

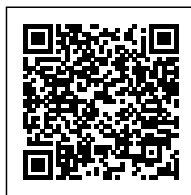
# THE PORTUGUESE STATE BUDGET - A SWAP FOR TAX REVENUES?

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How the Portuguese derivatives market will react to the new amendments introduced by the 2008 State Budget Law (Law 67-A/2007, of December 31) – the 'Budget law' – is an issue that we believe will keep banks, Portuguese swap counterparties and lawyers busy for some time.

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sobre el impacto de las enmiendas relacionadas con operaciones del mercado de derivados que han sido introducidas por el nuevo presupuesto luso.

Hasta ahora, una entidad financiera (EF) portuguesa que acordara una operación swap con una entidad no financiera tenía la obligación de realizar la retención fiscal sobre las ganancias derivadas de la parte contratante mencionada. No obstante, existía una estructura alternativa que utilizaba una EF no residente, en la que no era necesario imponer dicha retención.

A consecuencia de las enmiendas esta posibilidad ya no es factible. Los autores se preguntan si el resultado impactará sobre las EFs lusas que operan en el ámbito del hedging internacional.

The Budget law has introduced substantial amendments to the taxation of currency swaps, interest rate and currency swaps, and foreign exchange swaps ('swap transactions' ), by assimilating the gains deriving from them to interest income. Prior to this statutory change, these gains were simply deemed income on capital.

Previously, a Portuguese financial institution ('FI' ) entering into swap transactions with Portuguese counterparties (which were not a FI) would be required to withhold tax on gains payable to such party. The typical

alternative structure was to enter into such swap transactions with a nonresident FI, in which case gains payable to such a counterparty by a Portuguese resident would not be subject to withholding tax in Portugal by virtue of the application of any of the Double Taxation Agreements ('DTAs' ) to which Portugal is a party.

By statutorily changing the swap transaction gains characterisation, the Portuguese State's purpose is to increase tax revenues by having these gains subject to withholding tax in Portugal. This is done by maintaining the existing withholding situations, but also extending it to cases where the relevant beneficiary is not only a non-resident FI but also a resident in countries with which Portugal has entered into a DTA.

In fact, as of January 1, 2008, gains by a non-resident FI deriving from a swap transaction entered into with a Portuguese entity are now subject to withholding tax at the applicable rate of 20%, whenever the debtor is subject to corporate income tax (and/or must maintain an organised accounting system).

Moreover, in cases where a DTA applies and depending on the definition of 'interest' , a swap transaction gain, being locally assimilated to income interest, will no longer be exempt but merely subject to a reduced withholding tax rate (varying between 10% and 15%).

Although at reduced rates, it is likely that a relevant tax event will be triggered by the Portuguese affected party in their derivative contractual documentation, since the consequent gross-up obligations will tend to implode the economics of the affected swap transactions.

The Portuguese State's revenue aims for this tax change are however likely – as usual – to bounce as a result of the alternatives the Portuguese financial legal market has already identified to

circumvent it.

Nonetheless the ultimate question to be asked is: will these new alternative structures leave Portuguese institutional counterparties of swap transactions in a better (or at least a similar) position compared to where they were before the change in the law?

The question is likely to be answered pessimistically, which raises concerns over the 'light hearted' manner in which the changes were introduced, since they miss completely the target of increasing tax revenue, while affecting the capacity of Portuguese institutional companies to operate on an equal level in the international hedging arena.

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