Chapter Two

Income Tax in Ethiopia

What is income?

- Important tax base
- No comprehensive and permanently applicable definition of the term income
- Legal notion of income; Art. 2 (14) of poc 979/2016 “Income” means every form of economic benefit, including non-recurring gains, in cash or kind from whatever source derived and in whatever form paid, credited, or received
  - economic benefit – possible to assess in monetary terms
  - Kind of benefit - in cash or kind, service, any other form e.g. cancellation of indebtedness, A lawyer handled a court case for a doctor in exchange for medical treatment
  - Frequency of gains - immaterial. Recurring or non-recurring gains - periodically maturing benefits or may be benefits accruing to the beneficiary only once. Example: lottery winnings are income.
  - Source of economic benefit - from whatever source Income from criminal activities? lawful vs. unlawful/immoral sources of income.

Tax jurisdictions

- Income tax jurisdiction determines which government has the legal right to tax various types of income generated by individuals and entities.
- It became an accepted norm that states' taxing powers should have some sort of connection with taxable **subjects** (persons) and **objects**.
- The connection is thought to exist if the states' taxing power is based on either the relationship to a person (personal attachment) or a territory (territorial attachment).
- This thought has led to the formulation of the two famous income jurisdiction.

Income tax jurisdiction

- Scope of application
  - Residence/personality principle (the taxpayers place of living). J/n?

    Generally, if a person or entity is considered a resident of a particular country for tax purposes, they are subject to that country's income tax laws on their worldwide income. This means that their income, regardless of where it is earned, is subject to taxation by that country.
  - Source/territorial principle (the place the taxable item derived)

    a person or entity may be subject to income tax only on the income generated within that specific country, while income earned outside the country may not be subject to taxation.
  - Nationality – less tangible link b/n tax jurisdiction and tax payer

Residence ppl

- In Ethiopia - art. 7 of the ITP - income taxation is applicable to residents of Ethiopia with respect to their world wide incomes.
  - **Residents? Art. 5 of the ITP .**
  - The justification that persons shall share the public expenditure (costs) of the state whey they live.
  - Art 5 (1): the following are residents of Ethiopia (a) a resident individual; (b) a resident body; (c) the Government of the Federal Democratic Republic of Ethiopia, and any Regional State or City Government in Ethiopia.
  - Art 5 (2): a resident individual is an individual who: (a) has a domicile in Ethiopia; (b) is a citizen of Ethiopia who is a consular, diplomatic, or similar official posted abroad; (c) is present in Ethiopia, continuously or intermittently, for more than 183 days in a one-year period. The above elements should be satisfied alternatively not cumulatively.
  - Art 2 (5) a resident body is a body that: (a) is incorporated or formed in Ethiopia; or (b) has its place of effective management in Ethiopia.

- Non-residents with respect to their Ethiopian source income.
  - Ethiopian source income? art. 6 of the ITP
  - The state where an income is derived shall have the right to tax the income, irrespective of the place where the persons reside.
  - **The justification is that a state that creates the opportunity to generate an income should be given the right to tax that income.**
- Employment income derived by an employee shall be Ethiopian source income: (a) to the extent that it is derived in respect of employment exercised in Ethiopia, wherever paid; or (b) if it is paid to the employee by, or on behalf of, the Government of the Federal Democratic Republic of Ethiopia, wherever the employment is exercised.

- dividend paid to the person by a resident body;
- rental income from the lease of: im/movable asset located in Ethiopia;
- a gain arising from the disposal of immovable asset located in Ethiopia
- shares in, or bonds issued by, a resident company;
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- Principle of PE. - art. 4 of ITP (PE in Ethiopia)- **modification of source principle**.
- Permanent establishment' is a well-known concept that is widely used by tax laws to determine whether or not non-resident artificial persons (bodies) derive income in source states.
  - Applicable for non-resident doing business in ethiopia.
  - The term is relevant in determining whether income is Ethiopian source income (Article 6), the taxation of certain payments made to non-residents (Article 51), the transfer pricing rules (Article 79), the withholding of tax (including selfwithholding) from certain payments (Articles 89, 90, and 93).

- Grey areas. Hard to apply residence (due to they failed to meet the residence requirement and considering them as resident amount taxing them on their worldwide income which is unjustified) and source as it is/hard to come up with clear cut income distinction b/n the head and branch,

- Rationale behind pp of PE is that when the branch….become an enduring part of the economy of the country, it should contribute to z cost of z latter.
- Elements of PE/4/1/; place of business/certain space is available; fixed/distinct and exhibit a certain degree of permanence/; carried on business wholly or partly
- Effect of PE; pay tax but only z net income derived here not worldwide

The problem of double taxation

- Double taxation - impose similar tax on the same person/source income
- How it happens?
  - Source -source conflict
  - Residence - residence conflict
  - Source - residence conflict
  - Intera states (regional-region) common in federal arrangement
  - it is worth mentioning that the advancement of digital technology further complicates the traditional concepts of residence and source principles
- Problems:
  - defeats the principle of equity (taxpayers with same income pay different amount of tax);
  - affects the international trade/investment.
- Solution
  - Unilateral vs. Bi/multilateral
  - Tax credit (deduction method) vs. exemption method
- The case in Ethiopia
  - Unilateral – tax cr edit (art. 45. of ITP for Schedule 'C' taxpayers; art. 20 of ITR for Schedule 'A' taxpayers; art. 25 of ITR for Schedule 'B' taxpayers; art. 64 (3) & (4) of ITP for Schedule 'D' taxpayers.

