

PRACTICAL APPLICATION OF ART. 9 OECD MODEL CONVENTION: THE CZECH REPUBLIC

Veronika Solilová¹

¹Department of Accounting and Taxes, Faculty of Business and Economics, Mendel University in Brno, Zemědělská 1, 613 00 Brno, Czech Republic

Abstract

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All transfer prices determined between the associated enterprises must comply with the arm's length principle. The arm's length principle for associated enterprises is mentioned in Art. 9(1) of the OECD Model Convention, which was also adopted by the OECD Member states into their national law. However, not all OECD Member states adopted the next part of Art. 9, namely Art. 9(2), with the same way, some of them, like the Czech Republic, entered a reservation on Art. 9 (2) OECD Model Convention. In this paper the practical application of Art. 9 is analyzed from the point of view of the Czech Ministry of Finance, where the corresponding adjustment and time-limit issue are highlighted. On the basis of the results of analysis, where the history, context and purpose of Art. 9 OECD Model Convention have to be taken into account, are made some recommendations.

Keywords: transfer pricing, arm's length principle, corresponding adjustment, article 9, OECD Model Tax Convention

INTRODUCTION

Article 9 of the OECD Model Convention includes worldly widely used principle - arm's length principle – the basic transfer pricing rule used in international tax area. Under this principle, related taxpayers, so called associated enterprises, must set transfer prices for any inter-company transaction as if they were unrelated entities and all other aspects of the relationship were unchanged. It means that the conditions of controlled transactions do not differ from the conditions that would be obtained in comparable uncontrolled transactions and thereby transfer prices reflect market forces. However, when transfer prices do not reflect market forces and therefore the arm's length principle, the tax liabilities of the associated enterprises and the tax revenues of the second tax jurisdiction could be distorted. Any such distortions shall be

corrected by a primary adjustment that can be carried out by imputing or reducing of profits/expenses of associated enterprises. Moreover, the article 9 also involves the concept of corresponding adjustment of profits in cases where one tax administration adjusts associated enterprise's taxable profits due to a primary adjustment – applying the arm's length principle to controlled transactions involving an associated enterprise in a second tax jurisdiction. In addition, after a corresponding adjustment the allocation of profits between the two jurisdictions in case of associated enterprises is consistent with the primary adjustment and no double taxation occurs.¹ Thus, Art. 9 of the OECD Model Convention shall prevent economic double taxation² caused by a transfer pricing adjustments and consist of two parts. Art. 9 (1) dealing with primary adjustments, whereas Art. 9 (2) dealing with corresponding adjustments.

1 For more details see paras 4.32 – 4.39 of the OECD Transfer Pricing Guidelines (2010) (hereinafter OECD TPG) and para 11 of the Commentary on Art. 9 of the OECD Model Convention.

2 The treaty protection under Article 9(1) is applied to both actual and virtual double taxation. In contrast, a corresponding adjustment under Article 9(2) is only available in respect of actual double taxation.

The Czech Republic follows the OECD Model Convention, however, in 1997 entered a reservation on Art. 9(2) of the OECD Model Convention, which obtains the right not to insert paragraph 2 in its double tax treaties but to be prepared to accept this paragraph with an addition of a third paragraph which limits the potential corresponding adjustment to *bona fides cases*.

This paper is focused on the practical application of article 9 from the Czech perspective, where the application of corresponding adjustment and time-limit issue are highlighted because not carrying out of corresponding adjustment may result in adverse effect on the company's performance and survival. On the base of results of analysis; where the history, context and purpose of Art. 9 OECD Model Convention were taken into account, are made some recommendations.

The paper presents the results of the research in the project GA CR No. 13-21683S "The quantification of the impact of the introduction of Common Consolidated Corporate Tax Base on the budget revenues in the Czech Republic".

