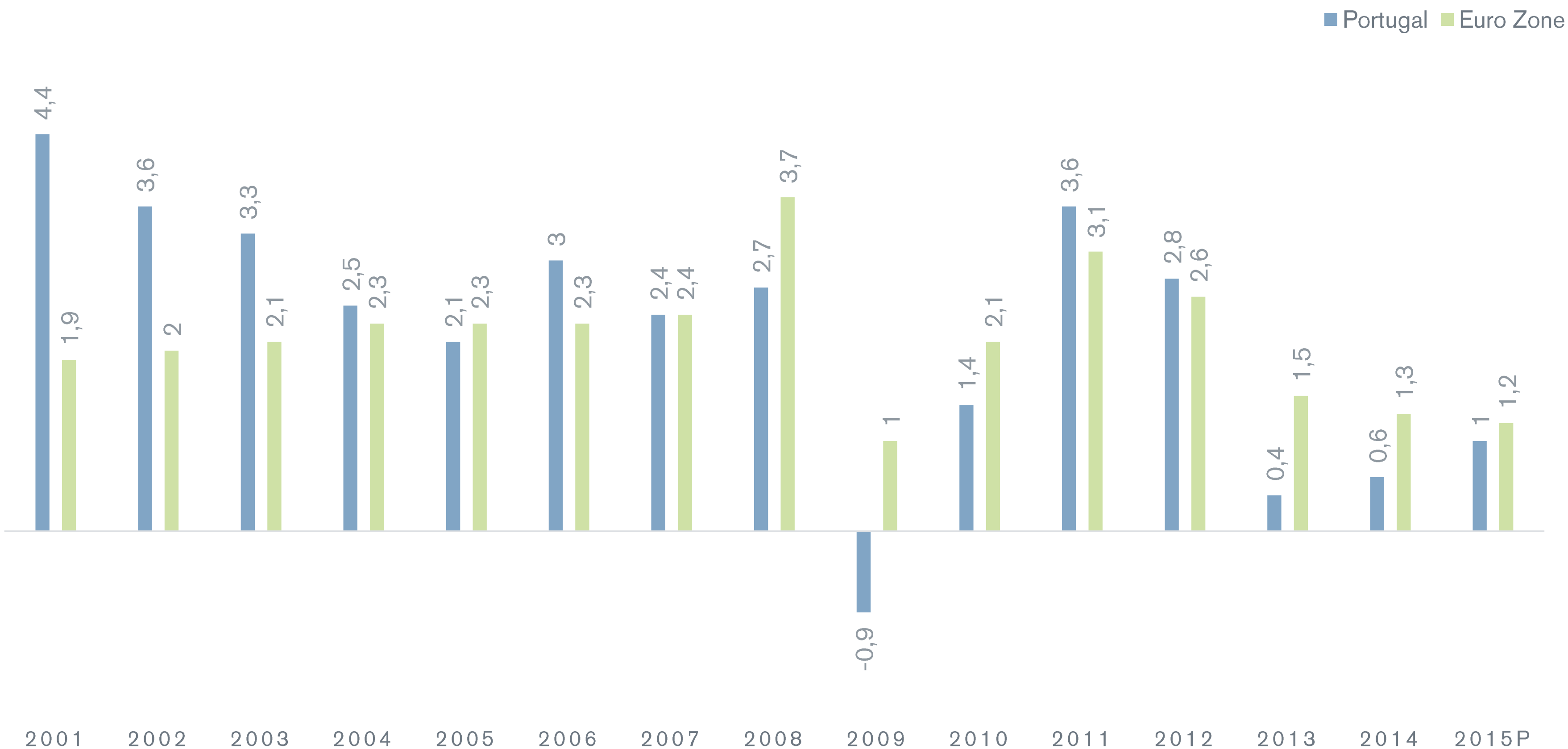
1.3. Unemployment rate



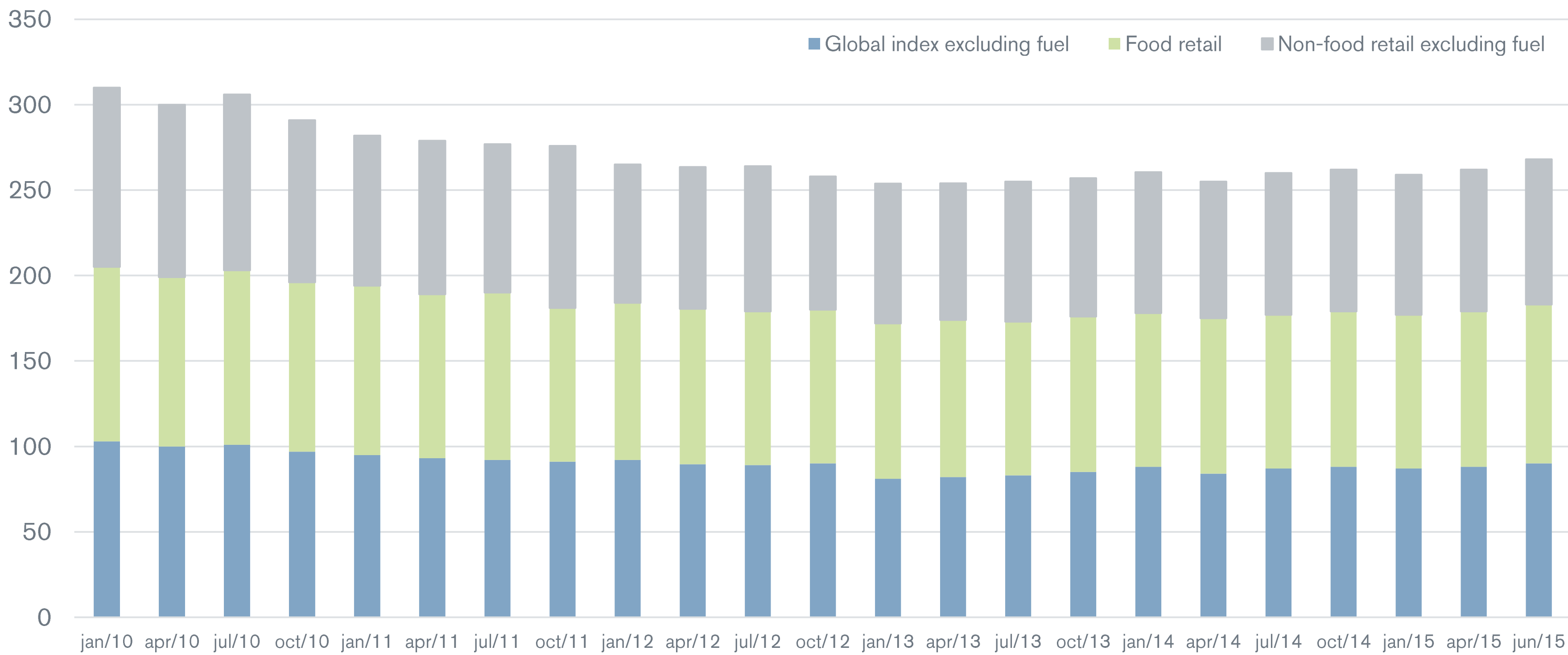
1.4. Portuguese government deficit



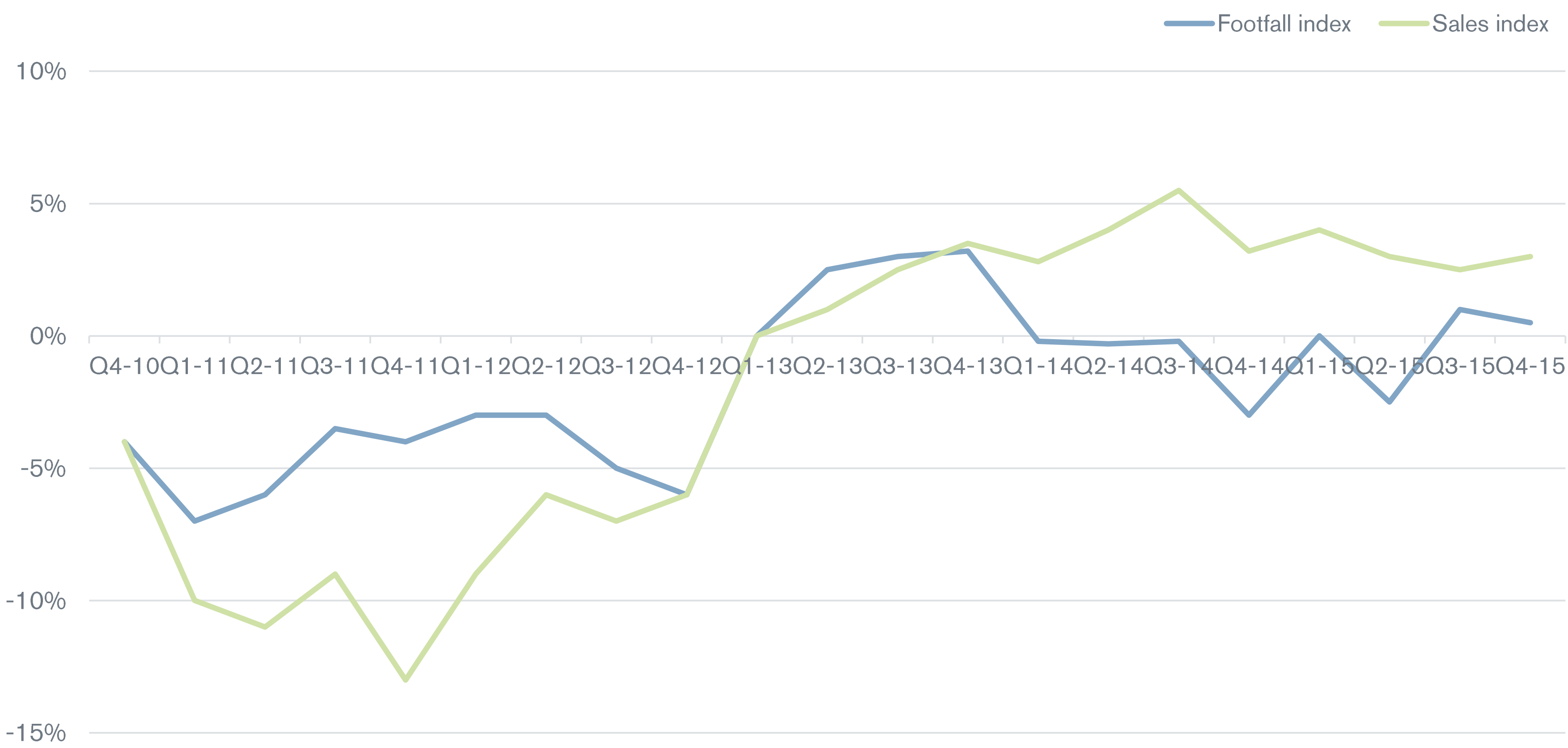
1.5. Consumer prices index