Income tax structure

- Theoretically two income tax structures – global and schedular
- Global tax- is imposed on the total income of the individual regardless of the types of activities and regardless of the source of income
  - Unitary definition of income
  - No distinguishing of sources of income
  - Aggregate all income
  - Apply a single rate (usually progressive). A single rate not mean flat rate rather to mean the structure of the rate is one. (in scheduler d/t rate structure for d/t sources)
- Merits
  - Enhance canon of equity – based on ability to pay. Aggregating income under a global tax renders a progressive tax scale more effective (vertical equity) and does not discriminate between income from different sources (horizontal equity).
- Demerits
  - Not helpful to meet diverse policy goals

- Schedular - different sources are taken into consideration for tax purpose and tax is levied and collected separately.
  - No unitary definition of income
  - Separate treatment of income sources (no aggregation – taxed separately)
- Demerits
  - Violate horizontal equity-equal income taxed differently
  - May be potentially more difficult to administer (the need to classify –characterization problem)
- Merits
  - Help to meet different policy matters
  - Administrative convenience (such as possibility to use withholding scheme; time convenience
- In reality no pure global or scheduler system (composite)

Income tax structure of Ethiopia

- Schedular – art. 8 of ITP
  - But not pure – art. 63 of ITP. A person who derives any income that is not taxable under Schedule A, B, C, or D shall be liable for income tax at the rate of 15% on the gross amount of the income
- Manifestation of the Schedules- in light of the two basic doctrines of scheduler income tax structure
  - The doctrine of source - answers the question, which income is subject to the concerned schedule
    - Reflected in Ethiopia's income tax (Arts. 12, 15, 20 and each provisions –including definitions- of Schedule 'D'
  - The doctrine of mutual exclusivity – each schedule has its own exclusive element
  - The doctrine reflected in Ethiopia's income tax through the following seven points

- Separate tax bases
- Exclusive income brackets and tax rate structures- except Schedule 'D' which has diverse tax rates
- Rules for computation of taxable income separate for each of the schedules (allowed exemptions, deductions,… d/t)
- Tax preferences are basically unique to each of the schedules- see Schedule 'E
- Aggregation is bound by schedules – 8 (2) of ITP

Taxpayers that derive incomes from two or more sources that fall under the same schedule are taxed on the aggregate of their incomes

- Rules of assessment and method of accounting.
  - Schedule ‘A’ and ‘D’ taxpayers primarily subject to withholding taxation while Schedule ‘B’ and ‘C’ taxpayers are subject to the regime of self-assessment (degree of assessment varies according to the categories of taxpayers)
  - Both Schedule ‘A’ and ‘D’ are subject to cash-basis tax accounting rule while Schedule ‘B’ and ‘C’ taxpayers may use either cash or accrual methods of accounting, except companies which always need to adopt accrual basis accounting
- Accounting periods or tax periods of the schedules is also different.
  - Schedule ‘A’ adopted a monthly accounting and simple PAYE; art. 10 (1) each calendar of the month
  - Schedule ‘B’ (13 (1) for the year) and ‘C’ (18 (1) for the year) adopted annual accounting;
  - Schedule ‘D’ has adopted event based or realization (the provisions use the word ‘derive’ to refer when realized)

Schedules

- Each schedules are expected to determine the following;
  - Taxable units/tax payers
  - Tax base
  - Taxable income
    - Gross income
    - Taxable income (gross income – exemptions/exclusions/deductions)
      - Exemption - refers to person/for different policy reason certain categories of persons exempted.
      - Exclusions -refers to the income/for different policy reason certain categories of income excluded from making part of taxable income. (The distinction between exemption and exclusion not apparent in the ITP)
      - Deduction – refers to expenses incurred to generate the income
    - Why taxable income? It tells the ability to pay. Plus, different policy goals serve through exemptions/exclusions
  - Applicable rates
  - Tax declaration and assessment (issue of tax administration)

Schedule A – employment income tax

- The tax is assessed on the gross income and there is little room for the application of deduction rules.
- Due to the application of the withholding system, employment income tax is easy-to-collect tax revenue.
- It claims little compliance and administrative costs. The tax is a high-yielding revenue collector in many countries.
- The withholding scheme is an effective method for securing an uninterrupted and reliable revenue sources.
- By reducing tax evasion, it furnishes the government with uninterruptable money to fund its activities.

Taxable Units of Schedule ‘A’

- Art. 10 (1) of the ITP reads that “… Employment income tax shall be imposed… on an *employee* who receives employment income…” **Who is an Employee**?
- Art. 2 (7) of the ITP defines employee as, “An *individual (natural person)* engaged, whether on *a permanent or temporary basis*, to perform services under the *direction and control* of another person, other than as an independent contractor, and includes a director or other holder of an office in the management of a body, and government appointees and elected persons holding public offices (office holders are paid essentially for the labour like employees)

- period of employment is immaterial
- Income from independent contract services is subject to Schedule ‘C’ not ‘A’. an individual engaged to perform services under an agreement by which the individual retains substantial authority to direct and control the manner in which the services are to be performed (Art 2(15).

