TAXATION OF CAPITAL GAINS DERIVED FROM THE ALIENATION OF SHARES: THE ISSUE OF THE QUALIFICATION OF SHARES AS IMMOVABLE PROPERTY UNDER THE MOZAMBIQUE AND ITALY DOUBLE TAXATION CONVENTION

TRIBUTAÇÃO DE MAIS-VALIAS REALIZADAS NA ALIENAÇÃO DE ACÇÕES: A QUESTÃO DA CARACTERIZAÇÃO DE ACÇÕES COMO BENS IMOBILIÁRIOS NOS TERMOS DA CONVENÇÃO PARA EVITAR A DUPLA TRIBUTAÇÃO CELEBRADA ENTRE MOÇAMBIQUE E ITÁLIA

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ABSTRACT

This article focuses on the tax framework of a capital gain derived from the sale of shares in an Italian resident company, with a registered branch in Mozambique, which had entered into a concession contract for the exploration of an oil and gas field situated in Mozambique.

Keywords: Capital Gains; Immovable Property; Double Taxation Convention

RESUMO

O artigo analisar o tratamento fiscal de mais-valias realizadas pela alienação de acções de uma sociedade italiana com uma sucursal em Moçambique, a qual celebrou um contrato de concessão para a exploração de um campo de petróleo e gás situado em Moçambique.

Palavras-chave: Mais-valias; Bens Imobiliários; Convenção para evitar a Dupla Tributação

[1] The authors which to thank their former law firm Colleague Gonçalo Martins Agostinho for his assistance in the drafting of this article. The authors can be reached at: geral@rpba.pt

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1. Introduction

The issue taken up here is the capital gains tax treatment of an offshore indirect transfer of assets. This issue, identified by the IMF, the OECD and the UN as a significant international tax issue for developing or low-income countries, mostly but not exclusively natural resource rich countries, has gained importance in recent years.

Our article analyses this highly complex matter, taking into consideration a recent case that thoroughly illustrates the problems and concerns that arise in this area of international taxation. It does not address any equity, efficiency or political economy considerations[2]. The aim is to, rather, provide an analysis of the difficulties surrounding the pure legal concepts, without a take on the correct allocation of taxation rights from the point of view of fairness or political economy. In practical terms, the illustrative case addressed here culminated with the undisputed collection of tax by the source country. This outcome

[2] For the analysis of these types of considerations please refer to the Report published by the Platform for Collaboration on Tax (PCT) – a joint initiative of the IMF, OECD, UN and World Bank Group – aimed at providing guidance on the design and implementation issues when one country seeks to tax gains on the sale of interests in an entity owning assets located in that country by an entity which is a tax resident in another country. See PCT's Toolkit on the Taxation of Offshore Indirect Transfers (4 June 2020). See also Perrine Toledano, John Bush & Jacky Mandelbaum, *Designing a Legal Regime to Capture Capital Gains Tax on Indirect Transfers of Mineral and Petroleum Rights: A Practical Guide*, (2017).

which is sharply at odds with the conclusions we draw on the tax treatment under the Convention between Mozambique and Italy for the avoidance of double taxation and the prevention of fiscal evasion with respect to taxes on income ("DTC")[3] also reveals the complexity of the issue and the existence of other nuances that supersede the technical aspects here discussed.

This article focuses on the tax framework of a capital gain derived from the sale of shares in an Italian resident company, with a registered branch in Mozambique, which had entered into a concession contract for the exploration of an oil and gas field situated in Mozambique. The main topic will be examined under the DTC provisions.

The facts that specifically provide the background for this article's technical analysis are the existence of a company ("A") that is the majority shareholder in another company ("B"), both tax residents in Italy. Company B operates in Mozambique through a registered branch and owns a significant participating interest in a concession contract of an oil and gas field situated therein. Company A has decided to sell some shares owned in Company B (henceforth designated as "Transaction").

In fact, the Mozambican Tax Authority has issued a statement explaining its position regarding the taxation of the Transaction, considering that the capital gain derived is taxable in Mozambique. It reads as follows[4,5]:

"Under article 101 (1) of the General Tax Law (GTL), approved by Law 02/2006, dated of March 22 [], [Company A]*, domiciled in Italy, requested to the [Mozambican] tax authority the issuance of a binding information relating to the sale of 35,71% of shares owned in* [Company B]*, that involved the indirect transfer of 25% of the participating interest in the concession contract for the Search and Production of Oil in Area 4 of the Bacia do Rovuma, owned by* [Company B]*, and therefore, the following is communicated:*

1. [Company A] *is a company with tax residence in the Italian Republic and, consequently, any income perceived from a Mozambican source shall be treated in accordance with the Double Taxation Convention concluded between the*

[3] *Convenção Entre a República de Moçambique e a República da Itália Para Evitar a Dupla Tributação e Prevenir a Evasão Fiscal Em Matéria de Impostos Sobre o Rendimento [Convention between the Government of the Republic of Mozambique and the Government of the Italian Republic for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income]* [unofficial translation] (14 December 1998).

