


Direct Tax Alert

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

Recently the Spanish Supreme Court ruled against the 'dynamic' interpretation of tax treaties. It held that the provisions of tax treaties cannot be interpreted based on later versions of a tax treaty in view of the subsequent model conventions (and their commentaries) published by the OECD where the definition of the relevant term is materially different.

The claimant, a Spanish company, claimed for the refund of the taxes paid with regards to the income attributable to its branch office in Switzerland, under the agreement between the Kingdom of Spain and the Swiss Confederation, to avoid double taxation (DTA).

The Spanish authorities rejected the refund and challenged the existence of the claimant's permanent establishment (PE) in Switzerland. They considered the financial activities performed in Switzerland (i.e. the granting of loans to other entities within the group) as ancillary to the main activity of the

company, in view of the definition of PE included under the amended provision of the DTA.

The claimant appealed the decision on the grounds that the authorities were applying retroactively an interpretation of PE that was not included in the DTA in force at the relevant time. The original provision of the DTA only excluded from the concept of PE some specific activities, but the exclusion was later amended to cover all activities of ancillary nature, in line with the OECD Model Convention.



Hence, the Supreme Court analysed whether it was valid to apply a dynamic interpretation to the definition of PE according to a provision of the DTA that was amended at a later time, under the guidelines of the OECD Model Convention.

The Court concluded that the agreed term of PE in the DTA was interpreted retroactively according to a definition which was not in force during the relevant period and which clearly extended the scope of the concept of PE, and that such interpretation by the Spanish authorities was not backed by national sources of law, unlike in other case law. This retroactive interpretation triggered double taxation for the claimant, which is contrary to the purpose of the DTA.

Dhruva comments

The Spanish Supreme Court ruled in favour of the appellant and declared invalid the decision by the Spanish tax authorities, which according to the Supreme Court was based on an incorrect interpretation of the legal system.

In the Indian context, an ambulatory versus static approach of interpreting a DTA has been a common subject matter of litigation with decisions in favour of both approaches.

The OECD Model advocates an ambulatory approach.

The Hon'ble Bombay High Court in the case of Siemens¹ after considering that the DTA expressly mentions that the 'laws in force' need to be considered, approved an ambulatory approach to interpretation of treaties against static approach and held that clarificatory explanations could be read into modern tax treaties.

However, the Mumbai Tribunal in a recent decision², distinguished the Bombay High Court ruling (supra) while analysing retrospective impact in the definition of 'Royalty' under DTA consequent to amendment in the definition of 'process'. The Mumbai Tribunal observed that the ambulatory interpretation should be discarded because that approach would legitimise a unilateral treaty override, and the outcome of ambulatory interpretation in such a case will be incompatible with the fundamental principles of treaty interpretation under the Vienna Convention.

This Spanish decision favours a static approach for interpretation of tax treaty.

On a going forward basis, one should be mindful of this debate and take an informed decision while interpreting the treaties.

¹ *CIT v Siemens Aktiengesellschaft* [2009] 310 ITR 320 (Bom)

² *ACIT v Reliance Jio Infocomm Ltd.* (ITA Nos. 6331 to 6334/Mum/2018)



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