

TAX LAW
TEACHING MATERIAL

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CHAPTER ONE

INTRODUCTION TO TAXATION

Introduction

Any government in the world, past and present, cannot discharge its responsibilities and exercise its powers without raising public revenues. Public revenues are generally divided into tax revenues and non-tax revenues. Because non-tax revenues such as prices, fees, fines borrowing, special assessment and the like are out of the scope of this course in general, the concern of this chapter is to deal with various aspects of tax revenue, which account for the lion's share of public revenues provided a country does have the necessary legal and institutional framework to raise taxes. In this chapter, as a prelude to other chapters which deal with different taxes implemented in Ethiopia, attempt will be made to discuss the meaning and essence of tax, theories and canons of taxation, classification of taxes, features of a good tax system and the Ethiopian fiscal federation (division of expenditure responsibilities and powers of taxation). It is hoped that this chapter serves as a spring board for the proper understanding of the subsequent chapters. As such, students are strongly advised to give proper attention to it so that it would be easier for them to cope with conceptual analysis, issues and problems that they will encounter under each chapter.

Objectives

Having completed this chapter, students should be able to:

- Define tax and analyze its basic features;
- Analyze theories and canons of taxation and evaluate their relevance to modern tax systems;

- Discuss the features of a good tax system;
- Discern constitutional principles applicable to assignment of expenditure responsibilities and division of power of taxation under the FDRE Constitution; and
- Realize that the points discussed in this chapter are irreplaceable inputs for the forthcoming chapters of the course.

1.1. Definition of Tax

According to a writer called Hugo Dalton, an economist “a tax is a compulsory contribution imposed by a public authority, irrespective of the exact amount of service rendered to the tax payer in return, and not imposed as a penalty for any legal offence.” Again to emphasize the compulsory element in tax the author states, “a tax, by definition, is a payment, in return for which no direct and specific quid pro quo (give and take) is rendered to the payer.”

From this definition, it is possible to understand that tax is a compulsory charge that is imposed on taxpayers without obtaining their consent. Therefore, failure to pay tax is a criminal offence punishable by law. However, it is good to take note of the fact that the existence of compulsory nature of the payment may not necessarily make the payment a tax. There is another element that should be fulfilled. The payment of tax does not entitle the payer to demand direct and definite benefits. However, we should bear in mind that the general public as a taxpayer can demand the government to do some thing although they cannot demand this individually. The tax collected by the government of a given country is to be used to finance the various objectives of government which will have benefits to the society at large.

These public services are rendered by the government because the government predominantly collected the money from tax sources.

Generally, taxes may be collected on the following categories:

- Taxes on income and expenditure;
- Taxes on property and capital transaction;
- Taxes on commodities and services.

1.2. Theories and Canons of Taxation

1.2.1. Theories of Taxation

Theories of taxation deal with the justifications for imposing tax as a duty in a given country. The theories dealing with these issues are broadly classified into two categories. The first category contains two approaches, viz., the Socio-Political Approach and the Expediency Approach. According to this first category, to impose a tax, there need not be any relationship between the taxes paid and benefits flowing from the authorities to the tax payers.

The second category, on the other hand, links the tax liability of the payers to the state activities. It maintains that, since the state is providing certain goods and services to the members of the society for free, it should charge for these goods and services. This approach simultaneously provides a justification for imposing taxes, i.e., government provides services and has a right to charge for them and a principle for apportioning the tax burden. Here again, there are two theories in this linking process. The first is the benefits received approach, which links the tax liability to the benefits, which the taxpayers are supposed to be receiving from the government activities. The second is the cost of service approach which links tax liability to the cost of providing the goods or services to the community by the government.

In addition to these theories under the two categories, there is another theory, which links the tax liability to the paying capacity of the taxpayers and it is referred to as the Ability to pay theory. Let us discuss these theories as follows.

A) Expediency Theory

What do you think is the essence of this theory?

According to this theory in the choice of various tax proposals, the authorities need not consider various economic or social objectives or the effects of a tax system. What they have to take into account is whether that tax proposal is practicable. Therefore, for this theory, taxes must be imposed if and only if they are practicable. In practice, however, every authority or government is pressurized by various economic, social and political groups to orient its tax policy in certain directions. Every group of people does its best to resist or change that goes against its interests. Governments, in many cases, have adopted certain policies because there are pressures to that effect. Further, depending upon the changing political strength of different economic groups, the

government is likely to reshape its tax structure. It is also evident that while imposing a tax, the government would be making a great mistake if it does not see the administrative feasibility, the cost of tax collection etc. However, to build up an entire tax system only on the consideration of expediency, it will be full of pitfalls. Thus, the tax policy must be anti-cyclical, pro equity and favorable to the welfare of the society so that it will develop the economy. When the tax policy is worked out without reference to these objectives, its role is essentially carved down to nothing. In such a case, it becomes a source of increasing the existing in-equalities of income and wealth and against securing socio-economic justice. Similarly, if a tax cannot be effectively collected, it is meaningless to impose it. Thus, practicability is an essential consideration in every tax proposal though it cannot be fully accepted. This is because expediency (practicality) does not suffice unless a tax system takes into consideration economic, social and political factors.

B) Socio-Political Theory

This theory was developed by the well-known German economist Called Adolph Wager. According to him, it is not the expediency but final social and political objectives, which should be the deciding factors in designing our tax system. Wagner did not believe in individualistic approach to a problem. He always looked at the problem in its social and political context and made efforts to find an appropriate solution thereof. Accordingly, for him a tax policy should not be designed to serve the needs of the individual members of the society. It should be used for the benefit of the society in so far as it is possible.

In other words, Wagner was advocating a modern welfare approach to the entire problem of evolving and adopting a tax policy. He particularly favored the idea of using taxation as an important means of causing reduction of income inequalities in society. In order to attain this purpose, he stated that all small incomes should be exempted from taxation. Thus, according to this theory, in a modern state taxation is designed to curb the economic inequalities arising out of the right to property.

C) Benefits Received Theory

According to this theory, the burden of tax must be imposed in proportion to the benefits received by a taxpayer from the expenditure incurred by the government, financed from tax

receipts. In other words, it means, the relationship between the taxpayer and the state runs in quid pro quo terms. It is basically an exchange relationship.

In this theory, the problem of reducing the income inequalities is ignored. This approach does not also consider the possible use of the tax policy for achieving economic growth or economic stability in the country. The theory considers only the way in which the goods and services should be supplied and financed by the government and the private sector.

This approach divides the services supplied by the government into;

- i. Those services to which the principle of exclusion does not apply and
- ii. Those services to which the principle of exclusion applies.

In the case of the first category of services, since every individual consumes these services, he should contribute to the public revenue according to the benefits received. In the second category of services, the tax-payers have the option to accept or reject the service supplied by the government. Actually, in this case the members of the society pay either the fees or prices and not the taxes. By definition taxes are compulsory payments against which there is no quid pro quo, while in this case the individuals embark upon voluntary exchange of their purchasing power with services supplied by the government.

This theory assumes a given distribution of income and wealth in the country and we estimate the benefits that the society gets. Since benefit is ultimately a subjective concept, there is no known infallible scientific method of measuring it. Income may be taken as an indicator of the benefits received. That means it may be inferred that the benefits, which each member of the society derives from the state, are in proportion to his her/its income. Such an inference would lead to the policy recommendation of proportional taxation. Adam Smith had taken similar approach when he said that each individual ought to contribute to the public revenue according to this ability. Smith equated the relative ability to pay of the taxpayers with the relative incomes, which they respectively enjoyed under the protection of the state. Thus, in due course, the benefits approach gradually degenerated into a form where it was basically a payment for the protection from the state.

D) Cost of Service Theory

This approach emphasizes on the semi-commercial relationship between the state and the taxpayers to a greater extent. The implication is that the taxpayers are not entitled to any benefits from the state and if they do receive any, they must pay the cost thereof. We notice that the defects of this approach are very similar to those of the benefits-received approach. In this approach, the state is asked to give up its basic protective and welfare functions unless the taxpayers are able to directly cover the costs. It thoroughly enables the government to recover the cost of services and therefore, this approach, unlike the benefits received one, specifically implies a balanced budget policy. In the process, the state is not to be concerned with the problems of income distribution. No effort is to be made to improve income distribution. Certain sources of public revenue will be ruled out according to this approach, including for example taxes on capital gains, inheritance, gifts, expenditure etc. Furthermore, by definition, the welfare activities of the state are ruled out including all sorts of relief activities. In modern economy, this principle has a very limited application.

This principle is also full of many conceptual difficulties. The first problem pertains to measuring the cost of state services and assigning them to the proper beneficiaries. Quite a number of state activities are in the nature of those goods (services) to which the principle of exclusion does not apply (no one can be denied a share in their consumption) but the cost of the service cannot be apportioned between different members of the society. No exact proxy is available for such apportionment, such as the income level, size of the family, etc. Look at the following example to clearly understand the limitation of this theory. Ato Endelibu Gashaw is an Ethiopian national. However, he has been troubling the people and the country by engaging in theft, raping, robbery, espionage, and other criminal activities. Above all, he has not paid any tax to the Ethiopian Government. In spite of all these, Ato Endelibu benefits from defense, infrastructures established by the government and the like as it is not possible to the Ethiopian government to exclude Ato Endelibu other than punishing him for the crimes.

Secondly, there are quite a few state services, which have externalities. These externalities appear in the form of social benefits and social costs. Should the state confine its attention to only the commercial costs as the private entrepreneurs do? Or should it take into account the

externalities also and estimate the net social cost in determining the tax liability? In such a case, it might pursue certain policies, which disrupt the life and growth of the economy. Subsidizing and augmenting the supply of merit goods would be totally ruled out. It might jeopardize the process of savings and capital accumulation; it might hasten the exhaustion of the mineral wealth; it might lead to the denuding of the forests; and so on. It will be a highly objectionable practice since the state is the custodian and protector of not only the existing generation, but also of the future generations.

E) Ability to Pay Theory

This theory considers the tax liability in its true form-a compulsory payment to the state without quid pro quo. It does not assume any commercial or semi-commercial relationship between the state and the citizens. It is based on the broad assumption that those who possess income or wealth should contribute to the support of public functions according to their relative abilities. The obligation to pay tax to the government is taken as a social or collective responsibility although the questions of 'who shall pay and in what amount' is necessarily an individual one. Those who have the means to pay should pay and those who do not have the means need not pay.

In short, the basic tenet of the ability-to-pay doctrine is that the burden of taxation should be shared amongst the members of the society so as to conform to the principles of justice and equity, and that this equity criterion will be satisfied if the tax burden is apportioned according to their relative ability to pay. In this regard, different indices are available for determining the relative ability-to pay of the taxpayers. Income, property, and wealth, or consumption expenditures are some of the indices of ability. In the subsequent parts, we shall try to see these indices.

- a) Income as criterion of ability to pay:-** Income is now widely accepted as an index or criterion of a person's ability to pay. A family's ability to pay depends primarily on the income received by the family. The income figure is the amount, which the family can spend on consumption goods and save. The amounts of saving that it can make are the primary determinants of how well the family lives or, in other words, of its level of living during the period. Accordingly, income is generally regarded as the best criterion of taxpayers economic well-being and therefore, of his ability to pay taxes. However, the

actual level of living which can be attained with a given money income depends in part of certain circumstances affecting the amount of income that must be spent in order to attain a given level of living. In considering this, the following three aspects are important.

- i) **Size of the family:** The most obvious factor is the number of persons in the family. The more children a family has, the lower will be the level of living which is possible within a given money income. In this regard, we have to see whether a person is married or not married. If a person is married, the size of the family will determine the ability to pay.
- ii) **Earned or unearned income:** Earned income is that income which is earned in the first instance from direct services while income derived from property, rent, interest, etc. is unearned income because this is earned from the already earned income. The idea is that a person having some unearned income possessed higher capacity to pay than does a person having equal earned income or a salaried person in the sense that in the former case smaller sacrifice is involved than in the later case. Consequently, earned income is taxed at a lower rate while unearned income is taxed at a higher rate.
- iii) **Windfall income:** it is an income where no efforts are involved in earning it. This income should be taxed at a progressive rate. Such income is mostly in the nature of capital gains enjoyed by property and other real asset owners.

Income is, therefore, the most reliable criterion to judge a person's ability to pay taxes. For purposes of taxation, gross income is considered unsuitable for it is composed of the cost elements. Consequently, net income is regarded as the best measure of the tax paying ability of a person because it reflects the sum of net receipts over costs.

- b) **Wealth as criterion of ability to pay:** - The ability to pay taxes is influenced not only by the income received by it during any given period of time but also by the amount of its accumulated wealth. The rationale behind considering wealth as a criterion of ability to pay tax is based on consideration of income received from capital. Thus, a tax on wealth is simply a tax on income earned on it. In the past, wealth was considered a better

index of the ability to pay than income because in addition to being a source of income, wealth provided security and insurance against risk. However, with the progress of the industrial society and the development of money economy, there was a shift from property to income as a primary test of an individual's ability to pay a tax. Wealth is unsatisfactory as a primary test of an individual's ability to pay a tax although it can provide a possible supplementary index of such ability.

- c) **Consumption expenditure as criterion of ability to pay:-** It has been argued by some economists that the appropriate measure of an individual's ability to pay is not his total income but the amount of income spent on consumption. This view was expressed mainly by John Stuart Mill, Irving Fisher and recently by Nicholas Kaldor. It is claimed that economic well-being depends upon consumption alone. Wealth accumulated yields no satisfaction until it is used for consumption purposes.

However, this index of ability to pay is not free from criticisms. It has been criticized on the ground that it favors the miser and it is difficult to make taxation progressive or even to prevent it from becoming regressive and would reduce the amount of revenue.

1.2.2. Canons of Taxation

What do you understand by canon of taxation? Why should we worry about canon of taxation?

Taxes must be levied with great care and rationality. In order to practice this rationality and care, the law maker when it passes tax laws and the tax authority when it administers tax must follow certain code of conduct in the form of principles of taxation. The various principles which have been developed since Adam Smith's days in order to guide the state in levying the taxes are called the principles or canons of taxation.

Adam Smith was perhaps the first writer to attempt to put a general statement of the principles of taxation. He was basically concerned with the ways in which an economy could increase its productive capacity and thereby achieve a higher rate of economic growth. He held strong view that in managing the affairs of the economy private sector was more efficient than the public sector and, therefore, the primary responsibility of economic growth should rest with the private

sector. In this respect, the private sector should be allowed the maximum possible freedom to function. The only additional consideration should be the provision of adequate revenue for the state in order to enable it to spend for its own maintenance, for defense, for enforcement of law and order and for financing certain social overheads and to ensure an equitable distribution of the tax burden. With this end in view, he laid down those principles of taxation, which were to satisfy these conditions. Adam Smith enunciated the following four maxims or canons, which should be incorporated in any sound system of general taxation.

Let us discuss canons of taxation as follows:

A) Canon of Equality of Benefit

According to Adam Smith, the subjects of every state ought to contribute towards the support of the government, as nearly as possible, in proportion to their respective ability; this is in proportion to the revenue, which they respectively enjoy under the protection of the state. In other words, the principle of benefits stated that the burden of taxation should fall on the people according to the benefit received by them from the state. The amount of tax should be that much which could be sufficiently compensated by the benefits, which the government confers on the taxpayer. Viewing it from the other angle, the principle implies the desirability of imposing taxes on the individuals according to the benefits which they enjoy from the government action. The principle naturally proclaims the justice of “do not take more than you give”. It means that the collective payment of taxes by the people should not exceed the value of the benefits conferred upon them in the form of public services by the government. It is undoubtedly true that whatever tax revenue the government collects from its citizens, it is spent on the various items of expenditure which provide amenities of one kind or another to the public. It is for the collective or public benefit that the taxes are levied; taxes are not levied for the individual benefit. It should not be interpreted that everyone should pay taxes according to the benefits he receives from public works. It is by definition true that the taxpayer expects no quid pro quo for payment of a tax. Consequently, the taxpayer cannot also expect that he would receive the benefit just equal to the amount of tax he pays. Taken collectively, however, the principle holds true.

B) Canon of Certainty

The canon of certainty implies that the taxpayer should be well informed as to the time, amount and the method of the payment of tax. There should not be any embarrassment and confusion

about the payment of tax. When the taxing authority demands tax at any time instead of a specified time, which the taxpayer knows before hand, it would cause great difficulty and bring great embarrassment to the taxpayer. If there is no certainty about the rate to tax and the taxpayer does not know what amount of tax he has to pay, the taxing authority gets the opportunity of practicing dishonesty and even if it collects the specified amount of tax, the tax-payer may feel cheated because he is not aware of the rate of tax beforehand.

Adam Smith has clearly stated this canon and has clearly mentioned about this canon in these words: the tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the taxpayer and to every other person. Where it is not clear, every person subject to the tax is put under the mercy of the Tax Authority. In other words, the tax system would be corrupt if the canon of certain is missing. Adam Smith has further pointed out that even a very small degree of uncertainty is a matter for great importance than a considerable degree of inequality in taxation. If the tax is 'certain' the taxing authority cannot exploit the taxpayer in any manner. This is the reason why Adam Smith assigned greater importance to the canon of certainty than to the canon of equity. He stated that 'an old tax is no tax.' The reason for this is that the taxpayers get accustomed to an old tax. Consequently, they do not feel its pinch.

C) Canon of Convenience

According to this canon, tax should be levied in such a manner and at such a time that it affords the maximum of convenience to the taxpayer. The reason for prescribing this canon is that the taxpayer makes a sacrifice at the time of payment of the tax. Consequently, the government should see to it that the taxpayer suffers no or least inconvenience on account of the payment of the tax. It is for this reason that modern governments pay special attention to the convenience of the taxpayers while collecting taxes from them.

According to Adam Smith, "every tax ought to be levied at a time, or in the manner, in which it is most likely to be convenient for the taxpayer to pay it. A tax upon the rent of land or of houses payable at the same term at which such rents are usually paid, is levied at a time when it is most likely to be convenient for the contributor to pay; or, when he is most likely to have means to pay. Taxes upon such consumable goods as are articles of the luxury, are all finally paid by the

customers, and generally in a manner that is very convenient for them. The taxpayer pays them little by little, as he has occasion to buy the goods or services. And he is at liberty too, either to buy, or not to buy, as he pleases; it must be his own fault if he ever suffers any considerable inconvenience from such taxes.” This canon of taxation is important for both the consumers and the government. The consumers feel least inconvenience in the payment of a tax and the government also comes to know the incidence of taxation and gets higher income by way of taxes as the tendency to evade taxation may be reduced to a great extent.

D) Canon of Economy

This canon implies that the cost of tax collection should be the minimum. The tax should be such as to bring the maximum part of the collected revenue into the government treasury. In other words, the difference between what the taxpayers pay to the government and what the government receives after meeting all expenses of tax collecting should be as minimal as possible. Elucidating his idea, Adam Smith stated that “every tax ought to be so contrived as both to take out and to keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state.” Thus, a tax should not require a large number of tax collecting officers whose salaries may eat up a greater part of tax revenue and whose perquisites may eat up a greater part of tax revenue and whose perquisites may impose another additional tax upon the people. It should also be such as not to obstruct the industry of the people and discourage them from entering into productive business. It should not ruin the people and should not subject them to the oppression of tax collector. There should be practiced utmost economy on the part of the state in the collection of tax.

Though it is not possible to conclude that these canons are universally accepted, their influence on modern tax systems is big.

OTHER CANONS OF TAXATION

In addition to the above four canons of taxation discussed by Adam Smith, following canons of taxation have been given by other economists. These are:

A) Canon of Productivity

This canon was developed by the well-known classical economist Charles F. Bastable. According to him, the systems of taxation should be based on considerations of productivity.

Taxes must be levied in order to accumulate enough money for the government to run its administration efficiently. Tax revenue must be enough to enable the government to secure enough facilities by providing free public goods and services for the people. If a tax yields poor income, it cannot be considered as productive tax. According to this canon, it is better to levy a few productive taxes rather than to impose unmanageable large number of unproductive taxes on the people. A large number of unproductive taxes creates problems not only for the people but also for the government because it gets no special increase in income from them.

Further, taxation must be dynamic. It must be based on earnings and mobility of money and income in future. This implies that a detailed study should be undertaken to avoid any kind of evil influences of taxation on the various sections of the community. No tax ought to discourage the productive capacity of the individuals.

B) Canon of Elasticity

The canon of elasticity implies that taxes should be so levied that the amount of revenue to be procured through them can be increased or decreased with the least inconvenience as the necessity of the state expenditure comes. For example, if the government needs more income at a time of crisis, the tax should be capable of yielding more income through an increase in its rate. The income tax satisfies this canon in ample measure. It can yield more income to the government during war period through an increase in its rate or through imposition of surcharge on it.

1.2.3. Canon of Diversity or Variety

This canon was also developed by Bastable. It implies that diversity should exist in the tax system of a country. The reason is that if the government levies a single tax, it will become easier for the taxpayers to evade it. But if the government imposes a large variety of taxes, it will be difficult for the people to evade or avoid them. But if the government imposes a large variety of taxes, it will be difficult for the people to evade or avoid them. Consequently, every taxpayer will pay some tax to the government according to his ability to pay. The diversification of taxes should be practiced in such a way that every section and every individual must pay something to the national exchequer when you have finished reading the whole chapters.

1.2.4. Canon of Simplicity

This canon implies that every tax should be simple so that the taxpayer can understand its implications without inviting the costly help of tax experts. If the tax is complex and complicated, taxpayers will have to seek the costly assistance of tax experts in order to understand its implications. Besides, a complicated tax also increases the chance of corruption in the country. Dear student evaluate the Ethiopian tax laws in the light of this canon.

1.2.5. Canon of Expediency

According to this canon, tax should be based on certain well-founded principles so that it may need no justification from the side of the government. In other words, the taxpayers should have no doubt about its desirability. From this angle, the old taxes are considered to be better than new taxes because the people have already got accustomed to the old taxes. The adage goes that ‘an old tax is not tax’. Thus, the state should not impose any new tax unless there is a sufficient basis for imposing it. According to the criterion of expediency, the government should, as far as possible, increase its revenue by increasing the rate of existing taxes.

1.2.6. Canon of Co-ordination

This canon of taxation implies that there must be co-ordination between different taxes that are imposed by the various tax-levying authorities. In the democratic set-up, although the taxpayers are the same, yet the central and local governments impose various taxes. In these circumstances, it is absolutely important that there is co-ordination between the various taxes imposed by various governments. Do you think that this canon works in federal countries? Why? This canon is relevance in federal countries since tax harmonization is important in these countries.

The above canons of taxation are considered to be the essential requirements of a good taxation policy although in practice it is very difficult to evolve a tax system, which is characterized by the presence of all these canons of taxation. However, every tax authority should, as far as possible, keep the above canons in view while devising its tax policy because it is only by doing so that the government may succeed in getting the maximum social welfare for the society.

1.3. Classification of Taxes

Why do we bother about classification of taxes?

Economists have classified taxes from different angles thereby providing us a long list of different kinds of taxes. In this section, therefore, we are going to see these different kinds of taxes and their merits and demerits in terms of the objectives of equity, efficiency, simplicity, resource allocation and so on. The following are some of the heads under which various taxes are classified.

1.3.1. Direct Vs Indirect Taxes

Taxes are generally classified as (i) direct taxes, and (ii) indirect taxes. Direct and indirect taxes have been defined by different economists differently. Accordingly, to John Stuart Mill, “a direct tax is demanded from the very persons who it is intended or desired should pay it. Indirect taxes are those which are demanded from one person in the expectation and intention that he shall indemnify himself at the expense of another.”

According to this definition, a direct tax is really paid by the person on whom it is legally imposed while an indirect tax is imposed on one person but is paid either partly or wholly by another person due to a consequential change in the terms of some contract or bargain between them. Thus, taxes are direct or indirect depending upon the fact whether or not they are actually paid by the people on whom their immediate burden of payment (impact) falls. According to this definition, personal income tax or a tax levied on houses occupied by their owners would be called a direct tax since there would be no shifting of the tax burden. According to this criterion, sales tax, VAT, customs duty or excise duty an indirect tax since the trader or manufacturer shifts its burden forward on the consumers or buyers. The tax burden of an excise duty may also be shifted backward on the factors of production or raw material producers depending upon the demand and supply elasticity of the product or commodity.

According to Taylor, “the terms ‘direct’ and ‘indirect’ tax are finally distinguishable in meaning only in terms of shiftability. Direct taxes are not shifted, while indirect taxes are shifted. The

decline in the use of these terms can be accounted for by inability to make such broad generalization with respect to many tax measures.

According to A. R. Prest, “the distinction between direct and indirect taxes is more commonly drawn by reference to the basis of assessment rather than the point of assessment. Those taxes, which are based on the receipt of income, are termed as direct whereas those levied on expenditure are termed indirect. Income-tax, profits tax and capital gains taxes are, therefore, direct; customs duties, excise taxes, VAT, turnover tax and stamp duties are indirect.’ Prest has distinguished between a direct tax and an indirect tax on the basis of the income and expenditure on which a tax is imposed.

According to Antonio De Viti De Marco, “direct taxes are the taxes on income from land, and the tax on buildings; the tax on intangibles or ‘movable property’, which falls on income from investments, as well as on that arising from business and professional activity; and, finally, the tax on total individual income. These taxes strike the taxpayers’ income at the moment of its production. Indirect taxes are those, which strike the private consumption of citizens and also transfer of property. They strike the income at the moment when the taxpayer spends it to acquire other goods. However, according to the method of tax collection criterion which is employed by the tax administrative machinery, those taxes are considered direct which are collected on the basis of lists containing the name of the tax-payers, and which recur at fixed intervals; those taxes are considered indirect which are collected on the occasion of certain definite acts, which do not come at fixed intervals and are not susceptible to a method of collection involving lists of names.

Sometimes the terms ‘impact’ and ‘incidence’ are used to clarify the distinction between direct and indirect taxes. The direct tax is that whose impact (immediate burden) and the incidence (ultimate burden) fall on the same person while an indirect tax is that tax whose impact and incidence fall on different persons. The impact of the tax falls on the person who pays it to the government in the first instance. However, the incidence of the tax falls on the person who finally bears the burden of tax. It is not essential that a person on whom the impact of the tax falls should also bear the incidence of the tax.

Direct taxes do have some merits and demerits. The merits are the following:

- a. **Direct taxes create civic consciousness:** A direct tax like income tax pinches the people on whom it is imposed. Consequently, the taxpayers immediately become conscious about their rights. They also see to it that the tax-income accruing to the government is not wasted on useless projects. Consequently, a direct tax creates civic consciousness.
- b. **Direct taxes are economical:** Direct taxes are economical in the sense that the cost of collecting these taxes for the government is relatively low as these taxes are usually collected at source.
- c. **Direct taxes reduce inequality of incomes and wealth:** Governments frequently use direct taxes as a means for reducing the glaring income and wealth inequalities in the community. Through this measure several socioeconomic evils can be mitigated.
- d. **Direct taxes are certain:** Another merit of direct taxes is that they are certain. The taxpayers know how much they have to pay and on what basis they are going to pay the tax to the government. Thus, the taxpayers can make adequate provision for the payment of tax in advance. The government can also estimate the amount of revenue from such taxes, which it will receive from the public, and accordingly it can prepare its development plans.
- e. **Direct taxes are elastic:** Another merit of direct taxes is that these taxes are elastic as the income from these taxes can be increased through appropriate increases in the rates in times of crises.

On the other hand, direct taxes suffer from the following weaknesses (demerits)

- a. **Direct taxes can be easily evaded:** There is always a possibility of tax evasion in the case of direct taxes. People do not show their correct incomes to the tax officials. For instance, studies reveal that, in India, there is large-scale evasion of payment of income tax on the part of the businessmen who derive a large part of their income earnings from unaccounted and undisclosed sources. In Ethiopia, although it is hardly possible to evade direct taxes under schedule A of the Income Tax proclamation of the FDRE and the regional states concerned, it is generally believed that there is a serious problem of tax evasion in other schedules.

- b. **Direct taxes are unpopular:** Direct taxes are directly imposed on individuals. People have to bear both the impact and incidence of these taxes. Thus, they experience their pinch directly. Consequently, direct taxes are not popular.
- c. **Direct taxes violate the principle of equity:** the burden of direct taxes falls almost exclusively on the richer sections of society while the poor sections are totally exempted from these taxes. This is not just and proper because the burden of state expenditure should be borne by all individuals in society according to their ability to pay. Do you agree with this? Why? Why not?

By the same taken, indirect taxes have also merits and demerits. The following are the main merits:

- a. **Indirect taxes are convenient:** An important merit of indirect taxes is that they are less inconvenient and less burdensome than are the direct taxes. The taxpayers generally pay these taxes in small bits and mostly when they buy goods and services in the market. The amount of tax is included in the price of the commodity and the consumer pays the tax without experiencing its pinch. Sometimes the consumer is not even aware of the fact that he is paying the tax in the form of the higher price of the commodity. Besides, the taxpayers pay the indirect taxes at a time when they have the means to pay these taxes. They are also not compulsory in the sense their payment can be avoided by avoiding the purchase of commodity although in some circumstances it is not possible to avoid the purchase of certain goods and services. For instance, in Addis Ababa it is only Berhanena Selam Printing press, a government profit making enterprise that publishes the Federal Negarit Gazetta. Hence, payment of VAT is unavoidable since this enterprise has been registered for VAT.
- b. **Indirect taxes cannot be evaded:** No individual can evade the payment of indirect taxes because they are collected in the form of higher prices of goods or services sold to the buyers in the market. The indirect taxes are paid when the goods or services are purchased in the market. Consequently, there is no possibility of the evasion of indirect taxes.
- c. **Indirect taxes lead to social welfare:** indirect taxes imposed on intoxicants like wine, opium, cigarettes, etc., serve a great social purpose by curtailing and limiting the

consumption of such harmful commodities. Curtailment of consumption of harmful goods indirectly increases social welfare.