Characterization problem

- the phrase ‘direction and control’ or ‘substantial authority’
- confusion between employment income and royalty, regarding payments made for preparation of teaching modules in Universities.
- employment income and dividends; mostly with respect to payments made to BODs of a share company.
- employment income and technical fee (15%) (which is taxable under Schedule ‘D’)

the determination of whether an individual is an employee or independent contractor involves examining several factors, including whether the hirer has the legal right to control how the work is done and the degree of integration of the activities of the individual in the business of the hirer. In determining the degree of integration, regard is normally had to the following: technical note

- Whether the individual is engaged continuously.
- Where the services are performed, in particular, whether they are performed at the hirer’s place of business.
- Whether the hirer controls the timing and scheduling of the work.
- Whether the hirer provides the working tools, plant, and other relevant facilities necessary for the individual to perform his or her work.

Tax base

Employment income? Art. 2 (9) of the ITP cross refer to Art. 12

1. salary, wages, an allowance, bonus, commission, gratuity, or other remuneration
2. value of fringe benefits/in kind benefits

- The main examples of fringe benefits are health insurance, employer-provided housing, the use of the employer’s car for personal purpose, and the provision of discounted goods or interest loan, a meal

Why fringe benefit is taxed? Ability to pay increased. Plus, for the sake of horizontal equity, broadning the tax base.

- Meaning, conditions and valuation of each benefits? Arts. 9-18 of ITR.
- Extent of tax liability - 10% of salary- Art. 19 ITR.

Excluded benefits from the ambit of fringe benefits, so not taxed

- the provision of a mobile phone by an employer for use by an employee;
- the payment by an employer of the cost of mobile phone calls made by an employee,
- tuition fees paid by an employer for the benefit of an employee

3. an amount received by an employee on termination of employment. (severance payments, back payments, compensation for redundancy or loss of employment

4. employment income tax paid by employer for the employee without withholding tax from the employment income (the message is do not increase salary in this way)

Incomes in respect of a past, current, or future employment'.

- Generally, both cash and in kind payments are tax bases- if the two cumulative tests fulfilled.
  - Existence of employment relationship (labour proclamation 1156/2019)
  - The payment should derived from this relationship (payments made to the employee due to services given by him/her to the employer).
  - Hence, any payment made in non-employment context does not fall within the scope of employment income.

Taxable income

- Taxable income of Schedule ‘A’: gross employment income minus exemptions/exclusions (for Economic, administrative or social reasons)
- No deduction of expenses. Why? May be because the employment income from the very beginning is paid to employees for their expenses. Two, the income is paid by another party, not the employee’s own income. Three, to generate more revenue for the government.

Exemptions

- Floor exemption/the first 600 birr – Art. 11/2/ ITP
  - social justice/small amount.
  - economic reasons -it would not be economical/cost effective for the government
- Schedule 'E' – Art. 65 (1) (a-d) ITP, exclusively for Schedule 'A' taxpayers
- Actual cost of medical treatment (including premium payments as per employees' medical insurance scheme- 54/2/ ITR)
  - a public policy of encouraging certain kinds of payments to employees and it is a reimbursement.

- Transportation allowance – if stipulated under the contract of employment/ad hoc transport allowances are not excludable/. because they
  - represent reimbursement of employee expenses.
  - MoFEC (MF) empowered to come up with limits.
- Hardship allowance
  - depending on the nature of the work or the nature of the place of work (like weather condition)
  - represent reimbursement of employee expenses and as incentive
  - MoFEC empowered to come up with limits.

- Transport expenses and per diem payments because they represent
  - Vs. transport allowance (tour on employment duty out of regular place work and payments for to work and from work-regular place of work)
  - Reimbursements/the employee has not derived any income but simply refunded for what he has expended.
  - MoFEC empowered to come up with limits. Unless limited per diem may be used excessively/without paying tax.
- Travelling expenses - if stipulated under the contract of employment.
  - reimbursement of employee expenses

- Free food and beverages Employees in the mining, manufacturing or agriculture business (Incentive)
  - MoFEC empowered to come up with limits.
- Employer's contribution to a pension fund.
  - Social reasons. since contributions are made for social security reasons, taxing now means no income is accumulating for this purpose.
  - Plus, the income is not yet flow to the pocket of the employee. When it mature it can be taxed, unless exempted/excluded from current tax base.
  - Without exceeding 15% of monthly salary

- i/compensation for personal injury or the death of another person.
  - strictly speaking, they are not incomes/simply indemnities to what is lost by such a person.
  - scope of another person?
- k/ scholarship payments for attendance at an educational institution
- o/ amount specifically exempted by other laws of ethiopia. E.g. compensation for employment injuries - art 112 of proclamation 377/2003 (labor law)

- Expatriate professionals- Art. 54 (1) (a) of ITR.
  - Recruited by investors in the export business
  - For the purpose of knowledge transfer
  - Not exceeding five year
  - MoFEC empowered to issue directive
- Unskilled employee- Art. 54 (1(b & c) of ITR.
  - Work for same employer not more than 30 days in a year and non-professional
  - Administrative inconvenience/economic reason. not regularly employed by a single employer hence hard for the tax authorities to trace the income of such employees through an employer.
  - Plus, social reason- mostly low income earners.