[4] Press Release 01/2017 of the Mozambican Tax Authority.

[5] The translation of the statement from Portuguese to English is of our full responsibility.

Mozambican Republican and the Italian Republic, ratified by Resolution 27/99, dated of September 8.

2. *According to the Definitions and article 29 (2) of Law 27/2014, dated of September 23, that approves the Specific Regime of Taxation and Tax Benefits of Oil Operations ("SRTTBOO"), the participations in entities which are part of Concession Contracts that are held by non-residents are considered immovable properties only for tax purposes.*
3. *Hence, the gains obtained by* [Company A] *derived from the alienation of shares in* [Company B] *are treated by Mozambican legislation (article 29 (2) of the SRTTBOO) as gains obtained from the alienation of immovable property rights located in Mozambique.*
4. *Under the terms of article 6.1 and 13.1 of the Double Taxation Convention abovementioned, all income derived from immovable properties located in the other Contracting State is taxable in that State.*
5. *Consequently, in accordance with the mentioned Double Taxation Convention, the Republic of Mozambique has exclusive taxing rights on any gains obtained by* [Company A] *derived from the transaction.*
6. *Thus, under the terms of article 40 (2) of the Personal Income Tax Code, approved by Law 33/2007, dated of December 31 ("PIT Code"), applicable as determined by article 45 of the Corporate Income Tax Code, approved by Law 34/2007, dated of December 31 ("CIT Code") and 29 (4) of the SRTTBOO, only 50% of the capital gains obtained by* [Company A] *are subject to taxation in Mozambique.*
7. *The taxable capital gains are subject to a 32% rate, under the terms of article 29 (1) of the SRTTBOO, as well as in accordance with article 61 (1) of the CIT Code.*
8. *Considering the available information to date presented by* [Company A] *to the Mozambican Tax Authority, the tax due will be approximately* […]*, taking into account the realization value of about* […].
9. *For purposes of liquidation and payment of the tax owed, due to the fact that the taxpayer is a non-resident entity, the designation of a person, either an individual or a legal one, with headquarters, residence or effective management in Mozambique, to represent the taxpayer before the Tax Administration is mandatory, so that the tax obligations can be fulfilled, as stated in article 43 of the Regulation of the CIT Code, approved by Decree-Law 9/2008, dated of April 16, although such obligations are only due when the transaction is concluded in accordance with the terms defined in the Purchase Agreement entered into by the parties."*

We will now examine the tax treatment of the Transaction, taking into account the background detailed above, according to the applicable DTC – in particular, if and to what extent Mozambique enjoys discretion to qualify shares as immovable property –, and if a taxing right might be supported by a mere adjustment to the definition of immovable assets in the Mozambican domestic tax legislation.

2. Domestic Law of the source country

2.1. Mozambican Law: Liability

The first step consists in analyzing whether the Transaction is liable to taxation in Mozambique or not, in accordance with its domestic tax law.

Law 27/2014, dated of September 23, which provides for the special tax regime and tax benefits applicable to petroleum operations, determines, in the Glossary annex to it, the meaning, for the purposes of the said regime, of the expression "*Immovable Assets*":

"petroleum reservoirs or deposits located in Mozambican territory as well as the concession contract, including direct or indirect equity stakes in the entities holding a concession contract, owned by either residents or non-residents"[6].

In article 29 (1) of that same Law, it is established that any gains obtained by non-resident entities in Mozambican territory, with or without permanent establishment, derived from the direct or indirect sale of petroleum rights in Mozambique, are taxable as capital gains at a rate of 32%.

In paragraph 2 of the aforementioned article, it is stated that those gains, including the ones arising from the disposal of shares in companies holding the said petroleum rights are, for tax purposes, deemed to be capital gains derived from the transfer of immovable property, Mozambique being the source of those gains.

These capital gains, according to paragraph 3 of the same article, are deemed as obtained in Mozambique regardless of where the share deal occurs.

Consequently, and taking only into account the Mozambican domestic legislation, the Transaction would be liable to taxation, to the extent that a disposal of Company B shares by Company A implies an indirect transfer of petroleum rights held in Mozambique, being such share transfer assimilated to a transfer of "*Immovable Assets*".

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[6] MZ, *Lei n.º 27/2014 que estabelece o Regime Específico de Tributação e de Benefícios Fiscais das Operações Petrolíferas* [Law 27/2014 that provides for the Special Tax Regime and Tax Benefits applicable to Petroleum Operations] (23 September 2014).

