

Tax Treatment of Financial Derivatives

Although the Russian market for financial derivatives is in the early stages of development, the Russian business community has proposed changes to the civil law under which judicial protection will be granted to certain types of derivatives. In addition, special provisions regarding the taxation of derivatives have been introduced in the Tax Code.

1. Introduction

Although the Russian market for financial derivatives is in the early stages of development, derivatives are quickly becoming a hot topic. Russian companies and foreign businesses with Russian operations are increasingly expressing an interest in both the international and local derivatives markets. This follows from increased borrowing by Russian companies through foreign debt capital markets, as well as an increasing focus on the use of derivatives as a risk management technique by Russian exporters and importers.

Some might say that the topic of financial derivatives is a sensitive one due to certain historical events that significantly slowed down the development of the market. The development of the derivatives market in Russia began back in mid-1990s when foreign banks started investing in government bonds which were denominated in roubles. In order to hedge the rouble against foreign currencies, foreign banks concluded derivatives contracts with Russian banks. Most of these derivatives were rouble/US dollar forwards.

In 1998, the rouble dramatically dropped against foreign currencies, and a number of Russian banks found themselves in a significant loss position due to the rouble/US dollar derivatives. A number of these banks challenged the validity of the derivatives contracts and sought relief before the Russian courts. Russian courts came up with the position that financial derivatives are, in effect, gambling. The resulting judicial interpretations and effect thereof on the enforcement of the contracts slowed down the Russian derivatives market for a number of years.

As a result, in practice there is generally a preference on the part of foreign counterparties to conclude Russian derivatives contracts with non-Russian subsidiaries or related entities of the Russian group outside of Russia, using foreign law to govern the contracts. However, Russian counterparties are increasingly requiring more flexibility in terms of where derivative contracts may be concluded. As a result, the Russian business community has proposed changes to the civil law under which judicial protection will be granted to certain types of derivatives.

This article will discuss proposed changes in the law. Nevertheless, as yet the problem of judicial protection of derivatives has not been resolved.

2. General Legal Framework Applicable to Taxation of Financial Income

2.1. Derivatives under civil law

The Civil Code of the Russian Federation (Civil Code) does not contain any definition of derivatives, nor direct provisions expressly regulating such agreements. As a result, under civil law, derivatives are not treated as securities.

The conclusion of derivatives and the performance of obligations thereunder should be carried out in accordance with the general rules for conclusion of contracts, and various legal provisions of the Civil Code may apply, depending on the specific character of the given transaction.

Therefore, due to the absence of direct legal regulation of derivatives, it is a complicated matter to determine the legal nature of some financial instruments. In particular, the legal nature of non-deliverable derivatives is a complex issue. As mentioned above, the respective transactions have been treated by the courts as gambling and, therefore, may not be enforced under Art. 1062 of the Civil Code.

The tendency of courts to dismiss such claims still exists because the courts generally continue to view them as gambling transactions. Therefore, due to the lack of a precise legal definition of non-deliverable derivatives, there is a high risk that the courts will refuse to consider claims relating to the performance of obligations thereunder.

2.2. Derivatives under tax law

Before 2002, there were no special rules on the taxation of derivatives, such that general principles could be applied in determining the tax treatment of derivatives transactions.

In 2002, special provisions regarding the taxation of derivatives were introduced in the Tax Code. The Tax Code defines the term "derivative" as an agreement which defines rights and obligations of the counterparties in respect of the basic asset. Such agreements include futures, options, forwards and non-deliverable instruments that provide for settlements between counterparties, depending on changes in the price of the basic asset.

* PricewaterhouseCoopers Russia, Moscow.

The Tax Code contains a non-exclusive list of basic assets, including foreign currency, securities, property and property rights, interest and indices.

As the definition of “derivative” under the Tax Code is broad, many transactions may be classified as derivatives for profits tax purposes. In some cases, taxpayers may choose to treat qualifying deliverable derivatives as either “derivatives” or as purchase-sale transactions with deferred delivery/payment. Criteria for the classification of contracts should be established in tax accounting policy. The above rules give flexibility to taxpayers.

Transactions classified as sale-purchase transactions with deferred delivery/payment are taxed as ordinary transactions under the general rules applicable to sale-purchase transactions, rather than as financial derivatives.