  Maintenance or child support payments
- Non-exhaustive-65/2/ - Council of Ministers may exempt any income by regulation for eco, admin or social reasons

Applicable rate

- After making the above exemptions/exclusions, the remaining is taxable income
- Apply the appropriate tax rate on the taxable income- art. 11 of ITP
- 0 –600 0%
- 601-1,650 10%
- 1,651-3,200 15%
- 3,201-5,250 20%
- 5,251-7,800 25%
- 7,801-10,900 30%
- Over 10,900 35%
- Progressive but not absolute. A kind of digressive rate.

Schedule ‘B’: Income from Rental of Buildings

- By its nature, renting buildings is a business activity as it involves an economic activity conducted for financial gain.
- The Income Tax Proclamation (No. 979/2016) defines business in terms of some activities, excluding ‘rental of buildings’.
- The exclusion is made to delimit the scope of Schedule B and C of the Proclamation.
- The existing tax policy documents and laws of Ethiopia do not specify the justifications for the separate treatment of rental income from buildings under Schedule B.
- It is not clear why income from the rental of buildings is not regarded as a business income…the continuation of this historical legacy/incident. Since 1949,

The Scope of Schedule “B”: the Law

- Schedule “B” is not intended to cover all forms of income from rental of property.
- There are Other provisions in other schedules of Ethiopian Income tax law which delimit the scope of Schedule “B”.
- Income from causal rental of property under Art. 58 is subject to D
- Art 50 income derived from casual rental of asset means gross income derived by a person who is *not engaged in the regular business of rental of movable or immovable asset.* The contrary reading - only rental activities of a building made on regular basis are subject to Schedule ‘B’. What does regularmean? TheAmharicversionreads “…በንግድስራላይበመደበኛነትያልተሰማራሰው

- Art. 22 of the ITR -income from lease of business assets (which can include a building) as part of the normal operation of a business, is subject to Schedule ‘C’. e.g. rental of buildings as a matter of course such as hotels, hostels, pensions and guest houses are not tax payers of Schedule ‘B’. Such business persons are taxable units of Schedule ‘C’ for the whole of their operations
- The rental part of their activities is fully integrated into their other businesses, which are taxable under Schedule ‘C’. doing so is appropriate since in the undertakings mentioned above (e.g., hotels and hostels); rental of rooms (which are buildings) is part and parcel of their business. Integrated with the business

- For businesses which engage in rental of buildings, however, without integrated it with their other businesses, like commercial banks engage in activities of building and then renting what they build. In such case, for the rental part, the banks will be taxable units of Schedule ‘B’ while for their main business activity (banking services), they will be a taxable units of Schedule ‘C’.
- this may lead to the splitting of income and then tax planning, Schedule ‘C’ has extensive deductions than Schedule ‘B’. Thus, to get more deductions (this will lower the taxable income which is very beneficial in progressive tax rate structure), taxpayers may shift their income to Schedule ‘C’ while it supposed to be taxed under Schedule ‘B’

- What is the solution? May be considering the proportion of rental activity vis-à-vis business activity and tax the whole income under either of the Schedules (i.e., if the rental activity is more taxing the whole under Schedule ‘B’ and if the business activity is more like the case of banks, taxing the whole under Schedule ‘C’). Or requiring stringent separate books of account can be considered.
- The system not only obliges taxpayers to split their income but also to split jurisdictions to which payments are to be made.
- Companies involved in real estate along with their main line of business are required to file their income tax under Schedule ‘B’ to the Regional Governments in which the real estate is located, and their income from their core or other business to the Federal Government

Tax base

1. ‘rental income’ derived from lease of a building or buildings - tax base of the Schedule is not a building, but when rented out
2. payments made by the lessee on behalf of the lessor according to the lease agreement. E.g if the lessee paid a debt of his lessor to the creditor of the latter in exchange of the rent
3. the amount a taxpayer is entitled to retain as a result of damage to the building and that has not been used by the taxpayer in repairing the damage
4. the value of any renovation or improvement to the building when the cost was borne by the lessee in addition to the rent payable to the lessor. If the lessee covers these costs in exchange of rent payments (as set-off), the lessor is not taxed (to the extent of the costs incurred).
5. If a taxpayer leases a furnished building, the tax also include any amount attributable to the lease of the furniture or equipment.

- Exemptions–Art. 15 (4) of ITP
  - Floor exemption/7, 200/ for individuals- Art. 14/2/

Exclusions

- income from casual rental of assets, including buildings.
- income from lease of business assets (which can include a building) as part of the normal operation of a business

Deduction

- For the purpose of Schedule B (and C as well), expenses (expenditures) are classified into ordinary and capital expenses.
- Ordinary expenses, such as insurance premium, land lease fee, municipality charges, and utility costs, are directly deducted from the gross annual rental income of the tax year.
- Capital expenses, such as costs incurred for the acquisition, repair, and maintenance of the leased building/s, furniture and equipment, are subject to depreciation rules.
- Capital expenses are not deducted at once from the gross rental income of the year.

- In taxation, depreciation is a cost (expense) recovery mechanism of capital assets that are used for deriving taxable income.
- It is used to allocate the cost of the asset over the supposed useful life of the asset.
- Since capital assets are used to derive income for a longer time, their costs should also be allocated for many years (or at least for more than one year).
- The depreciation rules allow both the taxpayers and tax administration to know the amount/portion of capital expenses to be deducted in each tax year.

- The straight-line method is the most common way, including in Ethiopia, of calculating depreciation. Amount of depreciation in every tax year remains the same or uniform.
- According to Ethiopia's income tax laws, buildings are depreciated at the rate of 5%.
- This means that the total capital cost would be deducted within 20 years.