Therefore, 50% of the Transaction would be taxable, at the said rate of 32%, as income of Mozambican source.

2.2. DTC Mozambique – Italy

Thereafter, it is important to analyze the provisions of the DTC entered into between Mozambique and Italy, approved by Resolution 27/99, dated of September 8, as they supersede the domestic legislation of the States, namely of Mozambique, according to article 8 (1) of Law 2/2006, dated of March 22 (General Tax Law).

2.2.1. The inapplicability of article 13 (1) of the DTC

Article 13 of the DTC, which was signed in 1998, is based on the OECD Model Tax Convention on Income and on Capital ("OECD-MC"), in its 1995 version. However, according to what we were able to ascertain, the DTC started being negotiated between the States before 1995. In this context, we will also make reference, whenever justified, to the earlier version of the OECD-MC (the 1977 version[7]). In both these versions, the referred article contains 4 paragraphs, but does not include a provision similar to article 13 (4) of the OECD-MC, introduced with the 2003 version, which stated:

"*Gains derived by a resident of a Contracting State from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in the other Contracting State may be taxed in that State*."[8]

Subsequently, article 13 (4) of the OECD-MC, was only modified in 2017, and currently reads as follows: "*Gains derived by a resident of a Contracting State from the alienation of shares or comparable interests, such as interests in a partnership or trust, may be taxed in the other Contracting State if, at any time during the 365 days preceding the alienation, these shares or comparable interests derived more than 50 per cent of their value directly or indirectly from immovable property, as defined in Article 6, situated in that other State.*"[9]

[7] The version of the Model approved in 1992 did not entail a comprehensive revision, but rather introduced minor changes to the text of articles 3, 12, 15, 17 and 24. Article 13 was not changed.
[8] *OECD Model Tax Convention on Income and on Capital: Article 13 (28 January 2003).*
[9] *OECD Model Tax Convention on Income and on Capital: Article 13 (21 November 2017).*

Article 13 (1) of the DTC reads as follows:"*Gains derived by a resident of a Contracting State from the alienation of immovable property referred to in article 6 and situated in the other Contracting State may be taxed in that other State.*"

This provision mirrors article 13 (1) of the OECD-MC, according to which, for gains from the alienation of immovable property, the primary right to tax belongs to the State in which the immovable property is situated.

In order for Mozambique to be able to tax the Transaction as the *situs* State based on this distributive provision of tax jurisdiction, the cumulative verification of two conditions would be necessary, also in accordance with article 6 (2) of the DTC:

a. the property must be situated in Mozambique; and
b. the property, situated in Mozambique, may be deemed as immovable property.

As we will show below, none of the above two conditions are verified.

2.2.1.1. Definition of the situs of the Immovable Property

In order to ascertain if Mozambique can tax the Transaction according with article 13 (1) of the DTC, it is necessary to determine whether the property at issue is regarded as "*immovable property*" or not, considering the referring of article 6 (2) of the DTC to the domestic legislation of the State "*in which the property in question is situated*".

This implies a previous assessment of (i) which property is at stake and (ii) its *situs*.

The property object of the Transaction, are the shares, and the expression "*situated*", present in articles 6 (2) and 13 (1) of the DTC, is not defined in these. As such, in this regard, article 3 (2) of the DTC is applicable, stating as follows:

"*As regards the application of the Convention by a Contracting State, any term not defined therein shall have the meaning which it has under the law of that Contracting State for the purposes of the taxes to which the Convention applies, unless the context otherwise requires.*" (our translation and emphasis added).

Paragraph 2 of the Commentary of the OECD-MC on article 6 states that:"*Defining the concept of immovable property by reference to the law of the State in which the property is situated, as is provided in paragraph 2, will help to avoid difficulties of interpretation over the question whether an asset or a right is to be regarded as immovable property or not*."[10]

Thereby, the very definition of the *situs* regarding the shares is not subject, by article 6 (2) of the DTC, to reference to the domestic legislation of one of the States. It is because the property is situated in a State that the definition of it as "*immovable*" is attributed to this same State, within certain boundaries, referencing to its domestic law. But it is not just any State which has the power of defining where the property is situated, as this requires a previous and autonomous interpretation. Otherwise, the most unreasonable connections with a territory might be alleged by a State in order to have certain property situated in its territory, this conduct potentially resulting in the preposterous situation of a State considering immovable property located in another jurisdiction as "*situated*" in its territory, in order to tax its current income or the capital gains deriving from its alienation.

Therefore, we conclude that it was not intended by the DTC that the States could decide at their own discretion beforehand the location of the property itself, when they apply a provision which attributes them a primary right to tax.