- d. **Indirect taxes help production and investment:** Another advantage of indirect taxes is that they serve as a powerful tool in molding the production and investment activities in the economy, i.e., they can guide the economy in its resource allocation. A proper structuring of indirect taxes encourages the development of high priority industries and discourages that of low priority ones.

Although indirect taxes are appreciated for their merits, the following are the major demerits:

- a. **Indirect taxes are uncertain:** The revenue accruing to the government from indirect taxes cannot be estimated accurately. As soon as a tax is imposed on a commodity, its price rises in the market and consequently, its demand falls. It cannot be said with certainty as to what extent the demand of the commodity will fall consequent upon imposition of the tax. Consequently, an element of uncertainty is always involved in the case of indirect taxes.
- b. **Indirect taxes do not create civic consciousness:** As indirect taxes are paid only when the consumers buy the goods they pay the amount of tax only in terms of the prices of these goods. They, therefore, do not feel an extra burden of tax. Consequently, they are not conscious about them. The taxpayers generally become indifferent towards their responsibilities and fail to keep a watch on the financial irregularities committed by the authorities.
- c. **Indirect taxes promote inflation:** Another weakness of indirect taxes is that they feed inflationary forces. Indirect taxes begin by adding to the sale price of the taxed goods or services without touching the purchasing power in the first place. Consequently, in the case of indirect taxes inflationary forces are fed through an unending spiral of higher prices, higher costs, higher wages and again higher prices.

It is not possible to say that one is better than the other because both of them do have their own advantages and disadvantages. Hence, the existence of both types of taxes is indispensable if a tax system is expected to function properly.

According to economists either of these two taxes can be better depending on the particular circumstances. Under certain circumstances, it is better to impose indirect taxes rather than direct taxes while under certain other situations, direct taxes may be better devices to use, or the vice versa. For instance, beyond a certain stage direct taxes may not be suitable for raising the required tax revenue as these may meet with greater taxpayer resistance. In such situations, indirect taxes are obviously a better choice. However, in order to reduce the inequalities of incomes and wealth, direct taxation should be adopted because indirect taxes are not amenable to fine graduations. Thus, the two kinds of taxes are mutually complementary and not competitive.

Are modern tax laws required to embrace both direct taxes and indirect taxes?

It is a must that all modern tax systems should embrace both direct taxes and indirect taxes since either of the two is not able to achieve all the purposes of modern taxation.

1.3.2. Classification of Taxes on the Basis of Rates

Taxes can also be classified on the basis of the applicable rates to different tax sources. According to this classification, taxes may be classified as proportional, progressive, regressive and digressive. A tax is called progressive when, with the increasing income the tax liability not only increases in absolute terms, but it also increases as a proportion of the income. If the tax liability increases in the same proportion as the increase in the taxpayer's income, it is termed as a proportional tax. If the tax liability as a proportion of income falls with the increase in taxpayer's income, it is termed as regressive tax. If the tax liability as a proportion of income falls with the increase in taxpayer's income, it is termed as regressive tax. On the other hand, in the case of progressive tax, the absolute tax liability of the taxpayer will increase. In the case of digressive taxation, there is a declining degree of progression as the tax base increase. Let us discuss them in detail as follows:

A) Proportional tax

In the proportional tax system, all incomes are taxed at a single uniform rate and it does not matter if the tax payer's income is higher or low. For example, if the rate of income tax is 10 percent, all persons shall have to pay the income tax at this rate as there is no change in the rate

of tax with the increase or decrease in incomes. The following table better illustrates this discussion.

Tax base income (In birr)	Rate of income tax (percent)	Amount of tax (in birr)	Income after tax (in birr)
100	10	10	90
1,000	10	100	900
10,000	10	1,000	9,000
100,000	10	10,000	90,000

A proportional tax has the following characteristics,

- (a) It is fixed and its proportionality does not change with the change in taxpayer's income and wealth.
- (b) It is fixed in amount and it is not levied in varying percentages.
- (c) The tax doesn't alter the proportion of difference of income after the payment of tax has been made. In other words, the relative status of the individual taxpayers with respect to income and/or wealth remains unchanged after the payment of a proportional tax.

Why do countries use proportional tax? Proportional tax is preferred for the following advantages:

- a. It is easy for individuals to evaluate the total amount of tax they have to pay. The taxpayers can easily and quickly calculate the amount of tax they have to pay to the government.
- b. The proportional tax is simple and easy to understand.
- c. There is no change in the existing distribution of income and wealth in the society as a result of proportional tax because all the taxpayers pay the tax at a single uniform rate regardless of their incomes. It is neutral with respect to income and wealth distribution and consequently it involves no structural change in the socio-economic set-up of the country.

However, proportional tax is not free from shortcomings as it has the following disadvantages:

- a) In the case of proportional tax, the burden of tax falls more heavily on the poorer section of society. The reason for this is that as income of an individual increases,

the marginal utility of money for him diminishes. In other words, the marginal utility of money for the rich is lower than the marginal utility of money for the poor. If the rich and the poor are taxed at the same rate, obviously, the poorer sections of society will be making greater sacrifice than the richer section. Consequently, the proportional tax system does not satisfy the important canon of equity and justice in taxation.

- b) This system of taxation does not reduce the inequalities of income and wealth; rather it enhances these inequalities and increases the gap between the haves and the have-nots.

B) Progressive Tax

A progressive tax is the tax, which varies with the change in the income of the individuals, and the rate of tax becomes gradually higher for the increasing incomes and lower for the lower incomes. It does not provide for a fixed and uniform percentage for all the income levels. If the income of a tax-payer increases, the rate of tax also increases and if the income decreases, the rate of tax also decreases. The following table illustrates the concept very well.

Taxable Income Groups (In Birr)	Exact Taxable Income of Individual	Rate of income Tax (percent)	Amount of tax (in Birr)	Income individual after tax (in Birr)
0- 1,000	1,000	10	100	900
1,001-2,000	2,000	15	300	1,700
2,001-3,000	3,000	20	600	2,400
3,001-4,000	4,000	25	1,000	3,000

As can be seen from the table, the rate of tax goes on progressively increasing with the increase in income. For purposes of taxation, individual incomes are divided into different tax slabs. For each income slab, there is a different rate of tax and this rate of tax goes on increasing with the increase in income. Progressive taxation has become popular in all countries of the world including Ethiopia today. The reasons for its universal popularity are the benefits, which accrue to the community from it. The following are some of the important advantages of progressive taxation:

- a) **Progressive tax is based on the ability to pay principle:** A very strong care for progressive tax rates exists in terms of the ability to pay and the corresponding sacrifice which taxation involves. This argument is based on the assumption that marginal utility of income falls as income rises. Since the ability to pay increases proportionally to the increase in income, the rate of tax goes on increasing with every increase in the size of income.
- b) **Progressive tax promotes equality of incomes and wealth:** This distribution on incomes and wealth in society can be made more equitable under progressive taxation because under it the richer persons are required to pay the tax at higher rate than the poorer persons.
- c) **Progressive tax is productive:** the government can increase its income substantially through a progressive tax. It can bring about a sizable increase in its income through increases in the rates during a period of economic crisis.
- d) **Progressive tax is economical:** progressive tax is economical in the sense that the government can bring about a sizable increase in its income through increases in the rates of tax without any substantial increase in the cost of tax collection.
- e) **Progressive tax is elastic:** This tax has the characteristic of elasticity. It is elastic in the sense that with minor changes in the tax rates substantial changes can be brought about in the tax income of the government.

Despite the advantages, progressive tax has the following disadvantages:

- a. **Progressive tax ignores the benefit received principle:** the benefit received theory of taxation does not favor a progressive tax rate especially when we consider the welfare activities of the government. According to this approach, the government should tax the poor people more on account of the benefits received from its welfare activities. Even if one ignores the welfare functions of the state, it becomes a point of debate whether the rich or the poor derive the maximum benefit from the state activities.
- (b) **Progressive tax reduces capital formation:** The degree of progressive taxation has an important bearing on the process of saving and capital formation in an economy. The critics of progressive taxation state that it is only the rich who can save and, therefore, if they are taxed more heavily than the poor, the saving potential will either be lost

completely or reduced substantially. Consequently, the process of capital formation is adversely affected as a result of progressive taxation.

- (c) **Scope for tax evasion:** A progressive tax offers great temptation for tax evasion and tax avoidance. The taxpayers invariably try to evade the payment of the tax by presenting false statements of accounts before the tax authorities and at the same time avoid payment of taxes by finding legal loopholes in the tax provisions.

C) Regressive Tax

A regressive tax is the opposite of the progressive tax. According to this method of taxation, the rate of tax diminishes as the income of an individual increases. Under this system of taxation, the poorer sections of society are taxed at higher rates than the richer sections of the society.

The following table demonstrates how regressive tax operates.

Tax base (In birr)	Rate of tax (Percent)	Amount of tax (in Birr)	Income after tax (in Birr)
1,000	15	150	850
2,000	10	200	1,800
3,000	7	210	2,790
4,000	6	240	3,760

As can be seen in this table, in a regressive system of taxation, the tax rate falls as the tax base (income) increases. The absolute amount of tax payable may also decrease or increase but however, at a decreasing rate.

Digressive Tax

This tax can be called a mild progressive tax. In a digressive tax, the rate of progression is not in the same proportion as the income. In this tax system, the rate of tax increases up to a certain limit and beyond which a uniform rate is charged. Thus, digressive tax is a blend of progressive and proportional taxation. The result of this tax is that the higher income groups make less sacrifice than the lower income groups.

1.3.3. Classification of Tax on the Basis of their Nature

1. Specific and Advalorem Taxes

Taxes imposed on commodities are classified as: specific tax and advalorem tax.

a) Specific Tax

When a tax is imposed on a commodity according to its weight, size, or measurement, it is called a specific tax. For instance, when a tax is imposed on the basis of its weight or the cloth is taxed according to its length or a tax on a picture is levied on the basis of its size, it is known as a specific tax. The main advantage of specific tax is that it is easy to level and more convenient to collect because it is collected either according to the weight of the commodity or according to size of the unit of the commodity. The main disadvantage of this tax is that it does not take into consideration the value of the commodity. Consequently, a cheap and a costly object may be taxed at the same rate.

b) Ad valorem Tax

When the tax is imposed on commodity according to its value, it is termed an **advalorem tax**. Whatever is the weight or size of the unit of the commodity, the tax is charged according to its value. Several imported commodities are taxed not according to their weight or size but according to their value.

The main advantage of an advalorem tax is that it is more equitable. While its main problem is that it is difficult to know the real value of the commodity at the time of imposing the tax. Generally, traders understate the value of the commodities in their invoices in order to escape the burden of the advalorem tax. In fact, it is difficult to choose between a specific and advalorem tax. A good tax system should have a judicious blending of both specific and advalorem tax, according to the nature of the commodities.

2. Single and Multiple Taxes

A single tax is a tax that occurs in a system in which the taxes are levied only on one subject. There is only one tax, which constitutes the source of public revenue. Whereas, multiple tax refers to the tax system in which taxes are levied on various items. It is absolutely against the single tax. It can be easily seen why this must be so. A modern economy is not one or single objective economy. It tries to forge ahead simultaneously along the paths of growth, equitable distribution of incomes and wealth and economic stabilization, etc. Since no single tax can be expected to help the economy on all fronts, choice for a multiple tax system becomes inevitable.

However, notwithstanding the superiority of the multiple tax system, too great a multiplicity of taxes is undesirable and should be avoided. Therefore, it is best to rely on a few substantial taxes for achieving the major portion of the tax revenue.

1.4. Characteristics of a Good Tax System

When is a tax system considered to be a good tax system? Why should we make our tax system good?

Tax revenue has occupied the most important place in the revenue system of almost all governments. This being the case, therefore, countries should strive to make their tax systems a good tax system. Generally, a good tax system should exhibit the following features. Firstly, in a good tax system taxation is only a part (though an important one) of the total budget of the government. On the revenue side, there are items other than taxation. Thus, in a good tax system taxes are not the only source of revenue. If tax is the only source of revenue, that system is not a good tax system. Why? Secondly, in a good tax system the volume, composition, rates, coverage, timings of collection, mode of collection and so on are fixed in a manner that do not negatively affect the taxpayers. Thirdly, for a certain tax system to be considered as a good tax system, the tax burden in the society should be equitably distributed so that each individual is made to pay his fair share of taxes. Fourthly, the attitude of the tax-payers is an important variable in determining the contents of a good tax system. The taxpayers must accept paying a tax as their duty. The taxpaying community must not be a kind of community that would like to be exempted from taxpaying, while it would not mind if others bear that burden. Fifthly, in a good tax system changes in the tax system are brought about only slowly and in stages. Even if it is decided to have an entirely new tax system the authorities cannot suddenly disrupt the whole old system. They have to gear their tax machinery to the new system.

1.5. Introduction to Fiscal federalism in Ethiopia: Focus on Division of Power of Taxation

1.5.1. General Remarks

What do you understand by fiscal federalism? In what form of government does the worry about fiscal federalism come into the picture?

The idea of fiscal federalism comes into the picture where there is a federal form of government- a form of government where we have two or more constitutionally recognized levels of government directly elected by the people with the respective legislative, executive and judicial power accompanied by financial powers. The division of these power in a federal set up combined with ultimate objective of balancing shared rules with self rules has led to the development of the study of fiscal federalism not only from economic but also from political and constitutional perspectives.

Fiscal federalism or fiscal decentralization is generally concerned with the study of distribution of expenditure responsibilities, the allocation of power of revenue raising, intergovernmental transfers for adjusting fiscal imbalances, the management of regional borrowing and institutional mechanisms for fiscal relations between levels of government. (Dear student, bear in mind that in this course, you will be exposed to some points of fiscal federalism very briefly as you will study it in detail when you engage in the course on fiscal federalism).

When there is a federal form of government, there must necessarily be division of power between the federating units and the central government. This division of power necessarily entails division of responsibilities between the two tiers of government. This division of responsibilities in turn brings about allocation of expenditure powers since no responsibility can be carried out without expenditure. Broadly speaking, the distribution of expenditure powers in each federation corresponds to the combined scope of legislative and administrative responsibilities assigned to each tier of government within the federation. The division of expenditure power also entails division of power of revenue raising. Hence, division of power of taxation is one of the most constitutional issues that arise in a federal set up. This is also true in Ethiopia. Therefore, in the subsequent pages, we will briefly discuss the constitutional principles dealing with division of power of taxation between the federal Government of Ethiopia and the Regions.

1.5.2. Fiscal Arrangement under the FDRE Constitution

As it has been neatly analyzed by Dr. Assefa Fiseha, (Federalism and the Accommodation of Diversity in Ethiopia, 2006, pp. 11-22) historically, Ethiopia remained to be a de facto federal state. However, since the adoption of the 1931 Constitution up to the downfall of the Dergue Regime,

the country became a genuinely unitary state where decentralization in general and fiscal decentralization in particular became of little significance and concern to the country. In fact, the Dergue Regime introduced some autonomous regions following the adoption of the 1987 PDRE Constitution although fiscal federalism was not implemented as the country was a unitary state. However, following the down fall of the Dergue regime, federalism was introduced in 1991 de facto and de jure in 1995 with the adoption of the FDRE Constitution.

Article 1 of the 1995 FDRE Constitution clearly states that Ethiopia is a federal state. Two level of government, each having its own sphere of competence in legislative, executive and judicial power have been established. The federal government would not interfere in the functions and powers of state governments and the state governments would not interfere in the functions and powers of the federal government. Just as the legislative, executive and judicial powers of the two levels of government have to be divided as between the federal and state governments, the necessary financial powers in respect of raising revenues and utilizing the revenues raised (expending) must also be carefully divided between the two levels of government. As such, the FDRE Constitution has regulated the affair under consideration by Arts. 94-100 of the Constitution.

1.5.3. Allocation of Powers of Public Revenues

Art. 95 of the Constitution deals with this issue. By virtue of this constitutional provision, the Federal Government and the states shall have their sources of revenue. These sources are determined by taking into account the federal arrangements of the country. According to the constitution, regulations of foreign exchange and circulation of money, administering of air, railways and sea transportation as well as regulating inter-state and foreign commerce and patenting inventions and protecting copyright are the powers and duties of the Federal Government. Therefore, in connection with these activities, the federal government can formulate its own sources of revenue. When we look at Art 52 of the Constitution, we can see that regional states have their own powers and functions. In connection with these powers and functions, regional states can formulate and execute their own sources of revenue. They can, for example, generate their revenue from land and other natural resources administered by them; they can also levy and collect taxes on sources reserved to them by the constitution.

1.5.4. Division of Power of Taxation

You know from your previous discussions that the major sources of revenue for most government are taxes. Hence, sharing of revenue will be meaningful between the federal government and regional states when the power of levying and collecting taxes has been given both to the regional states and the Federal Government. Therefore, the Constitution has carefully regulated power of taxation of the Federal Government and the states under Arts. 96, 97, 98 and 99 of the same constitution. These constitutional provisions have regulated the exclusive power of taxation of the federal government, the exclusive power of taxation of the regional states, concurrent power taxation and undesignated power of taxation.

3. Federal Power of Taxation

There are some broad principles which are followed by many federal states in tax assignment between the levels of government. Most writers on fiscal federalism have reached consensus of the following major principles which are followed as regards division of taxing power in federal countries. These are:

- progressive and redistributive taxes should be central;
- taxes suitable for economic stabilization should be central;
- tax bases distributed highly unequally between jurisdictions should be central;
- taxes on mobile factors of production are best administered at the center;
- residence based taxes such as sales of consumption goods to consumers are suited for states;
- benefit taxes and user charges might be appropriately used at all levels; and
- taxes which are based totally on immobile factors should be assigned to states.

A data collected by Anwar Shah, an expert on fiscal federalism, in 1994 shows that assignment of taxes in different federal countries generally conform to the above broad guidelines. Such countries include: Argentina, Brazil, India, Indonesia, Mexico, Nigeria, the Philippines, Russian Federation and many others. However, tax assignment system contained under the FDRE Constitution is somewhat unusual in that to a great extent the jurisdiction between the Federal Government and the Regional States over tax resources is structured not by the type of tax base.

Rather it is structured on the basis of categories of taxpayers as one can understand this when one reads Art. 96 and 97 of the Constitution.

Art. 96 of the Constitution provides the exclusive power of taxation of the federal government. According to Art 96(1), the Federal Government has the power to levy and collect customs duties, taxes and other charges on imports and exports. This is attributable to the fact that import and export businesses are licensed and regulated by the Federal Government. By virtue of sub-article 2 of this article, the Federal Government is also empowered to levy and collect income tax on employees of the Federal Government and international organizations. Thus, the incomes of employees of public bodies such as ministries, commissions and authorities of the Federal Government and international organizations like the United Nations, United Nations Higher Commission for Refugees, World Health Organization, African Union and the like are to be taxed by the Federal Government irrespective of their place of work in Ethiopia.

Another power of taxation of the Federal Government extends to levying and collecting income, profit, sales and excise taxes on enterprises owned by the Federal Government. Hence, public enterprises such as the Ethiopian Telecommunication Corporation, Ethiopian Electric Power Corporation, Ethiopian Insurance Corporation, Ethiopian Airlines and the like are bound to pay their taxes to the Federal Government though they may have branches and subsidiaries in the regions (Art. 96(3) of the Constitution).

As it is clearly provided under Art. 96 (4) of the Constitution, it is also the power of the Federal Government to levy and collect incomes taxes arising from winning of national lotteries and other games of chance. However, it may not be advisable to give exclusive power of taxation to the Federal Governments as there are situations whereby a person may get a negligible amount of income from chance-winning games such as bingo at the remotest areas of the nation where the Federal Government might not have tax collector or where it is not economical for the Federal Government to have tax collecting offices at that level. In spite of this, the Federal Government may solve this problem by delegating such powers to the regional states in accordance with the constitutional principles.

The other power of taxation of the Federal Government is in relation to taxes levied and collected on air, rail and sea transport services. Thus, if a person engages himself/itself in air, rail or sea transport services and generates income, the income tax shall be paid to the Federal Government. The rationale behind giving this power to the Federal Government seems to be that these services, in most cases, connect (involve) two or more regions. Therefore, the power of taxation of these services must be given to the central government. Finally, the Federal Government has also the power to levy and collect taxes on income of houses and properties owned by it. It has also the power to levy and collect taxes on monopolies and to levy and collect Federal stamp duties.

4. State Power of Taxation

Because Ethiopia is a federal Country, regional states are conferred with exclusive power of taxation. This exclusive power of taxation of the regional states is clearly provided in Art. 97 of the Constitution. Accordingly, regional states are empowered to levy and collect taxes on employees of the states and of private enterprises. This means that states are empowered to collect income taxes from employees of public bodies and public enterprises of the regional states. Regional states have their own legislative, executive and judicial branches of government. Hence, employees of these branches of states are duty-bound to pay their taxes to the concerned regional state. In addition, there might be regional public enterprises. The enterprises as well as their employees are required to pay taxes to the regional government. Private enterprises established in a respective region are required to pay their income tax to a regional state concerned. The state governments have also the power to determine and collect fees for land usufructuary rights, taxes on the incomes of private farmers and farmers incorporated in cooperative associations. States are empowered to levy and collect taxes on income from transport services rendered on waters within their territory, taxes on income from private houses and other properties within the state. They shall collect rent on houses and other properties they own. They are also empowered to levy and collect taxes from incomes derived from-small-scale mining operations and royalties and land rentals on such operations. Finally, states are also authorized to determine and collect fees and charges relating to licenses issues and services rendered by state organs and fix and collect royalty for use of forest resources.

5. Concurrent power of Taxation

In Ethiopia the regional governments and the Federal Government have Concurrent powers of taxation as provided under Art. 98 of the Federal Constitution. That some powers can be enjoyed concurrently under this constitutional arrangement can easily be understood from the reading of Art. 52(1) of the same Constitution. Now the question is as to what is meant by concurrent power of taxation: Its meaning under the FDRE Constitution is much different from what most federal countries take it to be. In these countries, concurrent power of taxation is used to designate a situation whereby both the federal government and the states tax the same tax base. For instance, in the USA, except taxes related to foreign trade and property taxes, which are reserved to the federal government and state governments respectively, all other taxes are concurrent taxes. In India, income taxes, estate and succession duties, excise duties, tax on advertisements, taxes on goods and passengers are concurrent sources of revenue for both the federal government and the state governments. In Canada, the power to impose direct taxes is concurrent power of taxation both the dominion and the provinces.

However, the FDRE constitution has given a totally different meaning to “concurrent power of taxation”. In our country, concurrent power of taxation designates those taxes which are jointly levied and collected by both the Federal Government and the Regional States. Each level of government cannot levy and collect these taxes independently. According to Art. 98, the Federal Government and the states shall jointly levy and collect profit, sales, excise and personal income taxes on enterprises they jointly establish, taxes on the profits of companies and on dividends due to the shareholders and taxes on incomes derived from large-scale mining and petroleum and gas operations, and royalties on such operations.

In all the sub-articles of the above article, we find the phrase “jointly levy and collect.” But the question is as to what this phrase does connote. According to Black’s Law Dictionary, in relation to taxation the word “levy” is the legislative function and declaration of the subject and rate or amount of taxation, exercise of legislative function, determining that a tax shall be imposed and fixing amount and subject of taxation. The dictionary also defines the word “collect” to mean,

“to receive payment.” Therefore, in relation to taxation, the word “collect” signifies the authority to receive money from the taxpayers concerned. So, what do we mean by the phrase “Levy and Collect”? This phrase is not unique to our constitution. Many other constitutions have also used it to refer to taxing power. For instance, the US Constitution provides that Congress shall have the power to levy and collect taxes and Art. 270 of the Indian Constitution also provides that taxes on income other than agricultural incomes shall be levied and collected by the Government of India. In explaining what the phrase “levy and collect” means Basu states that the words levy and collect are used in comprehensive sense and intended the entire process of taxation commencing from the taxing state to the taking away of the money from the pocket of a taxpayer.

Now, it may be easy for us to understand that the Ethiopian Constitution has taken the same meaning concerning this phrase under Art. 98. Under this article, the phrase “levy and collect” is used to mean the power to legislate and collect the money from the taxpayers. It does not include the power to apportion the proceeds from such revenue sources. Therefore, neither the federal government nor the states have the power to apportion the proceeds from taxes under Art 98. Rather, it is the House of Federation which determines the division of revenues as provided under Art.62 of the Federal Constitution. Therefore, by stating the phrase “jointly levy and collect” the Constitutional Assembly has meant that each level of government cannot unilaterally levy and collect taxes falling under Art. 98. For Instance, a decision regarding the modification of the rates of taxes falling under the above-cited article could only be made by the joint session of the House of People’s representatives and the state council concerned. Neither the House of peoples: Representative nor the State council concerned can unilaterally modify the rates of such taxes.

Now before we conclude this sub-section, let us say few words regarding the contents of sub-article two and sub-article three of the article under consideration. As we have mentioned earlier, sub-article 2 of Art. 98 stipulates that the Federal Government and states shall jointly levy and collect taxes on the profits of companies and dividends due to shareholders. Now, the meaning of the word company may not be clear to you at a first glance as it was a source of debate and confusion at the constitutional assembly. However, the word “company” in Ethiopian context

refers to the private limited companies and share companies which are recognized under the 1960 Commercial Code of Ethiopia.

It is easy for you to understand that a company may be established in any part of the country. For instance, assume that a private limited company has been established in Kombolcha (South Wello). In this case, both the Amhara National Regional State and the Federal Government jointly levy and collect taxes from the company and the dividends of the shareholders. Sub-three of Art. 98 of the constitution states that the Federal Government and the states shall jointly levy and collect taxes on incomes derived from large-scale mining and all petroleum and gas operations. This is a reaffirmation of what is provided under Art. 40(3) of the Constitution which provides that the right of ownership of all natural resources exclusively vested in the state and peoples of Ethiopia.

6. Undesignated Power of Taxation

From the foregoing discussions, it is possible to understand that the FDRE Constitution has tried to allocate exclusive powers of taxation to the Federal Government, to the states and to both levels of government concurrently. In spite of such allocation of power of taxation, the constitution has envisaged the possibility of the coming into existence of new tax bases which have not been recognized under the constitution. In order to solve this future problem of undesignated category of tax, the constitution has contained an Article for this purpose.

Of course, as you may understand from your course on Constitutional Law II all powers to the Federal Government alone or concurrently to the Federal Government and the states are reserved to the states by virtue of Art. 52(1) of the Constitution. However, Art. 99 of the Constitution has taken a significant departure from Art. 52 by stating that all powers of taxation which have not been specifically given to the Federal Government or the states shall be determined by a two-third majority vote at a joint session of the House of Federation and the House of Peoples Representatives. This shows that the constitution deliberately makes the assignment of any new taxes to be totally flexible. This means that it could be given either to the federal government or the states depending on the decision of the joint session of the House of Peoples Representatives and the House of Federation.

Chapter Summary

Any government is expected to discharge irreplaceable duties for the welfare of the people. In order to discharge its responsibilities and meet various needs of the people, the government needs public revenues. Public revenues are of two types. These are tax revenues and non-tax revenues. Although non-tax revenues such as prices, charges, fees, loans, gifts and the like do have important contributions towards the revenue needs of the government, tax revenues account for the lion's share which is true in many countries of the world. Taxes are compulsory levies imposed by the government as levying and collecting taxes is an inherent duty and power of the government. Despite the fact that taxes are compulsory levies, the government of a given country, particularly in our modern world, cannot exercise its power of taxation arbitrarily. Rather, it must be guided by certain underlying theories and canons of taxation. In sum, the government is expected to make its tax system a good tax system.

Economists and philosophers have so far formulated various theories and canons of taxation some of which (theories and canons) have influenced modern tax systems. Of the theories of taxation the conspicuous ones are the expediency theory, the socio-political theory, the cost of service theory, the benefits received theory and ability to pay theory. Among these theories, the expediency theory, the socio-political theory and the ability to pay theory have influenced modern tax systems although these theories do have their own limitations. The cost of service and the benefits received theories are least applicable to the modern tax system since they negate the nature of taxes. In addition to the theories of taxation, canons of taxation formulated by world renowned economists have played appreciable roles in shaping tax policies and laws. Particularly, canons of taxation called canon of equality of benefit, canon of convenience, canon of certainty and canon economy are very much useful. These canons were formulated and propounded by the renowned economist called Adam Smith. Other economists also came up with such canons as productivity, elasticity, diversity, simplicity, expediency, coordination and the like which do have merits towards making a tax system as good as possible.

As far as their nature is concerned, taxes may be classified into various classifications. Taxes may be classified as direct and indirect depending upon the shiftability or non-shiftability of the tax burden. If the tax burden cannot be shifted from the point of impact to the point of incidence, the tax is generally considered a direct tax; whereas if the tax burden can be shifted from point of impact to point of incidence, that tax is called an indirect tax. With regard to the applicable rates, taxes may be classified as progressive proportional, regressive or digressive. Moreover, taxes may be classified as specific and advalorem, single and multiple taxes.

The other pertinent point in relation to taxation is division of power of taxation between the Federal Government and federating units. This is particularly important to Ethiopia because Ethiopia has become a federal country de facto as of 1991 and de jure as of the adoption of the 1995 FDRE Constitution. Hence, the constitution has contained rules on fiscal federalism the conspicuous ones being rules dealing with division of powers of taxation between the federal government of Ethiopia and the regional states.