A taxpayer may conclude forward transactions for the purpose of compensation of potential losses, i.e. hedging. The Tax Code provides for special treatment of such hedging transactions, subject to certain criteria and requirements, described in more detail below.

The Tax Code describes how derivatives may be settled and distinguishes the following means of settlement: delivery of the basic asset; settlement/clearing of mutual claims and liabilities; and conclusion of a reverse transaction. This classification is important because tax law contains special rules for certain type of derivatives concluded by the banks which are settled by delivery of the basic asset. These rules will be described in more detail below.

The Tax Code also provides for classification as quoted and non-quoted derivatives. Quoted derivatives are those which satisfy the following conditions:

- the procedure for the conclusion, assignment and execution of the financial derivatives is established by Russian or foreign exchanges; and
- information about the prices of financial derivatives is published in mass media or can be provided by the exchange for three years after the transaction date.

Tax law does not contain any requirements for volume/liquidity of trading in derivatives on the exchange.

Derivatives that do not satisfy the above conditions are classified as non-quoted. In Russia, most derivatives which are concluded by Russian banks and companies fall into this category. However, the business community and authorities actively promote new derivatives that have recently been launched on the stock exchanges. Trade volumes on such derivatives are comparatively small but are growing rapidly.

In practise, to date there has been little experience regarding the application by the tax authorities of the above rules. The tax authorities have some experience reviewing currency derivatives concluded by Russian banks, but such derivatives are subject to special tax treatment. Apart from the above, the tax authorities have

very limited experience and knowledge about the derivatives market.

2.3. General comments on taxation of financial income

Generally, for corporate taxpayers, tax law does not distinguish financial income from any other types of income, with the following exceptions:

- dividends which are taxed at a lower rate compared to other types of income. The general profits tax rate is 24%, while the profits tax rate for dividends from Russian companies is 9%); and
- interest on state and municipal bonds may also be taxed at a reduced rate of 15%. In addition, interest income from certain issues of state and municipal securities could be exempt from tax.

There is no special tax treatment of capital gains. Capital gains are taxed at a general profits tax rate of 24%. Interestingly, some time ago the profits tax rate for the banking and insurance sectors was higher than for industrial companies. Perhaps one of the reasons behind this approach was that the financial sector provides “intermediary” services (i.e. does not produce “real” goods). However, this approach was ultimately abolished, such that the financial sector now is generally taxed at the same rate as other sectors of economy.

3. Tax Treatment of Financial Derivatives

3.1. Tax accounting

Profits tax law introduced a system of tax accounting, i.e. profits tax is calculated on the basis of tax accounting records, which are separate from accounting records. In addition, taxpayers must maintain special tax accounting ledgers for derivatives transactions. These ledgers should separate information on (1) derivatives that provide for a purchase-sale of the basic asset and (2) derivatives that provide for execution by way of settlement of mutual obligations or by means of concluding of a reverse transaction. Additionally, the tax accounting ledgers should account separately for quoted and non-quoted derivatives, as well as derivatives concluded for hedging purposes.

3.2. Corporate profits tax

3.2.1. General comments

Income and expenses for tax purposes are determined similarly for various types of financial derivatives. The tax treatment of the net result calculated under the Tax Code depends on the classification of a given financial derivative, for example depending on whether the transaction:

- is classified as a derivative by the taxpayer or as a sale-purchase transaction with deferred execution;
- fulfils criteria established for treatment as a hedging transaction; or
- is quoted or not.

3.2.2. *Transactions not classified as derivatives by the taxpayer, but instead as transactions with deferred execution*

Only deliverable transactions may be included in the category of transactions with deferred execution. It is vital that a taxpayer have clearly established criteria in its tax policy to separate these derivatives transactions for tax purposes. Income or loss incurred on such transactions (which are not classified as derivatives by the taxpayer) are taxed in the same way as ordinary sale or purchase transactions in the underlying asset. Term transactions that are not classified as derivatives in accordance with the taxpayer's tax policy *are not subject to revaluation* at the end of each tax/reporting period, unless the underlying asset is subject to revaluation (e.g. foreign currency transactions).

