THE PORTUGUESE BUDGET - SWAPPING VIRTUAL TAXES FOR REAL MARKET NEEDS

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The recent Portuguese State Budget for 2009 has reversed the controversial introduction in 2007 of new taxation aimed at swap transactions. The result, say Pedro Cardigos and Sofia Caetano of Cardigos & Associados, is a return to a more pragmatic appraisal of swap schemes and of double taxation treaties.

La introducción de nuevos tratamientos fiscales para las transacciones de intercambio en el presupuesto de 2008 portugués ha provocado la aplicación irregular de los impuestos, donde acuerdos preexistentes de doble imposición ya eran vigentes, comentan Pedro Cardigos y Sofia Caetano, de Cardigos e Associados. Después de mucho debate y mucha presión por parte de la industria, esto ha sido modificado en los presupuestos de 2009. El resultado es el retorno a un enfoque más pragmático de evaluación de los planes de intercambio y de los tratados de doble imposición.

In January 2008 Portugal's Budget Law introduced a new taxation of income deriving from a wide range of swap transactions by amending Section 5 of the Personal Income Tax Code (CIRS), explains Pedro Cardigos, partner at Cardigos. "In short, the amendment imposed a tax withholding duty on local non-financial counterparties. Notably when swap transactions were entered into with a non-resident financial counterparty in situations where such withholding did not already apply."

Since the introduction of the reform in January 2008, the Portuguese Government had therefore been able to tax swap income even when earned by residents in countries which have entered into a Double Taxation Agreement (DTA) with Portugal.

"As anticipated at its anouncement, this change ended up having a negative impact on derivative transactions, affecting the major domestic and international derivatives market players – including financial institutions, local companies, investors, state-owned enterprises, municipalities and the autonomous regions," says Sofia Caetano, also of Cardigos. "With little, if any, tax revenue increase to show in return."

As a result several international and domestic derivative market players, including the International Swaps and Derivatives Association (ISDA), took firm stands against the change. They argued that apart from the technical flaw of swap income re-characterisation as "interest income" the move was also completely against the international markets trend, says Pedro Cardigos. "If that was correct, then the issue became increasingly more obvious as the financial markets crises evolved and credit lines became scarcer and more selective."

Such lobbying efforts were well received by Portugal's then newly appointed Secretary of State for Tax Affairs, Carlos Lobo, he says. "After a face-to-face meeting with us and market representatives Lobos proved sensitive to the arguments, which were followed up with a report indicating the level of inconvenience, damages and claims against the contractual 'gross-up' resulting from the new withholding tax on swap revenues."

But even in the face of such arguments, the Proposals set out within the 2009 Budget presented to Parliament in October – although positive in presenting an extension of the existing withholding tax exemption on swap transactions between non-resident and domestic financial institutions to income arising from currency forward transactions – did not however abolish the contentious section introduced by the previous Budget, says Sofia Caetano.

"Despite this last-minute 'suspense' and to the final satisfaction of the banks, institutional clients and other derivatives players that maintained their lobbying efforts to the end, notably the ISDA, when the Budget Proposal was finally presented article-by-article in the voting stage, the Members of Parliment supporting the government approved the removal of the contentious section of the CIRS as part of the final version of the 2009 Budget Law."

The outcome is that gains deriving from relevant swap transactions will cease to be assimilated to interest income for all due purposes and, as income on capital, will recover the tax treatment they had prior to the 2008 Budget Law change.

In cases where a DTA applies, a swap transaction gain will be considered "Business Profits" or "Other Income", depending on each specific case. Consequently, clauses 7 or 21 of the "DTA" shall apply, meaning that in some cases the swap payments will only be taxable in the state of residence, no withholding tax whatsoever being levied in Portugal.

Having previously highlighted the potential "frustration" that the original amendment would likely bring to the Portuguese derivative market, its undoing is therefore a positive development, believes Pedro Cardigos.

"More than ever, market standard tax treatment on income from swaps entered with Portuguese non-financial counterparties is not only a significant tax amendment, but a change that will have relevant positive effects on the derivative markets in Portugal," he says. "It will help enhance the willingness of the most relevant international derivative players to assist local Portuguese players to more efficiently manage and hedge their risks, in an ever less certain market environment."