- The total annual expense of the taxpayer is a sum of ordinary expenses and capital expenses for the year. This is actual deduction

- For taxpayers that do not have the legal obligation to keep books of accounts (Category C taxpayers), falling under Schedule B, the following expenses are deductible from the annual gross rental income.
  - standard deductions/ an amount equal to (50%) of the gross rental income derived by the taxpayer for the year as an allowance for the acquisition, repair, maintenance, and depreciation of the building, furniture, and equipment and utility costs. other than fees and charges deducted above land lease fee, municipality charges

- Fees and charges paid to the government and 50% of the annual gross income constitute the annual allowable expenses of the taxpayers.
- **Depreciation and loss carry forward rules do not apply here.**

- The annual gross rental income is determined based on the tax authorities' estimate of the Category C taxpayers' income.

Applicable rates – art 14

- Bodies – 30% flat rate
- Natural persons- a combination of proportional and progressive rates.
  - 0-7,200 -0%
  - 7,201- 19,800 -10
  - 19,80 - 38,400 15
  - 38,401 – 63,000 20
  - 63,001 – 93,600 25
  - 93,601 – 130,800 30
  - Over 130,800 35
- **Time of payment**
- Taxes under this schedule, unlike taxes on income from employment, are to be levied and collected annually.

Schedule ‘C’: Business Income

Taxable Units of Schedule ‘C’

- Art. 18 (1) business income tax imposed …*on a person (individuals and body)* conducting business. *individuals refers* to sole proprietors or individual traders, body refers to “a company, partnership, public enterprise or public financial agency, or other body of persons whether formed in Ethiopia or elsewhere. Art. 2 (5) of the TAP
- the incorporation of partnerships as taxable units of Schedule ‘C’ is questionable? In many countries, partnerships are recognized as a mere association of persons not as entity-proper and for taxation purpose, they are not taxed at the entity level (i.e., the only taxpaying persons are the individual partners)

- the mere fact the existing system treats partnerships as incorporated entities for the purpose of tax does not mean it is proper.
- It have a legal personality, but the unlimited liability of partners makes it unincorporated business
- If partnerships are treated as bodies, it means, they are subject to the flat tax rates of Schedule ‘C’, just like companies. Subjecting both a partnership and a company to the same taxation treatments, may amounts as narrowing the choice of partnerships as form of business doings.

- the list of Art. 2 (5) of the TAP is not exhaustive; it has the effect of including, even non-business entities and religious institutions, as taxable units of Schedule ‘C’, as long as they conduct business. Thus, the important factor is the activity (whether it is business or not) not the identity of the person (whether it is a commercial or non-commercial entity).
- Art 65 exempted- income of non-profit org other than business income that is not directly related to the core function of the org
- cooperative societies, may be considered as body for the purpose of Schedule ‘C’, yet not taxable units of this Schedule. They are exempted from paying income tax at entity level and the tax is imposed on members where they are required to pay income tax on their dividends.

- On the other hand, Micro Enterprises which conventionally characterized as ‘a body’ are considered as ‘individuals’ for the purpose of their income tax liability. It means, still they are taxable units of Schedule ‘C’, but not as a ‘body’. Art. 19 (3) of the ITP, applies the progressive tax rate than the 30% flat rate for Micro Enterprises, like individual taxpayers of Schedule ‘C’

- They can be residents or non-residents.

Tax bases

- income derived from ‘business’- Art. 2 (2) (a) of the ITP describes business as; “any industrial, commercial, professional, or vocational activity conducted for profit and whether conducted continuously or short-term, but does not include the rendering of services as an employee or the rental of buildings.
- The purpose or motive of the activity is stipulated as the core element of business, i.e., it must be conducted ‘for profit’. The phrase ‘for profit’ has resulted in a number of controversies particularly with religious organizations. The phrase ‘for profit’ is to mean whether the activity generates profit or not.
- It is immaterial, for what purpose a person will use the generated profit. The characterization of the activity as business is more important than the identity of a person who derives the income.

- The phrase ‘whether conducted continuously or short-term’ indicates the frequency of the activity is immaterial. Hence, for the purpose of income tax, ‘regularity’ is not a determining factor for a certain activity to be considered as business. It is inclusive of undertakings which may be done at once or infrequently, keeping in mind the system able to reach them.
- the definition incorporates exclusions. Accordingly, the rendering of services as an employee and the rental of buildings are not considered as business. In fact, these activities are already subjected to Schedule ‘A’ and ‘B’, respectively.

- Art. 2 (2) (b) of the ITP provides the second alternative definition of business, which reads “any other activity recognized as a trade under the Commercial Code.
- The third alternative definition of business is provided under Art. 2 (2) (c) of the ITP which reads; “any activity, other than the rental of buildings, of a share company or private limited company whatever the objects of the company. the message of this provision, if someone wants to engage in non-profitable activities without paying business income tax, companies are not the preferable forms of entities to the undertaking.
- a gain derived from disposal of business asset done as part of corporate re-organization, will not be considered as gain. This allows businesses to engage in business reorganizations, such as mergers, without fear of income taxation

Deductions

- Art. 22 (a) ITP. For an expense to be deducted It has to be necessary and business related expense.
- How to test ‘necessary’? May be by using ‘ordinary’; primary motive (personal nature or profit motivated); reasonable expense
- cost of trading stocks
- depreciation for capital assets
- A loss on disposal of a business asset (other than trading stock)
- ART 23 – interest incurred by the taxpayer to the extent that the taxpayer has used the proceeds or benefit of the debt or other instrument that gives rise to the interest to derive business income.

