Portugal Taxation of Short-Term Lettings by Non-Resident Landlords

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Disclaimer

This report contains information of a generic nature and cannot preclude specialist advice in connection with specific situations.

Overview

Depending on the location and quality of one's investment residential property in Portugal, short-terms lettings (called *alojamento local* in Portugal) may provide a rather better return than a long-term letting. This being the case, additional advantages of short lettings include the elimination of the potential risk of a lengthy, costly, eviction process, and, subject to contractual terms, the possible occupation of the property by the landlord during occasional visits to Portugal.

A non-resident Portugal property owner who intends to let the property on a short-term basis (up to 30 days per letting) will generally want to retain the services of a local specialist manager to handle the operation. He can do this under one of the following 3 main types of arrangement, each one having different tax implications, which will end up affecting his net income:

1. A Portuguese special type of general partnership agreement, called *contrato de associação em participação*, between a management company (the General Partner) and the non-resident property owner (the Limited Partner).
2. A rental agreement (*contrato de arrendamento*) between a manager (the Tenant) and the non-resident owner (the Landlord).
3. A management agreement (*contrato de gestão*) between a manager and the non-resident owner, who in this case, unlike those of the partnership or the rental agreement, is the business operator, assuming responsibility for complying with all the legal requirements. Under this option, two alternative scenarios may be considered:
    a. That of the non-resident direct owner, whether individual or corporate; and
    b. That of a resident company or branch, ultimately owned by the non-resident owner.

A word of caution: *associação em participação*

Please note that in this report all mentions of "partnership" refer to the Portuguese-specific type of general partnership agreement called *contrato de associação em participação*. The main difference between this and the general partnership agreement under, or derived from, English law is that under this specific agreement, unlike the generality of its English counterparts, the partnership is <u>not</u> deemed transparent for taxation purposes; i.e. its profits are taxed in the hands of the general partner and the after-tax profits distributed to the limited partners are treated as capital income, being equated to dividends under the generality of the double taxation agreements (DTAs) signed by Portugal.

Although this suggests that Portugal's position in this matter is to equate the profits distributed by an *associação em participação* to dividends, it should be noted that in the event the applicable DTA does not explicitly do it, it is not impossible (although there are no known occurrences) that the Portuguese Tax Authority decide not to accept the application of the DTA reduced rate of tax applicable to dividends, in which case the general rate of 28% applicable to capital income would apply.

The Red Tape

Besides the standard requirements of an operation of this kind (furnishing and decorating the property, securing and managing bookings, managing check-ins/check-outs, providing consumables, cleaning, laundering, maintenance, etc), in Portugal the following legal requirements must be met:

- Compliance with the mandatory comfort, safety and information regulatory standards.
- Registration with the Tourism Authority, done through the local Town Hall, either online or at the Town Hall office.
- Registration with the Tax Authority.
- Collecting and paying municipal tourism taxes.
- Issuing an invoice in respect of each guests' stay and accounting for VAT, which must be charged at 6% (except for very small operations having annual sales of < €10,000) and is generally payable at 23%.
- Completing and filing a quarterly or monthly VAT return.
- Timely reporting to the foreigners and borders agency (SEF) the identity of each and every guest that checks in and out, which may be done online.
- Accounting annually for taxes on income, which since 2017 may in general be optionally treated as either business income or as rental income.

Partly because of the need to comply with all the red tape involved in the operation, the typical average remuneration of the manager is at least one third of the income net of VAT and booking platforms' fees, the overhead costs, namely utilities, maintenance and fixed annual property tax being borne by the owner.