Art. 95 of the Constitution has dealt with the principle of public revenue. According to this constitutional principle, the Federal Government and the regional states have power to employ their own sources of revenue taking into consideration the federal arrangement. To this end, the Federal Government can formulate its own sources of revenue within the bounds of the constitutional principle. The states can also design their own sources of revenue on the basis of the constitution which is the source document of the Ethiopian federal system of government. To this end, the constitution has contained some provision which regulate division of power of taxation.

The Ethiopian constitution has assigned certain categories of tax sources to the Federal Government and others to the regional governments. There are also some powers of taxation that can be concurrently exercised by the Federal Government and the regional states. This means that the Federal Government and the regions can jointly levy and collect taxes. Because one cannot be sure as to what tomorrow may have in store, the constitution has cautiously provided a provision dealing with undesignated powers of taxation. Undesignated power of taxation is power which is given neither to the Federal Government nor to the regional states. In this case, the solution is in the hands of the joint session of the two federal houses. This means that where

the country feels to introduce a new tax base, the power of levying and collecting such tax will be decided by the joint session of the House of Peoples' Representatives and the House of Federation. The two houses assign the power either to the Federal Government or the Regional States taking into consideration a number of factors.

CHAPTER TWO

INCOME TAX IN ETHIOPIA: THE SUBSTANTIVE PART OF PROCLAMATION NO 286/2002

Introduction

One of the most important tax bases is taxation from income. Imposing and collecting income tax in Ethiopia was an old practice. Therefore, income tax is not the outcome of modernization although the system has been modernized particularly during the 2nd half of the twentieth century and finally at the beginning of the 21st century. Because income tax is an important source of revenue, currently in Ethiopia a comprehensive income tax law has been adopted. Hence, the focus of this chapter is on the most important aspects of the income tax law. Apart from tracing the history of income tax in Ethiopia and discussing few items which are instrumental to the understanding of this law, this unit has been entirely devoted to the analysis of the substantive provisions of Proclamation No. 286/2002. In doing so, the four important schedules of the proclamation have been separately discussed. Under these schedules, the tax bases have been identified and discussed. The applicable rates have been shown and the appropriate deductions and exemptions have also been carefully treated. Whenever possible and appropriate, the discussions made have been supported by relevant examples which will be of great help to you in understanding the contents of the unit.

Objectives

Having completed this chapter, students should be able to:

- discusses the history of income tax in Ethiopia;
- define income from different perspectives;
- analyze the scope of application of the Income Tax Proclamation and its implications;
- identify the schedules of income tax and the sources of income, rates applicable, deductible expenses and exemptions.

1.1. Brief History of Income Tax in Ethiopia

The system of taxation in traditional Ethiopia was of fundamental importance. It provided not only for the upkeep of the monarch and the central government but also for a vast social hierarchy composed of provincial governors, lords and nobles, soldiers, the clergy and other privileged persons. It played a vital role in the history of Ethiopia especially in connection with state and religion.

Taxes were levied more or less on all productive activities of the society such as the peasants, handicrafts, workers, and traders. The peasants were obliged to pay from what they produced at home and from what they collected from their land. Handcrafts workers were liable to supply their superiors in one way or another with the produce of their toil. Traders were subjected to taxation on the goods they sold in the market. Hunters of elephants were subjected to ivory tax. Persons living in the neighborhood of mineral resources were obliged to supply mineral to the government. There were also taxes on livestock, cattle, camels, sheep, goats etc. However, the system of taxation was not even (uniform) throughout the country; it varied from place to place. For instance, sheep and goats were often taxed in Menz; camels were taxed in the pastoralists' areas of the country. A large portion of the population was also obliged to provide labor services to the superiors. This was the most notorious form of taxation under which an individual was obliged to render his service to his superior.

In traditional Ethiopia, taxes were paid in kind. However, monetary payments appeared to have steadily increased in the 19th and early 20th century, particularly on account of the growing use of money in the century at large. During this period, Maria Theresa dollar of Austria obtained great popularity as a means of exchange and for the payment of taxes. In the area of agriculture, a decree was issued in 1882. A tithe (one out of ten) was introduced requiring the peasants to pay one-tenth of their product to the tax officials. Emperor Menilik II of Ethiopia ordered his people to pay taxes according to their ability, the poor on the basis of their poverty and the rich of their riches. This principle embodied the idea that each individual would give grains in accordance with the amount he used to earn.

In 1901, the tax offices granary was set up in each district where the annual tithe had to be deposited. During this period, the peasants used to call the tax officials to their farm in order that what they produce to be measured. Then the peasants were subject to the payment of grain in accordance with the amount they obtained from their farm.

The enactment of modern income tax laws in Ethiopia is a recent phenomenon. The first income tax proclamation in Ethiopia appeared in 1942 as a personal and business tax proclamation, proclamation No. 60/1942. The drafters of this income tax law were predominantly British. In this law 'income' referred to every sort of income derived from any activity in the Empire of Ethiopia, but it did not include salaries received from members of the regular armed forces and income earned from agriculture. The second income tax law was adopted in 1949 and this proclamation was amended in 1956. According to this proclamation, there were three sources of chargeable income. These were income obtained from employment, from rent of lands and buildings and from businesses, professional and vocational occupation.

This proclamation was replaced by the 1961 Income Tax Proclamation which existed for more than four decades although it had undergone a number of amendments. This proclamation was repealed and replaced by Proclamation No. 286/2002. With a view to implementing the proclamation an important regulation, Regulation No. 78/2002 was issued by the Council of Ministers. Currently, the Income Tax Proclamation has been amended by proc. No. 608/2008. It is this proclamation which is operative in the Federal Government of Ethiopia currently. Therefore, the discussions which are going to be made under this unit depend predominantly on these new laws.

1.2. Definition of Income

When we talk about income tax, as the name itself indicates, the levies and charges are imposed on the income of persons. Thus, for one to be a subject of income tax, one must have an income. Therefore, we necessarily ask the question as to what is meant by income. The nature and definition of income is the subject of much discussion among scholars and experts. There is no comprehensive and permanently applicable definition of the term income. The concept income can be understood in the context in which it is intended to serve. This is because scholars and experts in various disciplines usually tend to give definition to the term from the vantage point of their field of specialization and concern. As a result, it is not easy to reach a consensus on its meaning. In other words, different scholars and experts construe the term 'income' in such a way that it is convenient to their field of study. For instance, economists, accountants and lawyers understand the term in relation to their own field of study and see the term in different aspects. Even within the legal systems of different countries, there is no a single universally

accepted definition of the term in the income tax law. This is due to the variation of the income tax system according to political and legal system changes. However, the problem of various understanding of the term can be avoided by giving a statutory definition to the term. This is because courts are chiefly interested in interpreting the intention of the legislature as expressed in the law and they are obliged to determine what the law says rather than what income is in fact. But it needs a great care in providing a statutory definition to the word income into tax words of art. The law thereby develops its own language. The process by which every day words become technical tax terms is that of statutory definition and the income tax is thus necessarily replete with definitions. In short, in the realm of tax laws, terms are not used in the way we understand in the ordinary parlance.

In order to show the problems in definition of ‘income’ in income tax laws, we will see how, for instance, the USA and UK handle the term in their statutes. In US, the constitutional amendment that introduced the tax merely states that Congress shall have power to levy and collect taxes from incomes, from whatever sources derived. Here the phrase ‘from whatever sources derived’ does not really provide a standard that can be used to decide whether or not the exclusion of certain items from taxation is appropriate. In the UK tax law, there is no provision which gives definition of income, and rather the statute tries to relate the income with the source of income which is taxable.

When we come to the Ethiopian context, unlike UK and the USA, Ethiopian tax law defines the term income under proclamation No. 286/2002. Art. 2(10) of this proclamation defines the term as:

Every sort of economic benefit including non-recurring gains in cash or in kind, from whatever source derived and in what form paid, credited or received.”

From this definition, it is possible to understand that income is an economic benefit. This means that benefits accruing to a person in the form other than economic are not considered income for the purpose of taxation. For example, spiritual benefits are not incomes; hence, the beneficiary cannot be expected to pay tax on them. The other thing that we can gather from the above definition is that the benefits accruing to persons may be recurrent or non-recurrent benefits. That means, they may be periodically maturing benefits or they may be benefits accruing to the

beneficiary only once. In addition, the definition tells us that the benefits may accrue to the beneficiary in cash, in kind, or in any other form. Accordingly, income is not limited to receipts of cash, but also extends to receipts of property, services, and other economic benefits. For instance, income may be realized on the cancellation of indebtedness or upon the purchase of property at a lower price than the actual market price of the property. In situations where income is received in a form other than cash, a cash equivalent approach is adopted. Under this method, the measure of income is its fair market value at the time of receipt. In order to understand what has been said at this juncture, have a look at the following examples:

Example 1

A lawyer handled a court case for a doctor in exchange for medical treatment rendered to the lawyer by the doctor. The lawyer receives income equal to the fair market value of the services provided by the doctor. Barter transactions of this nature are thus subject to taxation.

Example 2

Ato A is a taxpayer. He owed Birr 100,000 to Ato B evidenced by a promissory note payable due in six months. If Ato B remitted this debt, Ato A must normally recognize gross income of 100,000.00 Birr. Hence, this 100,000.00 Birr is taxable since Ato A earned income because of the remission of the debt.

However, it must be borne in mind that in case of return of capital, though the payment may be effected to a person in cash or in kind, it will not be considered as income if that person receiving payment does not get a benefit or gain. This situation, in some countries, is known as the return of capital doctrine. This doctrine is best illustrated by a simple loan transaction. When a taxpayer lends money and if it is repaid, no income is recognized since the repayment represents merely a return of capital to the taxpayer. However, any interest on the loan that is paid to the taxpayer would be income and it is taxable. The application of this return of capital doctrine is not limited to loans. It also applies to situations where a taxpayer is awarded compensation for injury inflicted upon him. Since such amount received represents a return of the personal capital destroyed, it is not an income. However, if the compensation awarded represents for lost profits, gains or incomes, the amounts are considered taxable since they are merely substitutions for income. The following example illustrates these two points very well.

Ato Awlachew was an employee of the Ethiopian airlines. The airlines dismissed Ato Awlachew alleging that he was absent from duty for ten consecutive days without good cause. Ato Awlachew brought suit against his employer claiming reinstatement and back pay for the lost wages. While he was out of work he sustained a serious bodily injury as a result of a car accident. He also brought suit against the tort-feasor. The court decided in his favor in both suits. In this case, the money awarded to him in the form of back pay is taxable since it represents a situation of income. In the second situation, the compensation awarded as a result of the tortious liability of the tort-feasor is not taxable because he did not gain income. It is simply a compensation awarded to him as a result of the injury he sustained in the hands of the tort-feasor.

The other important element of the definition of income is that of its source. As we can understand from a close reading of the definitional article of the income tax proclamation, this definition has not imposed limitations on the source of the economic benefit or gain so as to be considered as income. Dear students, Ato X does have a drug store. This last tax year, he sold drugs which are not allowed by the Ethiopian Drugs Administration Authority. He generated a substantial amount of money. Is it possible to collect income tax on the income X has derived by selling drugs which are not allowed to be sold?

It is possible to maintain that X should pay tax to the Ethiopia Government because as the Ethiopia law does not seem to have made any discrimination between lawful and unlawful sources of income.

1.3. Scope of Application of the Income Tax Proclamation /Tax Jurisdiction/ and the Problem of Double Taxation

1.3.1. Scope of Application

The law-maker in Ethiopia and elsewhere in the world usually defines the scope of application of certain legislation. Doing so is important to properly understand the law and implement it in accordance with the intention of the law-maker. It is in line with this that the FDRE Income Tax proclamation has tried to define its scope of application. In this regard, Art. 3 and Art. 5 of the Proclamation are crucial. As per Art.3(1) of this Proclamation, it is applicable to residents of Ethiopia with respect to their world wide incomes. This means that a resident of Ethiopia is duty-bound to pay income tax to the Ethiopian Government even if the income of such resident is

generated outside Ethiopia. In order to understand this better, have a look at the following illustration. Mr. Martin Luther is a Greek national who has a big supermarket in Toronto, Canada. He is a resident of Ethiopia since 2008. Yet, he does not get any income, whatsoever, in Ethiopia. Despite this, Mr. Martin Luther is required to pay income tax to the Ethiopian Government by the mere fact that he is a resident of Ethiopia. The Ethiopian Government imposes taxes on residents because they generate various kinds of benefits (such as defense, security, infrastructure, clean environment and the like) as a result of the activities of the government.

The next question that crosses your mind is as to what is meant by “residence”. Does the word residence, as used in the Income Tax Law, have similar meaning as that used under the 1960 Ethiopian Civil Code? When we examine the relevant provisions of the Ethiopian Civil Code in the light of the Income Tax Proclamation, it is easy to understand that the word residence used in the latter law is by far wider than the meaning given to residence under the Civil Code as the word residence in the tax law also includes domicile which is quite different from residence in the Civil Code.

With a view to shedding light on the concept of residence and residents, the Income Tax Proclamation has incorporated certain parameters. Accordingly, as per Art.5(1) of the Proclamation, an individual (physical person) is considered to be a resident if he/she

- a) has a domicile in Ethiopia;
- b) has an habitual abode in Ethiopia; and/or
- c) is a citizen of Ethiopia and a consular, diplomatic or similar official of Ethiopia posted abroad.

Although the stance of the proclamation is not as such clear, it seems to be safe to conclude that the above elements should be satisfied alternatively.

Illustration

Peterson is a Russian monk. In Russia, he has a business centre which generates a substantial amount of money (about 10 million USD annually). However, he stayed the whole year (in 2002 E.C tax year) at the Monastery of Abuna Tekle Hymanot, Debre Lebanese. He stayed in Ethiopia

as the monk likes the monastery for praying and other religious activities. In this situation, the monk is required to pay income tax to the Ethiopian government on the income he earns in Russia. Dear students, there is no doubt that the monk is duty bound to pay income tax to the Ethiopian government as he is an Ethiopian resident. The other important point worth noting is what is provided in Art. 5(2) of the Proclamation. This sub-article provides that an individual who stays in Ethiopia for more than 183 days in a period of 12 calendar months either continuously or intermittently shall be resident for the entire tax period.

The other essential issue in relation to scope of application of the Income Tax proclamation is as to when a body /a legal person/ is considered to a resident of Ethiopia and hence required to pay income tax. The answer to this question is obtained by having a look at Art. 5(3) of the same Proclamation. Accordingly a body is considered as an Ethiopia resident if it:

- a) has its principal office in Ethiopia;
- b) has its place of effective management in Ethiopia; and or
- c) is registered in trade register of the Ministry of Trade and Industry of the Federal Government or Trade Bureau of Regional Governments as appropriate.

It seems that these elements should be satisfied alternatively .This is because if we require these elements to be satisfied cumulatively, the purpose of the tax proclamation cannot be met.

In addition to the above requirements, a person is considered to be an Ethiopian resident if it is a permanent establishment. Under the tax proclamation, a permanent establishment means a fixed place of business through which the business of a person is wholly or partly carried on for instance, an administrative, branch, factory, workshop, mine, quarry or any other place for the exploitation of natural resources, and building site or place where construction and/or assembly works are carried out. (see Art. 2(9) of the Proclamation). In addition to the residence requirement, the Income Tax Proclamation has clearly stipulated that the proclamation shall apply to non-residents of Ethiopia with respect to their Ethiopian sources. For instance, Professor Wagaw Bedhasa is an American citizen of Ethiopian origin. He is a resident of New York. He came to Ethiopia last June 2010 in order to render consultancy service to Omega University on curriculum development. In return to the consultancy service, Omega University paid a lump sum of 1.5 million Birr to Professor Wagaw. In this situation, Professor Wagaw is obliged to pay

income tax to the Ethiopian Government since Ethiopia is the source of income for Professor Wagaw.

From the whole discussions so far made, as far as the scope of application of the Income Tax Proclamation is concerned, the proclamation has combined both the residence (personality principle) and the source (territorial principle). The combination of these two principles was made consciously by the Ethiopian Government with a view to generating large income tax revenues that would be used by the government in its developmental activities.

1.3.2. The Problem of Double Taxation

The combination of the resident and the source principles under the Ethiopian Income Tax Proclamation inevitably breeds the problem of double taxation. This is because the scope of application of our tax law gives rise to conflict of tax jurisdiction with other countries. Generally, there are three sources of conflict which result in the problem of double taxation. These are:

- ii) source-source conflict
- iii) residence- residence conflict
- iv) source-residence conflict

In the first type of conflict, two or more countries may claim the right to tax a given source based on the fact that they are the source of income. For example, the raw materials for steel industries in Ethiopia come from foreign countries. So, if the exporting country follows the source of raw material as the source of income, it may impose tax on it since doing so is its sovereign right. On the other hand, Ethiopia is the place of production using those raw materials and it has a sovereign right to impose tax on the income of the final products. In this case, it is clear that there is a problem of double taxation. There can also be similar type of problem when parts of a certain object are produced in one country but assembled in another country. Here based on the source of the particular income, it may face double taxation.

The second type of conflict is residence conflict. In this case, two or more states assert a right to tax a certain person, be it legal or physical person, who/which is a resident in their country. The third problem is referred to as source-residence conflict. This may happen when different

countries use different criterion to impose taxes. One country may base its taxation on source of income criterion and others on residence as this is legal for both states. Assume that Mr. A runs a business in Kenya where the country imposes tax on source. He is an Ethiopian resident where he is required to pay income tax by the mere fact that he is a resident of Ethiopia. It is clear that the individual is exposed to double taxation.

Double taxation causes different problems. Because of double taxation, taxpayers who/which earn the same amount of income would pay different amounts of taxes. Taxpayers subject to double taxation would be forced to pay more because they have an additional tax burden in other country/countries. Thus, this creates differences among taxpayers by defeating the canon of equity. Double taxation also becomes dangerous to cross-border investment and technology transfer. Hence, it is necessary to provide certain solutions to this serious problem. Generally, the problem of double taxation may be avoided by international treaties, bilateral treaties or unilateral action of the country concerned. In most cases, international treaties relieve the burden of double taxation in two ways. These are the exemption method or the deduction method. In exemption method, two or more states may conclude a treaty providing that the same subject matter would not be taxed more than once. The deduction method is different from the exemption method. In the exemption method the taxpayer is wholly relieved from paying taxes again from the same tax source. However, in the deduction method only partial exemption is given to the taxpayer. In deduction case, states may agree to allow the taxpayer to deduct the amount of the paid to another sovereign state from the same source. This shows that states recognize the right of other states to impose tax on the basis of residence or source.

Another way of treating the problem of double taxation is by the unilateral acts of a state. By way of unilateral acts, a state may take two alternative measures – it could be exemption or deduction (tax crediting). When the relief adopted is exemption, the taxpayer is not required to pay tax provided that the taxpayer has already paid elsewhere. Secondly, states provided deduction to the taxpayers. This method is called the credit method. In such a case, the tax that has already been paid tax in another country would be taken as a credit and the tax would be assumed to have been paid in the second state. If the tax liability of the individual economic unit is greater in the home country, he/she/it will be required to pay the difference. If the tax liability

in the first country is greater than the second state, no thing would be paid to the second state. The same is true if the tax liability is equal in both countries. In Ethiopia, the problem of double taxation is solved by international treaties, bilateral treaties and unilateral actions. As far as the second method is concerned, the country has concluded a number of bilateral treaties with foreign countries. The deduction method /tax crediting/ is also incorporated in the Proclamation with a view to avoiding the problem of double taxation. The fact that certain taxes may be exempted by international treaties to which Ethiopia is a party is envisaged by the proclamation (Read Art. 7, Art. 13(d) and art. 30(1(c) of the Income Tax Proclamation).

1.4. Schedules of Income Tax under the Proclamation

As far as the system of taxation is concerned, countries of the world have adopted two systems. These are the global /aggregation/ and the schedular system. These two systems do have their own features and rationales. In the global system, tax is imposed on the total income of the individual regardless of the types of activities he pursues and regardless of the source from which the individual obtained that income. Contrary to this, under the schedular system, the different sources are taken into consideration for tax purpose and tax is levied and collected separately. The Ethiopian Income Tax laws, past and present, have followed the latter system. The income tax proclamation has systematically classified the income sources into four schedules. Thus, incomes of taxpayers are taxed according to these schedules. Of these four schedules, the first one, i.e., schedule “A” deals with assessment of income tax from employment. Schedule B provides rules and principles for collection of income tax from rental of buildings. Schedule C covers income tax from business, and schedule D deals with miscellaneous income taxes. (Read Art. 8 of the Proclamation)

1.4.1. Schedule A (Income from Employment)

Employment is one source of income in the Ethiopian Income Tax Proclamation. As such, income tax is charged, levied and collected from it and income derived from employment is to be taxed according to schedule A of the proclamation. The relevant articles are Art. 10-13 of the Income Tax Proclamation and Arts. 3, 4 and 25 of the Regulation (Reg. No 78 (2002)). According to this schedule, every person deriving income from employment is liable to pay tax on that income. The rate provided by this schedule is the combination of progressive and proportional rates. As the schedule clearly depicts, the first 150 Birr is not taxable income. Such exclusion

may be justified on two important grounds. The first reason is attributable to the fact that this amount is so small that the government should not take a certain portion of it. If the government takes a certain portion from an employee who earns 150.00 Birr, this would not serve the purpose of social justice as the purpose of taxation, among other things, is distribution of wealth. Secondly, it would not be economical or cost effective for the government to levy and collect taxes on such a negligible amount of money. The amount of money to be spent by the government for the collection of these taxes would be greater than the amount of money to be collected from such source.

As you can understand from the schedule which appears here in below, the minimum rate imposed by the schedule is 10 percent on incomes falling from 151.00 Birr to 650.00 Birr. Whereas, the maximum rate provided in the schedule is 35 percent for all incomes from employment that are above 5000.00 Birr per month.

The following table shows income tax rates of schedule A. (See Art. 11 of the proclamation)

Employment Income (Per Month)		Income Tax payable in percent
Over Birr	To Birr	
0	150	Exempt threshold
151	650	10%
651	1400	15%
1,401	2350	20%
2,351	3350	25%
3551	5000	30%
Over 5000		35%

In order to understand how income tax from employment is calculated as per the above schedule, have a look at the following examples. Assume that Ato X derives a monthly salary of 2000.00 Birr from a certain company. The income tax is calculated as follows. As the schedule dictates, the first 150 is a tax free income; thus, when you deduct 150 Birr from 2000 Birr, there remains 1850.00 Birr. Out of this, the first 500.00 Birr is to be taxed at 10% rate and the amount of tax would be 50.00 Birr. The next 750 Birr (1400-650) is to be taxed at 15% rate and the amount of tax would be 112.50 Birr. The remaining 600.00 Birr (2000-1400.00 Birr) is taxed at the rate of

20% and the amount of tax to be paid would be 120 Birr ($600 \times 20/100 = 120.00$ Birr). Hence the tax obligation of this person will be $(50 + 112.50 + 120.00)$ 282.50 Birr.

Under this schedule, employment income includes any payments or gains in cash or in kind received from employment. This means that tax is to be collected whether the money to be paid is in a form of monthly salary, commissions, bonuses or tips or vacation pays. However, this is without prejudice to the exemptions made under the Proclamation and Regulation No. 78/2002. One of the most important features of schedule A is that it has contained exemptions. As a matter of fact, exemption of tax is as old as taxation itself. The various taxes which were known in Ethiopia had their own respective exemptions. For instance, land which was given to nobles for their own use and land given to ecclesiastics and religious establishments were more or less completely exempt from payment of tribute. There were also a number of tax exemptions which we do not mention here for scarcity of space. There have been also a number of tax exemptions which have been enshrined under the modern tax proclamations of Ethiopia. Generally, tax exemption is granted for investment, administrative, economic, political, and social and other important reasons. It is for these reasons that Art. 13 of the proclamation has granted exemptions.

Let us discuss each exemption one by one as follows:

- a) Incomes from employment received by casual employees who are not regularly employed provided that they do not work for more than one (1) month for the same employer in any twelve (12) months' period are exempted. Why are such incomes exempted? The rationale behind this exemption seems administrative reasons. Administration of taxes i.e. assessment and collection of taxes, requires personnel and equipment. In other words, taxation involves costs which are necessary for collecting taxes, such as salaries paid to tax officials and other costs involved in the collection of taxes. This means "gathering" taxes requires the consumption of resources by the tax authorities. This shows that the canon of economy is indispensable. This means that it is important that the cost of collection of tax should be the minimum possible. It will be useless to impose taxes which are too widespread and difficult to administer. These taxes entail an unnecessary burden upon the society in the form of additional administrative expenses. The productive efforts of the people suffer due to the wasteful use of its resources on the salaries of the officials.

Likewise, when we come to the exemption made by Art. 13(a) of the Proclamation, the cause of the administrative inconvenience are the fact that the employees are casual and are not employed by a single employer on a regular basis. Since they are not regularly employed, they will not be placed on a payroll of a single employer. This means that the tax authorities will not trace the income of such casual employees through an employer. This would necessitate arrangement of a mechanism for taxing the income of such persons which may need costs and expenses that may outweigh the benefit accruing in term of taxes. Therefore, exempting such kind of taxes from payment of income tax would be a solution for the inconveniences that arise during their collection. That is why this exemption is granted by the Proclamation under consideration.

- b) Pension contribution, provident fund and all forms of retirement benefits contributed by employers in an amount that does not exceed 15% of the monthly salary of the employed are exempted. These amounts contributed by the employer are social security schemes. Therefore, in order to encourage such schemes, the government should exempt such incomes from tax. These contributions are exempted so long as they do not exceed 15% of the employee's salary. In order to understand this better, look at the following example:

Employer X pays 2000.00 Birr to one of its employees. In addition, it contributes 400.00 Birr as provident fund to this employee. From this example, you can easily realize that 400.00 Birr is 20% of the salary of the employee. What is 15% of 2000.00 Birr? It is 300.00 Birr, for $2000 \times 15/100$ gives 300. Therefore, the remaining one hundred Birr (400-300) is taxable being added to the monthly salary of the employee.

- c) Subject to reciprocity income from employment received for services rendered in the exercise of their duties by:
 - i. Diplomatic and consular representatives
 - ii. other persons employed in any Embassy, legation, consulate or mission of a foreign state performing state affairs, who are nationals of that state and bearers of diplomatic passport or who are in accordance with international usage or normally and usually exempted from the payment of income tax. Diplomatic and consular missions and their representatives and international organizations and their officials are accorded a number of immunities and privileges in order to help them carry out the functions they are entrusted with. Privileges and immunities are granted under municipal laws as well as

international laws. Exemption from payment of taxes, direct or indirect, constitutes part of the immunities and privileges.

The Income Tax Proclamation of 1961 (as amended) had, long before Ethiopia accepted the Vienna Convention on Diplomatic Immunity, provided for the exemption from payment of income taxes of diplomatic representatives on the income they receive in exercising their official duty on the basis of reciprocity. The proclamation provided for similar exemptions for consular representatives, too. The same is true with Art. 13 of the 2002 Income Tax Proclamation. Apart from consular and diplomatic representatives, other persons employed in an Embassy legation, Consulate or Mission of a foreign state are exempt from paying income tax so long as they are performing state affairs, they are nationals of the state concerned and they bear diplomatic passport or those persons who are in accordance with international usage or custom normally and usually exempted from the payment of income tax.

With regard to the income tax exemption privileges of diplomatic representatives, both the income tax Proclamation of 2002 and the Vienna Convention have more or less similar provisions. The Vienna Convention, to which Ethiopia is a party, further elucidates the specific beneficiaries of the income tax exemption. As per the convention, apart from diplomatic agents, members of the administrative and technical staff of the diplomatic mission, members of the service staff of the mission, and private servants of members of the mission, who are foreigners are exempt from payment of income tax by reason of their employment in the mission.

d) Income specifically exempted from income tax:

- i. by any law in Ethiopia unless specifically amended or deleted by proclamation No. 286/2002.
 - ii. by international treaty
 - iii. by any agreement made or approved by the Minister of Finance and Economic development.
- e) Those incomes which are exempted by the regulations issued by the council of Ministers of economic, administrative or social reasons. (Reg. No. 78/2002)
- f) Payments made to a person as compensation or gratitude in relation to personal injuries suffered by the person or the death of another person.

These payments are, strictly speaking, not incomes. They are simply indemnities to what is lost by such a person. That is why they are exempted from payment of tax. Look at the following examples:

- 1) Ato Ergetie, while he was driving his car above the speed limit, knocked down a pedestrian and the latter sustained a serious bodily injury. The victim took his case to court and the court awarded him 20,000.00 Birr by way of compensation for the injury he sustained. This payment is not taxable.
- 2) Assume that the above accident resulted in the death of the pedestrian and assume again that the deceased has left dependants whose existence was dependent on the income of the deceased. In this case, the Ethiopian Law of Extra-contractual Liabilities provides that the dependents are entitled to compensation. The compensation paid by the tort-feasor to the dependants is not taxable as clearly provided by the labor proclamation (proc. No. 377/2003 as amended)

In addition to the exemptions provided in the proclamation per Art. 3 of the regulation, the following categories of payments in cash or benefits in kind are excluded from forming part of the taxable income of an individual for the purpose of computation of income tax:

- amounts paid by employers to cover the actual cost of medical treatment of employees. From this, we can understand that the money paid to the employee must be an actual payment; it must not be a fictitious one. In other words, the employee should produce a medical receipt which shows that the money advanced by the employer to the employee was actually utilized for medical treatment.

For example, if the Ethiopian Airlines pay 500.00 Birr for medication to one of its employees as per the collective agreement, this amount shall not be considered as an income of the employee and shall not be added in his taxable income:

- allowances in place of means of transportation granted to employees under contract of employment. This amount is not added to the salary of the employee and hence is not taxable.
- Hardship allowances: under certain circumstances depending on the nature of the work or the nature of the place of work, hardship allowances may be given to employees, and such allowances are not taxed.