If the above rule did not exist, all transactions with deferred execution would have been classified as derivatives for profits tax purposes. This rule allows the taxpayer to defer taxation of the result under transactions with deferred execution until the moment when title in the goods passes.

At the same time, such transactions could be challenged by the tax authorities on the basis of transfer pricing rules. In cases where the deferral is significant and at the moment of execution the price of the basic asset has increased significantly, the tax authorities may try to impose additional tax under Art. 40 of the Tax Code and calculate "deemed" profit for profits tax purposes on the basis of the new (increased) price.

Although not explicitly provided in the Tax Code, there is room for the tax authorities to challenge the classification of certain deliverable derivatives transactions as transactions with deferred execution. In this regard, there have been some unofficial clarifications from the tax authorities. For example classification of an option as a transaction with deferred execution could be challenged if one counterparty has the right and the other has an obligation to execute the deal.

3.2.3. *Transactions classified as derivatives*

The following gains are generally included in the calculation of *net (taxable) income* from a given derivative:

- positive variation margin calculated over the tax (reporting) period for quoted derivatives;
- amounts receivable by the taxpayer as a result of execution of derivatives during the tax (reporting) period, or calculated as a result of positive revaluation of the underlying asset for unquoted derivatives; and
- any other amounts receivable by taxpayer in relation to derivatives over the tax (reporting) period.

The following *losses* and *expenses* generally are taken into account in calculating the net result on a given derivative:

- negative variation margin over the tax (reporting) period for quoted derivatives;

- amounts payable by the taxpayer as a result of execution of a term transaction during the tax (reporting) period, or calculated as a result of negative revaluation of the underlying asset for unquoted derivatives; and
- other expenses incurred in relation to derivatives.

As the Tax Code does not explicitly describe how revaluations should be calculated, there are varying views on how different types of financial derivatives should be revalued. For example there are many uncertainties surrounding the revaluation of options, including how options should be revalued and whether options must be revalued at all if an option is out of the money.

One may have observed that the wording above describing the revaluation of quoted and unquoted derivatives is different. For quoted derivatives, the Tax Code addresses the variation margin, i.e. the Tax Code effectively refers to the rules established by the exchange where the derivatives are quoted. However, for unquoted derivatives, the Tax Code explicitly mentions revaluation. To be precise, the Tax Code refers to "the amounts calculated depending on the changes in price or any other quantifiable element which characterizes the basic asset".

With regard to non-quoted derivatives, it is unclear how to identify the above "changes" in price of the basic asset, i.e. how to calculate the market price of the non-quoted derivative if there is no official source of information about the market price of the basic asset.

The net result on a given derivative, calculated as the difference between income and expenses as described above, may or may not increase/decrease the general taxable base of the taxpayer, depending on the classification of the derivative.

The net result on *quoted derivatives* is included in the "general" tax base of the taxpayer, i.e. gains and losses on such transactions are netted against gains and losses incurred on other transactions (except transactions that are subject to specific tax treatment, e.g. transactions in securities). As mentioned above, currently there are very few quoted derivatives on the Russian market. However, exchanges are launching new derivatives contracts (e.g. for goods such as crude oil and gold, as well as for certain types of securities) and trade volumes on such contracts are rapidly increasing.

A negative net result from *unquoted derivatives* may not be deducted from taxable income from other transactions (except other unquoted derivatives). Thus, in effect, such results are placed into a separate basket, and any overall negative net result on this basket may not be used to offset taxable income in other categories. However, the net loss in this basket may be carried forward for ten years and netted against positive net result in this unquoted derivatives basket in future periods.

A positive net result from unquoted derivatives (decreased by any carried forward losses on unquoted derivatives) may be netted against losses incurred on the

taxpayer's other transactions (except for transactions that are subject to certain limitations, such as transactions in securities).

Derivatives transactions are subject to *transfer pricing* rules established by Art. 305 of the Tax Code. These rules require market comparability of the execution price as follows:

- with regard to quoted derivatives, the execution price should be within the price range registered by a stock exchange on the date when the transaction is concluded; and
- with regard to unquoted derivatives, the execution price should not deviate by more than 20% from the average price of comparable quoted term transactions. In cases when no comparable quoted derivatives are available, the price should not deviate by more than 20% from the estimated price of such term transactions on the date when the transaction is concluded. This estimated price must take into account the specific parameters of the transaction.