Article 6 (2) of the DTC is, thus, not a *carte blanche* which allows the States that so desire to define what is immovable property; instead, it is a rule empowering the States *in which the property in question is situated*, and still within certain limitations, to qualify the property thus situated in its territory as immovable property.

As such, the expression "*situated*" cannot have the meaning attributed to it by the State that in every instance is applying the DTC, insofar as the context clearly demands a different and autonomous interpretation, failing which, the practical effect and purpose of article 6 (2) of the DTC runs the risk of being eliminated.

[10] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 6 (21 September 1995).*

In fact, otherwise we would be facing a fallacy: a State would qualify an asset as immovable, thus expressing a material connection of the latter to its territory; and because it had already made such qualification of the asset as immovable, it would *ipso facto* be situated in its territory. It is not so: it is not because of the fact that the asset was qualified as immovable that it is situated in the State that gave it such a qualification; it is rather because the property is situated in a State, that this same State is able to qualify it as immovable.

The aforementioned, in our opinion, constitutes an essential argument in order for the context to prevent the recourse to domestic legislations of the States regarding the localization of property. Additionally, it is noteworthy that, usually, regarding disposal of shares, in applying DTC's, the *situs* bears no significance, in order to attribute tax jurisdiction over them. If one takes a look at articles 13 (4) and (5) of the OECD-MC, which are the provisions applicable to capital gains deriving from the disposal of shares, one will see that they do not take into account the location of such shares.

The Company B shares are registered in Italy and, because of this, and also for the reason that both Company A and B are companies incorporated and tax resident in that same State, such shares should be deemed as located in Italy. Therefore, it is Italy's domestic law which can determine if the shares held by Company A in Company B are considered as "*immovable property*" or not. Italian legislation deems such shares as movable property, according to article 812 (3) of its Civil Code.

However, hereinafter we shall assume, and merely for reasoning purposes, that such shares were situated in Mozambique, and therefore Mozambican domestic law would be applicable for its potential qualification as "*immovable property*", according to article 6 (2) of the DTC.

2.2.1.2. Definition of Immovable Property

As mentioned above, in order to apply article 13 (1) of the DTC to the Transaction, it is imperative that the asset disposed of is deemed immovable property according to its article 6 (2), which states as follows:"*The term "immovable property" shall have the meaning which it has under the law of the Contracting State in which the property in*

question is situated. (…) *It is otherwise considered as «immovable property» the usufruct of property, immovable and rights to variable or fixed payments as consideration for the working of mineral deposits, sources and other natural resources.* (…)" (our translation).

So, the first transcribed section of this article refers the concept of "*immovable property*" to the domestic legislation of the *situs* State of the asset, being that this renvoi has no place with regard to rights that must be *autonomously* deemed as immovable property, under the second section.

There is no reference to shares of a "*property rich company"* in the *positive list* of rights which are *autonomously* deemed by the DTC, according to its article 6 (2), as "*immovable property*". This finding becomes even more significant if combined with the fact that, when the DTC was signed, the UN Model Double Taxation Convention of 1980 – which, by comparison with the OECD-MC favors taxation by the Source State, usually a developing country – already had a provision similar to the abovementioned article 13 (4) of the OECD-MC, introduced with its 2003 version, a fact that Mozambique could not ignore.

This means that the different treatment of capital gains derived from immovable and movable property (even when the latter derives, indirectly, from immovable assets), under the DTCs, was a matter not only known but also with available suggestions of resolution at the level of the OECD-MC and the UN Model Double Taxation Convention, which the Contracting States of the DTC, Mozambique and Italy, have not embraced. As such, we must conclude that if the above States intended an assimilation of the shares of a "*property rich company"* to "*immovable property*", then this assimilation would have to be expressly mentioned in the *positive list* provided in article 6 (2) of the DTC, considering the absence of an equivalent article to the actual 13 (4) of the OECD-MC.

Thus, the mentioned qualification, expressed in Mozambican domestic legislation, of certain shares as "*Immovable Assets*" is incompatible with the DTC as a whole, to the extent that an assimilation of shares to "*immovable property*" was clearly and knowingly denied in the DTC.

We shall turn our attention, now, to the following section of the above quoted article 6 (2) of the DTC: "(…) *rights to variable or fixed payments as consideration for the working of mineral deposits, sources and other natural resources.*"

By comparing the wording of this article with all the other Conventions signed by Mozambique (Botswana, India, Macau, Mauritius, Portugal, South Africa, United Arab Emirates and Vietnam) and with the OECD-MC, it can be seen that article 6 (2) of the DTC has a unique feature: it does not contain the expression "*right to work*". At the OECD-MC the equivalent provision states that: "(…) *rights to variable or fixed payments as consideration for the working of, or the right to work, mineral deposits, sources and other natural resources.*"[11] (emphasis added).