1.6. Retail trade index

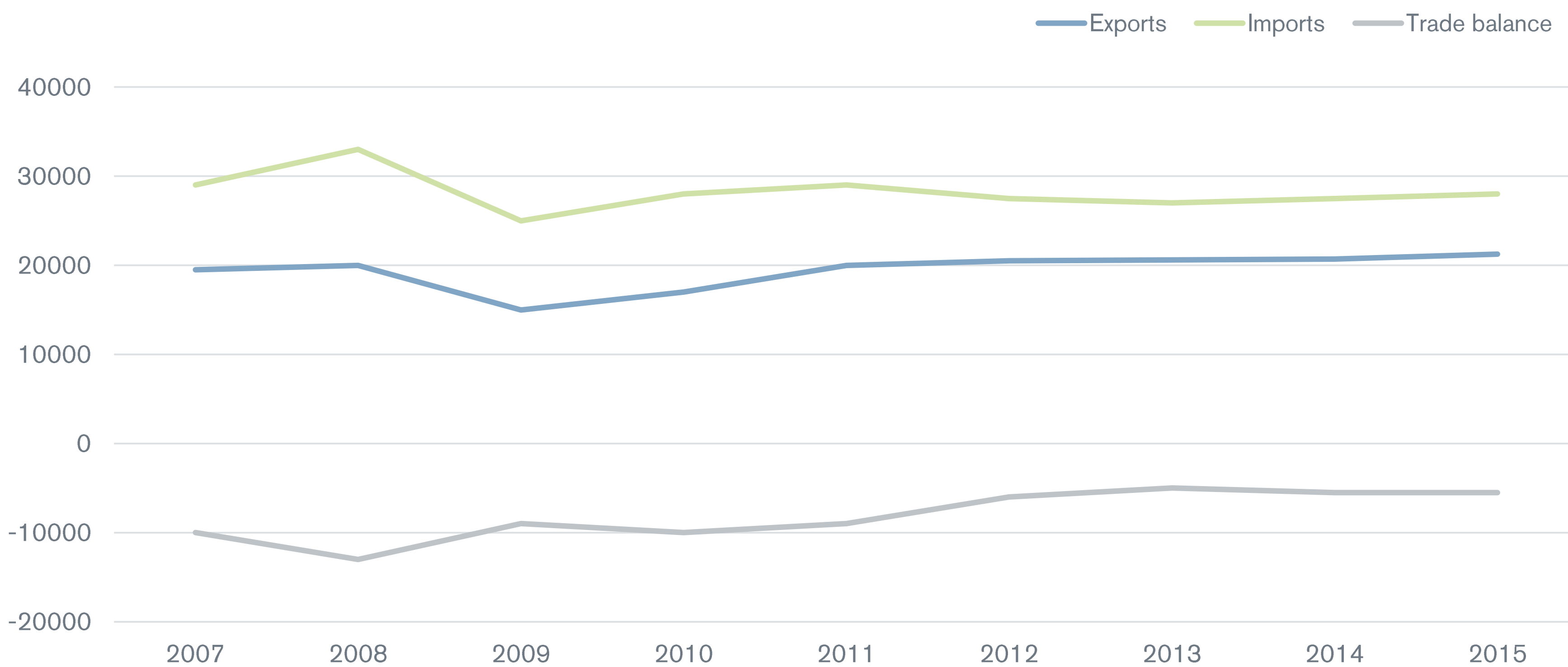


1.7. APCC´s footfall and sales index



1. OVERVIEW OF THE PORTUGUESE ECONOMY

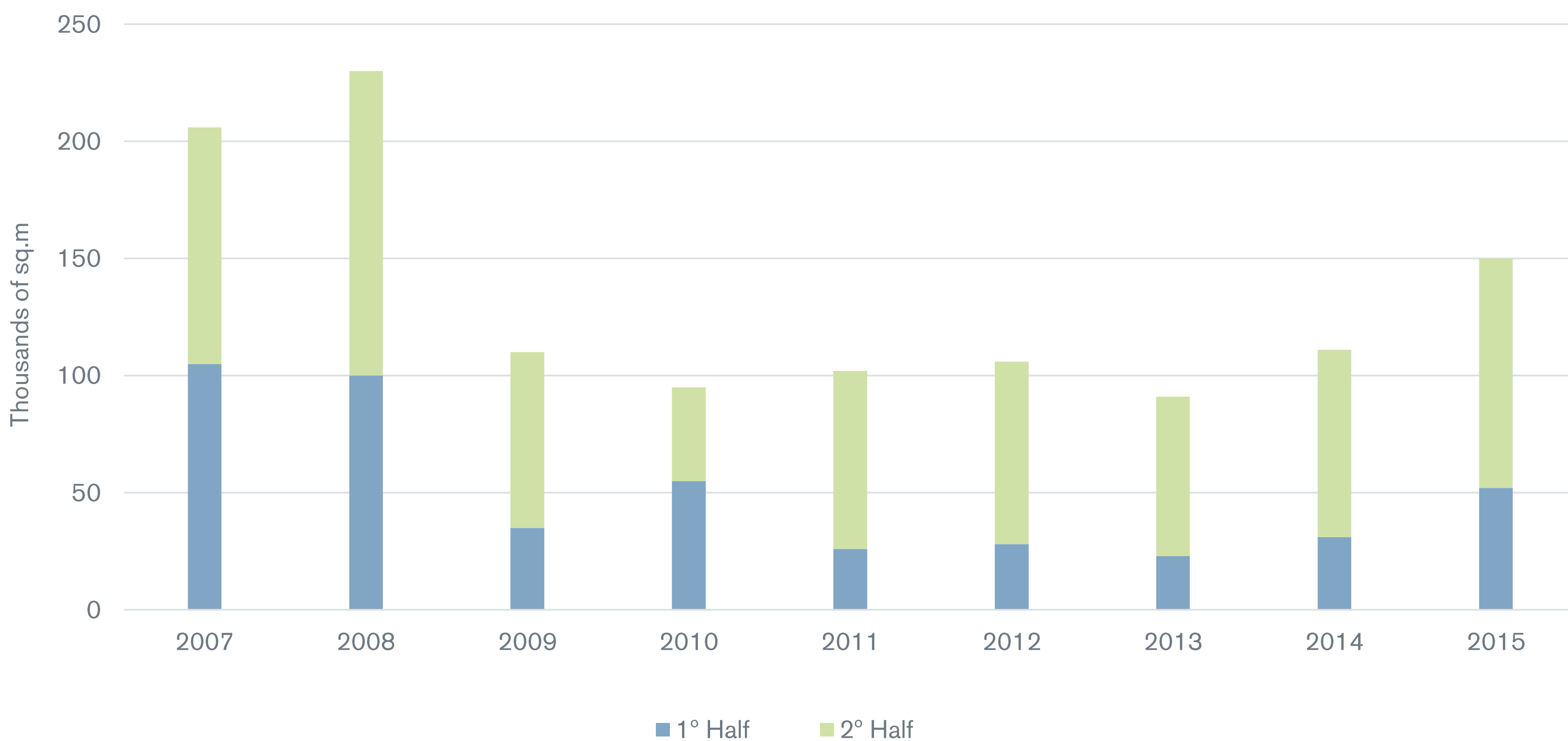
1.8. Balance of trade (first semester)