Poor development of the Russian derivatives market enhances the risk arising as a result of the lack of guidance on transfer pricing rules applicable to term transactions. In particular, there may be no comparative information available on quoted derivatives with regard to the instrument used by a taxpayer. Additionally, there have been no clarifications from the tax authorities regarding the methods for calculating an estimated price for unquoted derivatives.

3.2.4. *Tax treatment of premium paid/received*

Generally, the premium paid by the holder of a financial derivative will be treated by the tax authorities as a deductible expense, while the premium received by the issuer of the financial derivative will be treated by the tax authorities as taxable income subject to profits tax at the rate of 24%.

The Tax Code does not contain any rules regarding the date when such income/expense should be recognized for tax purposes, and there are differing views on this issue, including:

- on the date of execution of the derivative (or on the date when the taxpayer decided not to execute an option);
- on the date when the derivative is concluded; or
- over the life of the derivative. Depending on the conditions, the premium could be recognized proportionately to the volume of trading of the basic asset over the life of the derivative or equally over the life of the derivative.

In order to be deductible for profits tax purposes, the premium (as with any other expense) must be “economically justified”. This requirement could be interpreted in such a way that transfer pricing requirements should be fulfilled and there should be a valid economic reason for conclusion of the derivative.

If a taxpayer decides not to execute a derivative, the tax authorities may challenge the deductibility of the pre-

mium on the grounds that such expense is not economically justified.

3.2.5. *Tax revaluation of options*

The Tax Code is not clear regarding the revaluation of options, and there are no truly useful clarifications from the tax authorities on this point. As a result, in practise different taxpayers utilize different means of determining the proper revaluation of options for profits tax purposes.

One particular area of uncertainty and potentially challenge relates to the negative revaluation of an option if the price change is opposite to that predicted by the taxpayer (i.e. the price decreases where the taxpayer has bought a call option, or the price increases where the taxpayer has bought a put option, in which case the option is out of the money). Economically, the buyer of an option that is out of the money should not execute the option. Thus, it is questionable whether the negative revaluation of such an option by the buyer would be permissible for tax purposes.

3.2.6. *Tax consequences of closing/exercise of financial derivatives*

Upon execution of a derivative, the taxpayer determines either the amounts due to the taxpayer or the taxpayer's obligations, and calculates the net result taking into account the income and expenses that were accounted for tax purposes before execution. Due to ambiguities in the Tax Code, when an option has been previously revalued for tax purposes, there is a risk of double taxation, for example if the price of the underlying asset has gone up in the previous period and the taxpayer treated the revaluation gain as subject to profits tax. However, at the time of execution of the option, the tax authorities could argue that the underlying asset should be accounted for at the price which was indicated in the option agreement, and thus calculate the gain based on that price (such that profits tax paid on the positive revaluation of the option would not be taken into account when the underlying asset is sold).

In addition, if the taxpayer decides not to execute a derivative, it is unclear whether it is appropriate to “reverse” for profits tax purposes the positive and negative revaluation which was previously taxed. The tax authorities are likely to challenge such reversal if it would otherwise result in a lower tax base.

3.2.7. *Special tax rules for banks*

Tax law allows banks to include losses from non-quoted deliverable currency derivatives in the “general” profits tax base. As such, losses from such transactions may generally offset other categories of income that are not separately segregated. In practise, many banks do not execute derivatives by delivery, but instead settle them by concluding reverse transactions. The Tax Code distinguishes between different types of execution, for example by delivery of an underlying asset or by conclusion of

a reverse transaction on or before the day of execution. Many banks therefore believe that if a reverse transaction for all outstanding derivatives is concluded, such derivatives can be treated as “deliverable” for profits tax purposes.

3.2.8. *Special tax rules for hedging*

Tax law also allows taxpayers to include in the “general” profits tax base those losses from transactions in non-quoted derivatives if such transactions can be classified as hedging. Under the Tax Code, hedging transactions are defined as derivatives performed for purposes of compensation for potential losses which may arise as a result of an unfavourable change in the price of the subject of the hedge. Possible subjects of hedging include assets and liabilities, as well as cash flows connected with such assets or liabilities, or with anticipated transactions.