The petroleum rights held by Company B in Mozambique were granted through a concession contract. Taking into account the above, the conclusion to be drawn is that the concession for the exploration of an oil and gas field, in itself, is not autonomously deemed as immovable property according with the DTC.

However, and in any event, it is not Company B, itself, which intends to enter a deal regarding the granted exploration concession. It is Company A, shareholder of Company B, which is considering disposing of a portion of the shares held in the latter.

It has already been mentioned in section 2.1 – which we refer to – that the domestic legislation of Mozambique deemed, for tax purposes, the shares in this Transaction as "*immovable assets*". We have also noted, in the present section, that such qualification is contrary to the obligations laid down by the DTC.

But, even if such an assimilation of the shares of a "*property rich company"* to the "*immovable property*" it holds was possible, under the DTC, on the basis of the renvoi to the definition provided by the domestic legislation of the *situs* State, that extension of the mentioned concept would always have limits. In fact, it should only be possible to make that renvoi if the underlying assets, held by the company whose shares supposedly justify

[11] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 6 (21 September 1995).*

such assimilation to "*immovable property*", are themselves qualified as "*immovable property*" according with the DTC.

As aforementioned, the expression "*right to work*" is not included in the *positive list* of article 6 (2) of the DTC, by express option of the Mozambican and Italian States. As such, the concession for the exploration of an oil and gas field is not autonomously deemed as "*immovable property*" according with the DTC. It is so because the expression "*right to work*" was specifically removed from the *positive list* of article 6 (2) of the DTC, being that all other Conventions signed by Mozambique, and also the OECD-MC, comprise the said expression in the equivalent article. A *bona fide* interpretation and in accordance with International Treaty Law determines that the States committed themselves to not qualify a concession contract for the exploration of mineral deposits, sources and other natural resources, as "*immovable property*".

In a nutshell, if the DTC negotiator closed the door to the possibility of a concession for exploration contract to be regarded as "*immovable property*", under the DTC, the same qualification, as such, cannot be admitted, indirectly, via the window of a supposed assimilation to such concept of the shares of the company that owns the said contract. In other words, and in a simpler way: if a concession for exploration is not "*immovable property*", then surely the shares of a company that holds the said concession cannot be regarded as such. What is not, by itself, "*immovable property*", cannot be converted as such, by the interposition of a company.

However, assuming that an assimilation of the shares held by Company A in Company B to "*immovable property*" would be possible (which is not), by reason of the underlying asset qualifying as such (which does not), it should be noted that whenever an expression is not defined in the DTC – as is the case, at least partially, for the expression "*immovable property*" in all cases where the *positive list* of article 6 (2) does not apply -, one shall observe the aforementioned article 3 (2) to determine the extent of the renvoi to the domestic legislation.

First of all, there is a material difference between the wording given to article 3 (2) of the DTC, and the one which appeared in the corresponding article of the OECD-MC (in its

1995 version), which reads as follows:"*As regards the application of the Convention at any time by a Contracting State, any term not defined therein shall, unless the context otherwise requires, have the meaning that it has at that time under the law of that State for the purposes of the taxes to which the Convention applies, any meaning under the applicable tax laws of that State prevailing over a meaning given to them under other laws of that State.*"[12] (emphasis added).

Paragraph 11 of the Commentary of the OECD-MC on article 3 (2), states the following: "*This paragraph provides a general rule of interpretation for terms used in the Convention but not defined therein. However, the question arises which legislation must be referred to in order to determine the meaning of terms not defined in the Convention, the choice being between the legislation in force when the Convention was signed or that in force when the Convention is being applied, i.e. when the tax is imposed. The Committee on Fiscal Affairs concluded that the latter interpretation should prevail, and in 1995 amended the Model to make this point explicitly*"[13] (emphasis added).

At the signature date of the DTC (1998), this issue was already absolutely clarified in the OECD-MC, both in the wording of article 3 (2), as in the corresponding Commentary. However, the Contracting States, Mozambique and Italy, have eloquently chosen to agree in a different sense, as the following transcript of article 3 (2) of the DTC confirms:"(…) *any term not defined therein shall have the meaning which it has under the law of that Contracting State for the purposes of the taxes to which the Convention applies* (…)"(emphasis added).

A historically situated interpretation of the DTC and of the commitments entered into by the States upon signature supports the conclusion that these, distancing themselves clearly of the OECD-MC, had intended a static interpretation (historicist), and not an ambulatory one ("actualistic") in the renvoi to the domestic law of the States, when there is recourse to article 3 (2) of the DTC. This means that the domestic law at the signature date of the DTC should be applied, in order to ascertain the meaning of terms not defined by it.