Income Tax

As mentioned, taxes on income derived from short lettings may be optionally treated as either business income or as rental income. The calculation of taxable income and the applicable rates of tax under each option are currently as follows:

- The business profit of a short lettings operation by a Portuguese company, or by a partnership whose general partner is a Portuguese company, is taxed at 21% (but only 17% on the first €15,000 slice), such profit being calculated as:
    - 35% of sales under the simplified regime, which may be chosen where annual sales or assets do not exceed, respectively, €200,000 or €500,000 (an effective rate of 7.35%[1] on sales); or
    - The net taxable profit calculated under the rules of the general accounting regime, in which case the tax-deductible expenses borne by an owner-manager business include an annual depreciation calculated at 5% of the Tax Office valuation of the property, and at various rates, between 12,5% (furniture) and 33.33% (china and glassware), of the cost of furniture and equipment.
- The distribution of profits by a resident company to a non-resident shareholder, or by a general partnership to a non-resident limited partner (which is taxwise generally treated as a dividend distribution), is taxed at source at:

[1] This is a substantial increase from the effective rate that applied prior to 2017, which was 21% of 4% on sales, so an effective rate of 0.84% on sales.

- 28% in the absence of an applicable double taxation agreement (DTA); or
  - 15% under the less favourable DTAs; or
  - 10% under the more favourable DTAs; or
  - 0% under the EU Parent-Subsidiary Directive if the shareholder is a qualifying EU parent company.
- The distribution of profits to headquarters by the Portuguese branch of a foreign company is not subject to tax.
- Where the income of a short lettings operation is treated as the business income of a non-resident owner-operator (who must in this case register as a sole trader with the Portuguese tax office), then such income is taxed at a final rate of 25% of the gross income and social security contributions will apply unless the owner-operator already makes such contributions elsewhere.
- Where the profit of a short lettings operation is treated as rental income (an option that came into force in 2017), this is taxed at 28% in the hands of a non-resident property owner, such profit being calculated as sales less strictly direct costs, including annual property municipal tax (IMI), but excluding finance costs.

General Partnership

Under a general partnership agreement (*contrato de associação em participação* in Portuguese), the property owner (limited partner) contributes the right to the use of the property to the partnership and the manager (general partner) is in charge of the whole short-lettings operation, typically as part of a wider specialist operation. At the end of each financial year, the manager calculates the profit that was generated by the property's short lets and divides the after-tax profit between the two partners in the proportion provided for under the agreement. Under Portuguese tax law, this distribution to the limited partner is treated as "capital income" and under most double taxation agreements (DTAs) it is included in the definition of "dividend". In most cases there will in practice be "interim dividends" distributed at regular intervals throughout the year.

In case the owner is a resident of a country that has a DTA with Portugal and provided a certificate of tax residence is obtained to this effect, the general partner will withhold Portuguese tax at the DTA rate (typically between 10% and 15%) upon distributing the "dividend" to the limited partner. Such tax is final in Portugal and, as such, the property owner does not have to file a Portuguese annual tax return (which he would in the event he received rental income).

Obviously, the following factors will greatly influence the level of the overall tax burden of the owner/limited partner under this arrangement: (a) the expenses borne by the partnership; (b) the level of corporation tax payable by the general partner; and (c) the rate of withholding income tax borne by the limited partner.

(a) Expenses

Since the limited partner may not tax-deduct any expenses or the VAT thereon, the more expenses are borne by the partnership, the higher the net yield available to him.

(b) Corporation Tax

The level of corporation tax payable by the general partner on the partnership's profits (the first layer of tax) depends on his general operation and has nothing to do with the partnership itself.

Since this will have a direct impact on the limited partner's yield, it is recommended that the level of corporation tax allocated to the partnership be contractually limited to, say, 7.35% of the partnership's sales, which is the applicable rate under the simplified accounting regime. The implication in case the general partner is subject to the general accounting regime is that, in the event the corporation tax exceeds 7.35% of sales, then he will have to bear the difference. However, if the level of corporation tax does not reach this threshold, then both partners may benefit.

(c) Withholding Tax

As mentioned, the applicable income tax rate that the general partner must withhold from the "dividend" distributed to the limited partner will be 28% in the absence of a DTA (or, possibly, in the event the DTA does not equate the distributed profit to a dividend), or in that of a certificate of tax residence proving the entitlement of the limited partner to benefit from a DTA. Otherwise, depending on the specific DTA (there are 79 of them), the maximum rate will be either 10% or 15%.