In order to classify derivatives as hedging transactions, the taxpayer should prepare certain detailed documentation, as stipulated in the Tax Code, confirming the economic justification and hedging nature of such transactions. Particularly, the taxpayer must prepare calculations that demonstrate how these hedging transactions result in a reduction of potential loss (profit deficiency) on transactions in the underlying assets.

Numerous ambiguities in the definition of hedging transactions under the Tax Code increase the risks associated with such transactions. Due to these ambiguities, it is vital that taxpayers prepare adequate supporting documents to substantiate the hedging nature of term transactions. In the absence of proper documentation, general tax rules applicable to derivatives should be followed.

As mentioned above, the Tax Code provides a broad list of possible objects of hedge transactions. Thus, the taxpayer may be quite flexible in its choice of the subject of hedging. In practise, the taxpayer may hedge risks relating to individual transactions (e.g. currency risk on a loan) or risk relating to groups of transactions (e.g. cash flows of a company). Each of these approaches raises a number of issues, including the following:

- Hedging of an individual transaction could be easier in terms of demonstrating the link between the object of the hedge and the hedging transaction. However, it could appear that the overall currency position of the company is neutral (i.e. the company bears little or no aggregate currency risk). In this case, expenses associated with the hedging of individual transactions can be viewed as economically unjustifiable, as the actual overall risk borne by the company is low.
- Hedging of groups of transactions or an overall position of the company allows one to avoid the above potential challenge with regard to the economic justification of individual hedging costs. However, calculations of the overall position of a company with regard to a certain risk (e.g. currency risk) are likely to be more complicated in comparison to the analysis of individual transactions.

Companies that classify derivatives as instruments concluded for hedging purposes should prepare a formal calculation (report) which contains all the information explicitly described in the Tax Code. However, to improve the position and reduce the risk of challenge, it is also advisable to prepare additional supporting documentation describing the company’s approach to risk management and providing economic justification for the conclusion of the derivatives.

3.3. **Withholding tax and income tax treaties**

3.3.1. *Outbound payments under financial derivatives*

The Tax Code lists the types of income subject to withholding tax, but does not explicitly mention income payable under a derivatives contract. As such, a taxpayer may argue that withholding tax should not apply. However, there is a risk that the tax authorities will challenge such an approach.

Generally, income treated as Russian source (payable from Russia) is subject to withholding tax. The Tax Code contains a non-exclusive list of income that is treated as Russian source, and most income described in the list is passive-type income (e.g. income from the sale of real estate, dividends and interest on bonds). However, the list also refers to “other similar types” of income. As such, there is a risk that income on derivatives may be treated by the tax authorities as an “other similar type” of income and that the tax authorities would seek to impose withholding tax at the rate of 20%.

If there is an applicable income tax treaty between Russia and the counterparty’s country of residence, such income might also fall under the “other income” article so as to be generally exempt from withholding tax in Russia. Technically, in order to be relieved of the obligation to withhold tax, the Russian counterparty must make sure that the foreign counterparty has not created a permanent establishment in Russia and must obtain a tax residency certificate confirming that the foreign counterparty is resident for tax purposes in the jurisdiction of the treaty partner.

3.3.2. *Inbound payments under financial derivatives*

Foreign-source income paid to a Russian taxpayer under a financial derivative contract will be subject to general tax implications described above. Foreign taxes paid by Russian taxpayers in connection with such income would be taken into account and may be used to offset Russian tax liability. The amount of such creditable taxes may not exceed the amount of tax that would be paid in Russia on the same income, unless there is an applicable income tax treaty which broadens the limitation.

A credit for foreign taxes paid is permitted if the Russian taxpayer submits to the Russian tax authorities relevant documents confirming payment of such taxes outside Russia.

3.4. Stamp duty and indirect taxation

Generally, derivatives transactions should not be subject to any significant stamp duties.

Additionally, under the Tax Code, financial derivatives transactions are exempt from VAT. However, although not explicitly stated in the tax law, this rule does not apply to deliverable derivatives where the basic asset is a commodity. Generally, sales of commodities are subject to VAT at the rate of 18%. Deliverable derivatives with underlying assets such as securities or foreign currency should not be subject to VAT, due to special exemptions provided by tax law. Accordingly, no VAT should be charged on transactions in non-deliverable derivatives.