[12] *OECD Model Tax Convention on Income and on Capital: Article 3 (21 September 1995).*

[13] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3 (21 September 1995).*

Of such an interpretation follows the irrelevance of the qualification as "*Immovable Assets*" of Company B shares, resulting from Law 27/2014, which postdates the DTC.

However, even if we were to acknowledge that an ambulatory interpretation was required by the DTC at the time of the renvoi to the domestic law of the States – thought without any support in its wording and considering the context of its signature –, the definition given by the domestic legislation of a State, of terms not defined by the DTC, only applies if the context does not require a different interpretation, given that, as paragraph 13 of the Commentary of the OECD-MC on article 3 (2), explains:"(…) *since a State should not be allowed to make a convention partially inoperative by amending afterwards in its domestic law the scope of terms not defined in the Convention* (…)".[14]

Each rule which provides for a distribution of tax jurisdiction sets the limits of the ambulatory interpretation; in other words, it confines the update which is allowed in light of the Commentary of the OECD-MC to the mentioned article. Namely, the ambulatory interpretation cannot suppress the commitments entered into by the States upon the signature of the DTC.

Thus, a modification to the Mozambican domestic legislation, such as the one occurred subsequently to the signature of the DTC – in which the national definition of the concept "*immovable property*" is altered, unilaterally unbalancing the tax jurisdiction in favor of Mozambique, by effect of the application of a different distributive rule of the DTC, than the one it would be applicable, on those same conditions, at the moment of the DTC's signature –, constitutes *Tax Treaty Override*.

Since article 13 of the DTC follows the equivalent provision of the OECD-MC, in its 1995 version, being equally consistent with the 1977 version, it is worth to emphasize that Mozambican domestic laws seeking to influence, after 1998, the signature date of the DTC, its applicable rule regarding the alienation of shares which extract their value essentially from holding immovable property, are completely thwarted in their purposes.

[14] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 3 (21 September 1995).*

Effectively, it is important to notice paragraph 23 of the Commentary of the OECD-MC on article 13 (identical both in the 1977 and 1995 versions):"*Certain tax laws assimilate the alienation of all or part of the shares in a company, the exclusive or main aim of which is to hold immovable property, to the alienation of such immovable property. In itself paragraph 1 does not allow that practice: a special provision in the bilateral convention can alone provide for such an assimilation.* (…)"[15] (emphasis added).

Unless a specific provision establishing this kind of assimilation had been introduced in the DTC by Mozambique and Italy, intending for a domestic rule to impose tax on a disposal of shares of a "*property rich company"* as if the underlying assets would have been disposed directly, consists in *Tax Treaty Override*.

This position has been upheld by the OECD in 1989 in the Report "*Tax Treaty Override*"[16], having such a pronouncement been motivated by a piece of legislation enacted by the United States of America (the *Foreign Investors in Real Property Act* of 1980 - "FIRPTA") whose goal was precisely to derogate the DTC's entered into by the USA, at a time when these still did not include a provision matching the current article 13 (4) of the OECD-MC. Thus, what has determined the OECD to give a ruling on the infeasibility of the tax laws which assimilate a disposal of all or part of the shares in a company, whose corporate purpose is essentially or exclusively holding property, to the alienation of the property held, taking effect at the application of a DTC, was a legislative practice, by the United States of America, in everything identical to the one of Mozambique.

Therefore, what the Contracting States declined by mutual agreement may not, unilaterally, be sought, under penalty of breaching article 3 (2) of the DTC, and of article 8 (1) of the Law 2/2006, in connection with articles 26, 27 and 31 (1) of the Vienna Convention on the Law of Treaties, which establish the universal principle of "*Pacta sunt servanda*" and the requirement of a *bona fide* interpretation and application of the treaties.

[15] *OECD Model Tax Convention on Income and on Capital: Article 13 (19 October 1977)* and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 13 (21 September 1995).*
[16] OECD Committee on Fiscal Affairs, *Tax Treaty Override* (29 June 1989).

2.2.1.3. Article 13 (4) of the OECD-MC

Article 13 (4) in its pre-2017 version, already quoted, was introduced in the OECD-MC in 2003. Previous models did not contain a specific provision regarding capital gains deriving from the disposal of shares which draw a substantial portion of its value from immovable property.

This provision aimed at applying to gains deriving from the alienation of shares in a "*property rich company*" the same treaty regime that would have been applicable if the underlying immovable property had been disposed of directly.In this regard paragraph 28.3 of the Commentary of the OECD-MC on article 13 (4) reads as follows:"*By providing that gains from the alienation of shares deriving more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State may be taxed in that State, paragraph 4 provides that gains from the alienation of such shares and gains from the alienation of the underlying immovable property, which are covered by paragraph 1, are equally taxable in that State*."[17,18] (emphasis added).