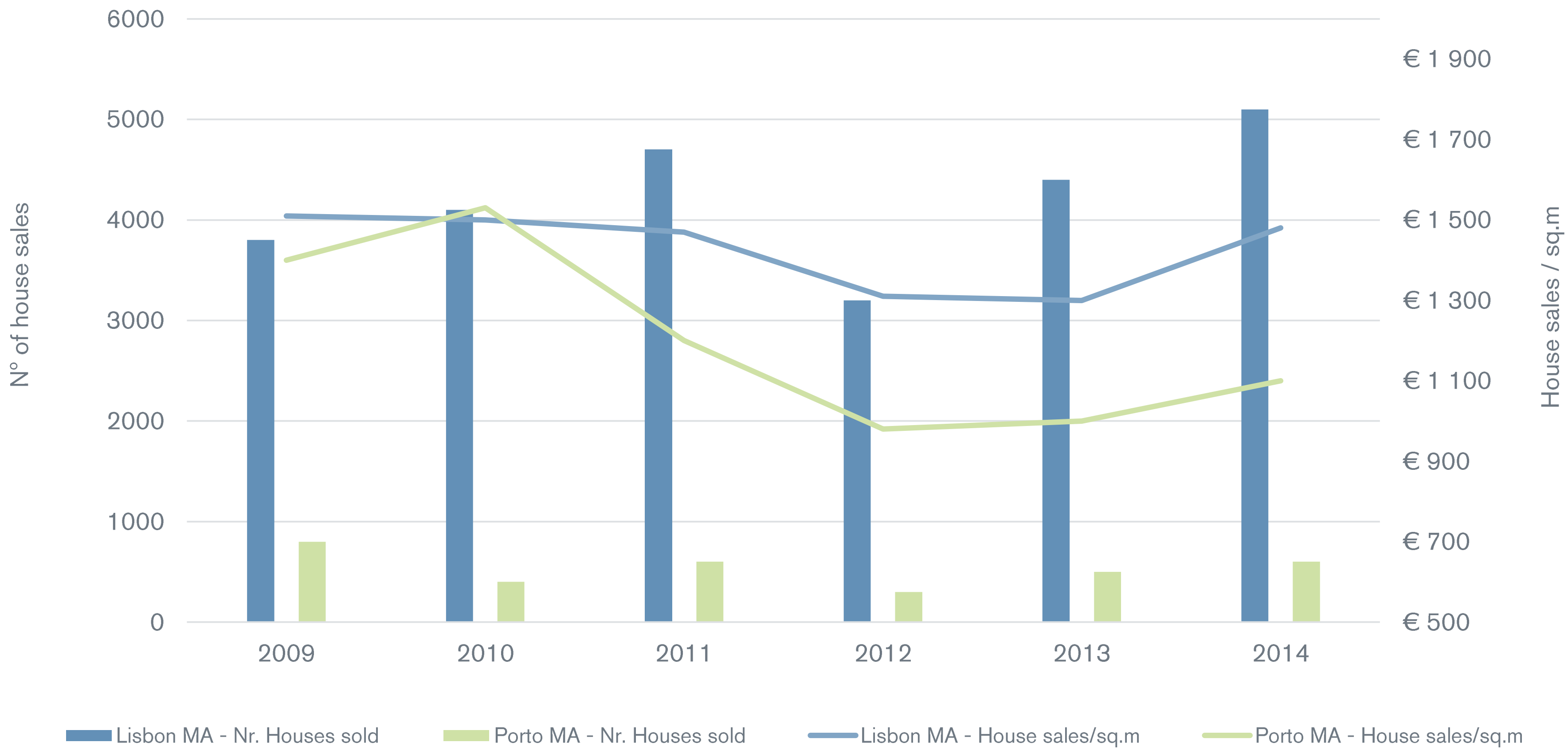
2. The Portuguese real estate market

2. THE PORTUGUESE REAL ESTATE MARKET

2.1. Take-up by semester

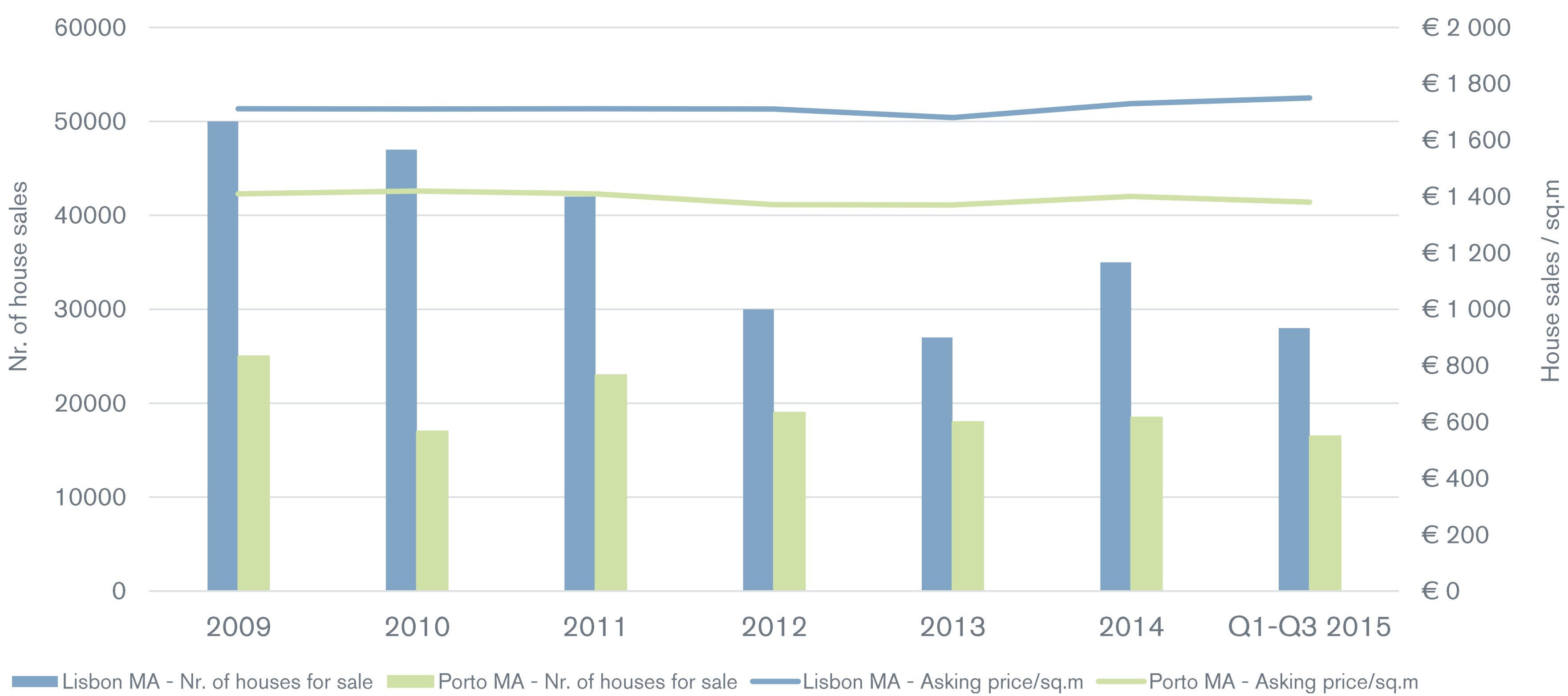


2.2. Residential market – Houses sold in Lisbon and Porto