- ART 24 **Charitable Donations;** when the donation is made:
- a) To Ethiopian Charities and Ethiopian Societies
- b) In response to a call for development or an emergency call issued by the Government to defend the sovereignty and integrity of the country, to prevent or provide relief in relation to man-made or natural disasters or an epidemic, or for any other similar cause;

- The total deduction FOR DONATION shall not exceed 10% of the taxable income of the taxpayer for the year.

- **26. Loss carry forward**
- 1/ If the total amount of deductions allowed to a taxpayer for a tax year exceeds the total business income of the taxpayer for the year, the amount of the excess shall be the taxpayer’s loss for the year.
- 2/ if a taxpayer has a loss for a tax year, the taxpayer shall carry the amount of the loss forward to the next following tax year and the loss shall be allowed as a deduction in computing the taxpayer’s taxable income for that following year.
- … but not for more than 5 years

Non deductable expenditure or loss

- an expenditure of a capital nature except to the extent provided for under Article 22(1)(c) of this Proclamation; I.E. DEPRECATION
- b) an increase in the share capital of a company or the basic capital of a registered partnership;
- c) voluntary pension or provident fund contributions in respect of an employee in excess of 15% of the monthly employment income of the employee;
- d) Dividends and paid-out profit shares;
- e) an expenditure or loss to the extent recovered or recoverable under a policy of insurance, or a contract of indemnity, guarantee, or surety;
- f) a fine or penalty imposed, or punitive damages awarded, for violation of any law, regulation, or contract;

Schedule ‘D’

- Lacks unifying features
- Covers diverse sources (miscellaneous types of income); no general and single source of income that represents the schedule. There are independent sub-schedules
- Intended to capture income sources not covered under the other schedules.
- Tax irregular/infrequent sources – passive income
- Incomes are subject to different rules: taxable income, tax rates, assessment, and collection methods are not the same across the sub-schedules.

- its methods of tax assessment and collection is a combination of withholding and self-assessment.
- royalty, interest, and dividend, income from game of chance are subject to withholding,
- while earning from casual rental of property, capital gains, undistributed profit are possible sources subject to the regime of self-assessment
- E.g deduction is allowed with respect to taxation of capital gain, but there is no deduction for Dividends and interest

- Since each sub-schedule has its tax rate, income aggregation rules do not apply to Schedule D. For instance, dividends and income from lottery winnings cannot be aggregated and taxed under the same tax rate. Even the same incomes falling under the same sub-schedule are not taxed on their aggregate. E.g A person deriving dividends from two or more different companies
- according to Art 64 The tax imposed on each income under schedule D is a final tax (no credit at the end of the tax year and it is subject to a withholding system)
- no monthly or annual tax year under Schedule D. The tax liability is due whenever a payment of income is made to the taxpayers

- Unlike Schedules A, B, and C, Schedule D contains flat tax rates and no distinction is made between body and individual taxpayers for the purpose of the tax rate

- If an income that is taxable under Schedule D is also subject to tax under one of the other Schedules (A,B, or C), then the income will be taxed under the latter and not under schedule D. art 64
- This is when Schedule A or B or C taxpayers derive schedule D income in connection with their core functions/ businesses. E.g. commercial banks derive business income from different sources and are taxed under Schedule C. They derive interest income from lending money. This income is not taxed under schedule D.
- Employers may allocate shares, as fringe benefits, to t heir employees. The dividends derived from the shares are regarded as employment income/fringe benefit and

- **Taxation of Non-Resident Entertainers -Art 53 -** musicians, dancers, comedians, musical groups, and theatre troupes are required to pay an income tax that is equal to 10% of the gross income derived from the performance in Ethiopia.
- Since the entertainers are non-residents, the duty to withhold the tax is imposed on the person that makes the payment to the entertainers
- However the Proclamation does not contain a separate and explicit provision for the income taxation of resident entertainers… so they may be taxed under schedule A (if they conduct it under employment) or schedule C (if they are independent contractors)

- **Taxation of Royalties-** income received by a person for the use of his/her intellectual property rights, such as copyright and patent (or sale of the same rights to) by another person. E.g. An income derived by artists and authors from the sale of music albums and books.
- The payers of the royalty must withhold the tax (if they are residents or non-residents with a permanent establishment in Ethiopia)
- But if the payer is non-resident and without a permanent establishment in Ethiopia, the resident (receiver of payment) shall have the duty of self-assessment (calculating and submitting to the tax authority)

- the room for overlapping between royalty and employment income, there are universities (withholding agents) that treat income from the writing of the textbooks as royalty and assess the income tax at the rate of 5%. Some universities regard the income from the royalty as employment income and calculate the tax under schedule A.
- The inconsistent characterization of the taxable incomes is not good for the tax system. It poses fairness and certainty challenges. Hence, the line that demarcates royalty from employment income needs to be properly delineated.