In DTC's concluded on the basis of the 1995 version of the OECD-MC, as the one here under analysis, any alienation of shares in a "*property rich company*" is regulated by the current article 13 (5) of the OECD-MC, whose matching article in the DTC is the 13 (4), which establishes the following:"*Gains from the alienation of any property other than that referred to in paragraphs 1, 2 and 3 shall be taxable only in the Contracting State of which the alienator is resident.*"

Therefore, and as already explained above, the Italian and Mozambican States having failed to introduce in the DTC a provision similar to article 13 (4) of the OECD-MC, any domestic legislation assimilating a disposal of shares in a "*property rich company*" to a

[17] *OECD Model Tax Convention on Income and on Capital: Commentary on Article 13 (28 January 2003).*

[18] This comment was slightly changed with the 2017 version of the OECD-MC, not altering the substance that we emphasized. The following bolt segments highlight the additions to the comment: "*By providing that gains from the alienation of shares **or comparable interests which, at any time during the 365 days preceding the alienation**, deriv**ed**(~~ing~~) more than 50 per cent of their value directly or indirectly from immovable property situated in a Contracting State may be taxed in that State, paragraph 4 provides that gains from the alienation of such shares **or comparable interests** and gains from the alienation of the underlying immovable property, which are covered by paragraph 1, are equally taxable in that State.*" (see *OECD Model Tax Convention on Income and on Capital: Commentary on Article 13 (21 November 2017).*

direct alienation of the underlying immovable assets cannot derogate the treaty rules of the DTC which establish a different standard, in which such an assimilation is absent.

The abovementioned conclusion is supported by paragraph 30 of the Commentary of the OECD-MC on article 13 (both in the 1977 and 1995 versions):"*The Article does not contain special rules for gains from the alienation of shares in a company or of securities, bonds, debentures and the like. Such gains are, therefore, taxable only in the State of which the alienator is a resident*."[19]

Finally, it should be noted that the request by the Mozambican authorities to renegotiate the DTC, namely to include in article 13 an identical provision to article 13 (4) of the OECD-MC, represents a clear acknowledgement that the distributive rules of the DTC, as they stand, do not allow Mozambique to tax the disposal of shares of a non-resident company, in which the deal takes place between entities, the buyer and the seller, also non-resident in Mozambique, even if the company whose shares are being disposed of holds petroleum rights in Mozambique.

2.2.1.4. The Irrelevance of the OECD Multilateral Instrument

Contracting States do not have necessarily to appeal to a bilateral negotiation in order to implement a certain modification to a DTC. Indeed, OECD acknowledged the inefficiency that such method imposes on the implementation of recommendations and, subsequently, also addressed this issue when designed the scheme underlying the OECD Multilateral Instrument (hereinafter "MLI") [20].

Action 15 of OECD provided for a multilateral instrument enabling committing jurisdictions the opportunity to implement the BEPS measures with a widespread reform and coordination within the existing network of DTCs, without requiring separate bilateral negotiations between them. The MLI has mandatory and optional parts for every signatory State. Each of them has to mention what are the optional rules it will apply, and

[19] *OECD Model Tax Convention on Income and on Capital: Article 13 (19 October 1977)* and *OECD Model Tax Convention on Income and on Capital: Commentary on Article 13 (21 September 1995).*

[20] *OECD Multilateral Convention to Implement Tax Treaty Related Measures To Prevent Base Erosion And Profit Shifting: Article 9 (24 November 2016).*

if two States have opted for the same rule on the MLI such rule will become applicable in a specific DTC, automatically changing it without a bilateral negotiation.

The MLI is intended to modify the bilateral DTCs of its signatories: (i) when both parties of that specific DTC signed the MLI; (ii) designated such DTC as a Covered Tax Agreement; and (iii) only to the extent that both countries decided to adopt some of the same provisions in the MLI.

For countries party to the MLI lacking a provision in their existing tax treaties equivalent to article 13 (4) of the OECD-MC, article 9 (4) of the MLI in effect incorporates such a provision into their tax treaties, which are modified by the MLI under international law, provided both treaty partners have opted in for article 9 (4) of the Convention.

For countries that already have in their tax treaties a provision related to the taxation of capital gains derived from the alienation of shares, the MLI offers two options for enhancing it. First, article 9 (1) of the MLI allows parties to modify their covered tax treaties by introducing a testing period into older, pre 21 November 2017, versions of article 13 (4) of the OECD-MC. Accordingly, article 13 (4) will refer to a period of 365 days preceding the alienation of shares for determining whether the shares derive their value principally from immovable property. Additionally, article 9 (1) of the MLI offers the parties the possibility to expand the type of interests covered by those previous versions of article 13 (4) of the OECD-MC. As a result, interests comparable to shares, such as interests in a partnership or trust, would be also included under the new wording of article 13 (4).