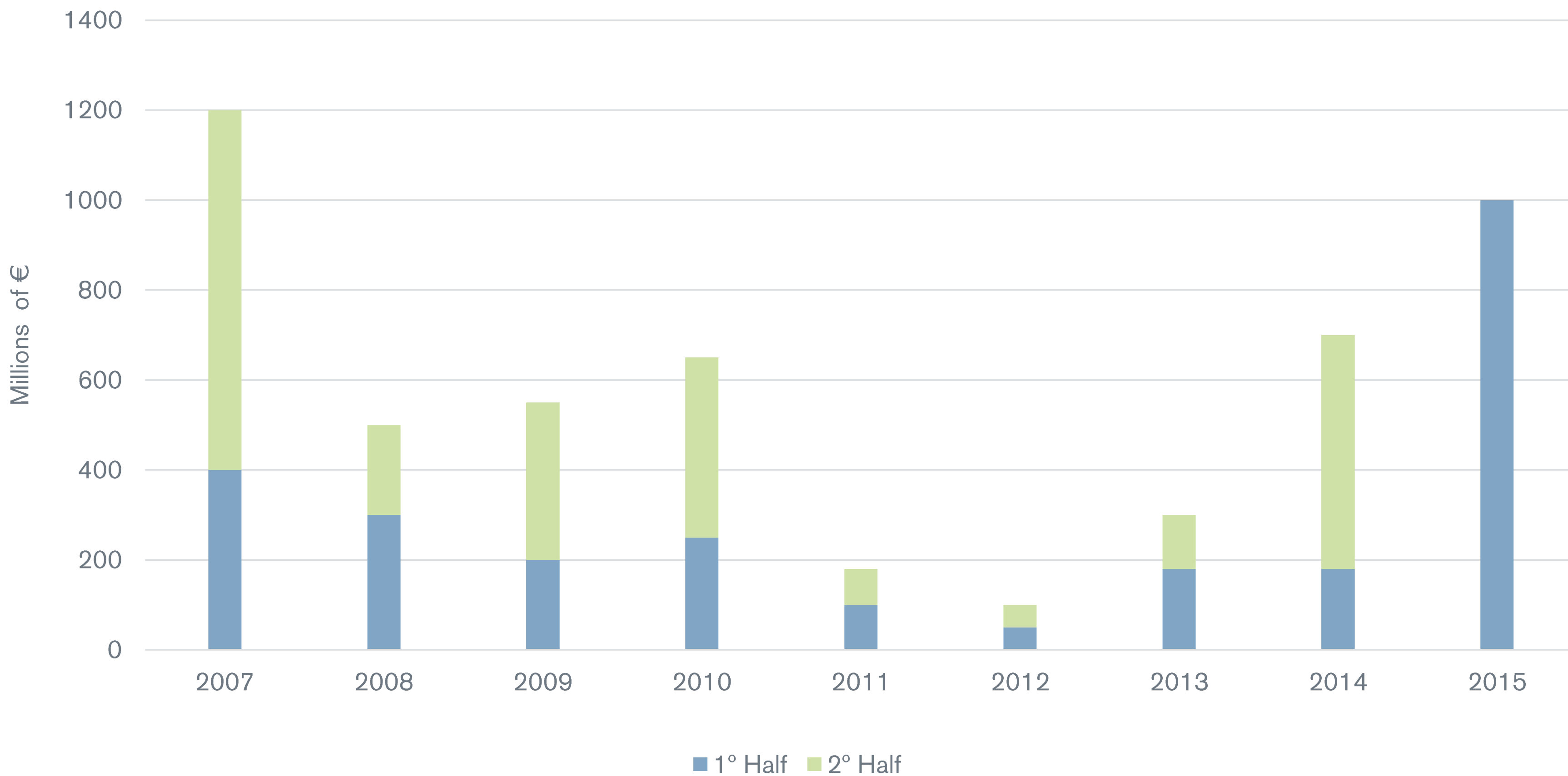


2. THE PORTUGUESE REAL ESTATE MARKET

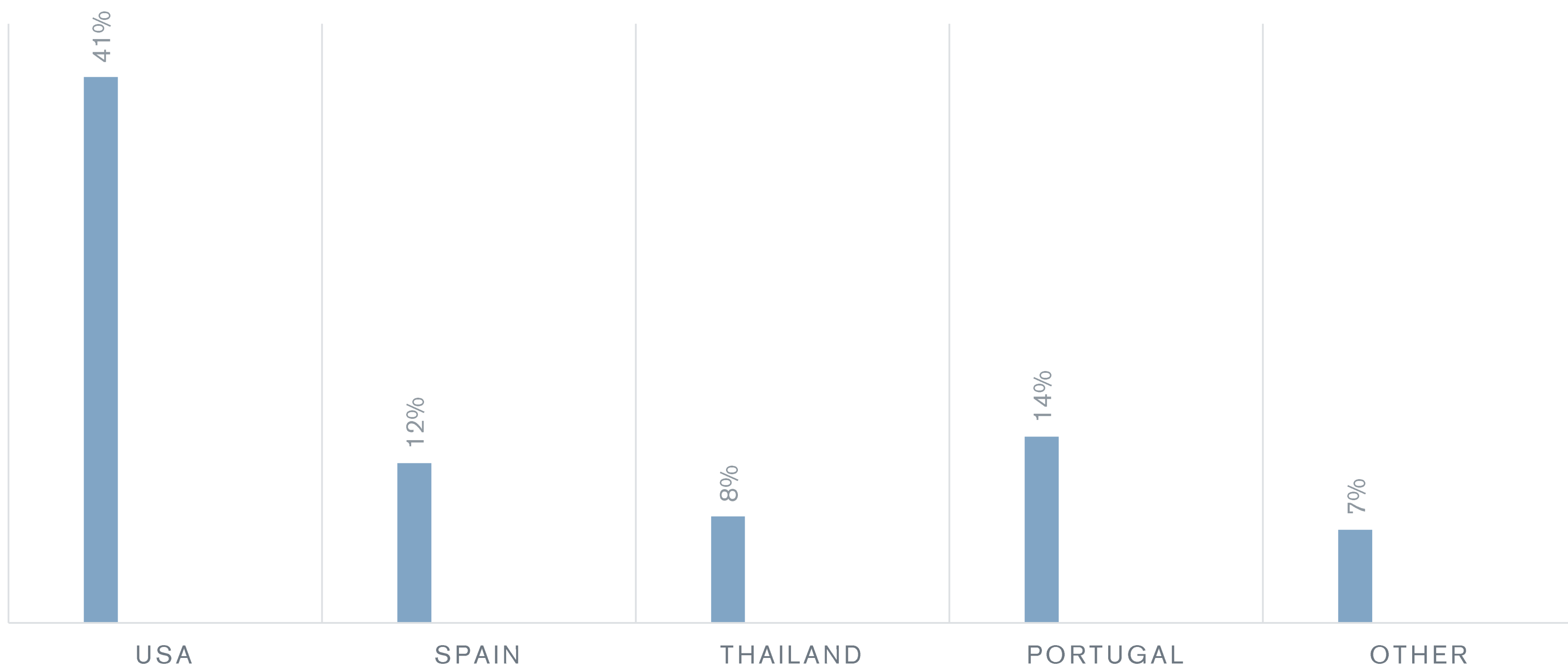
2.3. Residential market – Houses for sale in Lisbon and Porto