- Amounts paid to employees in reimbursement of traveling expenses incurred on duty are also exempted. Such reimbursement money is not taxable because the employee has not derived any income; he is simply refunded for what he has expended.
- Amount of traveling expenses paid to employees recruited from elsewhere than the place of employment on joining and completion of employment or in case of foreigners traveling expenses from or to their country are exempted.

Assume, for example, the commercial Bank of Ethiopia wants to employ a legal expert whose residence is in Addis Ababa while his duty station will be at Dessie. The bank pays 200.00 Birr to such expert as a traveling expense that is incurred when he travels from Addis Ababa to Dessie. This 200.00 Birr is tax free.

- Allowances paid to members and secretaries of boards of public bodies as well as to members and secretaries of study groups set up by the Federal or Regional Governments.
- Income of persons employed for domestic duties is not taxable. Thus house servants, maids and gardeners of individual persons are free from paying income tax, though they may have incomes as a result of their employment.

Therefore, the above lists of income are exempted from income tax. Except these categories, all incomes of an individual arising from his employment within a month shall be added and taxed as per schedule A of the income tax proclamation. For instance, Ato Demoz gets 2000.00 Birr as his monthly salary, 400.00 Birr as a position allowance, 150.00 Birr as transport allowance and 800 Birr as over-time work payment in one month. From this example, it is easy for you to understand that his salary, position allowance and over-time work payment i.e., $(2000 + 400 + 800 = 3200.00 \text{ Birr})$ is subject to income tax obligation. The amount paid to him in the form of transport allowance is, however, exempted from income tax as we have seen above, subject to the limitations determined by directives issued by the appropriate body. The tax on income from employment is charged, levied and collected monthly. Thus, where the income is received in the form of a payment covering a period longer than one month, the tax payable shall be computed by prorating the income received over the number of months covered by such payment. Therefore, if Ato Agegnahu is paid a salary of 24,000.00 Birr for one year, his monthly income

will be calculated by dividing the sum for twelve months ($24,000 \div 12$) and he will be taxed for 2000.00 Birr each month.

1.4.2. Schedule B (Income from Rental of Buildings)

The second Schedule of income tax recognized under the Income Tax Proclamation is schedule B. As you can understand from the reading of Art. 14 of the proclamation, this schedule provides the tax base, rate, exemptions and deductions. The tax base is, therefore, renting buildings. Buildings by themselves are not tax bases as per this schedule unless they are rented. The principle enshrined under this schedule is that a person who derives income from rental of buildings must pay an income tax provided that the income is not less than 1800.00 Birr per year or 150.00 per month. Taxes under this schedule, unlike taxes on income from employment, are to be levied and collected annually.

Gross income under schedule B constitutes the following receipts:

- a) all payments in cash and all benefits in kind received by the lesser from the lessee. Sometimes, there may be circumstances whereby the lessee may agree to pay the rent not in cash, but in kind or in any other form. In such a situation, the payments made in kind or in such other forms shall be assessed in terms of money and they will be considered as part of the gross income of the lesser.
- b) all payments made by the lessee on behalf of the lesser according to the contract of lease also form part of the gross income. For instance, in a contract of lease, the lesser and the lessee may agree that the lessee shall pay a certain amount of money for the creditor of the lesser in return for his enjoyment of the building of lesser. In such a situation, the amount paid by the lessee to the creditor of the lesser is considered as an income of the lesser and it forms part of his gross income under schedule B. Look at the following example: Ato Sebsibe borrowed one million Birr from Ato Cheru some three years before. Then in order to repay the loan, he leased his building to Ato Tigistu. Then Ato Sebsibe assigned the obligation to pay the loan he took from Ato Cheru to Ato Tigistu. Ato Tigistu pays 200,000.00 Birr to Ato Cheru in return for his enjoyment of the building. Therefore, the 200,000.00 Birr is the gross income of Ato Sebsibe and income tax is imposed on the taxable income of Ato Sebsibe.

- c) the value of any renovation or improvement made under a contract of lease to the land or building where the cost of such renovation or improvement was borne by the lessee in addition to rent payable to the lesser. Where the lessee made extra payments to the renovation or improvement of the house and if the house is improved, for instance if service quarters are constructed, the roof or fence of the building is changed or improved, then such improvement constitutes gross income to the lesser.
- d) if the lesser leased furnished quarters, the amounts received attributable to the lease of furniture and equipment shall also be included in the gross income of the lesser. A building, for instance, may be leased with household items like bed, mattress, cupboards, tables, chairs etc, and the lessee may be required to pay some amount of additional money for such household items and this amount forms part of the gross income of lesser under schedule B.

In the case of sub-lease, the gross income of the sub-lessor includes all payments effected to him as a result of the sub-lease agreement. However, his taxable income is the different between the income from sub-leasing and the rent paid to the lesser. If there is no difference or if the difference is negative, the sub-lessor will not be subject to the income tax proclamation as per schedule B. Look at the following example: Ato A rents a building from Ato B for 1,000,000.00 Birr per year and he (A) sub-leases it to Ato C for 1,200,000.00 Birr. Now Ato A's gross income is 1,200,000.00 Birr while his taxable income is the different between the what he has received from Ato C and what he has to pay to Ato B ($1,200,000.00 - 1,000,000 = 200,000$). Thus Ato A is required to pay tax on his income of 200,000.00 Birr.

In the case of sub-lease transactions, the owner of a building who allows a lessee to sub-lease his building is liable for the payment of the tax for which the sub-lessor is liable, in the event that the sub lesser fails to pay. Therefore, the owner of a building is considered as a guarantor of the sub-lessor as far as the amount of tax due for the tax collection in relation to the sub-lease agreement is concerned. This is a guarantee created by virtue of the law.

What we have mentioned above are the gross income of the lesser. However, gross income is not taxed. It is only on the taxable income that income tax is collected since there are deductible incomes on which tax is not imposed. However, the question that you may raise at this juncture is as to why deduction is allowed under the income tax proclamation we do need deductions as a

matter of equity and as a matter of social policy. Equity refers to the fairness in distributing the burden of government expenditures. A tax system viewed by the people as unfair or worse will be resented. Such a situation will not only make the job of the government difficult, it also even leads to rebellion. For instance, the taxes imposed by the British Government on American Colonies surely contributed to their willingness to use violence in the quest for their independence.

In addition, tax deductions meet several societal and equitable goals. Reducing gross income to a net figure by subtracting the tax payer's expenses is an unavoidable step in calculating taxable income. The Ethiopian Income Tax Law is premised on the idea that income appropriation is the best measurement of the taxpayers' ability to bear the cost of government. While gross income may give some indication of the taxpayer's income status, it would obviously be arbitrary and in many instances highly unfair to accept that figure as actual income. For example, a lawyer who receives Birr 100,000.00 in fees for this year may not get the whole amount. It all depends on how much he/she has to spend in the process-office rent, employees' wages, traveling expenses and many other expenses may have been incurred in generating the income received.

Furthermore, adjustments need to be made for special and unusual circumstances that affect one's ability to pay taxes. For example, the family that has catastrophes, medical expenses or that has lost its home due to fire has a reduced ability to pay income tax. One way in which a state can provide protection to such persons is through adjustment of tax laws. Adjustments should be made to encourage economically desired activities such as interest deduction to encourage saving or home ownership; and deductions for charitable contributions to encourage voluntary donation to worthy charities. Therefore, as a matter of social policy, deductions are intended either to make the distribution of tax payments among individuals fairer (equitable) or to encourage a socially desirable behavior. Moreover, it is designed to assure that living allowance and expenses incurred in generating income are taken into account.

It is partly for the above reasons that the following deductions are allowed under schedule B of the proclamation.

- a) Taxes that are paid with respect to the land and buildings leased are the first to be deducted from the gross income.

- b) 1/5 of the gross income received as rent for buildings, furniture and equipment as an allowance for repairs, maintenance and depreciation of such buildings, furniture and equipment. This deduction is applicable to taxpayers who which do not maintain books of accounts. Thus, if a tax payer who/does not maintain books of accounts gets 100,000.00 Birr per year by leasing his building, he is entitled to get a deduction of one-fifth (1/5) of the gross income i.e. $(100,000 \times 20/100) = 20,000.00$ Birr. This is in addition to what is provided in (a) above.
- c) For taxpayers maintaining books of account, the expenses incurred in earning, securing and maintaining rental income, to the extent that the expenses can be proved by the taxpayer are deductible. Such deductible expenses include but are not limited to:
- b. the cost of lease (rent) of land
 - c. amounts paid as interests on bank loans and insurance premiums
 - d. amounts paid to repair the building; and
 - e. depreciation of the building.

The amount of the depreciation is to be determined according to Art. 23(3) of Proclamation. According to this article, the acquisition or construction cost, and the cost of improvement or renewal of the building is depreciated on a straight line basis at five percent. Thus, the estimated total life of a building in Ethiopia is twenty years. The construction or acquisition cost of buildings, therefore, shall be depreciated over twenty years at a rate of five (5%) percent. For example, if a certain building is constructed with 1,000,000 Birr, yearly it depreciates by five percent, that is, $(1,000,000 \times 5/100 = 50,000.00)$ Birr).

Once the taxable income is determined by deducting those deductibles from the gross income, the tax rate to be applied as per schedule B is to be chosen. There are two types of tax rates to be applied on incomes from rental of a building. The first one is a flat rate and the other one is a combination of proportional rate and progressive rates. The flat rate of taxation is applicable to bodies while the blend of proportional and progressive rates is used for physical persons.

Assume that XZ is Share Company engaged in banking business. However, XZ Share Company rented its extra building to another share company called Limat Ethiopia. In the contract, it was agreed that the lessee would pay 1,200,000.00 Birr annually. Hence, the tax obligation of XZ

Company is obtained by multiplying the taxable income of the lesser by the applicable rate i.e. 30%. Assuming that the taxable income is 900,000.00 Birr, then the tax obligation will be $900,000 \times 30/100 = 270,000.00$ Birr.

In order to assess the tax obligation of physical persons we use the schedule. Look carefully at the following table which shows how income tax from rental or buildings on physical persons is calculated.

Taxable Income (In Birr Per Year)		Income Tax Payable (In Percent)
Over Birr	To Birr	Tax Rate (In Percent)
0	1800	Exempt threshold
1,801	7,800	10%
7,801	16,800	15%
16,801	28,200	20%
28,201	42,600	25%
42,601	60,000	30%
Over 60,000		35%

When you studied schedule A of the income tax proclamation, you noticed that there are certain exemptions provided in the proclamation and the regulations. How about under this schedule/ Under this schedule (B), bodies are not entitled to any exemptions while physical persons are entitled to the threshold exemption, i.e. the first 1800 annual income is free from tax obligation.

Activity 2

1. Do you think that members of the House of Peoples' Representatives are required to pay income tax under schedule A?
2. Why are bodies not entitled to tax exemption under schedule B?
3. Do you see any similarity between schedule A and B?

1.4.3. Schedule C (Income from Business)

Schedule 'C' is the third important schedule which is applicable to income derived from business activities. The scope of application of this schedule is determined by Art. 17 of the proclamation which provides that a person who derives (realizes) an income from entrepreneurial activities is required to pay a business tax as per the schedule. Therefore, the scope of application of this schedule extends to all incomes of persons (physical as well as legal) arising from business activities. The word "business" or "trade" activity is defined under Art. 2 (6) of the Proclamation under consideration. As per this article a "business" or "trade" is any industrial, commercial or vocational activity or any other activity recognized as trade by the Commercial code of Ethiopia and carried on by any person for profit. Please have a look at Art. 5 of the 1960 Commercial Code of Ethiopia). As can be understood from this definition, a transaction is judged as business or non-business activity by applying both the Commercial Code and Income Tax Proclamation. Activities that are considered as business (trade) by the two legal documents are tax bases according to our tax law.

Once the scope of application of the schedule is determined, the next thing that you have to grasp is regarding the determination of the taxable income. Like schedule B, taxable business income is to be determined, levied and collected annually. Like other schedules, in schedule C, taxes are levied and collected on the taxable income of the taxpayers. As you know from the previous discussions taxable incomes are those incomes that are subject to tax after the deduction of all expenses and other deductible items from gross income are made. To arrive at the gross business income of a taxpayer we have to resort to the profit and loss account or income statement of the taxpayer, which shall be drawn in compliance with the generally accepted accounting principles. Thus, based on these generally accepted accounting principles, the gross income of the taxpayer is fixed.

From the gross business income prepared in accordance with the generally accepted accounting principles there are some major expenses that must be deducted by virtue of Articles 20, 23, 25-28 of the Income Tax proclamation and Articles 8 and 10-14 of the Income Tax Regulation No. 78/2002, in order arrive at the taxable business income of the taxpayer. Pursuant to Art. 20 of the proclamation, expenses incurred for the purpose of earning, securing, and maintaining that

business income to the extent that the taxpayer can prove the expenses and subject to the limitations of the law are deductible. Dear students, what expenses should be deductible?

Generally, deductions are allowed when four critical requirements are met:

- a) The expense must be related to the earning, securing or maintaining of the business or the trade income.
- b) The expense must be ordinary and necessary.
- c) The expense must be reasonable and it shall not exceed the limit set by the law.
- d) The expense must be made or incurred during the taxable year. Let us discuss the above elements one by one as follows:

a) Expenses related to the carrying on the business

Whether an expense is deductible or not depends on the type of activity in which the expense was incurred. A deduction is allowed if it is incurred in an activity, which constitutes a trade or business. Similarly, a deduction is permitted if the amount is paid or incurred in an activity for the production or collection of income; and also for the running (maintaining) of the business. The purpose of this requirement is to deny deduction for expenses incurred in an activity, which is primarily personal in nature, such as the costs of pursuing a hobby. The activity must be done for profit so that it constitutes a trade or business. Profit-motivated activity is the cardinal yardstick necessary to establish existence of an income producing activity. Thus, if a taxpayer spends a huge amount of money on invitation of his customers at a seven star hotel with a view to promoting his business, the amount he spends must not be deducted for such expense is not related to the carrying out of the business in the normal course of circumstances.

However, there may be circumstances whereby a deduction is allowed for expenses that are related to the production or collection of income though that might not be paid to conduct a business or trade or an income producing activity. This expansion of deduction concept to include the so-called non-business or investment related expenses eliminates the need for an activity to constitute a business before a deduction is allowed. Before an expense is deducted, it must be established that it has a certain relationship to the trade or business or income producing activity. Similarly, production of income expenses must bear a reasonable and proximate relationship to the income producing activity. Whether expenditure is directly related to the

taxpayer's trade (business) or income producing activity usually depends on the facts. For example, the required relationship for business expenses normally exists where the expense is primarily motivated by business concerns or arises as a result of business rather than personal needs. This can be exemplified by the following hypothetical case:

Ato Belachew, an active businessman, knocked down a pedestrian while he was driving from his home to this place of business. Because of this, he was condemned to pay compensation to the victim by a court of law. In such a situation, the compensation he paid to the victim is not deductible because the expense is not a business related expense.

b) Ordinary and necessary expenses proved by the taxpayer

The second test for deductibility is whether the expense is ordinary and necessary and whether its payment is proved or not. An expense is ordinary if it is normally incurred in the type of business in which the taxpayer is involved. This is not to say that the expense must be habitual or recurring. In fact, the expense may be incurred only once in the taxpayer's life time and be considered ordinary. The test is whether other taxpayers in similar business or income producing activities would customarily incur the same expense.

A deductible expense not only must be ordinary but also necessary. An expense is necessary if it is appropriate, helpful, or capable of making contribution to the taxpayer's profit seeking activities. But you have to bear in mind that not all necessary expenses are ordinary expenses. Some expenses may be appropriate and helpful to the taxpayer's business but may not be normally incurred in that particular business. In such a case, no deduction is allowed. In order to better understand this explanation, let us see the following example. "Hippocrates" Medical College is established in accordance with the relevant laws of Ethiopia. The college usually arranges "get together" in order to motivate the working spirit of the staff. It is also aimed at attracting other students to the college. In doing so, the college incurs considerable amount of money for the get. However, deduction cannot be allowed here because although the expenses incurred for the above purposes are necessary, they are not ordinary expenses.

The other requirement in connection with these two things is that the taxpayer must prove the fact that amounts (expenses) are paid. To prove payment, the taxpayer may be required to adduce receipts, cash invoices etc by the tax collecting authority. Mere allegation of the taxpayer shall not be taken for granted. The taxpayer has to prove the amount paid as an expense for the purpose of the business.

c) Reasonable Expense

The other most important requirement for deduction is that the expense must be a reasonable expense. The reasonable standard is often raised in situation involving payments like salary, transportation allowance and position allowance to owners of the business who at the same time are employees of the business. In these situations, if the salary paid exceeds that ordinarily paid salary for similar services, the excessive payment may represent a non-deductible payment.

Usually in determining whether a certain expense is reasonable, we may take into consideration the provisions of the law. For instance, Art. 21 (1(c) of the Proclamation provides that voluntary pension or provident fund contribution over and above 15% of the monthly salary of the employee is not a deductible expense. This limit can be taken as a standard for the measurement of the reasonableness of the expenses. But in situations where there is no limit set by the law, the following parameters may be of help to judge whether the expenses are reasonable or not:

- i. the duties
- ii. volume and complexity of business handled
- iii. individual's ability and expertise (i.e. a professional and a laborer may not be paid the same)
- iv. number of available persons capable of performing the duties of the position.
- v. the taxpayer's payment policies and history.

d) Expenses paid or incurred during the taxable year

An expense is allowed to be deducted only if it is paid or incurred during the taxable year.

When we come to the Income Tax proclamation, it provides some lists of expenses that must be deducted from gross income in calculating taxable income. Accordingly, the following are deductible expenses.

A) Interest paid

Interests paid by the taxpayer can be deducted provided that the rate of the interest does not exceed by more than two percent from that set by the national Bank of Ethiopia and the Commercial Banks and if it is paid to lending institutions recognized by the National Bank of Ethiopia or to foreign banks permitted to lend to enterprises in Ethiopia. In this regard, look at the following hypothetical example. ABC is a private limited company established in accordance with the 1960 Commercial Code of Ethiopia and other pertinent laws. It is engaged in importing spare parts. In order to strengthen its financial position, it borrowed 1 million Birr from the Commercial Bank of Ethiopia in 2001 E.C fiscal year. The company is expected to repay the loan at the end of the above cited fiscal year. The payment includes the principal debt and interest at the rate of 10 percent. Hence, the interest to be paid by the company is $(1,000,000 \times 1 \text{ year} \times 10/100)$ 100,000.00 Birr. Therefore, the 100,000.00 Birr is deductible from the gross income of the company. This means that assuming that the company's income is 10,000,000.00 after all other deductions having been made, then the taxable income of the company will be $(10,000,000.00 - 100,000)$ 9,900,000.00 Birr.

B) Gifts and Donations

As a matter of rule, gifts and donations are not deductible expenses as provided in Art. 21(1(n) of the Proclamation. However, Art. 21(2) provides that gifts or donations may be deductible expenses where they are allowed by regulations issued by Council of Ministers. It is by virtue of this provision that Council of Ministers has allowed the deduction of certain gifts or donations when the requirements stipulated in Art. 11 of the regulation are satisfied. Accordingly, gifts and donations made by the taxpayer can be deducted from gross income if the recipient of the donation is registered as a welfare organization and where it is certified by the registering authority and that the organization has record of outstanding achievement and its utilization of resources and accounting system operates with transparency and accountability or if the contribution is made in response to emergency call issued by the government to defend the sovereignty and integrity of the country, to prevent man made or natural catastrophe, epidemic or for any other similar cause or if the donation is made to non-commercial education or health facilities. In spite of this, however, the grant and donation made for purposes listed above may only be allowed as deduction where the amount of donation or grant does not exceed ten percent (10%) of the taxable income of the taxpayer.

C) Loss Carry forward

Sometimes, if not always, businessmen or legal persons which carry out business activities may incur loss instead of profit under a particular tax year. In that tax year, such taxpayers are not expected to pay tax because no income is earned. A taxpayer who/which incurred loss in a certain tax year may make considerable amount of profit in the next tax year. In this situation, the loss incurred in the previous tax year should be carried forward and be taken as a deductible expense in accordance with the provisions of the proclamation and the regulation.

D) Depreciation Allowance as a Deductible Expense

The other amount allowed to be deducted from gross income in calculating taxable income is depreciation allowance as provided under Art. 23 of the Income Tax Proclamation. This article provides the rate of depreciation for the different kinds of goods. Depreciation is a decline in an asset's value because of use, wear and tear. The depreciation may be classified as accumulated depreciation (the total depreciation currently recorded on an asset), annual depreciation (the annual loss to property due to regular wear and tear) and functional depreciation (depreciation that results from the replacement of equipment) that is not yet worn out, but that is obsolete in light of a new invention or improved machinery allowing more efficient and satisfactory production. As per Art 23(1) of Proclamation No. 286/2002, the owner of the business assets is allowed to deduct depreciation for business assets in determining the taxable business income. However, sub-article 2 of the same article tells us that not all business assets are to be depreciated. For instance, fine arts, antiques, jewelry, trading stock and other business assets not subject to wear and tear shall not be depreciated.

According to Art. 23(3) of the proclamation, the acquisition or construction cost and the cost of improvement, renewal and reconstruction of buildings and constructions shall be depreciated individually on a straight-line basis at five percent (5%). This means the depreciation method employed here is the straight-line depreciation method, a depreciation method that writes-off the cost or other basis of the asset by deducting the expected salvage value from the initial cost of the capital asset, and dividing the difference by the assets estimated useful life.

Art. 23(4) of the Proclamation provides that the acquisition or construction cost and the cost of improvement, renewal and reconstruction of intangible assets shall be depreciated individually in a straight-line basis at the rate of ten percent (10%). Furthermore, sub-article 5 of the same article states that business assets such as computers, information systems, software products and data storage equipment shall be depreciated according to the pooling system, at twenty –five percent (25%) and all other business assets at twenty percent (20%). (Read sub-articles 6-10 of the proclamation along with Art. 13 of the Regulations).

E) Capital participation

Capital participation (reinvestment) made by taxpayers in other business can be deducted. If a resident company or partnership reinvests the profit it earned to raise the capital of another company or partnership, such amounts shall be deductible from its taxable income provided that the shares of the resident company are subject to taxation under schedule C and the investing body has a share holding of at least 25% by value or by number in the share capital or the voting rights. However, the amount to be deducted through this capital participation cannot exceed five percent of the taxable income of the resident company or registered partnership in each accounting year. To sum up, participation deduction is allowed only to legal persons provided that they reinvest their money to raise the capital of another legal person within the limits provided by law.

F) Cost of Trading Stock

As clearly provided under Art. 22 of the Proclamation, the cost of trading stock of the business is deductible. This is aimed at ascertaining the income of the person for a tax period from a business. This cost is determined on the basis of the average cost method i.e. the generally accepted accounting principle under which trading stock valuation is based on the average costs of units on hand. The term trading stock means, as defined by sub-3 of this article, any business asset that is either used in the production process and becomes part of the product, or that is held for sale. Assume that Ato Anberbir has opened a pastry at the beginning of Meskerem 2002 E.C. In this tax year, he bought honey, butter, sugar, cream, salt, flour, oil, coffee, milk and the like. These are trading stocks and the cost incurred by Ato Anberbir to buy all these items is a deductible expense.

G) Bad Debts

Usually, taxpayers grant credit to their customers to increase sales or profits. They are willing to take reasonable loss from bad debts to increase their profits. Generally, deduction is allowed for a debt that becomes worthless within the taxable year. A partially worthless debt must be charged off to the extent of its worthlessness and to that extent deducted for the year. In Ethiopia today, bad debts are deducted by virtue of Art. 25 of the proclamation where an amount corresponding to this debt was previously included in the income, the debt is written-off in the books of the tax payer and any legal action to collect the debt has been taken but the debt is not recoverable.

H) Special Reserves for Finance Institutions

In the determination of taxable business income of finance institutions, a deduction is allowed for special (technical) reserves. The deduction is allowed on the basis of the directives issued by the National Bank of Ethiopia.

In addition to the deductions provided in the proclamation, the regulation also provides that the following are deductible expenses:

- expenses paid or incurred as a direct cost of producing the income such as the direct cost of manufacturing, purchasing, importation, selling and such other similar costs;
- general and administrative expenses connected with the business activity, such as expenses paid for office supplies like paper, pens, inks, salaries to workers etc that are related to the business are deductible;
- premiums payable on insurance directly connected with the business activity. Thus if a certain importer gets imported business commodities insured, and as a result pays a certain amount of premium, the amount is deductible;
- expenses incurred in connection with the promotion of the business, inside and the outside the country, subject to limitation set by the law.
- commissions paid for services rendered to the business provided that the said services were in fact rendered and the amount paid as commission for said services corresponds to the normal rates and paid by other business or persons or bodies similarly situated for similar circumstances;

- in the case of a business located and operating in Ethiopia as a branch, subsidiary or associated company of a business located and operating abroad, a payment of any kind made to the holding or associated company of the business abroad can be deducted from the gross income in calculating the taxable income where the payment in question was made for services actually rendered and where the said service was necessary for the business and could not be performed by other persons or bodies or by the business itself at a lower cost.

Once the taxable income is determined, the tax rate to be applied as per schedule C is determined. The rate applicable for this schedule is to be found under Art. 19 of the Proclamation. As per this article, there are two types of tax rates to be applied on taxable business income. The first one is flat and the other one is the combination of progressive rate and a flat rate (proportional rate). The former (30%) is to be applied where the taxpayer that derives business income is a legal or artificial person like share companies, private limited companies, partnerships and the like. For example, if Blue Nile International Bank gets a taxable business income of 20 million Birr, the tax to be paid by this company is $(20,000,000.00 \times 30/100)$ 6 million Birr. On the other hand, the combination of progressive rate and proportional rate is applied where the taxpayer that derives the taxable business income is an individual or physical person. Therefore, if Ato Negardras gets a taxable business income, the tax that he has to pay is to be calculated by using the following rates of schedule C.

Taxable Business Income (Per Year		Income Tax Payable
Over Birr	To birr	(In percent)
0	1800	Exempt threshold
1,801	7,800	10
7,801	16,800	15
16,801	28,200	20
28,201	42,600	25
42,601	60,000	30
Over 60,000		35

Let us take the following example in order to understand how income tax under the above schedule is calculated. Assume that Ato Negadras gets 100, 000.00 Birr of a taxable business income. Then the income tax to be paid by him is calculated as follows: The first 1800.00 Birr is exempted. Then the next 6000.00 Birr is taxed at 10 percent ($6000 \times 10/100$) which gives 600.00 Birr. The next 9000.00 Birr (16,800-7800) is to be taxed at 15% ($9000 \times 15/100$) which gives 1350.00 Birr. Again the next 11,400.00 Birr (28,200-16,800) is taxed at 20% which gives ($11,400 \times 20/100$) 2280.00 Birr. Then the next 14,400 Birr (42,600-28,200) is taxed at 25% and gives ($14,400 \times 25/100$) 3600.00 Birr. Then the next 17,400.00 Birr (60,000-42,600.00) will be taxed at 30% which gives ($17,400 \times 30/100$) 5,220 Birr. The remaining 40,000.00 Birr is to be taxed at 35% and the result will be ($40,000 \times 35/100$) 14,000.00 Birr. Therefore, the total tax liability of Ato Negadras is obtained by adding the above sums.

The other important feature of schedule C is tax exemption. In our previous discussions, we said that some incomes are exempted from tax obligation, among other things, for economic, social, political and administrative reasons. Incomes exempted from tax obligations under this schedule are also justified, in one way or another, by the above reasons. Under Schedule C, we can notice two types of exemptions. The first one is threshold exemption that is applicable only to physical persons while the second one is general exemption which is applicable to all taxpayers under this schedule provided that the criteria set forth in the law are satisfied. The first one is noticeable from the schedule while the second one is dealt with by Art. 30 of the Proclamation.

According to Art. 30, the first income that is exempted from tax obligation is an income generated by awards for adopted or suggested innovations and cost saving measures. The other is income generated from public awards for outstanding performance in any field. These are exemptions specifically provided for by this proclamation. The article under consideration also envisages the possibility of exemptions when such is provided under any domestic law in force and any international treaty ratified by Ethiopia or an international agreement made or approved by the Minister of the Ministry of Finance and Economic Development. For instance, the Ethiopia investment law provides tax holidays for investors which is intended to attract and motivate investment (see the relevant provisions of Ethiopian Investment Laws).

The other important exemptions given under this article pertain to the revenues generated by the Federal Government, Regional Governments and the National Bank of Ethiopia. The rationale behind this latter exemption is quite understandable. Schedule C is applied to collect income taxes from business activities. Obviously, the Federal Government as well as Regional Governments, except public enterprises, do not engage in profit making activities. As such, the revenue they generate in different mechanisms is not subject to income tax. In addition, if the government collects tax on its revenues that would be meaningless for the tax collected would ultimately go to the same pocket. Therefore, the exemption is aimed at avoiding taxing money from one pocket by one hand and deposits such money in the same pocket by another hand. The justification for the exemption of the national Bank of Ethiopia is the same.

1.4.4. Schedule D (Miscellaneous/other Incomes)

The fourth income tax schedule included in the 2002 Income Tax Proclamation is schedule D. This schedule covers income tax from other sources that are not covered by schedules A, B and C. This schedule contains articles dealing with different tax sources. These tax sources include income from royalties, incomes paid for services rendered outside Ethiopia, incomes from games of chance, income from dividends, income from casual rental of property, interest income and incomes from specified non-business capital gains. Unlike the first three schedules, under schedule D, the tax rates provided are not uniform. There are distinct flat rates applicable to each tax base under this schedule. Let us discuss the tax bases covered under schedule D and the corresponding tax rates as follows.