Italy signed the MLI (although it is still not in force) and chose to apply article 9 (4) to its Covered Tax Agreements, but these do not include the DTC under analysis. It also reserved the right for article 9 (1) not to apply to its Covered Tax Agreements.

However, no further digression on this topic is necessary given that, whilst Italy has signed the MLI, Mozambique did not even express an intention to implement the MLI into its legal system. This means that the MLI does not impact the DTC between Italy and

Mozambique in any way, implicating that the wording of article 13 of the DTC in force is still the same as it was established in 1998.

2.2.1.5. Applicability of article 13 (4) of the DTC

Taking into account the analysis above, the distributive rule of tax jurisdiction of the DTC, applicable to the Transaction, is article 13 (4), which allocates the exclusive right to tax a possible disposal of shares of Company B by Company A to the State of Residence of the seller (in this case, Italy).

3. Conclusions

Considering the case analyzed above, it can be extrapolated that Contracting States do not enjoy an ample margin to classify certain assets as "*immovable property*" for the purposes of the application of DTCs entered into by them. A domestic unilateral provision does not suffice to source the gain on a transfer of shares and enable a country to tax it.

In the absence of a specific article dealing with capital gains on the alienation of shares of a company whose only asset is an immovable property (an article along the lines of model article 13 (4)), its taxability should be covered under the article dealing with alienation of shares of a company.

This case highlights the importance of the concept of 'immovability' in international taxation and the need to consider domestic provisions alongside the positive listing of bilateral treaties entered into.

In fact, if we were to acknowledge that the said shares are situated in Mozambique, even so, the commitments entered into by the States upon the DTC signature would not allow Mozambican domestic law an assimilation to the concept of "immovable property" of shares in a "property rich company", in the absence of an express mention of such shares in the positive list, provided in article 6 (2) of the DTC, and taking into account the lack of an article, in the DTC, equivalent to article 13 (4), as introduced in the 2003 OECD-MC version.

Notwithstanding, even if an assimilation, for DTC effects, of the shares of a "*property rich company"* to "*immovable property*" was possible, on the basis of the renvoi to the definition provided by the domestic legislation of the *situs* State of the asset, that extension of the mentioned concept would always have a limit: that the underlying assets are themselves to qualify as "*immovable property*", according with the DTC. In a nutshell, if the DTC negotiator closed the door to the possibility of a concession for exploration contract to be regarded as "*immovable property*", under the DTC, the same qualification cannot be admitted as such, indirectly, via the window of a supposed assimilation to such concept of the shares of the company that owns the said contract. In other words, and in a simpler way: if a concession for exploration is not "*immovable property*", then surely the shares of a company that holds the said concession cannot be regarded as such. What is not, by itself, "*immovable property*", cannot be converted as such, by the interposition of a company.

However, assuming that an assimilation of the shares held by Company A in Company B to "*immovable property*" would be possible (which is not), by reason of the underlying asset qualifying as such (which it does not), it should be noted that whenever an expression is not defined in the DTC – as is the case, at least partially, for the expression "*immovable property*" in all cases where the *positive list* of article 6 (2) of the DTC does not apply –, one shall observe the aforementioned article 3 (2) of the DTC to determine the extent of the renvoi to the domestic legislation.

Considering the drafting of article 3 (2) of the DTC, and the context in which it was agreed upon, the renvoi to the Mozambican domestic law is static, to the provisions in force at the signature date of the DTC. From such an interpretation stems the irrelevance of the qualification resulting from the Law 27/2014, which postdates the DTC.

Even if we were to acknowledge that article 3 (2) of the DTC, requires an ambulatory interpretation, at the time of the renvoi to the domestic law, for the purposes of article 6 (2) of the DTC, the qualification of the shares as immovable property, by reason of law postdating the signature of the DTC, intending or effectively unbalancing the taxing rights attributed by the Convention, in favor of Mozambique, would be illegitimate, in the

context of its application, consisting in a paradigmatic example of unacceptable *Tax Treaty Override*.

In this situation, the Tax Treaty protected the residence country's exclusive right to tax the transaction and the application of contrary domestic law rules could not be viewed as supplementary to the treaty; instead, they were an override.

It is acceptable, in general, that domestic income tax laws include a specific provision taxing offshore indirect sales of property with a domestic situs. However, legislative action across countries should not forgo the aim of maintaining legal certainty, which is paramount for both governments and investors. It is important that a country complies with its good faith obligations with respect to the interpretation of DTCs in force.