2.4. Commercial investment by semester



2.5. Commercial investment by origin – 2015



3. Types of property interests

3. TYPES OF PROPERTY INTERESTS

3.1. Freehold and other forms of property interests

Freehold (*direito de propriedade*) is the most common form of property in Portugal. Freehold gives the owner the rights to use, exploit and dispose of a certain immovable asset. These rights include the right to build on a property subject to the applicable licensing requirements. Properties may be owned by more than one natural or legal person, where each owns proportional and intangible share of the property. Each co-owner may dispose of his portion without the consent of the other co-owner(s), but the co-owner(s) will have a right of first refusal.

Portuguese law allows buildings or building developments to be divided into "fractions" where each fraction, which may be an apartment, a store or an office, is owned by a single owner and the common areas of the building are co-owned by the owners of the building's fractions. All owners together constitute the community of owners of the commonly owned property (condominium) including the staircases, outside area, roof, etc. Each owner may freely dispose of or encumber his fraction of the property including his share in the condominium.

Other property interests recognised under Portuguese law include:

- Building rights (*direito de superfície*). Building rights give their holders the right to construct and maintain a building or plantation on or beneath the surface of the property. The building right may be temporary or permanent, transferable or not; and

- Usufruct (*direito de usufruto*). Usufruct rights give their holder the right to use and collect the fruits and benefits (*frutos*) of the property, which include the rents and other periodic revenues that may be generated by the property.

In general, property and property-like interests (the so-called *rights in rem*) which are set out by the Portuguese Civil Code and other legislation are subject to registration with the land register and may only be constituted, mortgaged or transferred by way of a public deed executed before a notary. No property rights or similar rights may be created by contract other than in the manner specified in the law.

3.2. Lease rights

Commercial leases are the most common arrangement in Portugal for the use of offices and retail stores. Under a commercial lease, the lessor grants the lessee the right to temporarily use the leased property with the obligation to return it at the term of the contract.

Portuguese law allows the parties to freely stipulate the main terms and conditions of the lease, such as the rent, rent review conditions, cost allocation, duration, renewal conditions, termination options, etc.

The maximum term of commercial leases is 30 years. There is no statutory term and the parties are allowed to specify the applicable term. In the absence of a contract term, the implied statutory term is 10 years. Typically, commercial leases for office space and stores have a duration of 5 to 6 years.

The rent is usually payable on a monthly basis, but different payment dates may be agreed. Rent free periods and rents including a variable component are common in Portuguese office and industrial leases. As a rule, the rent is updated on an annual basis in accordance with the consumer price index (excluding housing) published by the National Statistics Institute (*Instituto Nacional de Estatística*) but the parties may agree otherwise.

The assignment of the lease included in the transfer of a business as a going concern (*trespasse*) does not require the consent of the landlord. Eviction of defaulting tenants must be enforced through court proceedings or, in some cases, through a special administrative eviction procedure with the National Lease Office (*Balcão Nacional do Arrendamento*).

Leases of stores in shopping centres, retail parks and other similar developments where the owner or manager also provides certain management and operation services to the lessee are not subject to the statutory rules on leases, allowing the parties to freely determine the terms and conditions of the lease, subject only to general contract law rules and principles.

Typically, the main rules on the operation of the development are set out in a "regulation" approved by the development owner or manager. Rent-free periods, stepped-up rents and rents with variable components are common in this type of leases. The costs of utilities, services, maintenance and improvement works in respect of the shops are normally borne by the lessee in the form of "common service charges", which include management fees, other common areas related services and, sometimes, certain marketing costs.

4. Structuring the acquisition

4. STRUCTURING THE ACQUISITION

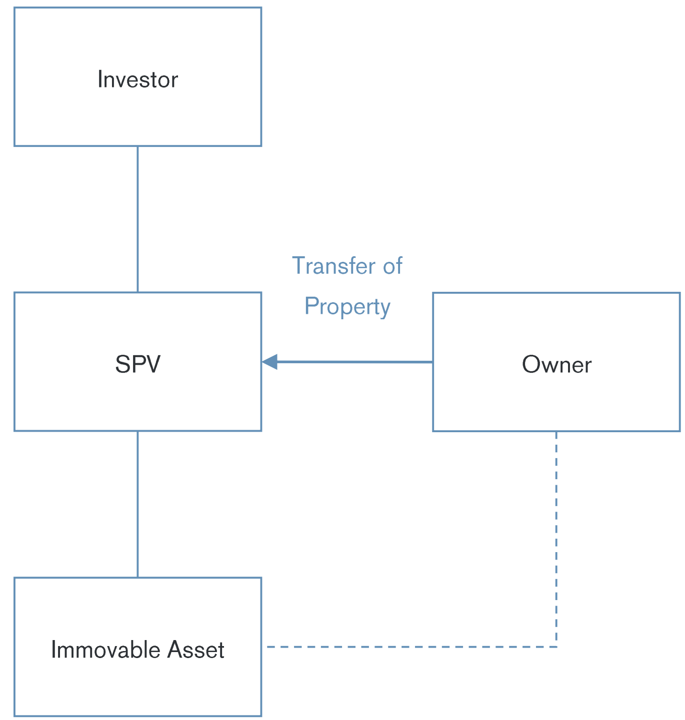
4.1. General aspects

Investments in property in Portugal may be carried under any of the following structures:

- Direct ownership by the investors;
- Indirect ownership by way of the incorporation of a foreign special purpose vehicle; and
- Indirect ownership by way of the incorporation of a Portuguese special purpose vehicle.

In general, the incorporation of a foreign or Portuguese special purpose vehicle (SPV) is the most suitable scheme to hold property rights in Portugal, as it has advantages in the investment and in the divestment process, limits the liability of the investor and has a lower tax impact.

SPV structures also avoid the need for the execution of a public deed for subsequent transfers of the asset, which will not trigger real estate transfer taxes, as the transfer of the shares in the SPV will automatically cause the transfer of property rights to the buyer.



4.2. Companies *vs.* real estate investment funds

Typically public limited liability companies (*sociedade anónima* – SA) are better suited for investing in real estate than private limited liability companies (*sociedade por quotas* – Lda) as:

- The transfer of shares is easier and can be made by transfer of the share title, while the transfer of shares in private limited liability companies requires, as a rule, the consent of the company and the registration of the transfer with the Commercial Registry Office; and
- The acquisition of control over 75% or more of the shares or equity in private limited liability companies that hold immovable assets will be subject to real estate transfer tax.

If investors intend to acquire multiple assets in Portugal, it may be advisable to incorporate a real estate investment fund (*fundo de investimento imobiliário* – FII) due to its more favorable tax treatment.