- **Taxation of Dividends (art 55)**- Bodies, such as companies, make different types of distributions to their shareholders. The distributions may be paid out of the profit of the body (dividends) and in some cases out of no profits (from the capital of the body).
- which distributions shall be regarded as a dividend? Entities may try to characterize a dividend as a return of capital or distribution paid out of the capital of the bodies.
- to prevent the tax base from erosion, the tax systems (especially in classical, not integrated tax system) may go further to characterize some of the distributions as dividends even though the bodies label the distributions otherwise E.g repayment of Loans, distribution of in-kind

- redemption of shares, and distributions made during liquidation.
- our Income Tax Proclamation of defines a dividend as a distribution of profits by a body to its members. This means that a distribution which is a return of capital is not regarded as a dividend.
- However The Proclamation (art 2(6) tries to treat some forms of distributions as dividends and bring them to the tax net. These include:

a. An amount of Return of capital above its nominal value. E.g. nominal value is 1000 Birr. To reduce its capital, the Company lowers the nominal value of share to 800 Birr and repays 200 Birr per share. In this case, no dividend is subject to tax. But if it repays 300 birr, the 100 birr is considered as dividend

b. An amount returned on redemption of shares in excess of its nominal value of shares/membership interest

c. An amount, returned to the member on liquidation of body, in excess of its nominal value

d. Constructive or disguised dividends that are made to the member under the pretext of “real transactions. E.g, a company agreed to borrow a certain money from the shareholder and to pay interest on the loan. When the substance or enforcement of the contract is examined, it is a simulated or fake arrangement made between the two parties for the payment of a dividend in the form of loan repayment.

- **NB -** Unlike the 2002 proc, the 2016 proc In addition to share and private limited companies, profits distributed by partnerships, public enterprises, cooperative societies, and other similar forms to their members are regarded as dividends and subject to income tax.
- No deduction - it is the gross amount of the dividend that is subject to the income tax.

- **Taxation of Interest** – until the 2016 proc tax on interest was imposed only on depositors of money in banks.
- Under 2016 proc interest is a periodic or lump sum amount, as consideration for the use of money or being given time to pay, and includes,

- Interest paid on deposits
- Interest paid on debentures by companies
- Interest paid on loans
- Discounts
- Other functionally equivalent payments

- tax rate is 5% for interest derived from savings (deposit of money) with financial institutions, such as banks, that are residents of Ethiopia.
- For all other types of interest, the tax rate is 10% of the interest. E.g. interests derived from depositing money with foreign financial institutions, debentures and loans
- no deduction: The taxpayers are taxed without deduction of any expense.

- **Taxation of Income from Games of Chance:** it is non-recurrent income. The deriving of the income is based on an uncertain event of chance. E.g. Lottery, bingo, sports betting,
- Governments earn income from the organizers and winners of games of chance in tax and non-tax forms, such as license fees. E.g. the permit fee for sports betting 500,000 Birr and the renewal fee is 100,000 Birr… and the person that operates the gaming business must pay the required taxes under Schedule C
- The winner pays 15% tax on the gross amount of the winning. No deduction
- The person who pay money or any other economic benefit to the winners of games of chances, are required to withhold 15% of income tax from the payment.

- There is no obligation to pay tax when the income from the winning is less than 1000 Birr
- In USA professional gamblers (is pursued full time, with regularity, to the production of income for a livelihood, and is not a mere hobby), it is a trade or business.
- In our law no distinction is made between professional vs. amateur gamblers. But art 64 may be applied - In the case where an income is taxable under Schedule D and one of the remaining Schedules, the provision gives priority to the taxation of the income under the latter schedules.
- This implies that there is a legal room for taxing professional gamblers under Schedule C.

- When the income is derived in non-cash forms, such as houses, cars, and mobile phones, valuation will be made to estimate the monetary value of the income and assess the income tax. As of art 75

- **Taxation of Income from Casual Rentals (art 58)-** When an income is derived from the casual rental of either a movable or immovable asset in Ethiopia … 15%
- If the rental is carried out on regular basis, the income derived from the rent will be taxed under either Schedule B (if the property is a building) or C (if the property is other than a building).
- Tax on income from causal rent is governed by selfassessment, not the withholding rule.
- the Proclamation requires the taxpayers to file a tax declaration ‘within two months after the date of the transaction giving rise to the income’

- An income that is derived from the rental of industrial or scientific equipment may be characterized as both a royalty and income taxable under Article 58. In this situation, the Proclamation treats the income as royalty and prioritizes its taxation under royalty

- **Taxation of Gains on Disposal of Certain Investment Asset (capital gains) Art 59**
- Capital gain refers to an increase in the value of an investment asset when the asset is disposed of (sold, exchanged, gifted). When an asset is sold for a higher price than the original purchase price, there will be a realization of gain and the seller must pay tax on the gain.
- The tax base for capital gain tax is the gain derived from the disposal of the taxable assets.
- When the asset is disposed of by way of gift, it is the donee, not the donor that is regarded as the taxpayer.

capital gain tax is not levied on the disposal of all types of investment (capital) assets. For instance, the disposal of vehicles and machinery does not trigger the tax (considered as *depreciating assets* rather than investments, they tend to lose value over time due to wear and tear, technological obsolescence).

The Proclamation limits the application of the tax to **Buildings, Shares, and Bonds**: Buildings, especially real estate, often appreciate in value over time due to factors like location, demand, and inflation. Similarly, shares and bonds are viewed as investments with the potential for capital gain. Art 59

- Immovable assets – 15% - Art 59 (7) gain derived from the disposal of a building, however a building which is held and wholly used as a private residence for 2 years before its disposal, is not treated as an immovable asset for the purpose of capital gain tax
- Shares and bonds – 30% - it is higher to discourage speculative trading

- If trading by immovable assets, shares, and bonds is the core activity of a person, the gain from the disposal of such assets is treated as business income and taxed under Schedule C. e.g sale of buildings by real estate companies.