MATERIALS AND METHODS

Within the paper, mainly the method of description will be used, as it is the basic method, which enables the precise identification and description of researched phenomenon. This should help to classify the gained information in order to reach the higher level of structure and transparency of individual information basis. Furthermore, other important method which will be used is comparative analysis method, which enables to reach scientific knowledge by the comparison of individual processes and phenomenon. In addition, the others methods, namely analysis, quantification, induction and deduction should be followed by the method of synthesis, which will be applied in the process of the creation of the partial outcomes about the actual situation of associated entities in the Czech Republic and of the proposal recommendations in compliance with the OECD Model Tax Convention as a final result. The basic sources of the research were OECD Model Conventions, OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (hereinafter OECD TPG) and concluded Czech double tax treaties.

RESULTS AND DISCUSSION

1. Historical Background, Purpose and Context of Art. 9 OECD Model Convention

In the beginning of the last century a lot of jurisdictions considered subsidiaries

as permanent establishment of their parent company for tax purposes. According to this approach, there was no need to have a provision similar to article 9 dealing with allocation of business income between associated enterprises. But it was changed when affiliated companies were excluded from the definition of a permanent establishment in 1928. Due to a lack of a new provision related to the allocation of business income between associated enterprises, they risked being subject to double taxation as mentions (Wintendorf, 2010).

In 1932 was signed the first tax treaty³ that included an allocation norm for business income between associated enterprises in the form of the arm's length principle. Furthermore in 1933 was issued the *Carroll Report* which referred to the arm's length principle as a suitable allocation norm as states (Carroll, 1933). In addition, the arm's length principle was implemented in international taxation law by the League of Nations Draft Convention in 1933. Until the first OECD Model Convention (1963), the classification of article dealing with the arm's length principle was several times changed, but into the first OECD Model Convention was included as Art. 9(1) based on the London Model (1946). What is important to mention there, that the wording of article 9(1) has remained unchanged since that time. However, the provision about corresponding adjustment in cases of associated enterprises was not included there. Corresponding adjustment was only applied to transactional allocation of business income between head office and permanent establishment, no between associated enterprises.

OECD stood before question whether economic double taxation is eliminated by the article 9(1) even the lack of a rule for corresponding adjustment or not. As states (OECD, 1970a) the first answer to the question was a statement that article 9(1) serves a useful tool by which economic double taxation is eliminated, but the second answer after a targeted campaign from the US side as states (OECD, 1970b) was a recommendation to the OECD Committee to add a provision regarding corresponding adjustments in 1970. Consequently, the para 2 – corresponding adjustment – was added to article 9 during the first revision of the OECD Model Convention in 1977 with purpose to avoid economic double taxation.

After two years, in 1979, the OECD published its first transfer pricing report, the *OECD Report on Transfer Pricing and Multinational Enterprises* (hereinafter OECD Report (1979)) which was supplemented and followed by other reports dealing with the complexity of transfer pricing issues. During the period 1992 to 1997 was OECD Report revised. Results of revision were i) entering the reference⁴ to this report in Commentary

³ The arm's length principle was implemented in the U.S-France treaty 1932 for the first time.

⁴ Thus, now is possible to use the OECD TPG and the OECD Report (1979) as a predecessor to OECD TPG, as a means of interpretation of article 9.

on Article 9 of the OECD Model Convention (1992)⁵ and ii) publishing the *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations* laying down more detailed guidelines on the application of the arm's length principle, because article 9 and Commentaries on article 9 do not contain detailed guidance on the arm's length principle. However, like the OECD Commentary, the OECD TPG are not legally binding in international tax law, but they are considered as a means of interpretation as far as they were available when the respective tax treaty was signed, as states (Vienna Convention, Art. 31, 1969). The aim of the OECD TPG is to create an international consensus on a common interpretation of the arm's length principle and its application, as mention (OECD, 1997 and 2010b).