Rental Agreement

Another possibility will be for the owner to let the property to the short-lettings operator, under an agreement that allows the latter to sub-let it short term and pay a monthly rent comprising a fixed and a variable amount, the latter being calculated as a percentage of the operation's turnover.

The tenancy agreement must be registered with the Tax Authority, there being 10% Stamp Duty payable by the landlord on the first month's fixed rent. The non-resident landlord must then issue the rent receipts online through the tax office portal.

In the event the tenant is a business (which is usually the case), under this option the gross rent is subject to withholding income tax at 25% and the landlord has to submit an annual income tax return, in conformity with which his final tax bill, calculated at the rate of 28% on the net rental income, will then be calculated and settled, either by an additional tax payment or by a refund from the Tax Authority. The calculation of the taxable net income takes into account all the ex-VAT expenses the landlord had in connection with the property, including municipal taxes and rates, but excluding finance costs, provided the expenses are documented by invoices containing his Portuguese taxpayer id number (*NIF*).

Management Agreement with the Non-Resident Owner

Sometimes the short lets operation is undertaken in the name of the property owner, who has in this case to register with the tax office and the municipality as a self-employed sole trader, to whom the manager provides management services under a management services agreement and possibly a power of attorney.

This solution is generally the most unfavourable to the property owner and should be avoided, given the following disadvantages:

- Even if the manager handles all the legally mandatory requirements on behalf of the owner, the responsibility for non-compliance or incorrect compliance rests with the owner, who only afterwards will have the right to recur to a court of law to exercise his rights of recourse against the manager for breach of contract.
- The management service does not usually include the handling of the accounts and tax returns, which means an accountant's fees will add up to the costs borne by the owner.

- In his self-employed capacity, unless he already contributes to a recognised social security system in another country, the owner will be liable to monthly social security contributions in Portugal starting in the second year of activity. The amount of the contribution depends on the previous year gross income, on the basis of 70% of which the contribution bracket is calculated. For example, if such income was €30,000, the monthly contribution will be €585.64 (for details on how to calculate the contribution, please check the section Social Security / Self-employment on belionpartners.com/taxation-of-individual-income).

The applicable rate of income tax is 25% of the gross annual income.

Management Agreement with a Resident Corporate Owner

Another possible arrangement is for the non-resident owner to purchase the property through a corporate vehicle. This can be either a Portuguese company or a Portuguese branch of a foreign company. Both pay the same level of corporation tax, the only significant difference lying in the Portuguese taxation of profits' distribution (if made, since the owner may decide to accumulate profits as a reserve for future investments). In the case of a Portuguese company, outgoing dividends are taxed at either 28% or at the applicable DTA rate (10% or 15%, depending on the DTA); in that of a branch, the profit may be transferred to headquarters free of any additional tax.

Although the branch is a more tax-efficient option, there may be reasons for choosing a company. For example, in the event the property purchase is a Golden Visa qualifying investment, a Portuguese single-member private limited company is probably the only practical alternative to direct ownership by the Golden Visa applicant (there is theoretically the possibility of using the branch of a non-Portuguese EU single-member private limited company, but this remains to be tested in practice).

In the case of corporate ownership, the arrangement with the short lets manager can consist of the latter's appointment as company director or branch manager, depending on the chosen option. If the manager already contributes to Social Security, then there will be no associated social security costs.

This option eliminates two of the big disadvantages of carrying out the short lets operation in the name of the sole trader property owner: the responsibility for complying with the legal requirements rests with the company and ultimately with the manager (if appointed company director or branch manager) and the social security costs are eliminated (but there remains the accountant's cost).

The applicable rate of corporate income tax is 21% (17% on the first €15,000 slice of profit) and, provided gross annual sales do not exceed €200,000 and total assets do not exceed €500,000, the business may opt to be taxed under the simplified accounting regime, which results in an effective rate of tax of 7.35% on sales (5.95% on the first slice of €42,857 of sales).

