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Spanish Supreme Court to Settle on Dynamic Interpretation of Tax Treaties

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The classic issue of dynamic versus static interpretation of tax treaties arises again. Not only is this a hot topic in the international tax arena, but it is also a permanent pain in the Spanish Supreme Court's neck since its judgment on the *Julio Iglesias* case of June 11, 2008 (available here).

In that case, the Supreme Court confirmed the application of article 17.2 of the OECD Model Convention (taxation at source of income for personal activities carried out by an entertainer but accrued by a different person controlled by the artist), even when the Double Tax Treaty between Spain and the Netherlands, which lacked a similar provision, applied. This DTT only confers taxing rights to the source state when income is accrued by the entertainer.

At law school we were taught that, in the field of taxes, judges are inclined to decide based on fairness and equity, even when the wording of the law should result in a different outcome. The Supreme Court disliked the fact that the old Dutch tax treaty had a loophole for tax abuse, because it did not consider the taxation of companies controlled by entertainers. Therefore, it decided to follow a more than doubtful dynamic interpretation of tax treaties to include in the 1972 Dutch tax treaty the specific rules for companies that the OECD recommended to include in the 1992 amendment to the Model Convention.

After more than ten years, this judgment and related others continue to be some of the most criticized judgments of the Supreme Court. In fact, Supreme Court judges have publicly expressed that they were a bad solution for an imperfect legal instrument that should be fixed by the legislator.

This feeling of regret is probably behind the decision of the Supreme Court to reconsider its traditional doctrine on dynamic interpretation of tax treaties in its order of November 28, 2018 (available here). The case involved the definition of permanent establishment and how its evolution in successive versions of the OECD Model Convention affected passive permanent establishments such as Swiss finance branches.

This was the case of an international group (engaged in activities related to the orthopedic and medical devices market), whose Spanish subsidiary had a branch in Switzerland. This branch was registered before the Swiss authorities, had a few employees and premises at its disposal, and its activity consisted of managing a couple of intragroup loans, duly documented as well. Income

from the branch was included in the tax base of its Spanish head office but considered exempt for being income obtained by a permanent establishment located abroad (under article 23 of the Double Tax Treaty between Spain and Switzerland and confirmed by article 22 of the Spanish Corporate Income Tax Act).

Based on the above, the Spanish High Court denied the exemption on the basis that there was no permanent establishment under the definition of article 5 of the Treaty, which was also the relevant definition for domestic purposes. In particular, the Court held that "the mere collection of interest and, when applicable, the renewal of the principal of a loan at maturity without any payment or need to negotiate of any kind cannot be considered a substantial and essential financial activity for the company as a whole but merely an auxiliary activity."

Triangular cases with "soft" permanent establishments (those that can qualify under the definition of the Model Convention so that the resident state must grant an exemption but that may be disregarded by the source state because of their limited substance) are well known. The European Commission has recently confirmed that the structure does not constitute state aid (the famous *McDonald's* case, available here). However, this type of branch is actually under high pressure: article 10 of the MLI empowers the source state to deny treaty benefits if the tax paid by the permanent establishment is less than 60% of the tax that would be imposed on its head office, and ATAD 2 includes the concept of disregarded permanent establishment to deny the application of the exemption by the residence state. Additionally, for passive income from permanent establishments, CFC rules in ATAD should be enough to prevent the application of the exemption.

This Swiss finance branch is not presented as one of these paradigmatic triangular cases, at least formally, given that the judgment of the High Court expressly mentions that the Swiss tax authorities certified that it was a branch duly registered in Switzerland and complying with its tax duties. Despite this recognition at the source state, the question remains. Is an office whose tasks are limited to collecting interest from intragroup loans enough of a fixed place of business to deserve a full tax exemption in the head office residence state?

The Spanish tax inspection took the view that such tasks were not enough to create a permanent establishment because they were not of a substantial but rather an auxiliary nature, which was confirmed by the High Court.

The analysis on the dynamic interpretation arises in the appeal of the taxpayer to the Supreme Court. After unsuccessfully arguing on factual terms regarding the activity of the branch before the High Court, the taxpayer shifted strategy towards analyzing the concept of permanent establishment relevant to the case. The DTT signed between Spain and Switzerland, applicable to the tax periods concerned, was an old one again (signed in 1966). In its definition of permanent establishment, article 5.3 did not contain the classic exclusion of permanent establishment whose activity is of a preparatory or auxiliary nature. The only exclusions in the definition of permanent establishment were activities associated to advertising, supply of information, scientific research or similar activities, but always provided that they were carried out for the company itself (section e) of article 5.3).

The taxpayer argued that there was actually a permanent establishment under the treaty definition, given that the Swiss branch was a fixed place of business and its activity, consisting of financing other entities of the group, could not be considered similar to advertising, supply of information or scientific research. The taxpayer claimed that any other interpretation based on language that was

not included in this definition but on the Model Convention and its Commentaries was not acceptable under the Vienna Convention on interpretation of treaties. Additionally, it argued that subsequent developments of the Double Tax Treaty confirmed this interpretation: the countries agreed to modify the definition of permanent establishment through a Protocol that entered into force in 2013 (not affecting the tax periods concerned), which actually added a new section that excluded from the definition those cases where the combination of certain activities of the permanent establishment was of a preparatory or auxiliary nature. No modification was introduced to section e) of article 5.3.

The Supreme Court has accepted the challenge and expressly mentions that the process will lead to the "determination of the boundaries of the well-known dynamic interpretation of the Double Tax Treaties signed by Spain based on the OECD Model Convention."

In the BEPS era we are living, intragroup finance branches are probably not popular, so they are the target of new anti-abuse measures such as the extended CFC ATAD rules or the denial of tax reliefs at source and at residence. But it would be blatantly inappropriate to expand the dynamic interpretation of tax treaties just to close loopholes.

Though obvious, tax laws are enacted by the legislative powers of each State exercising the people's sovereignty, while the OECD Model Convention is drafted by government representatives. Simply put, the Model Convention and its Commentaries are drafted by a group of tax inspectors, or as others with more prestige have said, the Commentaries are made by the tax authorities, and the duty of the court is to interpret the treaty, not to give effect to the views of one party to the case.[1] They simply reflect the opinion of the persons who worked on the OECD Model Tax Convention, not the views of a parliamentary legislature.[2]

We are looking forward to hearing from the Supreme Court. Maybe Julio Iglesias is too.

References[+]

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