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His Excellency Mr. Carlos Lobo
Portuguese Secretary of State for Tax Affairs,
Avenida Infante D. Henrique, number 1, 1149-009, Lisbon,
Portugal

24 June 2008

Representations of the International Swaps and Derivatives Association ("ISDA") on Law 67 – A/2007

His Excellency,

The International Swaps and Derivatives Association ("ISDA") is writing with regards to the 2008 State Budget Law, approved by the Law number 67 – A / 2007 of December 31.

ISDA represents participants in the privately negotiated derivatives industry and was chartered in 1985, and today has over 825 member institutions from 56 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities.

The above statute and the additional provision to article 5 of the Portuguese Individual Income Tax Code (CIRS), which is also applicable to companies and other corporate entities, treats all gains obtained from FX swaps, interest rate swaps, currency swaps and forward FX transactions as "interest income" to all effects, including for the application of the Double Taxation Agreement (hereinafter referred as "DTA"). Prior to this statutory change, these gains were simply deemed income on capital (individual income tax – category E).

The underlying purpose of this change, was to subject such gains to tax, using deductions at source (withholding), when the beneficiary is domiciled in a country with which Portugal has a convention aimed at the avoidance of double taxation. Prior to the change, such gains (which are now regarded as interests) were considered as contractual payments and article 21 of the DTA (other income) applied, which meant that in some cases the payment was only taxable in the State of residence, i.e. no withholding tax was imposed in the State of source.

These changes are already having an impact on crucial domestic and international derivatives market participants such as financial institutions, local companies, investors, State-Owned enterprises (known as EPEs), Municipalities and the Autonomous Regions of Madeira and Azores. As of January 1 2008, gains of a non-resident financial institution 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. Furthermore, in cases where a DTA applies and depending on the definition of “interest”, a swap transaction gain, being locally assimilated to income interest, may be subject to a reduced withholding tax rate (varying between 10% - 15%) when previously they were tax exempt in the State of source. This can result in a triggering of a tax event for the affected party, whereby under the standard wording of the ISDA Master Agreement, Section 5(b)(ii), termination rights based on a tax event may be invoked.

These changes are likely to have a negative effect on the OTC derivatives markets in Portugal as many financial institutions consider the new provisions and ways in which to reduce the impact on their business. OTC derivatives play an important role in helping both large international companies and smaller domestic firms manage their risks effectively. Any changes in the tax treatment of derivatives in any one jurisdiction should be considered in the broader international context of the financial markets and the global nature of many of the market’s participants. We hope that this statement together with other representations by our member firms will help to facilitate the process of a thorough review of the tax changes and the likely negative effects on the derivatives markets and financial institutions concerned.

If you have any questions on the content of this letter please contact Antonio Corbi at ISDA in London +44(0)203 088 3550.

Yours sincerely,

Ed Duncan
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