Property funds in Portugal are regulated and subject to an authorisation of the Portuguese Securities Commission (*Comissão do Mercado de Valores Mobiliários* - CMVM).

FIIs may be open or closed funds depending on whether the participation units issued by FIIs are variable or fixed.

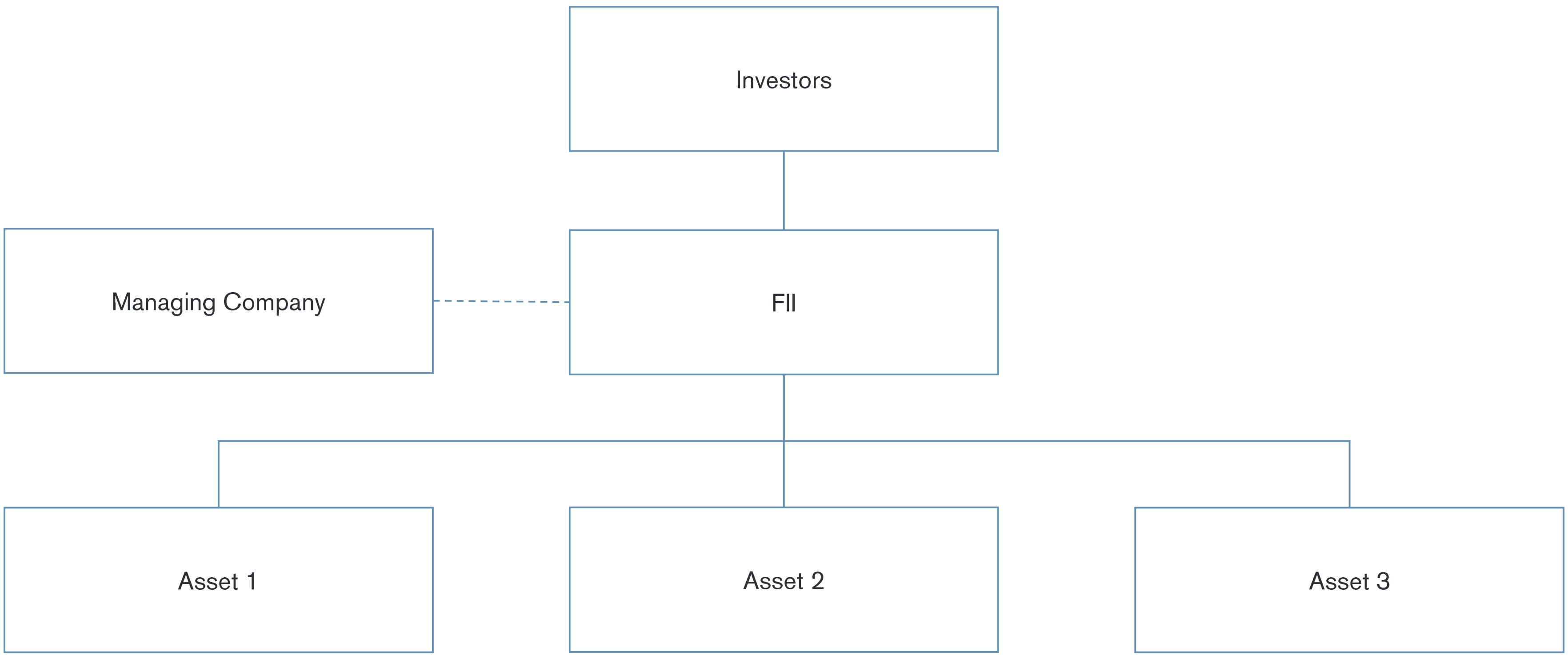
FIIs can acquire any property rights over immovable assets for leasing, resale or another economic purpose and shareholdings in real estate companies. FIIs may enter into financial arrangements, such as interest rate and currency swaps and other derivatives instruments, for hedging purposes only.

FII managers are financial companies incorporated with the sole purpose of acting as managers of FIIs registered with the CMVM.

FII's managers must have a minimum share capital of €125,000 and own funds of at least 0,5% of the total net global value of FIIs under management up to the amount of €75 million, plus 0,1‰ of the amount in excess of €75 million.

FIIs may issue participation which may be sold by way of a private or public offerings. The participation units may be listed in a stock exchange.

4.3. Investing through a FII



4. STRUCTURING THE ACQUISITION

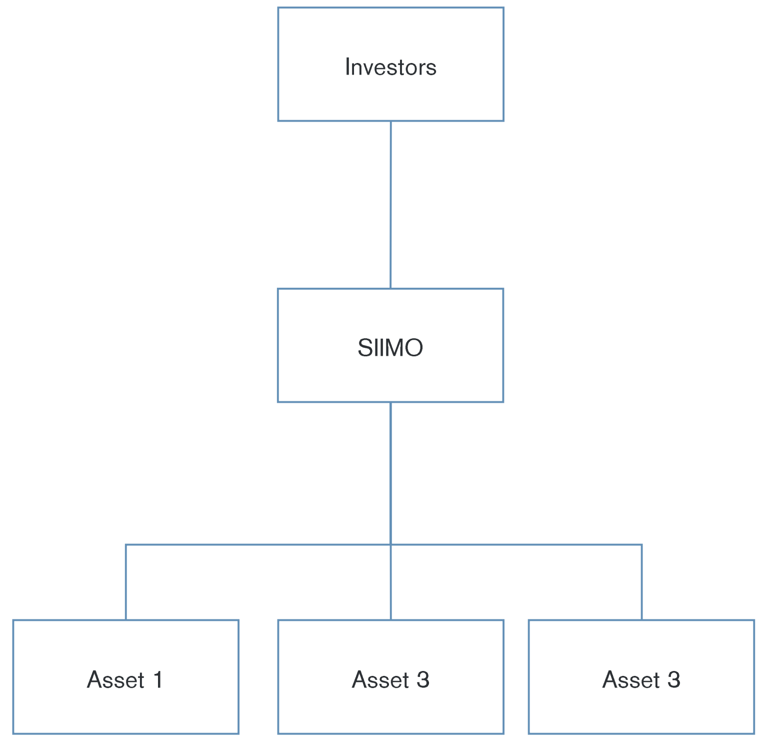
4.4. Real estate investment companies

Since 2010, as an alternative to the incorporation of a FII, investors may also consider the incorporation of a real estate investment company (*sociedade de investimento imobiliário* – SIIMO).

SIIMOs are financial intermediaries. The incorporation of SIIMOs is subject to the authorisation of the CMVM.

The main rules governing SIIMOs are:

- SIIMO may be SICAFI or SICAVI, depending on whether their share capital is fixed or variable. SICAFI are subject to the rules of closed FII and SICAVI to the rules of open FII.
- SIIMO may be managed by fund managing companies. If the management is not entrusted to a fund managing company, SIIMO will have to comply with the fund managing companies and FII minimum capitalisation requirements described above.
- SIIMO must be incorporated with a minimum share capital of €375.000.
- SIIMO must hold a minimum of €5 million of net assets.



5. Financing the transaction

5. FINANCING THE TRANSACTION

5.1. General aspects

The financing of real estate investments may take a variety of forms. It is common to obtain financing from the following sources:

- Equity or shareholder loans;
- Bank debt/bonds; or
- Financial lease.

Under Portuguese law equity may assume a variety of forms:

- Ordinary and preferred shares; and
- Quasi-equity debt instruments.

Portuguese law allows the issuance of ordinary voting shares and non-voting preferred shares which carry the right to receive a preferred dividend.

Preferred shares are a suitable form of funding to allow investors to recover their investment in the form of dividends. However, it must be noted that if the company cannot distribute profits in two successive years, the preferred shares will be converted in ordinary shares.

The acquisition vehicle may also be funded by participating loans made by its shareholders that may take the form of supplementary capital contributions (*prestações suplementares*), accessory contributions (*prestações acessórias*) or convertible bonds.

