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Spanish Supreme Court rules on limits to dynamic interpretation of tax treaties

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Executive summary

The Spanish Supreme Court (*Tribunal Supremo*) issued a favorable decision on 3 March 2020, which was recently published,[1] setting relevant precedent regarding the limits of a dynamic interpretation of tax treaties.

The resolution is of special interest in relation to the rules governing the interpretation of tax treaties in light of the Organisation of Economic Co-operation and Development (OECD) Commentaries to the Model Tax Convention (the Commentaries) and, by extension, the OECD Transfer Pricing Guidelines.

Detailed discussion

Background

A Spanish company (SpainCo) operated in Switzerland by means of a branch located therein. SpainCo took the view that, under the Spain-Switzerland tax treaty,[2] signed in 1966, this branch triggered a permanent establishment (PE) in Switzerland.

The Spanish tax audit reassessed the Spanish Corporate Income Tax (CIT) returns filed by SpainCo for fiscal years 2005 and 2008 and disallowed the domestic exemption applied to the income attributable to the Swiss PE, on the grounds that the presence in Switzerland did not give rise to a PE.

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According to the Spanish tax audit assessment, the branch carries on a strictly financial activity, consisting of granting intra-group loans. The Spanish tax audit considers that the sole collection of interest and, in certain cases, renewal of the loan without negotiation do not constitute a substantial, essential and significant financial activity for the enterprise as a whole, but rather a purely auxiliary activity.

The position of the tax audit was later on upheld by the Spanish National High Court, on the grounds that according to the 2005 Commentaries "a fixed place of business through which the enterprise exercises solely an activity which has for the enterprise a preparatory or auxiliary character, is deemed not to be a PE."

Hence, this assessment is made by interpreting the 1966 Spain-Switzerland tax treaty invoking the Commentaries to the 2005 Model Tax Convention (OECD MTC). The Commentaries refer to a new clause added in this 2005 version of the OECD MTC to the list of exceptions to the notion of PE: "the maintenance of a fixed place of business solely for the purpose of carrying on, for the enterprise, any other activity of a preparatory or auxiliary character."

Nevertheless, the 1966 Spain-Switzerland tax treaty did not include this exception that was added to the 2005 OECD MTC. Furthermore, Spain and Switzerland revised the tax treaty later in 2006 and 2011, amending the list of exceptions to the notion of PE but did not specifically include this one.

The Decision

The Spanish Supreme Court ruled in favor of the taxpayer based on the following determinations:

- The Commentaries (and the TP Guidelines) have no normative value binding for a judicial court and are not sources of Law.
- The Commentaries may not be directly invoked without the basis of a tax rule with normative value, like a tax treaty, since doing so entails, in the case at hand, ignoring the notion of PE agreed by both jurisdictions and substituting it by a different and extended notion of PE.

  In this regard, the Supreme Court considers that the tax audit and High Court's interpretation result in an unfavorable, retroactive and unilateral interpretation of the notion of PE that is alien to the applicable tax rules, which have been applied in the State of source, Switzerland. In fact, SpainCo had been effectively taxed in Switzerland on the grounds that such profits had been obtained by means of a Swiss PE.
- The Spanish Supreme Court also highlights that under no circumstance may the tax authorities and courts' interpretation give rise to double taxation without having considered the effective taxation paid in the State of source and the possibility to avoid it by means of the mutual agreement procedure (MAP) set forth in Article 23 of the Spain-Switzerland tax treaty.

Implications

In this relevant decision, the Supreme Court addresses the limits of the use of soft law, which may not replace the functions of the legislative power and may not go beyond the wording and aim of a given tax rule. Moreover, in the case of tax treaties, a unilateral interpretation would go against the notion of a bilateral tax treaty, where two States agree on the distribution of taxing rights between them.

Also, interpreting a tax treaty provision in light of new versions of the Commentaries to the OECD MTC that introduce differences in the substance of the meaning, terms and scope of domestic legislation or bilateral treaties is not allowed. It would result in a treaty override.

As a final consideration, in this decision of the application of a domestic exemption closely linked to a treaty clause, the Supreme Court stresses the role of the MAP. This may prove especially relevant in the context of tax audits not only in the case of a PE assessment, but also with respect of other areas such as, but not limited to, transfer pricing, beneficial ownership or characterization of income.

Endnotes

1. Case number 308/2020.
2. 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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