As state (Wintendorf, 2010 and OECD, 1977, 1992 and 2010a) the primary purpose of Art. 9 OECD Model Convention is to prevent economic double taxation caused by a transfer pricing adjustments, where Art. 9(1) is concerned with the taxation of business profits from transactions between associated enterprises which is covered by taxing right of the two residence states pursuant to Article 7(1) and Art. 9(2) is involving the concept of reduction of income in cases where one tax administration made a primary adjustment. However, article 9(1) does not mention any methods how primary adjustment is made; furthermore, does not provide the legal basis for the primary adjustment, because the legal basis and the method of primary adjustment are stated in national tax law. In addition, the primary adjustment is not conditional on the other contracting state agreeing with the adjustment. In respect of (OECD, 2010a and OECD, 2010b)⁶, a corresponding adjustment is not made automatically, but once the contracting state agrees that the primary adjustment is justified both in principle and as regards the amount, then a corresponding adjustment shall be made. Thus other contracting state is not liable to make a corresponding adjustment, if it considers the transaction carried out at arm's length. But in this situation economic double taxation occurs. So, how can a taxpayer eliminate economic double taxation in this case? What must be done for elimination economic double taxation, when, like article 9(1), article 9(2) does not specify the method by which a corresponding adjustment is to be made

or in respect of the worst situation when article 9(2) is not included in the double tax treaty?

In cases of dispute regarding the consistency of profit adjustments and the resulting economic double taxation, article 9(2) suggests to consider corresponding adjustment requests under mutual agreement procedure of Article 25 OECD Model Convention. Moreover as state (OECD, 2010b) it is recommended to initiate a mutual agreement procedure of Article 25 OECD Model Convention to determine corresponding adjustments notwithstanding of inserting of article 9(2) in double tax treaties. This statement is very important to take into account in case of the Czech Republic, which usually does not insert article 9(2) in its double tax treaties.

2. The Practical Application of Art. 9 by the Czech Ministry of Finance

In 1997 the Czech Republic⁷ has entered a reservation on Art. 9(2) OECD Model Convention⁸ which obtains the right not to insert paragraph 2 in the double tax treaties but to be prepared to accept this paragraph with an addition of a third paragraph which limits the potential corresponding adjustment to *bona fide* cases. This reservation was not withdrawn by the Czech Republic during the last revision of the OECD Model Convention in 2010⁹.

Entered reservation on article 9 reflects the Czech tax treaty network as almost 53 per cent of the double tax treaties are without Art. 9(2) OECD Model Convention. Further 32 per cent of the Czech tax treaties contain Art. 9(2) OECD Model Convention and comprise of the third paragraph limiting the potential corresponding adjustment to *bona fide* cases as stated in the reservation to Art. 9(2) OECD Model Convention. Moreover almost 9 per cent of the Czech tax treaties comprise provisions related to time limit in case of a primary or corresponding adjustments. This time limit is mentioned either in Art. 9(3) or in Art. 24 or 25 related to mutual agreement procedure. Only 14 per cent of the Czech double tax treaties are totally in line with Art. 9 OECD Model Convention, however, there are only two Czech double tax treaties of them which were signed after entering the reservation on Art. 9(2) OECD Model Convention in 1997. So it can be considered that Czech tax treaty policy complies with its reservation on Art. 9(2) OECD Model

5 For more details see OECD Commentary 1992, Art 9 MN 3.

6 For more details see OECD Commentary on Art. 9(2), MN 6, 2010a and OECD TPG, MN 4.35, 2010b.

7 For details see Statement of government of the Czech Republic regarding becoming an OECD member 15th November 1995: www.mzv.cz/file/188235/vstupni_prohlaseni_cesky.doc last access 24th July 2012.

8 For more details see OECD Commentary 2003, Art. 9 MN 16. In this year Hungary also entered a reservation to this Art. 9.

9 Nowadays, on the basis of the last revision in 2010 only 5 member states, namely the Czech Republic, Hungary, Germany, Italy and Slovenia, reserve the right not to insert Art. 9 (2) OECD Model Convention. Australia has a general reservation on Art. 9 OECD Model Convention. Furthermore, there is also one observation on Art. 9 OECD Model Convention with regard to thin capitalization made by United States.

Convention, as almost 85 per cent of Czech double tax treaties contain article 9(1) or article 9(1) with other paragraphs (for details see Tab. I. below).