A) Income Tax from Royalties

This tax base is intertwined with intellectual property. This tax is imposed on the recipient of a consideration (payment) for the use or the right to use the product of the intellect which may be an invention, a copyrightable work, a trade make or a trade secret or any other product of the mind. According to Art. 31 of the Proclamation, the term royalty means a payment of any kind received as a consideration for use of or the right to use, any copyright or literary, artistic or scientific work including cinematography films and films or tapes for radio or television broadcasting, any patent, trade mark, design or model, plan, secret, formula or process, or for the use or for the right to use of any industrial, commercial scientific equipment, or for information concerning industrial commercial or scientific experience.

As to the tax rate applicable to royalties, art. 31 (1) provides that royalties are liable to tax at a flat rate of five percent (5%). Look at the following example. Ato X, a well-known legal scholar, wrote a book entitled “The Basic Principles of Ethiopian Tax Laws” and leased his entitlement of copyright to the Faculty of Law, Addis Ababa University for a consideration of 200,000.00 Birr. Then the income obtained by Ato X is taxed at 5% and becomes $(200,000 \times 5/100)$ 10,000.00 Birr.

Why do you think is the rate applicable to royalties is so small as compared to rate used in schedules A, B and C? Why are no deductions and exemptions?

The Ethiopian Income Tax Proclamation made the rates, in most cases, lower in schedule D with a view to addressing various economic, social and political considerations. As the rates are lower, it is not appropriate to apply exemptions and deductions as doing so will be detrimental to the income of the government.

One important point worth noting in relation to Art. 31 of the Proclamation is that whether this article is used to collect income tax on incomes derived by selling intellectual properties such as patents, trademarks, copyright, industrial design and the like. This article does not seem to deal with this issue as we can understand this particularly by reading the Amharic Version of the article. This is because the caption of Art. 31 says “የፈጠራ መብትን በማክራየት የሚገኝ ገቢ” which means income obtained by leasing intellectual property right. Does this mean that those who/which sell their intellectual properties and gain income are exempted from payment of income tax? Assume that Ato Tibebu, an accomplished poet in Ethiopia, wrote a poem and sold the copyright to Shebelle publishing House S.C. In return to the copyright Ato Tibebu got 2000,000.00 Birr from the S.C. Would it be lawful if the tax authority collects 5% tax from Ato Tibebu?

B) Income from Rendering of Technical Service

This is governed under Art. 32 of the proclamation. As per this article, the term technical service means any kind of expert advice or technological service rendered. In this case, all payments made in consideration of any kind of technical services rendered outside Ethiopia to resident persons in any form shall be liable to tax at flat rate of ten percent (10%). Such income tax must

be withheld and paid to the Tax Authority by the payer. From this explanation, it must be clear that the person who/which rendered the service may be an Ethiopian resident or not. What matters is the fact that the service is rendered outside Ethiopia to an Ethiopian resident. In this case, the taxpayer may be an Ethiopian resident or non-resident since the taxpayer is the person who rendered any kind of technical service outside of Ethiopia to an Ethiopian resident. In order to understand this explanation, let us see the following hypothetical case.

The Ethiopian Shipping lines (ESL) received a technical service in Bombay by an Indian Engineering Company and the ESL paid 2,000,000.00 Birr to the said company in return for the technical service it received from the company. In this case, the income received by the Indian Company is subject to income tax obligation at ten percent (10%) i.e. $2,000,000 \times 10/100 = 200,000.00$ Birr. In this hypothetical case, the Ethiopian shipping Lines is duty-bound to withhold and pay the 20,000.00 Birr to the Tax Authority. Dear Student, is it possible to conclude that Art. 32 of the Income Tax Proclamation is compatible to Art. 3(2) of the same Proclamation? It is hardly possible to conclude that Art. 32 compatible to Art. 3(2) of the same Proclamation.

C) Income Arising from Chance Winning (Games of Chance)

Every person deriving income from winning at games of chance (for example, lotteries, *tombolas* and other similar activities) is subject to tax at the rate of 15% as per Art. 33 of the Proclamation. In this case, the payer is duty-bound to withhold and pay the money due to the Tax Authority as provided under Art. 67 of the same Proclamation. Take a look at the following example. Ato A won a lottery worth 200,000.00. He shall be charged at the rate of 15%. The first 100.00 Birr is exempted from tax. Hence, the taxable income of Ato A is $(200,000 - 100) = 199,900.00$ Birr.

D) Dividends

These incomes pertain to business organizations which are recognized by the 1960 Commercial code of Ethiopia and foreign laws. Therefore, under this heading the taxpayers are shareholders who are entitled to dividends from the profit of the business organization declared in accordance with the provisions of the law, the memorandum of association, the articles of association and the meeting of shareholders as the case may be. In this case, every person deriving income from dividends shall be subject to tax at the rate of ten percent (10%).

Assume that Ato A is a shareholder of Blue Nile International Bank. He received 10,000.00 Birr from the bank as a dividend. Ten percent of this income is subject to tax obligation. Hence Ato A is required to pay $(10,000 \times 10/100)$ 1000.00 Birr as an income tax. In relation to taxes on dividends, it is worthwhile to ask whether this article is also applicable to income tax on dividends distributed by partnerships to partners. We are obliged to raise this issue because this article talks about dividends distributed by share companies and private limited companies. However, the fact that partners are duty-bound to pay income tax on their income distributed by the partnerships has been envisaged by Art. 6(i) of the Income Tax proclamation which talks about sources of income that can be subject to income tax. Despite this, since the appropriate rate is not provided in Art. 34 of the Proclamation. It is not lawful to collect income tax on dividends (profit shares) distributed by business organizations other than share companies and private limited companies

E) Income from Casual rental of property

The rental of property provided under this schedule is quite different from what is provided under schedule B of this proclamation. Under this schedule (D), the rental of property is casual including any land, building, or movable asset while the property to be rented under schedule B is only building. As per the fourth schedule (D), the duration of the rent is not relatively permanent. Assume that Aleph Business College wants to rent the Hall of Freedom University, a privately owned university. In return to the hall, Aleph Business College paid 50,000.00 Birr. In this case, Freedom University is required to pay income tax at the rate of 15%.

F) Interest Income on Deposits

When you deposit your money in banks, usually in saving account, your money bears interest at the rate determined by the National Bank of Ethiopia. Then, you are required to pay tax out of the income that you get in the form of interest at a flat rate of five percent. Assume for example, you deposited 1000,000 Birr at interest rate of 3% per annum. The money was deposited for two years. The money that would accrue to you in the form of interest is calculated as follows: $1000,000.00 \times 3/100 \times 2 = 60,000.00$. This means that the 1000,000.00 Birr has borne 60,000.00 Birr in two years. Hence the income tax that you are required to pay is calculated at 5%. Then $60,000 \times 5/100 = 3000.00$ Birr. Three thousand Birr is the income tax that must be paid to the

government. Finally, it is good to note that the taxpayer is not entitled to any kind of deduction or exemption.

G) Gains on Transfer of Certain Investment Property

This is the last type of income under schedule D of the Income Tax Proclamation. It is an income, which a person gets by transferring his investment properties such as buildings that are held for business and shares. As per Art. 37 of the same proclamation, a person is required to pay a tax on gains obtained from transfer (sale or gift) of the following types of properties under schedule D.

- i. if buildings held for business, factory or office in municipal areas are transferred and as the result of this transfer gains are obtained, the seller will be taxed at 15%.
- ii. If shares of companies owned by a person are transferred and as the result of this transfer gains are obtained, the person shall pay thirty percent (30%).

For these purposes, gains are determined by deducting the historical cost of the building or the par value of the share from the sales price. When calculating the capital gain through this method, inflation adjustments are to be determined by the appropriate authority, in respect of buildings, taxes paid for the land and the building will be deducted.

Thus, if Ato A sells his building that was destined for office purposes for 150,000 Birr and if the construction cost of the building was 90,000.00 Birr, subject to those inflation and tax deductions, he will pay a capital gains tax for 60,000.00 Birr ($60,00.00 \times 15/100$). Gains obtained from the transfer of buildings held for residence are exempted from this tax provided that such buildings were fully used for dwelling for two years prior to the date of transfer.

Chapter Summary

Historically, income tax generally dates back to the history of government. In Ethiopia, too, different segments of the society were subject to the payment of income tax. Modern income tax laws were adopted in Ethiopia after the liberation from Italian invasion. Some laws dealing with income tax were promulgated between 1942 and 1960. However, these laws were short-lived. The most comprehensive income tax law was adopted in 1961 which served the country for more

than four decades. But this law underwent a number of amendments. Finally, this law was totally repealed and replaced by the current proclamation adopted in 2002 (Proclamation No 286/2002).

When we come to the meaning of income, the word has never been accorded a single universally accepted definition. Various professionals define the term from their own perspective. In other words, professionals such as accountants, economists and lawyers define the term from the vantage point of their specialization. In spite of the definitional problems encountered, the word income can be understood from statutory legal/ definition and such definition is applied for the purpose of collecting tax. For instance, Art. 2(10) of the current Income Tax Proclamation has defined income as every sort of economic benefit including non-recurring gains in cash or in kind from whatever source derived and in which manner paid, credited or received. From this definition, it is possible to understand that income may be obtained in cash or in kind so long as it involves economic benefit. The source of income may also be whatever source.

In addition to understanding the meaning of income it is good to have a fair understanding of the scope of application of the income tax law. Unless we have a clear picture of the scope of the law, it is difficult to bring those persons, who are obliged to pay income tax, under the ambit of the Ethiopian Income Tax Law. To this end Art 3 and Art. 5 of the same proclamation are relevant as they show us the persons who are subject to the payment of income tax to the Ethiopian Government. Once we have understood the meaning of income and the scope of application of the prevailing Income Tax Law, we have to identify the gross income and the taxable income of the taxpayer. Gross income is the total income or the aggregate receipts obtained by the taxpayer while taxable income is the amount of income of which actual tax is levied and collected after the necessary deductions having been made. Even after the taxable income is known, we have to apply the correct system of income taxation. In the world today, there are two systems of income taxation. These are the global system and the schedular system. In the global tax system, income tax is imposed on the total taxable income of the individual whatever the source of the income might be in the case of the schedular system, different source are taken into consideration and the tax is to be imposed on the different sources. The Ethiopian Income Tax Law has adopted the schedular system of taxation. Therefore, the Ethiopian income tax proclamation has provided four relevant schedules depending on the sources of income to be

taxed. These schedules of income are identified by the English alphabets A, B, C and D. Their Amharic equivalents have also been given in the proclamation. Each schedule addresses different sources of income.

To begin with, schedule A of the Income Tax Law regulates income taxes imposed on employment. This schedule provides the exempt threshold of income and the rates applicable to each levels of taxable income. In other words, the schedule has provided a combination of proportional and a progressive tax rate for the taxable income of an employee. The schedule is applicable to government employees and private organizations and non governmental organizations alike. Schedule B of the Income Tax Proclamation is applicable to incomes generated from rental of buildings. This schedule provides the rates, the exemption and deductions. While income taxes under schedule A are to be collected monthly, income taxes under schedule B are to be levied and collected annually.

The third important income tax schedule is schedule C. The schedule is applied when we assess income taxes derived from business activities. Hence, the application of this schedule is brought to the fore, when we want to collect income tax from physical persons as well as legal persons who/which are engaged in business activities. This means that in order to apply this schedule, we have to be sure that the taxpayer has engaged in business as defined under the proclamation and the relevant provisions of the Commercial Code of Ethiopia. This schedule provides the rate, deductions and exemptions. Like schedule B, business income tax under this schedule is assessed and collected annually.

The fourth schedule of income tax is schedule D. Unlike the previous schedules, this schedule covers different income taxes derived from different sources of income. Because of this, this schedule has provided different tax rates which suit the different sources of income. Tax bases governed under this schedule are:

- income tax from royalties
- income tax from rendering of technical service
- income tax from dividends
- income tax on interests

- income tax from gains on transfer of certain investment property
- Income from rental of property.

CHAPTER THREE

INCOME TAX IN ETHIOPIA: THE PROCEDURAL PART OF PROCLAMATION NO 286/2002 (AS AMENDED)

Introduction

The current Income Tax Proclamation has contained two relevant parts. These are the substantive part (in which you studied, meaning of income, scope of application of the law, the tax sources covered by schedules, the applicable rates, deductions and exemptions), and the procedural part. As you may understand, the substantive part is the cornerstone for the Income Tax Proclamation. However, without the procedural part the substantive part becomes meaningless as any substantive law does not achieve the purpose which it is meant to achieve unless accompanied by procedural law. That is why this chapter, as a direct continuation of chapter two, is devoted to the analysis of the salient elements of the procedural part of the Proclamation. To this end, the provisions of the Proclamation dealing with withholding schemes, tax accounting principles, declaration of tax, assessment of tax, payment of tax, enforcement mechanisms, administrative penalties, tax offences and appeal procedures will be analyzed.

Objectives

Having completed this chapter, students should be able to:

- analyze the withholding procedures;
- identify withholding agents;
- analyze tax accounting principles
- discuss the procedures used for declaration and assessment of income tax under each schedule;
- analyze provisions dealing with payment of tax and enforcement mechanisms;
- discern the consequences of failure to comply with the income tax obligations;
- discuss provisions dealing with administrative penalties and tax offences;
- identify appeal procedures that can be availed by aggrieved taxpayers.

1.1. Withholding Procedures /Schemes/

When we examine closely Arts. 51-57 of the Income Tax Proclamation, we can realize how withholding procedures are relevant for proper administration of the Income Tax Proclamation. A close scrutiny of these articles reveals that the withholding procedures are applicable to all schedules of the proclamation except schedule B. Why isn't schedule B dealt with by these articles?

1.1.1. Withholding of Income Tax on Employment Income

As far as the withholding of tax on employment (schedule A) is concerned, the matter is regulated by Art. 51 of the Proclamation (proc. No 286/2002), Art. 2(4) of Proc. No 608/2008 (Income Tax Amending Proclamation) and Art. 25 of the Income Tax Regulation. According to Art. 51(1) of the Proclamation, an employer is required to withhold tax from every payment to an employee unless the income is expressly made tax exempt by the Proclamation and the Regulation. The Obligation of the employer to withhold such tax has priority over all other obligations to withhold any other amount from payments to an employee. Assume that ABC Share Company is an employer of Ato Ujulu by paying a monthly salary of 6000.00 Birr. Ujulu was sued by Ato Otaro since the former failed to pay the price of goods which he (Ujulu) took on credit from Ato Otaro. The court found in favor of Otaro and Ato Ujulu became a judgment debtor. The court to which execution file was made ordered the employer of Ato Ujulu to withhold the salary of Ato Ujulu and pay the withheld amount to the decree holder to the extent permitted by Ethiopian law. In this situation, if a clash of interest occurs between the Tax authority and the decree-holder, then priority should be given to the Tax Authority by virtue of Art. 51(2) of the Proclamation.

An employer shall pay the withheld tax to the Tax Authority within thirty (30) days of the end of each calendar month and each payment need to be accompanied by a statement with respect to each employee who derives taxable income for the month. Such statement must be prepared in the form and furnished in the manner prescribed by the Tax Authority. In addition, such statement is required to contain the name, address, TIN of each employee, the amount of taxable income derived by each employee from employment, the amount of tax withheld and the amount of any tax-exempt derived by the employee.

1.1.2. Withholding of Income Tax on Import of Goods

To which of the Income Tax schedules does this scheme of withholding apply? Why does the tax Authority resort to withholding when goods are imported? As you may understand, businessmen or business entities who/which are required to pay their business income tax under schedule C pay their income tax annually. However, when such taxpayers import goods for commercial use, a current payment of income tax is collected at the time of import of goods. In this situation, the collected amount is treated as tax withheld that is creditable against the taxpayer's income tax liability for the year. The amount collected in imports of goods shall be three percent (3%) of the sum of cost, insurance and freight ("CIF value"). Ultimately, when taxpayers declare his/her/ its tax obligation, if the amount of income tax collected on the import of goods results in underpayment of business income tax due for the year, the taxpayer is required to pay the difference with the declaration. If, on the other hand, the amount represents,, an overpayment of income tax, the Tax Authority shall refund the taxpayer the amount overpaid within three months period. The Tax Authority can do this after ensuring the accuracy of the books and records of the taxpayer.

In order to better understand the above explanations with respect to withholding of income tax on import of goods, look at the following illustrations:

Illustration 1

Ato Bogale Dessalegn has been licensed to import used vehicles. In the 2002 E.C tax year, he imported vehicles whose CIF value was 30,000,000.00 Birr. The tax withheld at the time of importation is obtained by multiplying 30,000,000.00 Birr by 3% which means $30,000,000.00 \times 3/100 = 300,000.00$ (Three hundred thousand Birr). This 300,000.00 Birr is part of the income tax obligation of Ato Bogal Dessalegn. However, Ato Bogale's total tax obligation, the allowed deductions and exemptions having been made, was 1.5 million Birr. In this case, Ato Bogale is required to declare only 1.2 million Birr because he paid 300,000.00 Birr at the time of importation which is creditable against the income tax liability of Ato Bogale for the tax year.

Illustration 2

Dear student, have a look once again at the above hypothetical case. Then, assume that the tax obligation of Ato Bogale was found to be 200,000.00 Birr, the allowed deductions and exemptions having been made. Hence, it is possible to realize that Ato Bogale overpaid money to the Tax Authority at the time of importation. In this situation, the Tax Authority is required by law to refund the money which is not due to the government. In this case, the Tax Authority should refund 100,000.00 Birr to Ato Bogale that was overpaid at the time of importation of the vehicles.

1.1.3. Withholding Income Tax on Payments

This is the third important withholding scheme provided under the Ethiopian Income Tax proclamation which has been dealt with under Art. 53 of the Proclamation, Arts, 24 and 25 of the Regulations. In addition, the Tax Authority is also empowered to issue directives that would help for the proper implementation of proclamation and the regulation. Before we go into the details of this scheme of withholding it is good to take note of the following issues. Who/which payers/ are required to withhold income tax? From whom? What is the difference between this withholding scheme and withholding schemes that have been discussed above? Why is such withholding scheme necessary? Has it been properly implemented in Ethiopia? These are the major questions that will be answered subsequently. According to Art 53(1) of the Proclamation, organizations having legal personality, government agencies, private non profit institutions, and non-governmental organizations are duty-bound to withhold income tax on payments which are subject to withholding tax by virtue of Art. 24 of the Regulations (Reg. No. 78/2002). From this sub-article of the Proclamation, the withholding agents are clearly and exhaustively provided. These are:

A) Organizations having legal personality:- what organizations do have legal personalities?

Organizations do have legal personality whenever they are registered and requirements stipulated by special law are satisfied. Hence, organizations which do not have legal personality do not have the power and the obligation to withhold income tax from payments.

Assume that Ato Assefa does have a business enterprise solely owned by him. Hence, Ato Assefa's enterprise is not required to withhold income tax from payments it makes to those persons who/which supply goods or services to the enterprise.

- B) Private non-profit institutions: what are such institutions? Can Idir and other civic associations be considered to be included in this category. The answer is in the positive.
- C) Non-Governmental organizations which are established in accordance with the relevant laws of Ethiopia are withholding agents.

The next issue that must be raised is: on what type of supplies (goods and services) are such withholding agents required to withhold income tax? The answer for this crucial question is obtained by having a look at Art. 24 of the Regulation. As per this article, the afore-mentioned withholding agents are duty-bound to withhold income tax of 2% from payments they make to taxpayers who/which provide the following goods and/or services:

- D) supply of goods involving more than 10,000.00 Birr in any one transaction or one supply contract.
- E) Rendering of the following services involving more than Birr 500.00 in one transaction or one service contract. These services are:
- consultancy service
 - designs, writing materials, lectures and dissemination of information;
 - lawyers, accountants, auditors and other services of similar nature.
 - sales persons, arts and sports professionals and brokers including insurance brokers and other commission agents.
 - advertisement and entertainment program for television and radio broadcasts;
 - construction services;
 - advertisement services;
 - patents for scientific and intellectual works;
 - rent for lease of machineries, building and other goods including computers;
 - Maintenance services;
 - Tailoring;
 - Printing;
 - Insurance.

To sum up, withholding of income tax is to be accomplished by those persons clearly identified by the Proclamation when they (the agents) make payments to those persons who/which supply goods or services or the combination of goods and services to the above named withholding

agents. This means that other persons which /who effect payments to any person who/ which supplies goods and services are not bound to withhold income tax using the 2% rate on the payments. To make the previous discussions more understandable, the following illustrations are helpful.

Illustration 1

Ato Gashahun is a well-known legal professional on Ethiopian Tax Laws. Because of this, the Ethiopian Justice and Legal System Research Institute approached him to write a course material on “Ethiopian Tax Laws.” Ato Gashahun accepted the offer happily and the contract of service was concluded in writing. In the contract, it was stipulated that the Institute would pay a total sum of 60,000.00 Birr to Ato Gashahun in return to the service he would render to the Institute. In this situation, the Institute is obliged to withhold 2% of the payment, i.e., $60,000.00 \times 2/100 = 1200.00$ Birr and transfer it to the Tax Authority within the time stipulated by the tax law. This is so because the Institute is a government agency and the service it obtained is a service what is enumerated under Art. 24 of the Regulation.

Illustration 2

ABC is a non-governmental organization established to assist HIV/AIDS victims in Ethiopia. In order to accomplish its blessed objectives, the organization usually receives consultancy services from various consultants on different fields. Recently, the organization got consultancy services from Cure Ethiopia Consultancy Group- a business organization established as per the Commercial Code of Ethiopia. In return to such service, the organization paid 200,000.00 Birr. In this situation, the organization is duty-bound to withhold a 2% income tax from such payment i.e., $200,000 \times 2/100 = 4000$ Birr and account to the Tax Authority within the time prescribed by the tax laws.

Illustration 3

The Ethiopian Teachers’ Association bought 100 computers by paying 5000.00 Birr for each computer. The purchase was made from Omega PLC which supplies various types of computers and computer accessories. This means that the total sum paid by the association is $100 \times 5000 =$

500,000.00 Birr. Hence, the tax to be withheld by the Association is $500,000 \times 2/100 = 10,000.00$ Birr.

1.1.4. Withholding of Schedule D Income on Payments

Dear Students, have a look once again at the provisions included in schedule D of the Income Tax Proclamation (Arts. 31-37). Which of these articles do contain withholding agents? The following discussions offer the answer to this question. Under schedule D of the Income Tax proclamation, the law has obliged the payers to be withholding agents in relation to payment of royalties (Art. 31), payment in return to technical service (Art. 32), payments in relation to games of chance (Art. 33) payment of dividends (Art. 34) and interest income on deposits (Art. 36). This means that withholding agents are not necessary in relation to income from casual rental of property and gain on transfer of certain investment properties (See Arts. 35 and 37 respectively) Therefore, when we talk about withholding of schedule D income tax on payments, payments made in accordance with Art. 35 and 37 of the proclamation are excluded.

As regards the other tax sources, tax sources other than Art. 35 and Art. 37, the payer of any payment subject to tax under schedule “D” is duty bound to withhold from the payment the amount of tax required. The obligation of the payer to withhold tax has priority over all other obligations to withhold amounts from payments to a payee (the taxpayer). The withholding agent (the payers must pay the withheld income tax to the Tax Authority within 15 days of the calendar month and each payment shall be accompanied by a statement with respect to each taxpayer who/which received payments during the month.

Assume that Tana International Bank distributed dividends to shareholders on the 16th of Nehassie 2002 E.C. The total amount of dividends distributed to shareholders was 60,000,000.00 Birr although the amount received by each shareholder was not the same. In any case, the amount of tax to be withheld by the Bank is $60,000,000 \times 10/100 = 6,000,000.00$ (Six Million Birr) and the Bank is required to pay the 6,000,000.00 Birr tax to the Tax Authority within 15 days reckoned from the 1st day of Pagume 2002. In other words, the Bank must pay such income tax up on to 10th of Meskerem 2003 E.C.

1.2. Tax Accounting Principles

Dear student, why is it necessary to deal with tax accounting principles? What are tax accounting principles? Are these tax accounting principles incorporated in Ethiopian Income Tax Law? These are some of the questions that we will address under this sub-section. Accounting principles are the conventions, rules and procedures that define approved accounting practices at a particular time. Therefore, tax accounting principles are resorted to when we determine the gross income, taxable income, deductions, exemptions time and manner of payment of income Tax. The question that might cross our mind at this juncture is whether or not all schedules of the Income Tax Proclamation are amenable to tax accounting principles.

The procedural part of the Income Tax Proclamation has, among other things, contained tax accounting principles. Art. 58(1) of the proclamation stipulates that for the purposes of ascertaining a person's income accruing or derived during a tax period, the timing inclusions and deductions are to be made according to generally accepted accounting principles. When we say "generally accepted", what is our reference? the whole world or Ethiopia? Under our Income Tax Proclamation, there are two methods of tax accounting. These are the cash-basis accounting method and the accrual basis of accounting. As it has been clearly provided in Art. 58(2) of the Proclamation, a taxpayer is at liberty to account on cash or accrual basis. However, a company shall account for tax purposes on a accrual basis. Why is it compulsory for a company, be it a share company or private limited company, to account for tax purpose on accrual basis?

According to Art. 58(4) of the Proclamation any person may apply in writing for change of method of accounting that means, to switch from cash method accounting to accrual method of accounting or from accrual basis to cash method accounting. The Tax Authority may allow such change where it is satisfied that the change is necessary to clearly reflect that person's income. Where the taxpayer's method of accounting is changed with the approval of the Tax Authority, adjustments to items of income, deductions or credit must be made in the tax period following the change. The adjustment is made with a view to avoiding the omission of an item. The adjustment is also necessary to avoid the taking of one item into account more than once.

A taxpayer who/which is accounting for tax purposes on cash basis is required to account for amounts to be included in calculating that person's income where they are received or made available to that person. By the same token, an expense is incurred where it is paid by the taxpayer. Accrual basis method of accounting is quite different from the cash-basis accounting because a person (taxpayer) who/which is accounting on accrual basis is required to account for the amounts to be included in ascertaining that person's income where they are receivable by that person. An expense is incurred by a person where it is payable by the person. Subject to the exceptions provided in the proclamation, an amount is receivable by a person when that person becomes entitled to receive it, even if the time of discharge of the entitlement is post-poned or the entitlement is payable by installments. In order to shed light on the above discussions, let us closely examine the following illustrative example:

Wisdom and Justice General Partnership has been established by four competent lawyers, called Bewuketu, Aemero, Beka and Semmu who are specialized in different aspects of domestic as well as international law. The general partnership's accounting method is on accrual basis. Because the general partnership is extremely famous, it concluded a contract with a relevant body of the Federal Government of Ethiopia to represent the Federal Government before an arbitral Tribunal which was established by the agreement entered between the Eritrean Government and the Ethiopian Government so that the Arbitral Tribunal would decide the compensation that might be due to each government. In the contract concluded between the Ethiopian Government and the General partnership, it was agreed that the government would pay a total sum of 50 million Birr that would be paid when the Arbitral Tribunal would finally dispose of the case. In this case, you can understand that 50 million Birr accrued to the general partnership although no cash was received by the general partnership until the dispute is decided. Hence, the general partnership is required to pay tax on the basis of the income that has accrued to it. The same is true with the expenses that might be incurred by the general partnership to consider them as deductible expenses.

In the case of person accounting for tax purposes on accrual basis, the timing of inclusions in the deductions from income relating to a long-term contract (a contract for manufacture, installation, or construction, or in relation to each, a performance or related services which is not to be

completed within a tax period) of a business of that person shall be accounted for on the basis of the percentage of the contract completed during any tax period. The percentage of completion is determined by comparing the total costs allotted to the contract and incurred before the end of the tax period with the estimated total costs including any variations or fluctuations.

1.3. Declaration and Assessment of Income Tax

What do you understand by declaration and assessment of income tax? What is the difference between these two concepts? What taxpayers are required to declare their income? Whose business is assessment of tax? These are the conspicuous points that are going to be presented to you under this section. It is worthy to notice that declaration and assessment of tax are two crucial procedures that are instrumental for the proper implementation of the Income Tax Proclamation. To this end, the Proclamation has devoted several provisions dealing with declaration and assessment.

1.3.1. Declaration of Income

For the proper implementation of the tax law, the primary obligation of each taxpayer is that she/he/it is required to declare /her/his/its income within the time limit provided by the law. This declaration of income provides the basic data for the assessment of the tax and it is an important fact to the tax officials in order to determine the taxable income of the persons. The special form provided by the Tax Authority contains particulars regarding all revenues and expenditures to be taken into account in computing the taxable income. This clearly depicts that declaration is an indispensable data for the tax officials. Declaration of income protects the taxpayer from arbitrary imposition of tax by the officials, as the taxable income of the taxpayer will be determined on the basis of his/its declaration unless the taxpayer falsified the account he/it maintained. Again when the taxpayer declares his income the tax officials immediately assess the taxable income of the taxpayer save in cases of fraud, and this facilitates tax assessment.

The imposition of obligations to declare income and pay income tax is obviously for the purpose of insuring tax collection. To this end, two systems are employed: the withholding system and the self-reporting systems. The withholding system is applied in respect of incomes that arise from employment, royalties, chance winnings interest on deposits, payments made in services rendered from abroad and income on dividends. In such cases, the persons who/which make the

payments serves as tax collecting intermediary as they are required to withheld the income tax and forward it to the tax authority. To sum up, the withholding system works in respect of schedule A and most of the tax sources of schedule D.

The self-reporting system (self-declaration) is employed as regards all other income sources as well as employment in special situations. An individual who works for more than one employer in one month or an employee of international organization having diplomatic immunity or working in embassies, missions and other consular establishments of a foreign government is required to declare his income by himself.

