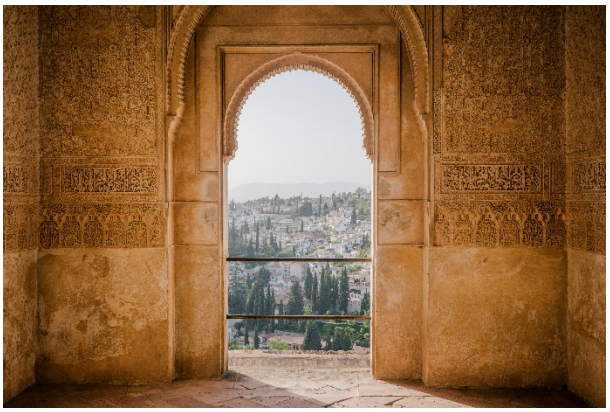
Interpretation of double tax agreements: static or dynamic?

The Spanish Supreme Court decides on the limitations of the application of dynamic interpretation of double taxation agreements



The Spanish Supreme Court has analysed the application of the concept of beneficial ownership to the interpretation of article 12 (royalties) of the Double Tax Agreement ("DTA") between Spain and Switzerland from 1967, following the Commentaries to the OECD Model Convention, which were drafted and published at a later date, despite the fact that no mention to beneficial ownership is included in Article 12 of such DTA.

The main discussion in the case revolves around the withholding tax rate applicable to the royalty payments made by a Spanish entity to its Swiss parent company, and where the US top parent company is the owner of the IP rights. Both the tax authorities and the Spanish National court understood that the DTA Switzerland-Spain was not applicable to the case, and therefore the royalties' payments were subject to a general withholding tax rate.

One of the main arguments given by the Supreme Court is that, while other articles of the DTA Spain-Switzerland such as article 10 (interest) or article 11 (dividends) were amended in 2006 to include a reference to beneficial ownership following the new versions of the OECD Model Convention, the original text of article 12 remained intact.

It is relevant to transcribe here the conclusions of the Supreme Court in this case, as they correspond exactly to the conclusions given by this Court several months before, in its March decision:

a) The dynamic interpretation of treaties cannot be applied retroactively to a case governed by a previous law

b) The interpretation cannot exclusively be supported by comments, models or interpretative guidelines that have not been explicitly assumed by the signatory states in their agreements, for purposes of the Spanish constitution, and without prejudice that the criteria might be used as guidance by the courts when the comments or recommendations result in the same conclusion as the interpretation of the agreement or of other sources of law.

c) The interpretation of the tax authorities and the courts cannot, by any means, contravene the interpretation of the agreements, without assessing ex ante the

effective taxation in the other signatory state and the methods to avoid the double taxation provided by the DTA (article 23).

d) Even in the case where the beneficial owner is located in a third country to the signatories of the DTA, the beneficial ownership clause can never be implemented in the way the tax authorities have – that is, disregarding the DTA Spain-Switzerland (and, eventually, the other applicable DTA to the beneficial owner who is not identified in the decision) – to apply the national law to the withholding tax on royalties, which seems to pursue an extraordinary, unjustified and anomalous enrichment.

Finally, the Spanish Supreme Court rules in favor of the taxpayer and recognizes the application of the 5% withholding rate according to the DTA Spain-Switzerland, which according to the court is the only "logical, grammatical and systematical interpretation of this clause". The main argument is that the amendments to the DTA have not incorporated the concept of beneficial ownership, despite having the possibility to do so.

For this reason, to the extent that the silence of the DTA Spain-Switzerland with regards to beneficial ownership can be considered as an active silence of the signatories, it cannot be overruled by the application of the beneficial ownership concept in its interpretation. The Spanish Supreme Court confirms the position that was already reflected in its previous decision from March 2020, whereby the text of the DTAs should prevail against the generalized and unconditional application of the Commentary to the OECD Model convention.

Although we share the view of the Supreme Court that each case needs to be examined individually on an ad-hoc basis, and that the interpretation of the tax authorities in the case analyzed here clearly exceeded and disregarded the agreement by the signatories, a static interpretation of the DTA could however strip away the value of the instruments conforming what is known as soft law. These instruments of soft law which have been agreed by the states, allow to integrate and work efficiently towards the taxation of a globalized economy. With all the due cautions that are necessary to preserve the rule of law and the national sources of law, in our view, the correct use of these international instruments of interpretation could provide legal certainty to taxpayers and a greater fairness against the static interpretation of agreements, which disregards the evolution of taxation.

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