In case of tax dispute regarding the compliance of the arm's length principle and the consistency of profit adjustments is important a conception of article 9 in concluded double tax treaty. In this respect there can be identified four situations. **The first:** If a double tax treaty contains article 9(2) and economic double taxation is incurred due to a primary adjustment made by other contracting state, a taxpayer shall fill in his additional tax return and return it to the Czech tax authority. Subsequently, the Czech tax authority decides whether agrees that the primary adjustment made by other contracting state is justified both in principle and as regards the amount. Once the Czech tax authority agrees with a primary adjustment, then the Czech tax authority also indicates that the arm's length principle was not followed from the Czech

side and therefore **there is obligation to make a corresponding adjustment**. By inserting Art. 9(1) OECD Model Convention in the double tax treaty, the contracting states committed to follow the arm's length principle and thus to avoid economic double taxation. When the Czech tax authority does not make a corresponding adjustment, a taxpayer can open a mutual agreement procedure set up under Art. 25 OECD Model Convention.

The second: If a double tax treaty also contains article 9(1), 9(2) and 9(3) limiting the potential corresponding adjustment to *bona fide cases*. If the Czech tax authority agrees with a primary adjustment, but the case cannot be considered as a *bona fide case*, then **there is no obligation to make a corresponding adjustment**.

The third: If a double tax treaty does not contain article 9(2) and only includes article 9(1) regarding a primary adjustment, accordingly to the Czech Ministry of Finance there is no obligation to make

I: Czech double tax treaties¹⁰

Concluded double tax treaties	Article 9 – Associated enterprises	Note	Portion (%)
Belgium, Belarus, Brazil, Bulgaria, Egypt , Estonia, Philippines , France, India, Indonesia, Iceland, Japan, Jordan, Republic of Korea, Lithuania, Latvia, Hungary, Macedonia, Malaysia, Mexico, Moldova, Netherlands, Poland, Austria, Russia, Greece, United Arab Emirates, Singapore, Serbia and Montenegro, Sri Lanka, Sweden, Tajikistan, Ukraine, Great Britain, Venezuela, Vietnam, Armenia, Italy, Cyprus, Bahrain	Only Art. 9(1)	Double tax treaties with Egypt and Philippines contain time limit provisions in case of a primary adjustment in Art. 24 or 25 related to Mutual Agreement procedure. This time limit is not mentioned in Art. 9.	53% of double tax treaties with Art. 9(1)
Denmark, Ireland, JAR, KLDR , Luxemburg, Germany, Nigeria, Norway , Portugal, Romania, Tunisia	Art. 9(1) and 9(2)	Double tax treaties fully in line with Art. 9 OECD Model Convention, including primary and corresponding adjustments. Double tax treaties with KLDR and Norway were signed after entering the reservation on Art. 9 OECD Model Convention.	14% of double tax treaties in line with Art. 9 OECD Model Convention
Spain, Malta, Canada, Finland, Switzerland , Albania, Australia, Georgia, Croatia, Israel, Kazakhstan, Kuwait, Lebanon Morocco, Slovenia, Slovak, Turkey, USA, Uzbekistan, Azerbaijan, Ethiopia, New Zealand, Syria, China, Bosnia and Herzegovina, Hong Kong	Art. 9(1), 9(2) and 9(3) or 9(4)	Only double tax treaty with Malta contains time limit provision in case of a <u>corresponding adjustment</u> in Art. 9(3) with other paragraph limiting the corresponding adjustment to <i>bona fide cases</i> . Other double tax treaties with Canada, Finland and Switzerland contain time limit for a <u>primary adjustment</u> in Art. 9(3) and a limitation of a corresponding adjustment to <i>bona fide cases</i> in Art. 9(4). All the rest of double tax treaties contain Art. 9(3) limiting the potential corresponding adjustment to <i>bona fide cases</i> without any part relating to time limit. Only double tax treaty with Spain contains time limit provision in case of a <u>primary adjustment</u> in Art. 9(3) without any other paragraph limiting the corresponding adjustment to <i>bona fide cases</i> .	32% of double tax treaties with limitation of corresponding adjustment to <i>bona fide cases</i> , 9% of double tax treaties with time limit, 1% of double tax treaties without limitation of corresponding adjustment but with time limit only.