In the case of schedule B and schedule C income, the taxpayer himself shall declare his income to the Authority within the following time limits depending upon the category of taxpayer. How do you know category of taxpayers? The current Income Tax Proclamation in its Art. 2(16) has envisaged three categories of taxpayers. These are category A , category B and category C taxpayers. In order to understand as to when a taxpayer is considered as one of such categories, Art. 18 of the Regulation is important. As per this article, category A includes any company incorporated under the laws of Ethiopia or in a foreign country and any other business having an annual turnover of Birr 500,000.00 (Five hundred thousand) or more. Category B taxpayer is any business having an annual turnover of over Birr 100,000.00 (hundred thousand Birr) while category C taxpayer is a taxpayer whose annual turnover is estimated by the Tax Authority as being up to Birr 100,000.00.

According to the Income Tax Proclamation,

- i. Category A taxpayers shall declare their income within four months from the end of the tax year.
- ii. Category B taxpayers are required to declare their income within two months from the tax year.
- iii. Category C taxpayers, unlike the above two categories, are required to pay their incomes between the 7th day of July to the 6th of August (Hamle 1 to Hamle 30)

How about declaration and assessment of schedule “D” income? This is regulated by Art. 67 of the Proclamation. According to this article every taxpayer who /which has schedule D income, not subject to withholding at source constituting a final tax, shall prepare a declaration of that

income in a form prescribed by the Tax Authority. Taxpayers are duty-bound to submit this declaration to the Authority within two months from the end of the Ethiopian Fiscal Year- the budgetary year of the Ethiopian Government (from Hamle 1- Sene 30 of each year.) Then, the tax calculated in accordance with the declaration, after the amounts provided in Art 7 of the Proclamation paid during the year with respect to the schedule D income subject to declaration having been reduced, shall be transferred by the tax payer to the Tax Authority simultaneously with the declaration.

After the taxpayers have complied with the duty of declaring their income, the next step is that the tax authority is expected to examine and investigate what has been declared to it. This means that it has to check whether the taxpayer had carried out his duty in filing the special form in accordance with the tax law. In examining the income declared, the basic principle is that a declaration is assumed to be correct unless otherwise proved. The need for examining the content of the declaration made by the taxpayer is that some of the taxpayers may try to evade or conceal their income from the Tax Authority. In other words, no tax will work effectively, especially an income tax, unless the Tax Authority maintains an aggressive attitude with respect to the correctness of the taxpayer's actions. If the tax officials have doubts about the contents of the declaration, they may order the taxpayer to bring additional material evidence to check whether the declaration is in line with the evidence available or the tax officials may go to the premises of the taxpayer and examine the activities of such taxpayer. (Read Arts. 38-50 of the Proclamation)

1.3.2. Assessment of Income Tax

How do you define the word assessment? The word assessment has not been defined in the Income Tax Proclamation. In spite of this, we can understand that by assessment is meant the determination of the tax liability of the taxpayer when we read the provisions of the Income Tax Proclamation. Generally speaking, there are two popularly known types of assessment, which differ from one another in the degree of participation required from the taxpayer or tax administrator in determining tax liability. These are official (government) assessment and self-assessment. Under the official assessment, it is the tax authority which finally determines the tax liability whereas the payer's role is confined to presentation of information and document. So, the degree of participation of the taxpayer is either non-existent or very much minimal. Self-

assessment, on the other hand, invites for high participation from taxpayer to determine the tax due. In this case, the taxpayer prepares necessary documents and statement of accounts and then calculates his own tax liability. The tax authority investigates only when there is suspicion for fraudulent acts to willfully suppress taxes payable. The self-assessment gives an opportunity for the taxpayer to assess his tax liability so that from the taxpayer point of view this type of assessment is more acceptable and deemed to be a fair way of imposing tax liability. However, in the Ethiopian context, the assessment is an official type; the taxpayer is required only to file its tax returns with appropriate payment. The process of determining the tax liability is all the effort of the Tax Authority.

The rules of taxation naturally have an authoritarian character, but tax laws do not grant the taxing authority a privileged position; nor do they deprive the taxpayer a means of defense against arbitrary taxation. The tax law stipulates bases for the tax assessment so that the tax officials could not employ other methods of assessment other than stated in the appropriate law. This is to curtail abuse of the power of the tax officials in assessing the tax. This is clearly reflected under the Income Tax Law under consideration (see art. 40 of the Income Tax Proclamation). When we come to basis of assessment, there are two bases of assessment. These are assessment on the basis of accounts and assessment by estimation.

The income tax Proclamation imposes an obligation on certain taxpayers in accordance with their category of income or form of organization. The current Income Tax Law categorizes those taxpayers under schedule C and B into three groups as provided in Art. 2 (16) and 48 of the Proclamation and Art. 18 of the Regulation. These categorizes are category 'A', category 'B' and category 'C'.

Art. 19 of the Regulation requires category 'A' and 'B' taxpayers to maintain books of accounts which are expected to show gross profit and the manner in which it is computed, general and administrative expenses, depreciation, provisions of profit and loss statements. Coming to category 'C' of schedules B and C, Art 68 of the Proclamation provides that a standard assessment method shall be used to determine the income tax liability of the taxpayers. Art. 21 of the Regulation further provides that category 'C' taxpayers are required to pay tax in accordance

with schedule '1' and '2' attached with the regulation (please have a look at the schedules attached at the end of Regulation No. 78/2002). If, on the other hand, category 'C' taxpayers maintain books of accounts acceptable to Tax Authority, they shall pay on the basis of such books of accounts. To sum up, if the records and accounts maintained by the taxpayers are considered satisfactory by the tax authority, tax shall be assessed on the basis of the records and books of account.

The second basis of assessment of income tax is assessment by estimation. For different reasons, the tax payers may be subjected to taxation on the basis of estimation. What do you understand by estimation? Though it is not defined by the relevant laws, its dictionary meaning refers to judgment or approximate calculation. The main point during estimation is that the tax officials must assess the tax liability in a fair and equitable manner. In other words, they must not assess the tax liability arbitrarily and they must not have the intention to punish the taxpayers; rather they should estimate the tax in good faith. In order to achieve this goal, they must assess the tax in accordance with the available evidence and the circumstantial evidence that is associated with the income to be assessed.

To this end, the tax authority employs different mechanisms to get necessary information as to the actual activities of a certain business. It is empowered to send inspectors to the place of business or practice of the taxpayer to check same or any vouchers, stocks or other material items of the taxpayers, and to require any taxpayer or any employee thereof who has access to or custody of any information, records, or books of account to produce the same and to attend during normal office hours at any reasonably convenient tax office and answer any questions relating thereof. (See Art. 38 of the proclamation). In addition, for the purpose of assessment by estimation, the Tax Authority uses purchases, sales on services, income information obtained from other party like National Bank and Customs Authority for foreign transaction, public enterprises and government organizations and wholesaler. There are different grounds that justify to assess the tax liability by estimation. The following are some of the grounds: (read Art. 69 of the proclamation)

i) **Failure of the taxpayer to maintain books of accounts**

Previously, we have said that category A and B taxpayers are required to maintain books of accounts by the income tax law. Whenever these categories of taxpayer fail to carryout the obligation, the Tax Authority is entitled to assess the tax liability by estimation. (See art. 69 of Proclamation No. 286/2002).

ii) Rejection of Books of Accounts by the Tax Authority

For justifiable reasons the records of account may be unacceptable to the Tax Authority. For instance, records of accounts may be rejected because of fictitious evidence adduced by the taxpayer, concealment of income, indicating higher expenses than what are actually the case and other reasons. In this case, the Tax Authority is entitled to assess the tax liability by estimation.

iii) Failure by the taxpayer of declaration of income

A taxpayer is required to declare his/her/its income within a specified time provided by law. However, if the taxpayer fails to declare his/her/ its income within the time specified under the law, the Tax Authority may assess by estimation. Finally, one point needs to be raised. This is aggregation of income during assessment. As our previous discussions reveal, in Ethiopia the system adopted is a scheduler system which means that tax sources falling in different schedules are assessed separately. However, a taxpayer who/which derives income from different sources under the same schedule shall be assessed on the aggregate of such income. Assume that Ato Habtamu has a five-star hotel in the middle of Addis Ababa from which he generates an annual taxable income of 30 million Birr. Ato Habtamu has also a supermarket from which he earns an annual taxable income of 10 million Birr. He has also a laundry from which he earns an annual taxable income of 2 million Birr. Therefore, since all these source of income fall under schedule C of the Income Tax proclamation, all these sources are assessed being aggregated.

Does aggregated assessment work for schedule D of the Income tax Proclamation?

Aggregated assessment does not work for schedule D because schedule D includes various tax bases with different rates. As such, each tax base must be assessed separately.

1.4. Payment of Tax and Collection Enforcement

The ultimate obligation of any taxpayer is payment of tax which is due to the Tax Authority. Failure to make a timely payment results in the imposition of interest and late payment penalty.

The interest is to be calculated from the date the tax is due to the date it is paid. The interest rate is twenty five percent (25%) plus the prevailing interest rate of the commercial banks during the time. Thus, if Ato A failed to pay a tax in the year 2009 and if in that year the interest of the Commercial Bank was 6%, Ato A will be obliged to pay an interest of 31 percent.

On the other hand, if a person pays tax in excess of his liability, the Tax Authority shall set-off the excess with other tax liabilities of the taxpayer. If still, there remains excess, the Tax Authority is duty-bound to refund the remainder to that person within 90 days. If the excess is not refunded within the 90 days time limit, he will be entitled to an interest of 25% plus the prevailing interest rate of the commercial banks. The request of refund shall be instituted within three years from the time the notification assessment was served to the taxpayer or from the date the tax or interest was paid. The Tax Authority shall make a decision in writing to the applicant. If the applicant taxpayer is not satisfied with the decision of the Tax Authority he/it can take his/its case to the Tax Appeal Commission.

When we come to the enforcement aspect, as per article 77 of the Proclamation if the taxpayer is not willing to pay the tax due, the Authority will have the right to seize or attach the property of the former. Such seizure may be made on the accrued salary or wages of the taxpayer, it can be made on any property of the taxpayer, or it can be made on any other person who owes money or property to the taxpayer. However, such seizure shall extend only to property possessed and an obligation existing at the time the seizure is made. Future goods or obligations cannot be seized. During seizure, the tax authority has the right to request police officers to be present. It has also the right to sell the property seized at public auction or in any other manner that it has approved. But the sale cannot be made before 10 days after seizure except that the commodities (goods) seized are perishable. If the goods seized are perishable, the Authority can sell them after a reasonable period having regard to the nature of the goods.

The Authority can make seizure on employee's remuneration or other property of any person with respect to any unpaid tax only after notifying such person in writing of its intention to make such seizure. The notice shall be given to the taxpayer not less than thirty (30) days before the day of the seizure. However, if the Authority makes a finding that the collection of the tax is in jeopardy, a demand for immediate payment of such tax may be made without regard to the thirty days (30) prior notification period. In any case, the Tax Authority cannot seize properties that are

not liable to attachment as per the 1965 Civil Procedure Code and other legislation and amount of employee's remuneration that is less than 150.00 Birr. For example, wearing-apparels, bed and beddings, cooking utensils, necessary foodstuff, seeds and the like are not to be attached by virtue of Art. 404 of the Civil Procedure Code.

As per Art. 78 of the Income Tax Proclamation, a person in possession of property subject to the seizure and on which a seizure has been made, is duty-bound to surrender such property on the demand of the Tax Authority. If such person fails or refuses to surrender such property, he shall be personally liable to the government in a sum equal to the value of the property not so surrendered; but not exceeding the amount of taxes for the collection of which seizure has been made. In addition to this personal liability, if the failure or refusal to surrender is without reasonable cause, such person shall be liable for an additional charge equal to fifty percent (50%) of the amount recoverable. On the other hand, a person in possession of property who surrenders or makes payment in accordance with the above mentioned requirement should be discharged from any obligation or liability to the delinquent taxpayer or to any other person arising from such surrender or payment.

For the proper collection of tax, the tax authority has a preferential right (claim) over all other claimants upon the assets of the person liable to pay the Tax until the tax is paid. However, the right of priority of claims of the Tax Authority does not extend to the extent of affecting secured creditors. The right of secured creditors over the property mortgaged or pledged remains intact although the tax authority enjoys priority right. The preferential right is applicable with respect to non-secured creditors of the taxpayer.

1.5. Rewards and Administrative Penalties

The Income Tax proclamation (under Art. 84 and 85) authorizes the Tax Authority to give rewards for persons that provide a verifiable and objective information of tax evasion through concealment, under reporting, fraud or any other improper means and also for taxpayers and officers for outstanding performance and discharge of duties.

On the other hand, taxpayers are subject to the following penalties for failure to live up to the requirement of the income tax law:

- a) penalty for late filing or non-filing

- b) penalty for understatement of tax
- c) penalty for late payment
- d) penalty for failure to keep proper records
- e) penalty for failure to withhold tax
- f) (penalty for failure to meet TIN requirements

N.B: In order to understand the specific penalties under each of the above heading, you are hereby advised to have a close look at Art. 86-93 of the Income Tax proclamation (See also Arts 91b, 91c, 97a, of proclamation No 608/2008)

1.6. Criminal Offences /Tax Offences/

Though criminal offences are the subjects of the criminal law, since tax offences have been provided under section IX of the Income Tax Proclamation, it is advisable to have a quick glance at the relevant provisions of this Proclamation. Pursuant to articles 95-102 of same proclamation, various kinds of tax offences are created and their respective penalties are provided. These tax offences, as they are violations of criminal law of Ethiopia, are made to be charged, prosecuted and appealed in accordance with Ethiopian Criminal Procedure Code. Offences created as per these articles include tax evasions, making false or misleading statements, obstruction of tax administration, offences by tax authority employees, unauthorized tax collection and aiding or abetting, offence in committed in relation to sales register machine (Read proc. No 608/2002).

1.7. Appeal Procedure under the Income Tax Law

The power of the government to levy and collect taxes is unchallenged, provided that the power is exercised regularly and within the bounds of the law. Correspondingly, every person who is qualified to be a taxpayer is duty-bound to pay taxes in accordance with the requirements of the law. However, taxpayers may be aggrieved by the actions of the government in connection with levying and collecting taxes from them. Therefore, the law has provided mechanisms of airing grievances by the taxpayers. These mechanisms are means of rectifying the errors committed by the Tax Authority. It is because of this that the Ethiopian Income Tax Law of 2002 has included some important provisions that are used to entertain the grievances of the taxpayers. The mechanisms are administrative, quasi-judicial and judicial.

Upon receipt of a tax assessment notification, the taxpayer, in principle, is duty-bound to settle accounts with the authority within one month. If, however, he is not in accord with the assessment of the Authority the following options are available to the taxpayer. The first option open to him is an administrative means. The administrative remedy may be sought from an organ called a Review Committee established by virtue of article 104 of the Proclamation. According to article 104 of the proclamation, members of the Review Committee are to be appointed by the Director General of the Federal Revenue and Customs Authority or the competent authority of the regional governments, upon the recommendation of the head of the Tax Authority. When the taxpayer opts for administrative means, he is required to file an application for a review of assessment by this committee within ten days of the receipt of assessment notification. In this case, the review committee examines the validity of the taxpayer's claim. The investigation process may involve going into the files of the taxpayer, and inspection of the premises where activities are carried on. If the findings of the committee warrant revision of the assessment, it will be performed accordingly, and the new assessment will be served on the taxpayer afresh. (See Art. 105 of Proclamation No. 286/2002).

The appeal remedy can safely be divided into quasi-judicial and judicial **per se** remedies. The quasi judicial remedy is sought before the Tax Appeal Commission which is established at the Federal, regional, zonal and woreda levels. However, before a taxpayer takes his/her/its case to the Tax Appeal Commission, he/she/ it should meet certain preconditions stipulated in article 107(2) of the Proclamation. According to this sub-article, appeal to the Tax Appeal Commission is accepted if the aggrieved taxpayer makes a deposit of 50% (fifty percent) of the disputed amount to the Tax Authority and if he/she/ it lodges the appeal with the Tax Appeal commission within 30 (thirty) days following the day of receipt of the assessment notice or from the date of decision of the Review Committee. Then, by virtue of Art. 115 of the Proclamation, the Tax Appeal Commission is empowered to confirm, reduce or annul any assessment appealed against based on factual grounds and the relevant provisions of the law. Besides, it is authorized to make consequential orders thereon as may seem just and necessary for the final disposition of the matter. The burden of proving facts before the commission (tribunal) lies on the person objecting to the assessment or decision of the Tax Authority.

The judicial per se remedy is available to both the taxpayer and the Tax Authority alike. Both parties have the right to lodge their appeal to the competent regular court whenever they are dissatisfied by the decision of the Commission. In order to avail himself/herself of the judicial remedy, he/she/ it should file the appeal within 30(thirty) days from the date of receipt of the written decision of the Tax Appeal Commission. The appellate court can, however, entertain only issue of law. The court is precluded from going into the merits of the case, as it is required to send back the case to the commission having rectified only what is considered legally erroneous in the decision.

If still the parties are dissatisfied by the decision of the court, they can appeal to the next court of appeal within 30 days of the decision of the lower court.

Chapter Summary

The 2002 Income Tax proclamation is divided into the substantive and procedural parts. The substantive part deals with what we have seen under the previous unit (Unit Two) while the procedural part deals with the issues covered under this unit. The most important aspects of this unit are withholding procedures, tax accounting principles, declaration of income, assessment of income tax, payment of income tax, enforcement mechanisms, rewards, administrative penalties, tax offences and appeal procedures. The withholding of income tax applies to schedule A, withholding on imports of schedule C, withholding on certain payments effected by organizations having legal personality, non-profit organizations and non-governmental organizations. The withholding scheme is also applicable to schedule D of the Proclamation in the majority of cases. As far as tax accounting principles is concerned, there are two methods. These are the cash method accounting and the accrual method accounting. Although taxpayers do have the freedom to follow either of these methods, companies are duty-bound to account their tax obligation using the accrual method.

Although the word assessment is defined nowhere in the Income Tax Proclamation, by now it must be clear to you that by assessment is meant the determination of the tax liability of a person who is subject to income tax. Basically, there are two types of tax assessment. These are official /government/ assessment and self-assessment. As the name itself implies, under the official

assessment, the tax authority determines the tax liability while in the self-assessment, the taxpayer has great involvement in determining the tax due from him.

The key aspect of assessment of tax liability is identification of the taxpayer. The first task of the tax authority is to identify the persons or the bodies which bear the burden of tax before imposing any tax on them. This identification of the taxpayer can create a smooth relationship between the Tax Authority and the taxpayers. Taxes may be assessed on the basis of books of accounts or by estimation. Taxes are assessed on the basis of books of accounts when the taxpayers are those who/which are obliged to maintain books of accounts. However, where the books of accounts and records maintained by the above persons are not acceptable to the Tax Authority, or where these persons fail to maintain books of accounts or fail to declare their income, the authority resorts to assessment by estimation. The other ground which leads the authority to assess income tax by estimation is where the taxpayers are not required to maintain books of accounts and records.

The collection of income tax cannot be complete unless assessment is assisted by declaration of income by the taxpayers. This is the primary obligation of each taxpayer. In declaration of income tax, there are two important systems. These are the withholding system and the self-reporting system. Basically, the withholding system is employed under schedules A and D of the Income Tax Proclamation while the self-reporting system is used under schedules B and C and employment income in special situations.

Assessment of income tax is followed by payment of the income tax what is due from the taxpayer. Payment is the central obligation of the taxpayer and the central purpose of the Income Tax Law. In order to realize this obligation of the taxpayers, the law has designed some collection enforcement mechanisms. In addition to tax collection enforcement mechanisms, there are serious administrative penalties. There are also serious criminal punishments that may be instruments to deter tax offenders of various types. In addition to the enforcement mechanisms, the procedural part of the Income Tax Proclamation contains provisions which deal with appeal by aggrieved taxpayer can take his grievance to a Review Committee Tax Appeal Commission and regular courts.

CHAPTER FOUR

VALUE-ADDED TAX (VAT) AND TURNOVER TAX (TOT)

Introduction

Under this chapter, we will study the two important indirect taxes. These are the value-added tax and turnover tax. Because these two taxes do have some common features, it has been opted to treat them together under this chapter. This does not mean, however, that the two taxes are the same in all respects. This is because there are certain glaring differences between these two taxes. Therefore, different sections and subsections are devoted for the analysis of each type of tax. As far as VAT is concerned, its historical background, meaning, basic features, taxable activities, taxable transactions, exempt transactions, time, place and value of supply, registration, VAT payable, crediting mechanisms and the like are discussed. Coming to turnover tax, conceptual underpinning of turnover tax, scope of application of the law, rate of the turnover tax, exemptions and some other procedural aspects of the law are discussed.

Generally, this unit is devoted to the discussion of VAT and TOT together because the Ethiopian VAT law has been complemented by the TOT law. This is so because the VAT Proclamation has been designed to cover those taxpayers whose annual turnover is above 500,000.00 Birr. Therefore, the Turnover Tax Proclamation which covers what is not covered by the VAT proclamation (taxpayers whose annual turnover is below 500,000.00 Birr) is necessary. That is why the Turnover Tax proclamation, Proclamation No. 308/2002 was adopted and entered into force on the same date as that of the VAT proclamation.

Objectives

Having completed this chapter, students should be able to:

- analyze the historical background of VAT and define VAT.
- analyze what a taxable activity is and its implication in the context of Ethiopian VAT;
- discuss taxable transactions and the applicable rates;
- enumerate exempt transactions and analyze the rationale behind tax exemptions;

- discuss place, time and value of supply and their implications.
- grasp VAT payable and the crediting system;
- analyze rules applicable to registration and as to who is required to register for VAT;
- differentiate the types of taxpayers in the context of the Ethiopian VAT;
- discuss turnover VAT;
- identify goods and services subject to TOT;
- analyze the applicable rates in TOT ;
- identify exempt transactions on TOT and
- discuss other procedural elements of the TOT Proclamation.

4.1 Meaning and Features of Value-Added Tax

The understanding of the value-added tax has been somewhat confused. The confusion is attributable to the fact that VAT is assimilated to sales tax and on the other hand it is confused as a tax to be paid by business entities. The confusion is understandable because VAT is inherently a sales tax although it has its own unique features that made it distinct from all other sales taxes. Because VAT belongs to the family of sales tax, at first glance the tax appears to be imposed on business entities while actually the ultimate burden of the tax is borne by consumers. Business entities merely serve as tax collecting agents though the Ethiopian VAT Proclamation call them taxpayers for the purpose of convenience. (Read Art. 3 of the Ethiopian VAT Proclamation)

Let us see the following definition of VAT so that we will have a glimpse of the concept. The Encyclopedia of Value-add Tax defines it as:

“A sales tax, designed like other sales taxes, to tax private consumption by individuals of the goods or services subjected to tax.”

Black’s Law Dictionary (8th ed, 2004) defines the term as:

“A tax assessed at each step in the production of a commodity, based on a value added at each step by the difference between the commodities production cost and its selling price.”

When we closely read the two definitions, it is possible to realize that the first definition indicates one of the essential features of the VAT i.e., its being a sales tax. Besides, it expressly

indicates the actual incident where the real burden of the tax rests and therefore avoids any confusion that may arise in this regard. Aside from these, the definition offers no complete picture regarding the distinctive features of the value added tax. As compared to the first definition, Black's Law Dictionary definition gives a better description of the concept. It specifically indicates two peculiar features of the tax; namely, its base and the fact that the tax is imposed at each step on the basis of the value added.

In essence, VAT is nothing but it is a sales tax imposed on sales transaction which is measured as a percentage of the product or the services rendered. Like all other sales taxes, the VAT is a tax on consumption which is to be paid ultimately by consumers of a taxable product as measured by the price they pay for goods and services. As in other sales taxes, the tax is collected through the medium of business entities. But the value-added technique of collecting tax is different from those employed to collect other sales taxes. First and foremost, as the name value-added implies, a business entity operating in a VAT regime is liable to collect VAT in proportion to the value it added to a taxable item. To determine the tax liability of a given taxpayer, each taxpayer applies the tax rate to its figure of taxable sales and deducts from this tax paid on its purchases of material inputs used to produce the taxable sales.

There are different ways of computing tax liability of a given firm. The main thing, however, is the crediting system by which firms are allowed to deduct taxes they paid on their material inputs against their taxable sales and it is this feature that makes it completely different from other sales taxes. The other basis feature of VAT is its multi-stage character. A value-added tax is imposed on a taxable product every time it changes hands in the chain of production and distribution. This distinguishes it from most sales taxes that are imposed at a single point in the chain of production and distribution which could be either at the manufacture level, wholesale level or retail level. As a multi-stage tax, VAT greatly resembles the turnover tax which likewise is collected throughout the production and distribution process. However, as opposed to VAT which is imposed on the value-added of a given item, the turnover tax is imposed on the gross value of a taxable product throughout the process.

As has been said previously, in effect VAT is nothing but an alternative technique of collecting sales tax. In fact, an identical result could be achieved by levying a retail sales tax, for the latter simply is the total value-added of the raw materials accumulated throughout the transactions. However, the fact that the VAT is collected fractionally has a practical advantage over the retail sales tax. Since the defining features of VAT is its rebating mechanism, a clear understanding of the terms input tax and output tax is very important to understand how VAT operates. Input tax is paid by business entities on the purchase of inputs that are used to produce a taxable product. Output tax is the tax a business entity collects from the sale of taxable products. As a result, a firm's liability is only the difference between the input tax and output tax.

4.2. Historical Background of Value-added Tax (VAT)

The concept of value-added tax was analyzed and propounded for by American fiscal experts in the 1920's. Nevertheless, despite the urgings and pressures of many of its fiscal experts, the USA failed to implement the tax at a national level. But there is still an ongoing debate on these issues. A Value-added Tax (VAT) which is presently the key component in the tax systems of a vast number of countries was initially introduced in France in 1954. In France, the tax replaced the turnover tax prevailing till then and its introduction was the result of World War II, which in its aftermath, left the country in a serious financial crisis that demanded a large amount of revenue to reconstruct. This tax gained recognition at an organization level in the Common Market of the European Economic Community (EEC) in 1970. As stated in the preambles of the first and second directive of the Council of European Economic Community, which established the common market, the application of a value added tax was made a compulsory prerequisite of membership with a view to harmonizing the tax system of the members. This was one of the main reasons for the widespread interest the tax received the world over and for its subsequent application in some states. The value-added tax is now implemented over 120 countries in the world-Many African Countries have also introduced this tax.

Coming to Ethiopia, the value-added technique of collecting sales tax was introduced in the country only recently by Proclamation No. 285/2002. This tax was introduced in lieu of the sales tax collected at the manufacturer's level. The turnover tax was also adapted to govern the area where VAT does not apply. The introduction of the VAT was part of the tax reform the

Ethiopian State tried to undergo. The introduction of VAT faced resistance from business entities because they feared that they would be burdened with collection costs. There was not much protest from the general public on whom the ultimate burden of the tax is imposed. In spite of the above opposition and resistance to VAT, the tax was introduced in 2002 and it was implemented in January 2003. And now VAT is operative throughout the country and researches demonstrate that it has become an appreciable source of public revenue to the country.

4.3. Types of Value-added Tax, Methods of Computing VAT Liability and Advantages and Disadvantage

4.3.1. Types of Value-added Tax

Previously, we have said that the crediting or rebating by business entities of the tax they paid in their business input against their taxable sales is the unique feature of a value added. However, there are different treatments, to purchases of business inputs and on the basis of this, there are three types of VAT.

a) Gross product value-added tax

This type of VAT is the most unflavored type, for although generally a business is allowed to deduct the tax it paid on its business inputs. Under this type, taxes paid on purchase of capital goods, such as machinery, building and depreciation are not allowed to be rebated. As a result of this, determination against the use of capital goods, its use, apart from theoretical discussion, is very much restricted.

b) Income type value-added tax

This form of VAT greatly resembles that of gross product in the treatment of capital goods, in that both exclude the refund of tax paid on purchase of capital goods. However, in this type, periodic allowance for depreciation can be taken.

c) Consumption type of value-added tax

This is the most widely used and theoretically accepted type of VAT. Its popularity is due to the fact that VAT paid on all business purchases including capital equipment and depreciation are allowed of rebate. As a result, it is a much easier method for both tax collectors and taxpayers, since they do not need to make a distinction between capital goods and current expenditures in

determining liability. The consumption type of VAT is the most important one in the world today.

4.3.2. Methods of Computing VAT Liability

The value that a firm adds to the goods and services it buys from other firms can be determined in three different methods. These are:

- a) **Credit method:** in this method, sometimes known as the invoice method, value-added is determined by deducting the amount of tax that is paid on business input from the amount of tax that is collected from taxable supplies. This method of calculating VAT liability is favored since it could minimize evasion.
- b) **Subtraction method:** Under this method, deducting from the total sales of a taxable activity, the amount of purchases used to make a taxable transaction and then applying the rate which determines liability of VAT.
- c) **Addition method:** this approach consists in adding various bookkeeping items, specifically the payments made by the firm to the factors of production employed in producing the product, such product, as wages, interests, rent, royalties and profits and then applying the rate.

However, of the three methods of computing VAT liability, the credit method or the Invoice method is predominantly used in the world.

4.3.3. Advantages of VAT

VAT has the following advantages:

- a) Because of the rebating or crediting system so peculiar to the VAT, the method of collection and refunding is so transparent that it allows little room for evasion. Moreover, since the tax is collected at multi-stage and businesses are allowed of refund on the tax they paid on the inputs, there is little incentive to evade.
- b) Since it allows credit on business inputs, the VAT has anti-cascading effect. Thus the imposition of the tax does not interfere in the decision of firms on what and how to produce. In other words, it is neutral.
- c) As it is a tax on consumption, it merits from one of the advantages of such taxes. That is, as it taxes only the part of incomes that is utilized for consumption, it encourages saving and investment.

