

Spanish Supreme Court confirms case law on limits to dynamic interpretation of tax treaties

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Executive summary

The Spanish Supreme Court (*Tribunal Supremo*) issued a decision (case number 1996/2019) on 23 September 2020, confirming the most recent case law regarding the limits on the dynamic interpretation of tax treaties.

This decision is extremely relevant for the interpretation and application of tax treaties that have not been amended in line with the latest versions of the Organisation for Economic Co-operation and Development (OECD) Model Tax Convention (OECD MTC). In addition, it follows a case issued on 23 March 2020 (See EY Global Tax Alert, [Spanish Supreme Court rules on limits to dynamic interpretation of tax treaties](#), dated 17 June 2020), which also addressed the interpretation of the Spain-Switzerland Tax Treaty.

Detailed discussion

Background

As a result of a tax audit dealing with the transfer pricing policies of a multinational group, a Spanish company (SpainCo) was deemed as paying royalty income to a Swiss tax resident related party.

The Spanish tax audit considered that the 5% withholding tax rate applicable on royalty payments under the Spain-Switzerland Tax Treaty,¹ signed in 1966, did not apply because the income recipient was not the beneficial owner.

Although article 12 of the Spain-Switzerland Tax Treaty does not require that the recipient of the royalty income is the beneficial owner, the position of the Spanish tax audit in the tax assessment, which was later on upheld by the Spanish National High Court, was that the concept of beneficial ownership is applicable since treaties must be interpreted following the spirit of the Commentaries to the OECD MTC.

In addition to this, the Spanish tax audit and the National High Court also rejected the application of the 10% withholding tax rate to the royalty payments in accordance with the Spain-United States (US) Tax Treaty applicable at the time, on the grounds that no evidence was provided that a US entity was the actual beneficial owner.

The Decision

In this Decision, the Spanish Supreme Court reviewed and has reinforced some of the positions set forth in the Decision issued on 23 March 2020, to rule in favor of the taxpayer. It also addresses the concept of beneficial ownership, rejecting the interpretation that such clause is necessarily embedded in the text of a treaty provision.

The following is a summary of the positions relevant to the Court's Decision:

- ▶ On the value of soft law, the Supreme Court held that the Commentaries cannot apply retroactively to a case where a prior rule was applicable.

The Commentaries can be used as guidance as long as they refer to wording which has been expressly accepted by the signatories to the relevant tax treaty and to the extent they are not in contradiction to the "authentic interpretation" of such treaty.

- ▶ In this specific case a relevant factor in the Court's Decision is that, while a beneficial ownership requirement was included in articles 10 and 11 of the Spain-Switzerland Tax Treaty (dealing with dividends and interest payments, respectively) in the 2006 Protocol, it was not included with respect to royalty payments, in article 12.

The Supreme Court sees this as evidence that the signatories to the Treaty did not intend to require beneficial ownership for royalty payments.

- ▶ With respect to beneficial ownership, the Supreme Court rejected the approach that beneficial ownership is always applicable (as if it was "embedded" in the taxation system), which could potentially override the actual intention of the States entering into a Tax Treaty.
- ▶ Finally, the Court was critical of the position of the Spanish tax audit and the National High Court that the reduced withholding tax rate in the Spain-US Tax Treaty was not applicable either.

The Supreme Court determined that it is not acceptable to deny the benefits of a tax treaty based on lack of beneficial ownership and the indicia that the actual beneficial owner is resident in a third jurisdiction (the US) and then deny the application of the tax treaty with that third jurisdiction on the grounds that such beneficial ownership has not been evidenced.

The Supreme Court stressed that under no circumstance may the interpretation of the Spanish tax authorities and courts go against the proper interpretation of the tax treaties without previously assessing the effective taxation in the other jurisdiction and the routes available to avoid it under a Mutual Agreement Procedure.

Impact

In this relevant Decision, the Supreme Court has again confirmed the position to limit the use the Commentaries, as soft law, as guidance for the interpretation of the wording and purpose of the actual rules (and not to override them).

EY will continue to monitor how this interpretation is received by the Spanish Tax Administration and the practical impact of this Decision not only with respect to tax treaties, but also with respect to domestic provisions where the beneficial ownership clause is not expressly included.

Endnote

1. Convention between Spain and the Swiss Confederation for the Avoidance of Double Taxation with respect to Taxes on Income and Capital, signed on 26 April 1966.

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