On the other hand, derivatives transactions may result in restrictions for recovery of input VAT. Under VAT law, input VAT related to income not subject to VAT is not recoverable, but should be expensed (i.e. such input VAT is a deductible expense for profits tax purposes).

3.5. Tax planning

3.5.1. Comparison of tax treatment of financial derivatives and other instruments

When determining whether to use a “traditional” instrument or a derivative, taxpayers should consider whether there is any benefit to be obtained by placing the transaction under the special derivatives rules discussed above.

Generally, the tax treatment of certain types of instruments such as debt securities, loans and investment fund units is more clear, with less room for interpretation and fewer possible positions to take. If using a derivative, despite the ambiguities discussed above, the taxpayer may obtain a certain flexibility in the approach to the taxation of derivatives under the special rules. On the

other hand, the ambiguities and lack of detailed guidance on the treatment of derivatives often requires that a position be taken, and such positions are often subject to challenge by the tax authorities.

3.5.2. Anti-avoidance legislation

There are no explicit anti-avoidance tax rules, nor any explicit tax law principle of substance over form. However, judicial practice in tax cases is such that the substance-over-form principle and commercial purpose of transactions (i.e. transactions concluded not for tax optimization purposes) are becoming more significant for judges. In addition, the tax authorities are becoming more aggressive in seeking to challenge the tax position of companies that they believe are using tax optimization schemes, even though technically there are no explicit provisions in the Tax Code allowing such challenges. In fact, the authors are aware of court cases that were decided in favour of the tax authorities when the tax authorities challenged the tax position of companies that had no actual substance or challenged transactions undertaken for the primary purpose of minimizing the group's tax burden.

Furthermore, civil law contains general anti-avoidance and substance-over-form provisions, and the tax authorities may seek to apply these as a legal grounds for challenging aggressive tax planning schemes. For example civil law defines “sham transactions” (entered into in order to hide other transactions) and transactions which “contradict the rules of law and morality” as void transactions. The Civil Code also allows stakeholders to void transactions. Thus, despite the lack of specific anti-avoidance and substance-over-form provisions in the Tax Code, the tax authorities may nevertheless seek to reclassify a transaction and/or the status and nature of a taxpayer's activities.

4. Conclusion

Legislation regarding the taxation of derivatives in Russia is relatively new and underdeveloped. A number of aspects and issues remain to be clarified and further developed. Although in the past judicial practice treated derivatives in a negative manner, there is a legislative initiative to cease treating certain types of derivatives as gambling.

Another hurdle is that there is little or no practice regarding the interpretation of tax law on derivatives by the tax authorities or the courts. Taxpayers must pay significant attention to their in-house tax function which reviews the tax treatment of derivatives, and must be well prepared for potential challenges and questions from the tax authorities. This can be facilitated if the taxpayer develops tax policy on derivatives transactions, develops a concise risk management policy, documents the economic justification for the conclusion of the derivatives and develops appropriate tax accounting records.

The authors are aware that there are initiatives underway to introduce changes to the law regarding the tax treatment of derivatives. Issues and provisions under consideration include:

- the introduction of special rules for professional participants in the derivatives market (e.g. banks and licensed investment companies), so as to allow to such taxpayers to deduct losses on non-quoted derivatives against quoted derivatives and their general tax base;
- the introduction of special standards for the conclusion of derivatives (a sort of Russian version of the International Swaps and Derivatives Association rules); and
- the justification of the hedging nature of derivatives similar to hedge accounting rules under IFRS 39.

Implementation of this initiative must be carefully reviewed from the perspective of existing practice in

order to make sure that the new rules do not bring about other negative implications for Russian taxpayers, and that such changes are acceptable to the market at its current stage. For example the introduction of hedge accounting for tax purposes may be a lengthy procedure, and many companies may be ill prepared to adopt such changes.

While this article focuses on many potential difficulties and uncertainties within the current system of derivatives in Russia, the market is continually developing. The authors are fully confident that the law will develop and improve (at least as to clarity) as the market itself develops, and that the participants, regulators and tax authorities will all become more sophisticated over time.

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