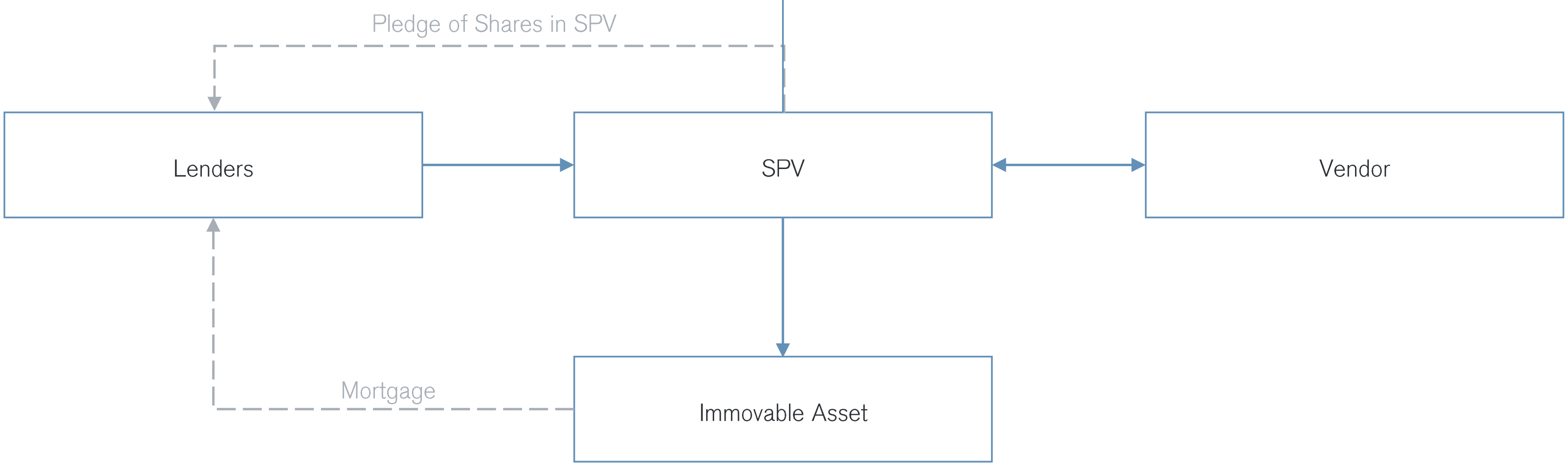
Funding of real estate assets is usually provided by bank financing or other financial investors under loan arrangements collateralized by the asset.

Under Portuguese law, collateral may be provided by way of mortgage over land, buildings and specified registered moveable property, pledge of moveable assets or assignment of proceeds.

Mortgages require the granting of a public deed, whereas the pledge would only need to be executed in writing in order to be valid and enforceable.

Pledges of shares of the real estate asset acquirer is also used. The pledge of shares is security provided by the investors whereas the mortgage is granted by the SPV.

5.2. Forms of security



5.3. The pledge of shares

Pledges are fixed charges created over the shares of the target or its subsidiaries, moveable assets or the business establishment of the target that give the lenders the ability to sell the assets or priority in the event of insolvency of the guarantor.

Pledges may be enforced by:

- Court sale (*venda executiva*);
- Private sale (*venda extraprocessual*); or
- Foreclosure of financial pledges (*apropriação*).

Enforcement by way of a court sale is the default procedure. If the parties choose to allow the private sale of the pledges they must so establish in the deed of pledge, provided that the sale is made for a fair consideration. To ensure that the sale is made at arm's length of the creditor and reduce the chances of such private sale being voided by other creditors or by the owner of the shares, it is advisable that the deed of pledge details the sale procedure, including the valuation method and the selection of the bidders.

As a rule, foreclosure of collateral is not allowed by Portuguese law. However, Decree-Law 105/2004, of 8 May 2004, which approved the legal framework applicable to the financial collateral arrangements, has allowed the foreclosure of financial pledges. Financial collateral arrangements are security agreements that meet the following requirements:

- At least one of the parties is a bank or another eligible entity;
- The collateral consists of cash or a financial instrument (shares, bonds and other securities);
- The secured obligations include payment obligations or the obligation to deliver a financial instrument; and
- The collateral is actually provided to the collateral taker and the collateral arrangement is documented by way of a contract or deed.

Under Decree-Law 105/2004, foreclosure of the collateral without a court proceeding is permitted as an alternative enforcement method provided that the parties agree on (i) the use of this method and (ii) the valuation of the collateral.

5.4. The mortgage

A mortgage enables the lender to be paid with respect to the secured liabilities by the value of certain immovable assets, or other assets treated as such, with preference over the remaining common creditors.

Mortgages must be created by way of public deed and registered before the relevant land or property registry office.

The mortgage is a charge over the mortgaged property as a whole, including any fixed parts thereof, but not over the proceeds generated by the mortgaged property.

The mortgage secures both the payment of the borrower's liabilities as well as other accessory obligations provided that the mortgage deed so specifies. The mortgage only secure the interests accrued during the three years prior to the enforcement of the mortgage.

The mortgage continues to encumber the mortgaged property until the secured liabilities have been fully discharged. In the event the mortgagor sells the mortgaged property to a third party, the purchaser of the mortgaged property, who is not personally liable for the secured liabilities, has the right to redeem the mortgage provided that it either discharges the secured liabilities directly or undertakes to deliver to the creditors the proceeds of the sale up to the amount of the secured obligations, otherwise the lien shall survive the sale.

Non-disposal covenants are not permitted. Any provision restricting the borrower's ability to sell or further encumber the mortgaged property is void.

The mortgagee may demand the replacement or the reinforcement of the mortgage if the mortgaged property is destroyed or its value is no longer sufficient to cover the secured liabilities.

The mortgagee cannot foreclose the mortgaged property unless otherwise authorised by a Court.

5.5. Financial and operational lease

Instead of acquiring the freehold, investors may opt to enter into a financial lease with a bank or another financial company whereby such financial company will buy the immovable asset and grant the investor the right to use the asset against the payment of a rental during a period of time after which the lessee may acquire the leased asset for a residual value. In general, the rentals will cover the price of the asset plus interests.

Financial lease agreements over immovable assets must be executed by way of a private deed and the signatures authenticated. Financial leases must be registered with the land register.

The term of the lease agreement should not be higher than the useful life of the asset and may not, in any case, exceed 30 years.

Under financial leases, the lessee will run all the risks and advantages inherent to the utilization of the asset. This means that the lessee instead of the lessor will depreciate the asset at the applicable rates. Although the parties are free to agree the terms and conditions of the lease, we should note there are specific accounting and tax rules should be considered to avoid the re-characterisation of the transaction.

Accounting Rule 9 establishes the provisions which imply the qualification of a lease as a financial lease, *e.g.*:

- The parties agree to transfer the freehold at the term of the agreement;
- The lessee has the option to purchase the asset for a price which is significantly lower than the fair market value of the asset on the date of the option exercise and it is highly likely that the lessee will purchase the asset;
- The duration of the lease covers almost all the useful life of the asset;
- On the date of the execution of the agreement, the value of the payments under the lease plus the purchase option and minus the additional costs, such as insurances, is higher or equal to the fair market value; or
- Due to its specific nature the leased asset may only be used, without adjustments, by the lessee.

6. Tax issues

6.1. Transfer taxes

The transfer of immovable property is taxable under the Municipal Property Transfer Tax (*Imposto Municipal sobre as Transmissões Onerosas de Imóveis* – IMT). IMT is calculated based on the higher of (i) the tax value of the property or (ii) the purchase price.

IMT rates are the following:

- Up to 6%, in case of residential urban properties;
- 6.5% for industrial or commercial urban properties;
- 5% for rural properties; and
- 10% in case the purchaser is an entity resident in a state, territory or region with a clearly more favourable tax regime.