Source: own processing

10 Czech Ministry of Finance, Review of concluded Czech double tax treaties. Available from: http://www.mfcr.cz/cps/rde/xchg/mfcr/xsl/prehled_smluv_3762.html. Last access on 7th January 2013.

a corresponding adjustment. However, this stance could be questioned in the light of the basic spirit of the double tax treaty, namely to eliminate double taxation. Furthermore, in respect of (OECD, 2010a)¹¹, the mere fact that the Contracting States inserted in the double tax treaty article 9(1) indicates that the **intention was to have economic double taxation covered by the tax treaty**. In addition, the tax dispute shall also fall within the scope of the mutual agreement procedure set up under Article 25 OECD Model Convention.

So, the implementation of a mutual agreement procedure under Art. 25 OECD Model Convention is evident from the wording of article 9(2) concluded double tax treaty provided that the double tax treaty contains the article 9(2). However, if a double tax treaty does not contain the article 9(2), the implementation of a mutual agreement procedure is evident from Commentary on Art. 25. Hence, as state (OECD, 2010a)¹² the taxpayers have an opportunity to open a mutual agreement procedure regarding the content of the arm's length principle in cases of lack article 9(2) in double tax treaties. But there is important to highlight that a mutual agreement procedure in all Czech double tax treaties is open-ended as the Czech Ministry of Finance did not insert a new art. 25(5) of OECD Model Convention into its double tax treaties, therefore there is no set out deadline for reaching an agreement, and a tax dispute can be long-lasting and burdensome without any solution. Thus, when a taxpayer do not want to open a mutual agreement procedure under Art. 25 OECD Model Convention due to above mentioned reasons, he can use an alternative to the mutual agreement procedure in the form of procedure under the EU Arbitration Convention, where is set out time limit for reaching a mutual agreement and therefore a taxpayer shall receive a result of his tax dispute more quickly.

Furthermore, time limit issues for adjustment are very interesting in respect of article 9 and national legislation. Only 9 per cent of Czech double tax treaties contain time limit provision in case of an appropriate adjustment, where only 1 of them includes time limit provision in case of a corresponding adjustment, namely double tax treaty with Malta, and the rest of them include time limit for a primary adjustment. Based on the concluded time limit provisions in double tax treaties, it could be considered, that without them, the appropriate adjustments (primary or corresponding) could be applied even after the time limit set by the national legislation. Accordingly to Czech tax legislation, Art. 148

of the domestic Tax Code No. 280/2009 Coll, as amended (hereinafter Tax Code) setting out time limit for tax assessment, which is determined on the period of max. 10 years, the Czech tax authority considers that there is an obstacle to make primary or corresponding adjustment after expiration of time limit under the national legislation in all double tax treaties. However as mention (Nerudová, Moravec, 2012; Sojka, 2008 and Šnek, Sojka, Nesrovnal, Fekar, 2008), this stance can be considered as an unjustified preference of national legislation, as the reason for non-performance of international treaty in connection with Art. 27 of Vienna Convention on the Law of Treaties. So the last situation, **the fourth**, which can be identified, is: If double tax treaty contains time limit provision for a primary adjustment or for corresponding adjustment. If time limit for corresponding adjustment is over, **there is no obligation to make a corresponding adjustment**. But if time limit for the primary adjustment is over, then **there should not be any obstacle for making a corresponding adjustment**¹³, however, the Czech tax authority has a different meaning.

Due to different point of view the Czech tax authority on a corresponding adjustment and related issues is now working on a decree which should determine the procedural aspects of a corresponding adjustment.

