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The Spanish Supreme Court rules on the
dynamic interpretation of tax treaties

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On 23 September 2020, the Spanish Supreme Court handed down an important ruling rejecting the dynamic interpretation of tax treaties in connection with the application of a beneficial-ownership clause.

On 23 September 2020, the Spanish Supreme Court handed down ruling 1196/2020, analysing a case in which the Spanish tax authorities rejected a taxpayer's entitlement to the benefits of the Convention of 26th April 1966 between the Swiss Confederation and Spain for the avoidance of double taxation with respect to taxes on income and on capital ("**Swiss-Spanish Tax Treaty**") on the grounds that the Swiss entity was not the beneficial owner of the income derived from the royalties, even though the Swiss-Spanish Tax Treaty makes no reference to beneficial ownership in its article on royalties. The ruling confirmed the taxpayer's entitlement to the reduced royalty withholding tax treaty rate.

The ruling is particularly notable due to the Spanish Supreme Court's conclusions regarding the dynamic interpretation of tax treaties and the affirming of the conclusions reached in its ruling handed down on 3 March 2020 (ruling 308/2020). Therefore, as subsequently explained, the case law on the issue has been established.

These two rulings of the Spanish Supreme Court slightly diverge from prior rulings by the Court on the dynamic interpretation of tax treaties, particularly the rulings handed down on 11 June 2008 (appeal 7710/2002) and 9 February 2016 (appeal 3429/2014). In those cases, the Spanish Supreme Court permitted, under certain circumstances, a dynamic interpretation of the corresponding tax treaties, although it did so on the basis of the application of **domestic Spanish law** that gave shape to the specific article of the tax treaty being analysed.

In the most recent case analysed by the Spanish Supreme Court, the Spanish tax authorities, applying a dynamic interpretation of the Swiss-Spanish Tax Treaty, had concluded that royalties paid by a Spanish entity to a Swiss entity should be subject to the standard Spanish royalty withholding tax, as the entity that received the royalties was not considered to be their beneficial owner. The Spanish tax authorities

also rejected the application of the reduced royalty withholding rate provided for by the tax treaty between the U.S. and Spain, even though the parent entity of the Swiss entity and deemed beneficial owner of the royalty income was a U.S. tax resident.

As indicated, the Spanish Supreme Court reached several interesting conclusions in this ruling handed down 23 September.

Firstly, the Court states that in no case may a dynamic interpretation of tax treaties be applied retroactively to a case subject to a prior legal framework.

Secondly, the Court states that, although the Commentaries on the OECD Model Tax Convention ("**Commentaries**") can be used by courts as a tool to assist on the interpretation of tax treaties, the Commentaries cannot be considered as a source of law if they have not been expressly adopted in the corresponding tax treaty ratified by the contracting States. In this context, the Court mentions that the original 1966 Swiss-Spanish Tax Treaty was renegotiated and amended after the Commentaries making reference to the beneficial ownership requirement were issued, and that at such time the contracting States, having had the opportunity to include the beneficial ownership restriction in the royalty article, chose not to do so.

Thirdly, the ruling states that the interpretation of the tax treaties by the tax authorities and courts cannot contravene the interpretation of the tax treaties themselves without taking into account the effective taxation in the other State and the ways established in the corresponding tax treaty to avoid the double taxation of income.

Finally, the Supreme Court holds that, even if the beneficial-ownership clause were applicable, it could nevertheless not be enforced in the way the Spanish tax authorities sought to, i.e. disregarding not only the Swiss-Spanish Tax Treaty but also that applicable to the U.S. tax resident parent company, which was allegedly the beneficial owner of the royalties.

In conclusion, we consider that this ruling, in conjunction with the Court's ruling from March 2020, establishes relevant jurisprudence regarding the application of a dynamic interpretation of tax treaties. The decision is also, indirectly, an important precedent regarding beneficial-ownership clauses, which are currently being cited extensively by the tax authorities as a basis to reject the application of tax benefits, such as the exemption on withholdings in connection with dividends or interest paid to EU entities.

In doing so, the Spanish Supreme Court affirms that soft law, such as the Commentaries, cannot be used to impose an additional requirement on the taxpayer so that the latter may be entitled to tax treaty benefits. Such would be the case, as discussed in the ruling, when requiring the recipient of the royalties to be deemed its beneficial owner, in those cases where the tax treaty ratified between the contracting States did not include such limitation. In the words of the Spanish Supreme Court, the beneficial-ownership clause cannot be considered as a “principle of natural law” applicable in all cases, including when its application conflicts with the literal wording of the legal text.

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