Under the general accounting regime, the net taxable profit may be decreased by the notional annual depreciation of the property and its equipment, calculated at 5% of the Tax Office valuation of the property and at various rates, between 12,5% (furniture) and 33.33% (china and glassware), of the cost of furniture and other equipment.

Comparing the Options

The following table compares the different options side by side:

COMPARISON OF SHORT LETS MANAGEMEMT OPTIONS

<table>
<tr><th>OPTION =></th><th>PARTNERSHIP</th><th>RENTAL</th><th>SOLE TRADER</th><th>CORPORATE</th></tr>
<tr><td>Main advantages</td><td>Simplicity of the arrangement and possible tax efficiency</td><td>Simplicity of the arrangement.</td><td>High level of operation control by the property owner</td><td>Operation control by owner. More tax-efficient and less liability-prone than sole trader solution</td></tr>
<tr><td>Main disadvantages</td><td>Tax efficiency depends on the rates applicable to the profit and then its distribution</td><td>Tax efficient only if compared to the highest levels of taxation under the partnership arrangement</td><td>Owner must register as a sole trader and assumes responsibility for complying with legal requirements</td><td>Costs associated with running a company. Manager may refuse to assume company / branch management responsibility</td></tr>
<tr><td>Specific costs</td><td>None</td><td>Issue of rent receipts and preparation of the annual tax return</td><td>Accountancy fees and possible social security contributions</td><td>Business compliance, including accountancy</td></tr>
<tr><td>Tax-deduction of expenses</td><td>May be all deducted by general partner, except annual municipal taxes on the property</td><td>Property-specific expenses may be deducted, except VAT, banking charges and finance costs</td><td>No acceptable deductions apply</td><td>All deductible, including depreciation, under the general regime; but not deductible under the simplified regime</td></tr>
<tr><td>Taxation of operation’s profit</td><td>May be limited to 7.35% of sales</td><td rowspan="2">28% of the net rent (gross rent less allowable expenses)</td><td rowspan="2">25% of the gross income (no tax-deductible expenses)</td><td>Either 7.35% of sales (simplified regime), or 17% on first €15k of profit and 21% on the remainder</td></tr>
<tr><td>Taxation of profit distribution to owner</td><td>10% or 15% under a DTA, or 28% in the absence of one</td><td>0% if the case of a branch or retained profits. Otherwise 10% or 15% under a DTA, or 28% in the absence of one.</td></tr>
<tr><td>Total tax burden on annual sales of €30k and a profit (or net rent) of €20k</td><td>From €1,470 + €1,853 = €3,323 (€16,61%) on the limited partner’s profit share</td><td>€5,600 (28%) on the net rent</td><td>€7,500 (25%) on the gross income; plus a possible social security contribution of €5,270</td><td>Either €2,205 (7.35% on sales or 11% on profit), or €2,550 + €1,050 = €3,600 (18% on profit)</td></tr>
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Conclusion

In conclusion, there is no clear winner among the four possible arrangements and the choice must take into account not only the particular circumstances of the property owner, but also those of his chosen manager.

In any case, from a taxation viewpoint:

1. Where the property short-term letting is expected to provide a sufficiently high yield to cover business compliance costs, the option of the Portuguese branch of a tax-efficient foreign company may be the best choice.
2. The general partnership arrangement may be a good choice, especially where a favourable DTA applies and the general partner is either subject to the simplified regime of accounting or accepts that the level of corporation tax allocated to the partnership be contractually limited to, say, 7.35% of the partnership's sales.
3. Depending on the level of tax-deductible expenses, to have the income treated as rental income may be more tax-efficient than the general partnership option, especially where the general partner is subject to the general accounting regime and does not accept that the level of corporation tax allocated to the partnership be contractually limited to, say, 7.35% of the partnership's sales.
4. The sole trader option is generally the worst possible arrangement from a taxation viewpoint, besides being an option that may pose non-compliance liability risks.

This is of course just a superficial analysis and it is recommended that specialist advice be taken by a Portugal property owner before deciding to rent it short term.