In addition, from a tax planning point of view, when a taxpayer does not want to bear a risk of a primary adjustment and consequently an economic double taxation, is possible to use a prevent tool in the form of bilateral Advance Pricing Agreement (hereinafter APA). In respect of bilateral APA, both contracting states set out that the control transaction follows the arm's length principle and during duration of their decision¹⁴ shall not make a primary and subsequently a corresponding adjustment.

CONCLUSIONS

Almost 46 per cent of Czech double tax treaties contain provisions regarding to primary and corresponding adjustments, where 32 per cent of them include corresponding adjustment which is limited to *bona fide cases*. In this case a taxpayer bearing an economic double taxation incurred due to a primary adjustment made by other contracting state shall fill in his additional tax return and wait for a decision of the Czech tax authority whether agrees with a primary adjustment and then makes corresponding adjustment for elimination

11 For more details see OECD, 2010a, Commentary on Art. 25, MN 11.

12 For more details see OECD, 2010a, Commentary on Art. 25, MN 10 and 11.

13 Of course there must be fulfilled the basis condition that other contracting state must agree with a primary adjustment.

14 In case of APA the decision of the Czech tax authority is effective for a maximum duration of 3 years from the date on which APA came into force, and after the expiry of the APA a new request has to be done. Decision for APA is charged by 10.000 CZK.

of economic double taxation. When the Czech tax authority does not agree with a primary adjustment, a taxpayer can open a mutual agreement procedure set out under Art. 25 OECD Model Convention.

Nevertheless almost 53 per cent of Czech double tax treaties include only article 9(1), so the Czech Ministry of Finance considers that there is no obligation to make a corresponding adjustment, as a tax treaty does not contain particularly provision regarding to a corresponding adjustment. In this case a taxpayer cannot fill in his additional tax return, but accordingly to Commentary on Art. 25 he can also open a mutual agreement procedure and hopes that contracting states will reach an agreement with solution of the conflict – economic double taxation.

However, it is important to highlight that all Czech tax treaties do not include a new article 25(5) regarding to a mutual agreement procedure and then an arbitration procedure after not reaching the agreement by contracting states. Therefore, the mutual agreement can be open-ended without any solution of conflict, where a taxpayer will bear

his economic double taxation. In this case is suitable to use the procedure under the EU Arbitration Convention which is not long-lasting as includes time limit for reaching an agreement with solution of a tax dispute. In addition, a taxpayer can use a prevent tool in the form of bilateral APA which freezes any income adjustment in a control transaction during a duration of APA.

At the end should be highlighted that only 9 per cent of Czech double tax treaties include time limit provision regarding primary or corresponding adjustments. Based these time limit provisions could be considered that without them, the appropriate adjustments can be applied even after expiration of time limit under the national legislation, but the Czech tax authority considers that there is an obstacle to make primary or corresponding adjustment after expiration of time limit under art. 148 of Tax Code. However, this stance can be considered as an unjustified preference of national legislation in connection with Art. 27 of Vienna Convention on the Law of Treaties.

SUMMARY

All transfer prices determined between the associated enterprises must comply with the arm's length principle. The arm's length principle for associated enterprises is mentioned in Art. 9(1) of the OECD Model Convention, which was also adopted by the OECD Member states into their national law. However, not all OECD Member states adopted the next part of Art. 9, namely Art. 9(2), with the same way, some of them, like the Czech Republic, entered a reservation on Art. 9(2) OECD Model Convention. This paper is focused on the practical application of article 9 from the Czech perspective, where the application of corresponding adjustment and time-limit issue are highlighted because not carrying out of corresponding adjustment may result in adverse effect on the company's performance and survival. On the base of results of analysis; where the history, context and purpose of Art. 9 OECD Model Convention were taken into account, are made some recommendations. Within the paper, mainly the method of description will be used, further comparative analysis method and the others methods, namely analysis, quantification, induction and deduction should be followed by the method of synthesis. The basic sources of the research were OECD Model Conventions, OECD TPG and concluded Czech double tax treaties.

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Contact information

Veronika Solilová: Ritve@email.cz