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NEWSLETTER

TAXATION OF REAL ESTATE CAPITAL GAINS REALIZED BY TAX RESIDENTS AND THE REINVESTMENT

SUMMARY

The taxation under Personal Income Tax ("PIT") of capital gains obtained with the sale of real estate may vary, depending on the taxpayers' tax residency status. For those who are considered as tax residents, there are tax benefits, namely the consideration of only half (50%) of the value of capital gain and the possibility of the gain being excluded from taxation, provide the realization value is reinvested, whether in the acquisition of another property or in the purchase of financial products, such as life insurance contracts, individual adhesion to pension funds or contributions to the public capitalization regime, all under certain specific conditions.

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TAXATION OF REAL ESTATE CAPITAL GAINS UNDER PIT

According to the Portuguese legislation currently in force, gains obtained with the sale of real estate (that are not considered as income from other PIT categories) may be considered as capital gains and subject to taxation under PIT's category G.

Despite this tax obligation affecting both tax residents and non-residents taxpayers, the Portuguese domestic law foresees different tax rules for each type of taxpayer, which has generated great controversy and litigation.

According to the regime currently in force, the value of income classified as capital gains should correspond to the balance determined between the gains and losses obtained in the same year.

In the case of sale of real estate properties, taxpayers' residents in Portuguese territory are taxed on half (50%) of the realized capital gain, at the marginal and progressive PIT rates (and this element creates a distinction in the treatment provided to tax residents and non-residents).

THE REINVESTMENT BENEFIT– HABITUAL RESIDENCY AND FAMILY HOUSEHOLD

In addition to the taxation regime being more favorable to tax residents, who are taxed only upon half (50%) of the realized capital gain, the regime currently in force provides for another tax advantage exclusively to those that are resident in Portuguese territory (and not to non-residents).

According to the Portuguese PIT Code, capital gains from the onerous disposal of a property used as the taxpayer's or his family's permanent and habitual residency ("habitação própria e permanente"), may be excluded from taxation, provided certain conditions are met. In fact, for this benefit to apply, a gain must be reinvested in the purchase of a property, also for the taxpayer or for his family's permanent and habitual residency. There are also other conditions that need to be verified, such as deadlines and reporting obligations which must be complied with.

It should be noted that legislator did not intended to create a mere benefit to taxpayers who decide to purchase a real estate property. It is not sufficient to

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purchase a property to be able to take advantage from this tax benefit: the capital gain must be the **direct result of the sale of the taxpayer's permanent and habitual residency** and that the amount realized must be **also used for the acquisition of another permanent and habitual residency**, either for the taxpayer or for his family.

Generally, the habitual residency of an individual must correspond to his tax domicile. Nonetheless, this may not necessarily be so, and many Courts have ruled, in line with existing rules, that this presumption is refutable by the taxpayer.

In fact, under the terms of the General Tax Law, an individual's habitual residency corresponds, unless otherwise specified, to his tax domicile. On the other hand, the PIT Code expressly provides that tax domicile conducts to the presumption of it being considered as the taxpayer's habitual residency, even though the taxpayer may, at all times, present evidence of the contrary, namely demonstrating that his habitual residency is located elsewhere or even to prove that he does not have one.

For such purpose, **any evidence admitted by law** can be presented and it is the Tax Administration's responsibility to prove the lack of veracity of the evidence presented by the taxpayer.

It should be noted that Portuguese courts have largely analyzed these issues, deciding several times in the opposite direction to the interpretation conveyed by the Tax Administration of the abovementioned provisions. In fact, according to the majority of the Courts' rulings, the legislator did not match the concepts of tax domicile and habitual residency for the purpose of recognizing this benefit because he did not intend to do so. As a result, the Tax Administration should not try to implement the coincidence of these concepts.

The **household** ("*agregado familiar*"), under the terms of the Portuguese PIT Code, is constituted by (not separated) spouses or those in a civil union and their dependents, or by a single parent and his or her dependents or also by single adopters and adoptees. Under the Portuguese legislation, dependents are defined as children, adopted and stepchildren (especially underage or under guardianship) as well as civil godchildren.

Thus, it should be concluded that there is a multiplicity of types of households, being certain that taxpayers and the rest of the household may not live together

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permanently (in fact, nowadays it is common to have parents who work in a country different than the country of residency of their children).

It should be noted that, as per the CAAD's ruling no. 103/2013-T, the option provided by the law, which admits the reinvestment for the acquisition of habitual residency of the taxpayer **or of his household** only has sense if one must not necessarily be the other's, making it clear that the habitual residency of a taxpayer, which is what is relevant for this matter, can be distinct from that of his household's.

REINVESTEMENT IN FINANCIAL INSTRUMENTS

Since 2018, there is also a possibility of reinvesting the capital gain obtained with the sale of a real estate property in the acquisition of same financial instruments.

Under the regime currently in force, gains from the onerous transfer of real estate that is considered as the taxpayer's (or of his household's) habitual residency are excluded from taxation if the capital gain obtained is used in the acquisition of one or more life insurance financial contracts, in the individual subscription to an open pension fund or even in the contribution to the public capitalization regime, and also if the remaining conditions are met, namely the taxpayer, his spouse or the person with whom he is in a civil union, on the date of the transfer of the real estate property, are in a retirement situation or have, at least, 65 years old, and also if other deadlines and reporting obligations are fulfilled.

CONCLUSIONS

The Portuguese legislation is designed to provide a tax relief in the taxation of capital gains generated by the sale of real estate by taxpayers that are considered as tax residents in Portugal, as it disregards half of the amount earned.

Benefits are even more clear when it comes to the sale of the taxpayer's habitual residency and the realization value (or part of it) is reinvested in the acquisition of another residency for the same purpose, or since the most recent changes even in investment in certain financial products, which generally aim at ensuring savings for retirement.

Thus, it is extremely important for resident taxpayers (especially, but not only) to be informed about the conditions for the admission of the exclusion of capital

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gains taxation from PIT and follow all steps legally determined for such purpose.

In particular, taxpayers must keep their tax address and tax domicile up to date and it should be noted that, in case of Portuguese citizens, the tax domicile corresponds to the address associated with their citizen card ("*cartão de cidadão*"), being it communicated by the civil authorities to the Tax Administration in case of any change or update of tax address, which will be registered as the taxpayer's tax domicile. In case of a foreign citizen, without a Portuguese citizen card, the tax address must be updated with the Tax Administration services directly.

Additionally, compliance with legally established timings and the correct reporting in the PIT return in the tax year of the sale and in the tax year of reinvestment (if different) are of the utmost importance.

In case the taxpayer does not comply with all the foreseen steps and the reinvestment is challenged by the Tax Administration – which has consistently tried to remove the recognition of this benefit defending that "habitual residency" and "tax domicile" are always coincident concepts and refusing to accept evidence presented by taxpayers of the contrary – it is relevant to note that the Courts already decided that such coincidence does not necessarily exist, at least for this purpose. Thus, the taxpayer can demonstrate that the sold property was used as his habitual residency – or of his household's – even if it was not registered as the tax domicile of any member of said household.

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