- **Taxation of Windfall Profit – art 60**
- The taxation of windfall profit was brought to the income tax system of Ethiopia by the Income Tax (Amendment) Proclamation of 2010. Minister of Finance and Economic Development issued a directive that aimed at the taxation of windfall profits generated by banks in 2010.
- National Bank of Ethiopia took an overnight measure of devaluation of the Ethiopian currency against the US Dollar by around 16.7%. It created an unexpected opportunity for commercial banks and other financial institutions to generate a significant amount of profit from their holding of foreign currency at the time of devaluation. 75% tax

- The Income Tax Proclamation of 2016 defines ‘windfall profit’ as any unearned, unexpected gains. it is an unexpected gain derived from the occurrence of lucky circumstances. The person that derives the gain has little or no expectation or control over the circumstances.
- Since windfall profit is generated from unforeseen circumstances, it is impossible to describe in advance in the tax laws the source of the tax base, the tax rate, and similar matters. E.g a major oil exporter suddenly experiences a dramatic increase in global oil prices due to geopolitical instability or a natural disaster.
- **Discovery of Natural Resources-** A mining company discovers a new gold deposit in its existing mining operation that significantly increases its potential output.

- **Taxation of Undistributed Profit art 61**
- The tax implication of retained (undeclared or undistributed) profit of companies was a source of dispute between taxpayers and the tax authority under Income Tax Proclamation of 2002.
- Taxpayers were in a view that the dividend tax became due only when the companies have actually declared and paid the profit (dividend) to shareholders.
- The Authority argued that the companies should withhold the dividend tax whether or not the dividend was retained or declared (distributed) to the shareholders.

- According to the decision of MoFED, a profit that was neither reinvested in any investment, including raising the capital of the companies, nor distributed to shareholders should be taxable.
- The Income Tax Proclamation of 2016 preferred to resolve the controversy by introducing an explicit and separate provision relating to the taxation of undistributed profit. If the profit of a body is not distributed to its members or reinvested in the body or other investments, it is taxed at the rate of 10%. Art 61
- Financial Reporting, auditing, Whistleblowing

- **Taxation of Repatriated Profit**
- Article 62 of the Income Tax Proclamation (2016) provides that there is a 10% tax on the repatriated profit of a permanent establishment of a non-resident body conducting business in Ethiopia.
- It is to reduce the chance of tax evasion by nonresident taxpayers through the repatriation of business profits out of Ethiopia.
- It may be to encourage foreign investors to invest their profit in Ethiopia
- It may be to compensate for protection given for foreign investors under investment law when they repatriate their profits.

- As of Art 64 where a given income is taxable under Schedule D and other schedules, priority is given to the taxation of the income under the other schedules. If we extend this general rule of Schedule D to Article 62, the repatriated profit, which is a business income, shall be taxed under Schedule C.
- But, this makes Article 62 non-functional and totally inapplicable provision as repatriated business profit is the only taxable income that falls under Article 62.
- repatriated profit is treated as separate taxable events in Ethiopian tax law.

- **Taxation of Other Income**
- Under 2002 proc Income that was not designated in one of the charging rules/schedules was escaping tax.
- Article 63 of 2016 Proc, incorporates a rule for the taxation of a residual category of income. A person who derives any income that is not taxable under Schedule A, B, C, or the sub-schedules of schedule D it shall be liable for income tax at the rate of 15% on the gross amount of the income.
- it broadens the tax base and raises more revenue for the government.
- it enhances the equitability of the tax system

- There are two requirements for an income to be a taxable income under Article 63.
- First, it shall not be a type of income that falls under one of the existing charging rules/schedules.
- Second, it should not be an exempt income.
- An example of income that could be taxable under Article 63 may include a reward given for whistleblowers of tax evasion pursuant to Article 134 of the Tax Administration Proclamation (No. 983/2016).
- The reward is 20% of the amount of the tax evaded at the time the tax is collected by the Authority

Schedule E – exempt income

- ART 65 (1) an amount paid by an employer to cover the actual cost of medical treatment of an employee;
- an allowance for transportation granted under a contract of employment;
- a hardship allowance;
- transport expenses and per diem payments to an employee travelling on a tour of duty;
- travel expenses of foreign employees from and to their country of origin paid pursuant to the employee's contract of employment;
- food and beverages provided for free to an employee by an employer conducting a mining, manufacturing, or agricultural business;
- allowances paid by the Government of the Federal Democratic Republic of Ethiopia to employees engaged in public service in a foreign country

- contributions by an employer to a pension, provident, or other retirement fund for the benefit of an employee provided the monthly total of contributions does not exceed 15% of the monthly employment income of the employee; pension to the extent exempt from tax under the Public Servants Pension Proclamation or the Private Organization Employees' Pension Proclamation;
- A public award for outstanding performance in any field or an award granted under Article 135 of the Tax
- Administration Proclamation to a tax officer for outstanding performance and a taxpayer for exemplary discharge of his tax obligations.
- An amount as compensation for personal injury or the death of another person;
- Salaries paid to domestic servants;

SCHEDULE‘E’–EXEMPTINCOME