- d) It encourages exports. This advantage is only available in the type of tax operating under the destination principle. Under this principle taxable products are subject to tax in those areas where they are consumed. Thus, exports are not taxed by a positive tax rate. Moreover, a further advantage of this principle is that businesses are allowed to credit taxes paid on business purchases used to produce the exportable items. On the contrary, VAT following the origin principle encompasses all products produced within the state under its operation. Thus, apparently the destination principle encourages exports.
- e) The revenue, potential of VAT is one of its attractive features. Surprisingly enough, despite the impact of poor administration could have on the amount of revenue, it is said that even poorly administered VAT produces a large amount of revenue. This could be due to the fact that it is a consumption tax. That is to say, since individuals will not stop consuming, taxes levied on consumption are generally reliable sources of revenue. The other reason is, as it encourages compliance, taxes are collected effectively, thus generating more revenue.

4.3.4. Disadvantages of VAT

Although VAT is appreciated for the above advantages, it is also criticized for some disadvantages. The following are the disadvantages of VAT:

- a) It is not simple and easy tax to adopt, especially in an underdeveloped country where the tax levying administrative set up is insufficient and inexperienced to understand a complicated tax structure.
- b) It needs an honest and efficient government tax administrative machinery to implement it. It is necessary that the country adopting this tax should be sufficiently advanced in its financial and economic structure and the firms should be in the habit of keeping proper accounts.
- c) It success largely depends on the cooperation of the taxpayers because in this case, tax evasion becomes a major possibility and a common practice.
- d) The system is highly uneconomical especially for the smaller firms since it requires them to maintain elaborate and costly accounts.

4.4. Introduction to the Ethiopian VAT

4.4.1. Power of Levying VAT

After a country decides to adopt VAT or any other tax, the issue that follows is as to which organ should be empowered to levy it. The necessity of determining this is even more important in a federal country like Ethiopia where regional states have also their own power of taxation. The need to determine this issue is more pressing where the federal state and the regional states have concurrent power of taxation. As you may remember, the FDRE Constitution allocates exclusive power of taxation to the Federal Government, exclusive power of taxation to the regional states and concurrent power of taxation. With respect to new taxes, the constitution provides that it would be decided by the joint session of the House of Federation and the House of Peoples' Representatives in accordance with article 99 of the same Constitution. Considering a number of factors, the joint session of the House of Federation and the House of Peoples' Representatives in April 2002, designated the power to levy VAT to the Federal Government. Therefore, regional states do not have the power to levy value-added tax in Ethiopia although they can collect such tax on behalf of the Federal Government by delegation.

4.4.2. Features of VAT in Ethiopia

A state contemplating a VAT is faced with many choices. It has to make, among other things, whether to credit purchases on capital assets and depreciation. After that it has also to select method of determining liability. It must as well decide what to tax, that is whether to tax exports or imports. Depending on the particular choice that can be made, there are many combinations of VAT. Many value-added tax laws in the world have been heavily influenced by the basic principles of European VAT although some countries such as Japan and New Zealand have adopted their unique VAT laws. The European VAT is characterized, among other things, by consumption type of VAT, credit method and destination principle. The Ethiopian VAT Law has also adopted the European Community VAT. This means that the Ethiopian VAT is characterized by the following important elements:

A) Consumption type: A consumption type of VAT is a VAT where the taxable person is allowed to deduct his tax on business inputs including the tax on capital assets. According to the Ethiopian value-added tax system, registered persons are allowed of relief on their input purchases including capital assets by virtue of Art. 21(1) of the proclamation so long as the assets used for the purpose of making taxable transaction.

- B) Credit method:** VAT liability in Ethiopia is calculated using the credit method as provided under Art. 20 of the proclamation. According to this article, VAT payable is the difference between the amount of tax charged on taxable transaction and the amount of tax creditable.
- C) Destination principle:** VAT could be imposed using a destination principle or origin principle. A destination principle provides that VAT is imposed on goods and services in the area of their consumption. As a result, exports are untaxed while imports are taxed. Inversely, in an origin principle VAT is a tax that is imposed on goods and services in the area of their origin or production irrespective of the area of consumption. Consequently, exports are taxed, while imports are not. The Ethiopian VAT has preferred the destination principle of tax for the reason that only supply of goods or rendition of services that are made in Ethiopia or partly in Ethiopia are, according to Art. 7(3), subject to tax. Import of services and goods are likewise taxed as provided in Art. 3 of the same Proclamation. Exports are, on the other hand, free from tax by the scheme of zero rating stipulated under Art. 7(2) of the Proclamation.

4.5. Taxpayers, Supply of Goods and Services and Taxable Activities under the Ethiopian VAT

In order to properly implement the VAT, it is crucial to identify the taxpayers, supply of goods and services and taxable activities. Therefore, it is imperative to entertain these points one by one as follows.

4.5.1. Taxpayers

It must be clear that VAT is an indirect tax. As such, the ultimate burden of such tax is borne by the final consumers. In other words, the actual taxpayers are consumers. However, when the Ethiopian VAT Proclamation under Art. 3 talks about taxpayers, it means that suppliers of goods and services to final consumers, importers of goods and non-resident persons who import services to Ethiopia are the taxpayers which means that these are the persons who/which service as a bridge between the actual taxpayers (the ultimate consumers) and the Tax Authority as the latter cannot reach each and every consumer who buys goods and services every day. Let us make this clear by the following illustrative example.

Berhanna Selam Printing Press is a profit making enterprise of the Federal Government of Ethiopia. It supplies publication services and goods such as published laws. In this situation, there are many consumers who/which buy goods and services. The government can reach such consumers via the intermediary of the printing press when one buys one proclamation worth 10.00 Birr, one pays $10 \times 15/100 = 1.5$ Birr to the government which is collected by the supplier (the printing press).

4.5.2. Supply of Goods or Services

This is another important aspect of VAT since collection of VAT is unthinkable without supply of goods and/or services. Supply of goods or rendition of services means the selling or leasing of goods or services by the supplier to the consumers. Under the Ethiopian VAT Proclamation, supply of goods and services has been regulated under Art. 4 and 5 of the Proclamation. Art. 3 of the Regulation (Regulation No 79/2002) is also important in order to have a full picture as to supply of goods or rendition of services for the purpose of collection of VAT in Ethiopia. Art. 4 of the Proclamation provides the guiding rules dealing with supply of goods and rendition of service while Art. 3 of the Regulation supplements what are dealt with by the proclamation. Art. 5 of the Proclamation deals with mixed supplies (the mixture of goods and services) and stipulates important points in relation to mixed supply.

Dear student, by going through though Art. 4 of the Proclamation and Art. 3 of the Regulation, when does supply of goods or rendition of services occurs attracting the payment of VAT by the consumers? What does that mean by mixed supply? What is (are) the legal effect(s) of mixed supplies? These questions are subsequently answered. According to Art. 5(1) of the VAT Proclamation, a supply of goods or rendition of services incidental to a main supply of goods or services is treated as part of the latter. In addition, the rendering of services incidental to an import of goods is part of import of goods. Despite this, however, a taxable transaction involving independent elements, one or more of which involves a separate supply of goods or rendering of services, which would be exempt from tax, is treated as separate transaction. An exempt transaction, which involves independent elements, which involve separate supply of goods or rendering of taxable services, is treated as separate transactions. In order to understand better these explanations, let us give illustrative examples as follows:

Illustration 1

Ato X is a supplier of grain mills and spare parts. Ato X sold about three grain mills to Ato Y. Each grain mill was worth 60,000.00. In the contract of supply, it was agreed that the supplier would give the service of installation of the mills and consultancy service as regards the proper functioning of the mills since the mills were newly imported to the Ethiopian market. In this situation, it must be clear to you that the supply is a mixed supply- the supply of the mills being the main supply and the supply of services is a supply incidental to the supply of the grain mills. This is because there wouldn't be the supply of the services if the supply of the grain mills was not made. This illustration also applies to the import of services incidental to the import of goods.

Illustration 2: (An exception to mixed supply)

Ato Worku Seid is a merchant who supplies books many of which are normal and some of which are talking books (books prepared in an audio recording that are a spoken reading of a printed book). In a certain transaction, Ato Worku supplied 100 normal books and 20 talking books. In this case, although the books were sold to the consumer in one transaction, the transactions on the normal books is a separate transaction from that transaction dealing with supply of talking books. This is because the transaction of normal books is a taxable transaction while the transaction involving talking books is an exempt transaction (please see the discussions on exempt transactions below and Art. 8(2) (p) of the proclamation and Art. 33 (2) of the Regulations)

4.5.3. Taxable Activity /Transaction/

Dear student, do you think that every supply of goods and services is subject to VAT under the Ethiopian VAT? Assume that Ato Bekalu Zeleke grows eucalyptus treat on a land covering about six hectares of land. He earns more than 1.5 million Birr annually by selling logs to consumers who buy the logs for construction and fuel purposes. Should Ato Bekalu be registered for VAT and collect VAT from the consumers? This is the most important question in relation to taxable activity; the answer to this question is to be obtained from the following discussions.

We started this sub-section by raising a serious question and one hypothetical case which sheds light on the question. This is because the term “taxable activity” is an elusive term to be understood as the phrase is differently defined and understood for instance in European countries, New Zealand and the like. Giving sufficient attention to the term is extremely crucial because the VAT that must be collected by any given country is determined by the definition the country has given to the term “taxable activity”.

In some VAT regimes, a person is a taxable person if he/she/it makes a sale above the threshold amount and such sales /supplies/ are made either in connection with certain economic or taxable activities or in connection with a business. The concept of taxable activity for VAT purposes generally is broader than the concept of trade for income tax purposes. Does this hold true under the Ethiopian situation? The Ethiopian situation a bit argumentative as will illustrate it later on.

In Europe, the Six Directive of VAT of the European Union, taxes sales (supplies) by a taxable person that conducts economic activity. The concept of economic activity under the Six Directive is very expansive and the test for economic activity is an objective one. In the UK, VAT limits taxable supplies to those made in furtherance of a business. AUK court, interpreting a business, held that “A business must amount to a continuing activity which is predominantly concerned with the making of supplies to others for consideration. There, are in effect, two parts to the test. First, for there to be an activity there must be sufficiency of sale to the supplies and they must be continued over a period of time. Second, the predominant concern of the person conducting the activity must be the making of supplies.”

New Zealand relies on the concept of taxable activity that is based on factors such as continuity and frequency of activity. The New Zealand Goods and Services Tax (GST) law taxes a broad range of economic activity by defining taxable activity to include activities of governmental entities and activity conducted continuously or regularly by any person, whether or not for a pecuniary profit.

The EU Six VAT Directive imposes obligations to collect and remit tax on “a taxable person” that is, on a person who/which engages in economic activities. Economic activity is broadly defined to include all activities of producers, traders and persons supplying goods and services

including mining, agricultural activities and activities of the professions. The exploitation of tangible or intangible property for the purpose of obtaining income, therefore, on a continuing basis shall also be considered an economic activity.

In some cases, the question is whether the person is engaged in activities that are extensive enough to be characterized as a business, rather than just a hobby or other “non-business” activity. What is a taxable activity under the Ethiopian context? Under the Ethiopian VAT, taxable activity is dealt with by Art. 6 of the Proclamation and Art. 4 of the Regulation. Art. 2(3) of Proclamation No 609/2008 Value-added Tax Amendment Proclamation, which has amended the VAT Proclamation is also crucial. According to Art. 6 of the VAT Proclamation (Proc. No 285/2002), before it was amended, taxable activity was defined as any activity which is carried on continuously or regularly by any person in Ethiopia or partly in Ethiopia whether or not for pecuniary profit. Taxable activity involves or is intended to involve, in whole or in part, the supply of goods or services to another for consideration. However, this article has been amended by Proclamation No 609/2008. Because of the amendment, Art. 6 of the proclamation reads as: taxable activity means an activity which is carried on by a registered person whether or not carried on continuously or regularly. What differences do you notice between the previous provision and the amended provision?

In the repealed provision, an activity would be a taxable activity if it were made continuously or regularly by any person. As per the new provision, however, a taxable activity is an activity which is carried on by a registered person whether the supply is made continuously or regularly. But the question worth asking at this juncture is whether replacing “any person” by “registered person” would be compatible to the scope of application of the Ethiopia VAT particularly when we evaluate it in the light of the fact that taxable activities are carried on by non-registered persons as provided in Art. 23 of the Proclamation. In fact, using the phrase “any person” in the repealed provision is not also correct because it is not any person who supplies taxable activities. Rather it is selected persons who/which engage in taxable activities which could be subject to VAT provided that other requirements for imposition and collection of VAT are cumulatively satisfied.

In any case, the Ethiopian VAT proclamation does not give as a complete picture as to what taxable activities are. Rather it leaves us in a state of confusion. However, the Amharic version of the proclamation may be of some help to understand as to what activities are taxable activities attracting the collection of VAT if the activities are not exempt transactions. This is because the caption of Art. 6 of the Proclamation begins by “ታክስ የሚከፈልበት የንግድ ሥራ እንቅስቃሴ” and the body of the article further provides that “ታክስ የሚከፈልበት የንግድ ሥራ እንቅስቃሴ ማለት” (which means taxable business activity) which is totally missing in the English version of the proclamation. Therefore, since the VAT Law is a federal law the controlling version is the Amharic version as clearly provided in Art. 5(2) of the FDRE Constitution and the Proclamation which established the Federal Negarit Gazette. Accordingly, in Ethiopia, it may be argued, taxable activity is a supply of goods and/or services which involve business activities. In other words, it may be maintained that taxpayers, to use the parlance of the law, are persons who/which engage in business activities. Would this conclusion be compatible to the practice? What does that mean business activities?

In fact, the Ethiopian VAT does not define what business activity is. Hence, it is imperative to attempt to provide the meaning of business activities from other sources. According to its dictionary meaning, business means the activity of making, buying selling or supplying goods or services for money. (see Oxford Advanced Learner’s Dictionary, 7th ed, p. 194). According to Black’s Law Dictionary (8th ed, 2004) the word business is defined as “a commercial enterprise carried on for profit.” According to a certain author “business includes any trade, commerce, or manufacture or any adventure or concern in the nature of trade, commerce or manufacture. Trade implies buying goods or services and selling them to make profit. If such transactions are on large scale, it is called commerce. However, business is not confined merely to purchase or sale of articles. It may even consist of rendering of services to others e.g., communication services such as telephone, fax, e-mail, telegraph or transportation services. Business includes manufactures also. The term manufacture refers to the production of articles for use from raw or prepared materials by giving these materials new forms, qualities, properties or combinations, whether by hand labor or machinery (Read, BB Lal, Income Tax Law and Practice, 3rd ed, 1981, p. 279-285).

Coming to Ethiopia, the word business or trade is not defined under the Commercial Code of Ethiopia. However, the Commercial Code, in Art. 5, has enumerated what trade activities are. Since the list is too long, we do not enumerate here. However, it is advisable to students to read Art. 5. In addition to this, it is important to read Arts. 6, 7, 8 and 9 of the same code because these articles have contained activities which cannot be considered as trade or business activities. Accordingly, agricultural or forestry activities fisherman ship, breeding fish, shell-fish or shells and hand craftsman are not considered business activities. As such, these supplies cannot be taken as taxable supplies under the VAT proclamation if we stick to the argument that “taxable activities” according to the Amharic version of Art. 6 of the VAT proclamation pertain to business activities.

Issues for Discussions

1. The Ethiopian Orthodox Church has many buildings in Addis Ababa surrounding the churches. The church has leased these buildings and has been generating considerable amount of money from the lessees. Yet, the church has not been registered for VAT and is not collecting VAT from the lessees to date (September 2010). However, the Ethiopian Revenues and Customs Authority (ERCA) is now urging the church that it should be registered for VAT and collect VAT. The church officials, on the other hand, believe that the supply made by the church is not a taxable activity within the meaning of the Ethiopian VAT. Whose position is correct in the light of the Ethiopian VAT? In other words, would it be lawful to compel the church to be registered for VAT and collect VAT from the lessees?
2. Ato Assamen Bekalu is a brilliant farmer in the lowlands of Delanta Woreda, South Wello, Amhara Regional State. Because he was committed to make poverty history (tale), he has engaged in breeding fish by constructing an artificial pond. In fact, his economic activity has become successful and he has been reputed to have sold a lot of fish. His annual turnover has become more than 800,000.00 Birr. Because of this, the tax officials of the Woreda have required him to register for VAT.
Should he be required to be registered for the collection of VAT as per the Ethiopian VAT laws?
3. Banks in Ethiopia do enjoy power of foreclosure by virtue of Proclamation 97/1997 and 98/1998 (as amended). As such, they sell pledged and mortgaged properties with the bank where the debtors failed to repay their loan as agreed. In this situation, the ERCA believes

that the banks should be registered for VAT and collect VAT from those persons who/which purchase the pledges and mortgages. However, Ethiopian banks argue that their supply is not a taxable activity. Whose position is lawful as per the VAT laws of Ethiopia?

4.6. Imposition of VAT and Transactions Exempt From VAT

Under Ethiopian VAT, persons who/which make taxable supplies are duty-bound to collect VAT in accordance with the rates of tax provided. However, those supplies who/which make exempt supplies are prohibited to collect VAT from consumers. Under this section, attempt will be made to discuss rules dealing with imposition of tax and exempt transactions.

4.6.1. Imposition of Tax

When we talk about imposition of tax, one of the most conspicuous points is to understand the rate applicable to a certain transaction since a supplier is required or allowed to collect VAT from consumers with the appropriate rate which is usually determined in advance by the law-maker of a given country. This is so because determining the rate is one manifestation of canon of certainty and hence a manifestation of a good tax system.

Most of the time, it is recommended that VAT should be imposed, as much as possible, with a few level of rates. This is so because it is helpful to avoid administrative complexities that emanate from the need to segregate which supply is imposed at which tax rate. Despite this, however, there are countries which levy VAT using differential rates. This is aimed at mitigating the regressive nature of VAT. The Ethiopian VAT as it seems to have been motivated by administrative ease has adopted only two levels of rates as provided in Art. 7 of the Proclamation. The first one is a flat rate of 15% while the second one is zero-rating. Hence, in Ethiopia, as a matter of rule all taxable supplies, except the zero-rated ones, are taxed at a flat rate of 15%. In other words, it makes no difference whether the supply is a domestic supply of goods or services or whether the supply involves import of goods or services. In whole, the 15% flat /proportional/ rate is the rule and the zero-rate (0%) is an exception to the rule. Look at the following examples:

1. Ato Dejene bought certain goods from Sheraton Addis Hotel which is registered for VAT. The prices of the goods were 200,000.00 Birr. Hence, the VAT to be collected from Ato Dejene by the hotel is $(200,000 \times 15/100 = 30,000.00)$ thirty thousand Birr.
2. ABC is a private limited company which is engaged in rendition of consultancy services to domestic as well as foreign investors who/which want to embark an agricultural investment. “Ediget Le Ethiopia” is determined to produce food grains such as maize, rice, sorghum and the like in Gambella lowlands. Therefore, it has recently obtained a full-fledged consultancy service from ABC. In return to the service, Ediget Le Ethiopia paid 10,000,000.00 Birr. In this case, ABC should add VAT using the 15% rate which gives $(10,000,000 \times 15/100)$ 1,500,000.00 Birr.

How about zero rating? As the name indicates no tax is actually collected since the rate is zero. This means that although those persons supplying zero-rated transactions are within the ambit of VAT, they collect no VAT from consumers. If that is the case, therefore, what is the importance of talking about zero-rated transaction? Why does the law deal with such transactions without imposing any actual tax liability on the consumers? How is a zero-rated transaction different from exempt-transaction?

To the extent that no VAT is collected in relation to zero-rate transactions, zero rated transactions are similar to exempt transactions as both of them generate no VAT revenue to the government. However, zero-rating operates within the VAT system while exempt transactions are out of the reach of the VAT system. Those taxpayers who are engaged in supply of zero-rated transactions are entitled to tax crediting for the VAT they pay while purchasing their inputs. However, persons engaged in supply of exempt transactions are not entitled to tax crediting. Most of the time, supplies are zero-rated to encourage exporters so as to enable them to compete in international trade. But a change of destination of zero-rated goods may result in VAT liability. For example, if goods which were meant to export end up in being sold in local markets, the transaction will be subject to VAT at the normal rate.

The next question that crosses your mind is what transactions are supplied at zero-rate? In order to get a fairly good response to this relevant worry, consulting Art. 7(2) of the proclamation and

Arts. 34-38 of the Regulations is important. Art. 7(2) of the proclamation provides that the following transactions are taxed with a tax rate of zero percent. These are:-

- a) the export of goods or services to the extent provided in the regulations. In this regard, Art. 35, of the Regulation which has six sub-articles, details zero-rated transactions in relation to export of goods or services. (In the interest of time and space, it is not possible to discuss all the details here; hence, students are strongly advised to critically and closely read the provisions of Art. 35 of the Regulations).
- b) The rendering of transportation service, or other services directly connected with international transportation of goods or passengers, as well as the supply of lubricants and other consumable technical supplies taken on board for consumption during international flights. In order to understand this further, look at the following hypothetical example. “Blue Bird Ethiopia” is a share company established to render road transportation services. The company has been established in accordance with the Commercial Code of Ethiopia whose head office is located in Addis Ababa although it has branch offices in Nairobi (Kenya), Arusha/Tanzania), Lilongwe (Malawi) Harare (Zimbabwe), Gaborne (Botswana) and Pretoria /South Africa). Hence, the road transport services are rendered with a view to connecting the above mentioned countries. Assuming that the transportation fare from Addis Ababa to Nairobi is 2000.00 Birr, the passenger is required to pay no VAT since the rate is a zero rate tax. Despite this, the share company is entitled to tax crediting for those VATS it pays for inputs of its transaction. The company may pay VAT when it purchases certain inputs such as paper, lubricants, tires, the vehicles, buildings, intangible assets and the like in connection with its business activities.
- c) The supply of gold to the National Bank of Ethiopia. Here, it is important to note that the supply is a domestic supply since supply of gold to the National Bank of Ethiopia from abroad is an exempt transaction as provided in Art. 8 of the proclamation and (see also Art. 37 of the regulation).
- d) a supply by a registered person to another registered person in a single transaction of substantially all of the assets of a taxable activity or an independent functioning part of a taxable activity as a going concern. In this case, notice should be given to the Tax Authority by the transferor and the transferee within 21 days after the supply takes place. The notice should include the details of the supply.

What do you understand by a going concern? According to Black's Law Dictionary, a going concern is a commercial enterprise actively engaging in business with the expectation of indefinite continuance. (Please read Art. 38 of the Regulation).

Look at the following example to better grasp the foregoing discussions (with respect to transfer of a going concern). Tana Car Renting Enterprise was established to rent various kinds of cars to wedding ceremony, visitors, and other persons. Because the taxable supply of Tana was above the minimum threshold set by the Ethiopian VAT, it was registered for VAT. As such, it was collecting VAT from consumers and remitting same to the Tax Authority.

However, because the share holders of the enterprise decided to change their business, the enterprise was transferred, its functions not being affected, to Genale Transportation Share Company which is also registered for VAT. When Genale took delivery of the Tana Enterprise, it paid 65,000,000.00 Birr. Because the transaction is zero-rated, Genale Enterprise paid no VAT along with the price. Although Tana Enterprise did not collect any VAT from Genale, it is entitled to tax crediting.

4.6.2. Exempt Transactions

Why are certain transactions exempt from VAT? When we say exempt transactions, we mean that the supplier of goods or services is not expected to collect tax from the consumers. This is because persons supplying exempt transactions are totally out of the ambit of the VAT system. As such, the suppliers are not obliged to discharge any obligation in relation to collection of VAT and they are not entitled to any benefit such as input tax crediting. When the transactions are exempt transactions the consumers consume the goods or services without paying VAT beyond and above the price.

Providing exempt transactions is one of the most important components of most VAT laws in the world. The Ethiopian VAT, being influenced by foreign VAT laws, has contained certain exempt transactions from which no VAT is collected. Exempt transactions have been dealt with Art. 8 of the VAT proclamation and Arts. 19-33 of the Regulations. The proclamation has put forward the guiding principles while the provisions of the regulation have regulated exempt transactions in

detail. As per Art. 8(2) of the proclamation, the following types of supply of goods and services are exempted from payment of VAT to the extent provided in the regulations:

The first exempt transaction is the sale or lease of a dwelling house used for a minimum of two years. A dwelling house is the one that is solely used for residential purposes. In other words, a dwelling house is devoted to satisfy one's need of shelter.

- 1) . This exemption is meant to benefit those individuals who want to buy or lease a dwelling house since the problem of dwelling house is an acute social problem in Ethiopian urban centers entailing a number of social and economic consequences. (In this regard, read Art. 2(5) of Proclamation No 609/2009 and Art. 19 of the Regulation).
- 2) As a matter of rule, the rendering of financial services is an exempt transaction. However, there are some exceptional situations where by financial services may be subject to payment of VAT. Therefore, it is not possible to conclude that all financial services are free from VAT. These exceptional situations have been provided in the regulation. In this regard, Art. 20 of the regulation is extremely helpful. For instance, Art. 20(1) of the regulation enumerates the financial services which are exempt from VAT while Art. 20(6) of the Regulation provides financial services that are not exempt from VAT. According to the latter sub-article of Art. 20 of the Regulation, legal, accounting and record package services, actuarial, notary, and tax agency services (including advisory services) when rendered to a supplier of financial service services or to a customer of to that supplier of financial services, safe custody of cash, documents or other items, data processing and payroll services, debt collection or factoring services, management services, and the like are not exempted. Let us elucidate this point by an illustrative example.

Illustration

Tana International Bank grants loan to those investors who want to invest in agriculture with a view to eradicating poverty on the face of Ethiopia. In addition to granting loans, the bank renders legal and accounting services to customers, which is aimed at encouraging investors. However, the bank receives reasonable price for the accounting and legal services it renders to its customers. From this example, we can understand that there are exempt as well as taxable transactions. The granting of loan is exempt by virtue of Art. 8(2) the proclamation while the

rendering of legal and accounting services is a taxable transaction by virtue of Art. 20(6) of the Regulation.

In Ethiopia, financial services are generally exempted because administering VAT in relation to such services is complicated given the realities in Ethiopia.

- 3) The supply or import of national or foreign currency and the supply of securities are also exempt. Currency, according to Art. 21(4) of the regulation, means any bank note or other currency of any country. Transaction relating to import or supply of securities covers transactions relating to issuance, transfer, or receipt of or any dealing with shares, stocks, bonds, treasury bills, or other debt of equity securities other than custody services, transactions relating to financial derivatives, forward contracts, options or similar arrangements, transactions relating to creation, issue, transfer, assignment or receipt of, or dealing with an option or warrant relating to securities. In addition, the underwriting of the issuance of securities is generally exempt although services obtained in connection with an underwriting such as advertising and printing cost, accounting, legal and advisory fees are not exempt transactions. Moreover, the exemption for securities does not include management or administrative services provided to a business whose principal activity is investing funds for share holders, members or other persons.
- 4) The import of gold to be transferred to the National Bank of Ethiopia is an exempt transaction. Such import of gold is exempt from VAT whether it is imported by the National Bank itself or other persons. Such importation is exempt regardless of the level of purity of the gold or the form in which it is imported. Such transaction is exempt from VAT because no purpose would be served by collecting VAT from the National Bank of Ethiopia for that would be taking money from one of our pockets and deposit same in another pocket. In addition, supply of gold to the National Bank of Ethiopia is to be encouraged since the gold to be deposited in the national bank is a useful asset to Ethiopia.
- 5) The rendering by religious organizations of religious or religious related services. What are religious services? As you know, there are many religions in Ethiopia. However, what do you understand by religion? How can we differentiate religious services from non-religious services? Generally speaking, services rendered by religious organizations that are integral to the practice of that religion are exempted. Assume for instance that W/rt Atsede and Ato

Hiskiel determined to conclude marriage in accordance with the dogmas and canons of the Ethiopian Orthodox Church. Accordingly, they went to church and concluded their marriage by taking the Holy Communion. Such service is rendered by the church and the church collects a nominal fee from the couples. In this case, since the service the church rendered to the couples is integral to the Orthodox belief, the service is purely religious not attracting the payment of VAT.

However, the activities of a religious organization that compete with the private sector or that are not integral to the practice of the religion do not come within the exemption. Accordingly, if the value of such supplies meets the minimum threshold of the Ethiopian VAT (Art. 16 of the proclamation), religious organizations must register. For instance, assume that the Ethiopian Islamic Affairs Supreme Council has established an institution whose aims is to render advisory and consultancy services to those laities who want to go to the Arab world for various reasons. Assume again that the Institute receives payment from those who receive the consultancy service. In this case, the consultancy service is not integral to the religious practice. As such, the institution should register for VAT and collect VAT from the service recipients. (To fully understand exempt and taxable transactions made by religious organizations, read Art. 23 of the regulation).

- 6) The import or supply prescription drugs are exempted. Here, we have to bear in mind that it is not all drugs that are exempt from VAT. Rather it is those drugs that are specified in directives issued by the Ministry of Health. In addition, rendering of medical services are also exempt. Generally, medical services are exempt if they are rendered in a qualified medical facility and/or by a qualified medical practitioner. A qualified medical practitioner includes a doctor, healer, dresser, health officer, physical therapist and the like that is required to register and registered with the Ministry of Health.
- 7) The rendering of educational services provided by educational institutions, as well as child care services for children at pre-school institutions are exempt. Exempt transactions are generally provided in detail under the regulation. The regulation has also contained rules dealing with educational services that are taxable transactions. For instance, the exemption for education services does not cover course in sports, games, video recording or photography or other hobbies or recreational pursuits unless they are part of a degree or diploma granting program, course such as picture framing, cooking and personal investment

that are designed to improve knowledge for personal purposes, music lessons that are not part of school curriculum. In addition, transactions involving the rental of facilities by the educational institution to an outside group, the sale of admission to school athletics events open to the general public, commissions and other fees received from the placement of coin-operated machines on the institutions property and the sale of non-course material, such as items containing the school logo.