In general, real estate transactions are exempt from Portuguese Value Added Tax (*Imposto sobre o Valor Acrescentado* – VAT). Notwithstanding, the seller or the lessor may, under certain conditions, opt to waive this exemption to deduct the input VAT.

When no VAT is charged, stamp duty is charged to the buyer of the property at a rate of 0.8% on the higher of (i) the tax value of the property or (ii) the purchase price.

IMT Rates

(property in mainland Portugal intended exclusively for housing purposes)

Value (EUR.)	Rates	Deduction
Up to 92,407.00	0%	0.00
From 92,407.00 to 126,403.00	2%	(1,848.14)
From 126,403.00 to 172,348.00	5%	(5,640.23)
From 172,348.00 to 287,213.00	7%	(9,087.19)
From 287,213.00 to 574,323.00	8%	(11,959.32)
Above 574.323,00	6% (single rate)	

6.2. Property taxes

Ownership of immovable property is subject to the Municipal Property Tax (*Imposto Municipal sobre Imóveis* – IMI). IMI is levied on an annual basis on the value of urban property and land property located in Portugal and is owed by the property or usufruct owner or the holder of the surface right of a real estate unit at the following rates:

- 0.8% on land and attached facilities (*prédios rústicos*);
- Between 0.3% and 0.45% on urban properties (*prédios urbanos*); and
- 7.5% on properties owned by entities resident in a state, territory or region with a clearly more favourable tax regime.

The applicable rate within these ranges will be determined by the municipalities on a yearly basis and increase threefold in the case of urban property left vacant for more than a year or of buildings in a state of ruin.

The urban buildings and apartments will be deemed not to be in use if the owner has not contracted the provision of essential public services or there is no consumption of water, electricity, gas and telecommunications for a period of one year.

Urban buildings and apartments with a tax value of €1 million or higher will also be subject to stamp duty at the following rates:

- 1%, in case of residential buildings or land allocated to housing construction; and
- 7.5%, in respect of any building owned by individuals resident in a tax haven.

6.3. Taxation of SPVs

Should the investors decide to incorporate an SPV in Portugal, Corporate Income Tax (*Imposto sobre o Rendimento de Pessoas Coletivas* – CIT) will be charged over its taxable annual returns at the following CIT rates:

- 17% (up to €15.000, subject to *de minimis* rules); and
- 21% (above €15.000).

The effective taxation of the SPV may be increased to as much as 28.5%, as follows:

- Municipalities may charge a municipal surcharge (*derrama municipal*) of up to 1,5%; and
- State charges a State surcharge (*derrama estadual*) of 3%, 5% and 7% applicable to the net income in excess of €1.5 million, €7.5 million and €35 million, respectively.

It should be noted that Portuguese law contains certain anti-abuse rules which are applicable to companies holding real estate, such as transparency rules.

Transparency rules should be carefully reviewed on a case-by-case basis.

In addition, it should be noted that the deduction of interest and other costs may also be subject to certain restrictions.

6.4. Taxation of the investors

Personal Income Tax (*Imposto sobre o Rendimento de Pessoas Singulares* – PIT) and CIT are charged over the worldwide income obtained by individuals and companies resident in Portugal and on any income obtained by non-resident individuals or companies which is attributable to a permanent establishment in Portugal or is deemed to having been obtained in Portugal.

In general, income obtained by non-resident companies is taxed at a rate of 25%. Income obtained by non-resident individuals will be taxed at a rate of 25% or 28%.

In principle, it is possible to exclude (fully or partially) the taxation of certain incomes under the applicable double tax treaty, the Parent-Subsidiary Directive and the Interest and Royalties Directive.

However, in order to benefit from these exemptions the SPV and/or the investors may have to comply with certain conditions (e.g. minimum holding and minimum holding period).

Portuguese Income Tax Rates

(applicable to the income obtained by non-resident individuals)

Taxable income	Rates
Net profits (permanent establishment)	25%
Dividends	28%
Interest	28%
Capital gains	28%

6.5. Taxation of FIIs and investors

FIIs benefit from a special tax regime set out in the Tax Benefits Statute, which has been recently amended.

The following is a summary of the main tax rules that will apply to FIIs and investors as of 1 July 2015:

- The net income will be subject to CIT but will not be subject to municipal surcharge or State surcharge;
- Rentals, capital gains and capital income obtained by the FII will be exempt from CIT, provided they are not paid by an entity with head-office in a state, territory or region with a clearly more favourable tax regime;
- FIIs may deduct tax losses assessed in a certain tax period in the following 12 tax periods. The deduction may not exceed an amount of 70% of the respective taxable income of each period;
- Stamp duty will be levied over the net asset value of the FII at a rate of 0.0125% assessed quarterly;
- FIIs which are incorporated by way of a public offering will benefit from a 50% exemption in respect of IMI and IMT;
- Non-resident individuals or companies without head-office or permanent establishment in Portugal will be subject to a reduced CIT or PIT rate of 10%, unless they have their head-office in a state with clearly more favourable tax regime.

Although the incorporation of a FII presents some advantages, the maintenance of the FII will require the payment of, among other costs, a monthly surveillance fee to the CMVM and management fees to the fund managing company. Therefore, this structure will only be viable in the event the investors wish to acquire several property rights.

As of 31 March 2016, the acquisition of units, their amortization, a capital increase of reduction or other transactions involving closed FIIs incorporated by private offering will be subject to IMT if a sole investor (or two investors, if married or unmarried partners) becomes the holder of, at least, 75% of such units.

6.6. Sale of shares vs. sale of property

The tax implications of the transaction play an important role in the structuring of the acquisition.

Following the recent changes to the FII tax framework, the use of this type of vehicles became more attractive, among other reasons because certain FIIs may benefit from a 50% exemption of IMT and IMI. Rents and capital gains will be exempt at the level of FII and foreign investors will be taxed at a reduced rate of 10%. However, considering the applicable regulatory requirements, FII may not be suitable to all kinds of investments.

In general, the incorporation of a SPV in the form of a public limited liability company will be an efficient way to invest in property in Portugal from a practical/regulatory point of view as well as from a tax perspective.

As seen above, when investors decide to divest, the assets may be transferred by selling the shares in the SPV, which will not require the registration of the transfer with the land register and will not trigger the payment of IMT by the buyer of the shares.

On the other hand, following the 2013 reform of the CIT Code the general CIT rate has been reduced from 25% to 23% in 2014 and from 23% to 21% in 2015.

In addition to the incorporation of an SPV, investors may also consider the incorporation of a holding company (*Sociedade Gestora de Participações Sociais* – SGPS) to hold the shares in the SPV. Although this may duplicate the investment structure and entail additional costs, it may have some advantages, in particular when the investor owns more than one SPV.

Tax grouping rules are available and allow setting-off taxable income of one SPV with tax losses of others.


Our real estate, finance
and tax expertise

OUR REAL ESTATE, FINANCE AND TAX EXPERTISE

About us

In today´s competitive global market, Macedo Vitorino & Associados provides legal advice on the entire spectrum of real estate issues at all stages to domestic and foreign real estate developers and investors, financial institutions, equity investors, institutional investors and corporations.

Our lawyers are prepared to advise on a full range of asset acquisition and financing matters, including corporate and regulatory issues, such as:

- Property law matters
- Finance and security issues
- Tax
- Regulatory and administrative, including planning and environmental matters
- Corporate law matters

Our advice includes:

- Due diligence on the real estate asset and/or on the target company
- Incorporation of acquisition vehicles, including tax structuring
- Negotiation of purchase and sale agreements on behalf of sellers and buyers
- Negotiation of finance agreements
- Post closing actions regarding the transfer of the real estate asset or of the shares (registration, transfer formalities and relevant notices)
- Following up on the investment

We are mentioned by The European Legal 500 in twelve of fifteen practice areas, including Banking and Finance, Capital Markets, Project Finance, Corporate and M&A, Real Estate, Tax, Telecoms and Litigation. Our firm is also praised by IFLR 1000 and by Chambers and Partners.

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