- 8) The supply of goods or rendering of services in the form of humanitarian aid, as well as import of goods transferred to state agencies of Ethiopia, be it Federal or Regional, and public organizations for the purpose of rehabilitation after natural disasters, industrial accidents, and catastrophes are exempted. Look at the following example in order to understand how such exemption is applicable. Unfortunately, a certain river in Ethiopia went out of its bank because of the heavy rain that rained last Hamle and Nehassie of 2002 E.C in Ethiopia. The river flooded certain villages and the villages were trapped by the water. A successful company called “Ethiopian redeemer” quickly imported about four helicopters and donated them to the Ministry of National Defense so that the latter would save the lives of the villagers from such imminent danger. In this case, “Ethiopian Redeemer” is not expected to pay VAT at the time of importation since such imports are exempt transactions (for further understanding, please read Art. 26 of the Regulation).
- 9) In addition to the above, the following supplies are also exempted:
- the supply of electricity, kerosene, water, goods imported by the government, organizations, institutions or projects exempted from duties and other taxes to the extent provided by law or agreement.
 - Supplies by the post office authorized under the Ethiopian postal service proclamation, other than services rendered for a fee or commission.
 - the provision of transport, permits and licenses fees,
 - The import of goods to the extent provided under schedule 2 of the customs Tariffs Regulations.
 - supply of goods or services by a workshop employing disabled individuals if more than 60 percent of the employees are disabled;
 - The import or supply of books and other printed materials to the extent provided in the regulations.

By way of conclusion, the following points are worthy of notice. The first is that in order to further understand exempt transactions and exceptions of the supplies enumerated under no 9 above, it is mandatory to go very critically through Arts. 27, 29, 30, 31, 32 and 33 of the VAT Regulation. Secondly, the listing of exemptions provided in the proclamation and the regulations is not exhaustive. This is because the Ethiopian Ministry of Finance and Economic Development has been empowered to exempt other goods and services from the payment of VAT. (Read Art. 8(4) of the Proclamation)

4.7. Place, Time and Value of Supplies

Dear student, why does a student of Ethiopian VAT law worry about place, time and value of supplies of goods and services? Do we benefit anything by understanding the place, time and value of supplies? How do we determine the place time and value of supplies? These are the questions that need to be answered in our subsequent discussions.

4.7.1. Place of Supply

Determining the place of supply in VAT administration is crucial because knowledge of place of supply puts us in a position to understand the value of supply and hence, the VAT to be collected. This is because value of supply differs from place to place on account of transportation and other costs. For instance, in Ethiopia the value of a quintal of cement at Mughher Cement Factory is not the same as the value of a quintal of cement in Adigrat or Metemma, or any peripheral area of Ethiopia. Let us say that the value of a quintal of cement is 300.00 Birr at Mughher. Hence, if the supply is made at Mughher, the VAT to be collected from the buyer is $300 \times 15/100 = 45.00$ Birr per quintal. However, if such same quintal of cement is sold at Adigrat; the price may go to 350.00 Birr. This means that the VAT to be collected at Adigrat is $350 \times 15/100 = 52.50$ Birr. Hence, it is possible to note that there is a difference in the amount of VAT to be collected. That is why any VAT legislation gives attention to the place of supply. Accordingly, the Ethiopian VAT Proclamation, in its Arts. 9 and 10, has dealt with place of supply (Read Art. 9 and 10 of the proclamation very closely).

4.7.2. Time of Supply

Time of supply (timing) is also an important point in VAT laws. This is because timing rules are used to identify the tax period in which the taxpayer must report taxable supplies and claims tax credits /deductions/ for taxes paid for input transactions. In other jurisdictions, tax payers must use the accrual method of accounting to report sales (to file tax returns and payment of VAT) and claim input credits under a credit invoice VAT like the Ethiopian Vats. This means that taxpayers are required to report sales when goods are sold or services are rendered and they can claim input credits when the business acquires the goods or services eligible for the input credit. Japan allows businesses to follow their method of accounting used for income tax purposes in accounting for the computation of VAT. As we discussed under chapter three of this course, we have seen that the Ethiopian Income Tax accounting principles are the cash method accounting and the accrual method accounting. Do these methods of accounting also apply to accounting VAT liability and demanding tax credit?

The Ethiopian VAT law is not explicit in this regard. However, when we closely examine time of supply of goods and services as provided in the VAT proclamation and regulation, it seems that the Ethiopian VAT is not different from the European VAT accounting method. In other words, it seems to have advocated the accrual method of accounting. Having made these general introductory remarks, let us go to the specific provisions of the Ethiopian VAT dealing with time of supply. Time of supply is governed by Art. 11 of the Proclamation and Art 6 of the Regulations. According to Art. 11(1) of the proclamation supply occurs when VAT invoice is issued for that transaction. However, when VAT invoice is not issued within five days after the occurrence of supply, the supply is considered as having taken place at the time the goods are made available to the recipient, sold or transferred or the services are rendered; or in the case of delivery of goods that involves shipment of the goods, when the shipment starts. Let us support these discussions by the following illustrative examples:

Example 1

Ato Dechasa went to Berhanna Selam Printing press on the 7th of Meskerem 2003 E.C to buy the VAT Proclamation. Then, the supplier delivered the proclamation to Ato Dechasa; Ato Dechasa also paid the price of the proclamation. The supplier also issued a VAT invoice bearing the

above mentioned date. In this case, we can say that the supply occurred on the 7th of Meskerem 2003 E.C.

Example 2

Focus Ethiopia is a share company established by far-sighted Ethiopians to engage in development of real estate. It has been constructing many residential houses and transferring them to those who can afford. On the 6th of Hamle 2002 E.C, the general manager of the share company concluded a contract of purchase of cement with Mugher Cement Factory. The Cement Factory received the whole price of 5000 quintals of cement on the same date. However, the company issued the VAT invoice on the 9th of Hamle 2002 E.C. In this case, the time of supply is taken to be Hamle 9, 2002 E.C since the invoice was issued within five days after the delivery of the cement and payment of the price.

Example 3

Look at again the case provided in example 2 above and assume that the Cement Factory issued the VAT invoice to the purchaser share company on the 13th of Hamle 2002 E.C. In this situation, the time of supply is taken to Hamle 6 because the VAT invoice was not issued within five days after the occurrence of the supply.

From the foregoing discussions and illustrations, it is not difficult to understand that Art. 11(1) of the proclamation is the rule while Art. 11(2) of the same proclamation provides an exception. Further exceptions have also been provided in the remaining sub-articles of this article. As per Art. 11(3), if payment is made in advance (before the supply of goods or services) and if a VAT invoice is not issued within five days after the date of the payment, the supply is considered as having taken place at the time when the payment is made. For instance, if one pays the price on the 7th of Meskerem 2003, for goods to be delivered to him after three months, time of supply is not the time exactly when the goods are supplied but the time of supply is the time when the payment is made. This means that the time of supply is Meskerem 7, 2003 E.C. According to Art. 11(4) of the VAT Proclamation, if two or more payments are made to a supply, each payment is treated as made for a separate supply to the extent of the payment. Let us illustrate this by an example. “Lucy Photo” is a PLC which renders photography and video services. Ato

Kelemu concluded a contract with the PLC so that the PLC would video (record) the events of the marriage ceremony of his (Kelemu's) daughter. The total sum agreed for the service was 10,000.00 Birr. Out of this, Ato Kelemu paid 4000, 00 Birr on the 6th Tir 2002 E.C. The remaining 6000.00 Birr was paid on the 8th of Megabit 2002 E.C when Ato Kelemu received the final version of the video cassette. In this transaction, Lucy PLC is expected to issue two invoices since there are two times of supply (Tir 6 and Megabit 8) although the transaction is one transaction.

When we observe the practice in the light of Art.11(4) of the proclamation we can easily understand that it has deviated from the law. This is because suppliers who/which receive payments on installments tend to issue VAT invoice when the final installment is paid.

Pursuant to Art. 11(5) of the proclamation, if services are rendered on a regular or continuing basis, a rendering of service is treated as having taken place on each occasion when a VAT invoice is issued in connection with such services, or if payment is made earlier, at the time when payment is made for any part of such services. (In addition, so as to have full understanding about time of supply it is imperative to read closely sub-articles 6,7, 8,9 and 10. In fact sub articles 6,7 and 8 have been amended by Art. 2 (6,7 and 8) of proclamation No. 609/2008 which has amended proclamation No. 285/2002. Having a look at Art. 6 of the regulation is also advisable).

4.7.3. Value of Supply

Knowledge of value of supply is a pre-condition to determine the amount of VAT collected. In other words, we cannot determine the exact amount of VAT due to the Government without the knowledge of the value of supply. This is why the law-maker generally in the world and particularly in Ethiopia stipulates guiding principles dealing with value of supplies of goods or services.

The value of taxable supply generally is the amount of money and the fair market value of the consideration received. The European Union Sixth VAT directives defines taxable amount or value of a supply as “everything which constitutes the consideration that has been or is to be obtained by the supplier from the purchaser, the customer or a third party for such supplies

including subsidies directly linked to the price of such supplies. For goods, this amount generally is the purchase price or cost; for services, the full cost of providing the services. Taxable amount includes taxes, duties, levies and charges excluding the VAT itself, incidental expenses such as commission, packing, transport and insurance costs charged by the supplier to the purchaser. How about valuation under the Ethiopian VAT?

Under the Ethiopian VAT, value of supply is dealt with by Art. 12 of the proclamation and Art. 7 of the regulation. Value of imports is dealt with by Art. 15 of the Proclamation. According to Art. 12(1) of the proclamation, the value of a supply is determined according to the amount a person receives or is entitled to receive in return for the supply of goods or rendering of services. In this regard, it makes no difference whether the payment is made by the customer or any other third party. The amount of the supply includes any duty, taxes or other fees payable without including VAT. Here, it must be clear that the value of supply under the Ethiopian VAT is similar to the value of supplies in Ethiopian VAT with a view to elucidating the above discussion, let us give attention to the following example.

Gafat PLC is an outstanding importer of goods from foreign markets to Ethiopia. In the previous Nehassie 2002 E.C, the PLC imported 6 vehicles. The purchase price of each vehicle in Dubai was 60,000.00 Birr. However, the PLC paid 1000.00 Birr to brokerage, 2000.00 Birr for loading, and 30,000.00 Birr for transportation of the vehicles from Dubai to Ethiopia. Moreover, the PLC paid insurance premiums about 60,000.00 Birr. Furthermore, the PLC paid 100,000 Birr by way of sur tax, 80,000.00 Birr excise duty and 360,000.00 Birr customs duties. Beyond and above the afore-mentioned payments, the PLC effected 10,800.00 in the form of withholding tax as provided under Art. 52 of the Income Tax Proclamation. In this situation, in order to calculate the value of supply and charge VAT, all the above money incurred by the PLC should be added up. By doing so, we get 9,930,000.00 Birr. Therefore, the value of the supplies is 9,930,000.00 Birr. Hence, the amount of VAT to be collected from the PLC is $9,930,000 \times 15/100 = 1,489,500.00$ Birr (One million four hundred eight nine thousand and five hundred).

As per Art. 12 (2) of the Proclamation, if the person receives or is entitled to receive goods or services in exchange for a supply of goods or services the value of the supply includes the market price of these goods or services including any duty, taxes or other fees payable without

including VAT. In case where the person receives or is entitled to receive nothing of value in exchange for goods or services, the value of the supply is the market price including any duty, taxes, or other fee payable without including the VAT, (see Art. 12(3) of the Proclamation, (You are also urged to read Art. 12(4) and 12(5) of the Proclamation).

Although value of supply is determined in accordance with the above-discussed rules, sometimes the supplier may resort to adjustment of value of taxable transactions after the supply has already been made. This may even happen after the supplier has paid the VAT he/she/it has collected to the Tax Authority. When does adjustment of value of supply come into the picture? Adjustment of value of supplies has been regulated by the provisions of Art. 13 of the proclamation. According to Art. 13(1) of the proclamation, adjustment of value of supply comes into the picture where:

- the transaction is cancelled;
 - the nature of the transaction is changed;
 - the previously agreed consideration for the transaction is altered; i.e. when it is increased or decreased.
- the goods or services are returned in full or in part to the registered person.

Here, two questions are in order. The first one is: How can be services which have already been rendered to the consumer returned to the supplier? The second one is: can't invalidation of the transaction bring about adjustment of value of supply? Now let us discuss the grounds which lead to adjustment of value of supply. The first one is cancellation. By cancellation, it means that the contractual relationship between the supplier and the purchaser is done away with because of non-performance of the contractual obligation by either of the contracting parties. When the transaction is cancelled, the value of the good or service may be returned to the purchaser. Hence, the VAT to be paid by the purchaser becomes zero; hence, the need for adjustment of price. Assume that Ato A is a car dealer in Addis Ababa. He agreed to supply a car to Ato B for 800,000.00 Birr. The contract of sale of such vehicle was concluded on the 6th of Nehassie 2002 E.C. In the contract, it was agreed that the buyer would take delivery of the car on the 9th of Nehassie 2002 although Ato A took the whole payment as the time of the conclusion of the contract. However, when the obligation of supplier was due, he failed to make delivery of the

car. Because of this, Ato B cancelled the contract of sale of the car unilaterally since such right was stipulated in the contract. In this case, adjustment of value of supply is a must as Ato A issued a VAT invoice to Ato B when he (A) received the 800,000 Birr which resulted in $(800,000 \times 15/100) = 120,000.00$ VAT. To sum up, if Ato A remitted the 120,000.00 Birr to the Tax Authority, the latter should return this sum to Ato A so that Ato would return it to the buyer, Ato B.

Secondly, adjustment of value of supply is a must when the nature of the transaction is changed resulting in increment or reduction of price or switching the supply from taxable supply to an exempt supply so on and so forth. Assume that Ato Walelign agreed to supply to Womezeker National Library to supply 2000 normal books each worth 200.00 Birr. Ato Walelign issued a VAT invoice to the Library at the time of payment although the books were to be supplied three months after the conclusion of the contract. In the mean time, however, Ato Walelign and the library novated (changed) their contract of supply of normal books in to supply of talking books. It was agreed that Ato Walelign would supply the same number of talking books. But the price of each book was increased from 200.00 Birr to 300.00 Birr. From this hypothetical example, we can realize the because of novation of the contract, the transaction has changed from exempt supply to taxable supply. This is because the supply of normal books is exempt while the supply of talking books is a taxable supply. Hence, now the need to make adjustment is apparently clear. In other words, under the latter supply the value of taxable supply becomes $(2000 \times 300) = 600,000.00$ (six Birr which gives $(600,000 \times 15/100) = 90,000.00$ Birr VAT payment. The same becomes true if the value of the transaction is altered. If the price C the consideration) increases, the amount of VAT to be paid increases as they are directly proportional. On the other hand, if the consideration of the supply decreases, the amount of VAT decreases. In addition, invalidation of the transactions also results in adjustment of value of supply.

N.B. The discussions made with respect to adjustment become complete when students read Art. 13(2-10) of the Proclamation, as it is not possible to discuss here all of them because of scarcity of space.

4.8. Registration for VAT

Many VAT systems in the world define a taxable person who is registered (a registrant) or is required to register. The registration requirement is generally imposed on a person or a firm that

makes at least a threshold amount of taxable supplies. The requirement to file returns then is imposed only on those who must register. This is almost universally true in countries where VAT has been adopted. In Ethiopian legal system (VAT regime) registration of taxpayers (as used in the VAT law) does have a conspicuous place under the law. However, we must bear in mind that registered persons are not the only persons who/which collect VAT from consumers and account same to the Government. This is because persons who import goods or services are taxpayer as provided in Art. 3(2,3) and Art. 23 of the VAT proclamation even if they are not registered for VAT. Therefore, the question worth asking at this juncture is as to who /which entities/ are required to register for VAT. In order for a person to be registered for VAT two things should be cumulatively satisfied. These are, first the person must be one who/which supplies taxable transactions by engaging in taxable activities; second, the annual turnover of the supplier should meet the threshold provided in the law. These two requirements are, in fact, applicable to compulsory registration. In the case voluntary registration, the first element should be satisfied as second is not required to be met.

In Ethiopia, registration is regulated by Art. 3, Art. 16, Art. 17 and Art. 18 of the Proclamation and Arts. 8 and 9 of the Regulations. The Proclamation, as usual, has contained general provisions and the regulation has provided some detail provisions which are instrumental for proper implementation of the Proclamation. Now, let us analyze the provisions of the law as follows. To begin with, Art. 16(1) of the proclamation stipulates that a person who [which] carries on taxable activity and is not registered is required to apply for registration for VAT with the Ethiopian Revenues and Customs Authority when in any period of calendar 12 months the person made, during that period, taxable transactions the total value of which exceeded 500,000.00 Birr. In this case, the value of the person's taxable transaction is determined as per Art. 12 of the Proclamation that we have discussed previously. Alternatively, a person is required to register for VAT if at the beginning of any period of 12 calendar months; there are reasonable grounds to expect that the total value of the taxable transactions to be made by the person during that period will exceed 500,000.00 Birr. The tests provided in Art. 16(1(a and b) are applicable to compulsory registration.

However, under the Ethiopian VAT there is also a possibility whereby a person supplying taxable transactions but who/which does not satisfy the threshold may apply for voluntary registration as provided in Art. 17 of the Proclamation. As per this article, such person is allowed for registration, where such person he is regularly supplying at least 75% of his goods or services to registered persons. However, the Authority may deny the application for registration if the person has no fixed place of abode or business or the Authority has reasonable grounds to believe the person will not keep proper records or will not submit regular and reliable tax returns as required under the VAT proclamation.

Why do persons aspire for voluntary registration? Would there be any benefit that may accrue to them as a result of registration? The Ethiopian VAT does not tell use the reason as to why persons apply for voluntary registration. However, from the overall reading of the Proclamation, we can understand that persons aspire for voluntary registration to get tax crediting for them and to enable the ones who purchase goods or services from them (the former) to get input tax crediting.

Another point worth noting in relation to registration is deregistration (cancellation of registration). For a number of reasons, a person may not remain registered perpetually. This means that there are circumstances whereby a registered person may be non-registered. This reality has been governed by Art. 19 of the proclamation and Art. 10 of the VAT regulation. According to Art. 19(1) of the proclamation, a registered person is allowed to apply to have his/her/its registration for VAT cancelled. First, such person can apply for cancellation where he/she/ it has already ceased to make taxable transactions. Secondly, such person can apply for deregistration at any time after a period of three years of date of his/her/ its most recent registration for VAT if the registered person's total taxable transaction /annual turnover/ in the period of 12 calendar months are expected to be not more than 500,000.00 Birr. If any one of the above grounds surfaces out, deregistration may take place.

4.9. Calculation of VAT Payable and Tax Crediting under the Ethiopian VAT

Just like the European VAT, the Ethiopian VAT has followed the crediting system as we discussed it previously. As such, the calculation of the VAT payable to the Government by the

taxpayer is wholly intertwined with the understanding of output taxes, input taxes and tax crediting (the rebating system).

What do you understand by output tax, input tax and tax crediting?

According to Alan Shenk and Oliver Oldman, an output tax is the amount collected by the supplier from the buyers which constitutes the first step in computing the amount to be remitted (paid to the government). This is the amount to be obtained by calculating the value of supply by the applicable tax rate. For instance, if the value of supply of a transaction is “a” then, the output tax (OPT) is obtained by multiplying by the tax rate. In the Ethiopian context, the output tax is, therefore, calculated as $a \times 15/100$, i.e., $\text{out put tax} = 15a/100$. This is always true unless the tax rate is changed.

How about input tax? Input tax is a VAT paid by a supplier to another VAT registered supplier in when it (the former) buys goods or services that are inputs to the transactions which will fetch the output tax when they are sold. In order to have a clear picture about the explanations with regard to output tax and input tax, have a look at the following illustrative example.

“Dejen Ethiopia” is a private limited company established to purify honey harvested by Ethiopian farmers. The PLC supplies the purified honey to domestic consumers. Because the annual turnover of the PLC was found to be above the VAT threshold, the PLC has been registered for VAT as of the beginning of Sene 2002 E.C. In the accounting period of Sene, the company paid VAT for telephone services, consultancy services, vehicles, for containers of the honey, materials used for packing, and for other goods and services directly used for the taxable activity. The PLC paid a total sum of 300,000.00 Birr in the form of VAT for its (the PLC’s) suppliers since all the suppliers were registered persons. On the other hand, the PLC collected a total sum of 500,000.00 Birr from consumers by supplying honey and wax to consumers (purchasers). In this hypothetical case, the VAT paid by the PLC to buy its inputs is called an input tax, the VAT collected by the PLC (the 500,000.00 Birr) is an output tax.

Therefore, the VAT to be paid to the Tax authority by the PLC is obtained by deducting the input tax from the output tax. In other words, VAT payable is equal to (=) Output tax – Input tax. In our example, the VAT payable by the PLC is $(500,000.00 \text{ Birr (output tax)} - 300,000.00 \text{ (input tax)}) = 200,000.00 \text{ Birr}$. This is reaffirmed by Art. 20(1) of the proclamation when it says” the

amount of tax payable for any accounting period by a person who is registered for VAT or is required to register is the difference between the amount of tax charged (out put tax) on taxable transactions and the amount of tax creditable (input tax) under Art. 21 of the Proclamation.

The other concept highly related with calculation of VAT payable is tax crediting in countries where tax liability is calculated by the crediting or (the invoice) method. This is common in European VATS and the Ethiopian VAT regime. Tax crediting means refunding tax paid by the one who/which pays his/her/its out put tax. In our previous hypothetical example, the deducting of the 300,000.00 Birr from the 500,000.00 Birr is tax crediting or otherwise called input tax crediting. Input tax crediting is regulated by Art. 21 of the VAT proclamation and Art. 11 of the Regulation. Art. 4 of the Proclamation is also relevance to shed light on the discussion under consideration.

Art. 21(1) of the Proclamation states that the amount of VAT that is creditable is the amount of VAT payable (paid) by a registered person in respect of tax invoices or customs declarations issued to the person for imports of goods that take place during the current accounting period under Art. 14 of the proclamation and taxable transactions involving the supply of goods or rendering of services that are considered to take place during the current or preceding accounting period, where the goods or services are used to or to be used for the purpose of the registered person's taxable transactions. Pursuant to Art. 21(2) of the proclamation, where only part of the supplies made by a registered person during a tax period are taxable transactions, the amount of tax creditable under sub. Article 1 of the same article for that period is determined as follows:

- In respect of supply or import received which is directly allocable to the making of taxable supplies, the full amount of tax payable in respect of the supply or import is allowed as a credit.
- In respect of supply or import which is directly allocable to the making of exempt transactions, no amount of tax payable in respect of supply or import shall be allowed as credit.
- in respect of a supply or import received which is used both for the making of taxable supply and exempt transactions, the rule of apportionment of the credit shall be applied.

Although tax crediting is allowed for input taxes paid by the registered person, there are situations whereby tax credit is not allowed. These exceptional circumstances are provided in Art. 21(3), Art. 21 (7) of the Proclamation and Art. 11 of the Regulation. As per Art. 21(3) of the Proclamation, no tax credit is allowed on a taxable transaction to, or import by a person of a passenger vehicle, a road vehicle designed or adapted for a transport of eight or fewer seated persons including as double cab vehicle. However, there is tax credit if the person who bought such vehicle is in the business of dealing in or hiring of such vehicles and the vehicle was acquired for the purpose of such business. Besides, tax credit is allowed if the person who/ which bought such vehicle is engaged in the business of transporting passengers, for hire and the vehicle was acquired and is licensed for that purpose.

According to Art. 21(3(b) of the Proclamation, no tax credit is allowed for VAT on a taxable transaction to, or import by a person of goods or services acquired for the purposes of entertainment or providing entertainment unless the person is in the business of providing entertainment and the supply or import relates to the provision of taxable transaction in the ordinary course of that business or unless the person is in the business of providing taxable transactions involving transportation services and the entertainment is provided to passengers as part of the transportation services.

The other situation where tax credit is not allowed is what is provided in Art. 21(7) of the proclamation. Pursuant to this sub-article, the beneficiary of the duty-draw back scheme under proclamation No 249/2001 is not entitled to refund of VAT paid on imports under the scheme to the extent that the beneficiary claims credit under this article for tax on imports.

What is a duty draw-back scheme?

Duty-draw-back scheme is a scheme by which duty paid on raw materials used in the production of commodities is refunded upon exportation of the commodity processed and shall include refund of duties paid on goods re-exported in the same condition for being not in conformity with purchase order specifications, damaged, short delivery or not in market demand. (Read the Revised export Trade duty incentive scheme Establishing proclamation, Proc. No 543/2007.

4.10. Reverse Taxation

What is reverse taxation? What kinds of supplies are dealt with reverse taxation? Why reverse? What is reversed? These are the points that need to be analyzed under this heading. Reverse taxation (of VAT) has been hinted at Art. 3(1(c) and Art. 7(1(c) of the Proclamation. However, reverse taxation is fully dealt with by Art. 23 of the VAT Proclamation and Art. 12 of the Regulations. Reverse taxation comes into the picture where a non-resident person who/which is not registered for VAT in Ethiopia renders services in Ethiopia for a customer. The customer who/which receives the service is any person registered in Ethiopia or any resident legal person. When this happens, the customer (the consumer in effect) shall withhold from the amount payable to the non-resident person which amount is determined by the method of calculation determined by the Regulation. At this juncture, it must be clear that the supply is importation of service from abroad by a non-resident person and the consumers who/which are required to pay VAT are only registered physical persons and resident legal persons which are not registered for VAT. Therefore, it is possible to conclude that not every consumer of service is required to pay VAT. In other words, physical persons who are not registered for VAT are not required to pay VAT for the services that they have received from a non-resident person who/which supplies the service. To make the discussions easily understandable, look at the following examples:

Example 1

Ato Alemu is an Ethiopian resident who has engaged in the business of computer maintenance. In order to upgrade his skill, he was trained by a Chinese computer Engineering Business Company, which is not a resident of Ethiopia and not registered for VAT. Ato Alemu has also not been registered for VAT for his annual turnover does not meet the threshold of the VAT Proclamation. Ato Alemu received the training on line for which he has paid 100,000.00 Birr. In this case, the supplier is the Chinese company while the purchaser is Ato Alemu. However, Ato Alemu is not required to withhold VAT in relation to the payment to the Chinese company as physical persons who are not registered for VAT are not included under Art. 23 of the Proclamation.

Example 2

By concentrating on the case provided in example 1 above, assume that Ato Alemu is a VAT registered person. In this case, Ato Alemu is required to pay VAT. The amount of VAT is calculated as follows: $100,000 \times 15/100 = 15,000.00$ Birr. In the normal course of collecting VAT, this 15,000.00 Birr should have been collected by the Chinese company (the supplier of the services) and remitted to the Ethiopian government. However, because the Chinese company is a non-resident person which is not registered for VAT, tax administration would be difficult, i.e., if the above sum were collected by the supplier (in china) and again remitted to the Ethiopian Tax authority, that would involve serious inconvenience for the proper administration of such tax. Therefore, to curtail these ups and downs, the law requires that such tax be paid directly by the service recipient (the consumer). That is why such kind of collecting VAT is called reverse taxation.

Example 3

Ambassel Share Company is established with a business purpose of importation and supply of books to Ethiopian universities with reduced price. The share company wanted to improve its management system and entered into a contract with an Italian share company which gives important trainings for effective management of business organizations. The Italian company is not an Ethiopian resident. Nor is it registered for VAT in Ethiopia. As per the above contractual agreement, the Italian share company sent three competent trainers and the trainers trained the managerial staff of Ambassel Share Company for three weeks. In return to the service the Ethiopian company received from the Italian company, the former paid 600,000.00 Birr to the latter. In this case, Ambassel Share Company should pay VAT to the Ethiopian Government since it has consumed service supplied to it by a non-resident person which is not registered for VAT. In which case Ambassel should directly pay $(600,000 \times 15/100) = 90,000.00$ Birr to the Tax Authority. Hence, again you can realize that the payment is a reversed one as VAT is directly paid by the service recipient. If the Italian company were registered for VAT in Ethiopia, the 90,000.00 VAT would be collected and remitted to the Government by the Italian company. Dear students, how can the Ethiopian Tax Authority ascertain that service has been rendered by non-resident persons to Ethiopian residents? How can tax compliance be achieved?

The Tax Authority should put in place the appropriate controlling mechanisms in order to achieve tax compliance. In addition, the Tax Authority should inculcate in the taxpayers that payment of tax is one of the most important civic duties of Ethiopian citizens.

4.11. VAT Invoices

In our previous discussions, we said that the Ethiopian VAT is characterized, among other things, by the crediting mechanisms. This method of calculating VAT liability is called the credit or the invoice method. Hence, it is imperative to say few words in relation to VAT invoices. In addition, VAT invoices are so crucial to determine the amount of VAT to be collected, the amount of creditable VAT and adjustment of value of supply. VAT invoices have been dealt with by Art. 22 of the Proclamation. In fact, sub-article 1 of this article is repealed by Art. 2(10) of proc. No 609/2008 and a new sub article has been provided while sub-article 3 has been repealed without any replacement. As per the new article, a person registered for VAT and carries out taxable transaction is duty-bound to simultaneously issue a VAT invoice to a person who/which receives the goods or services. However, a person who [which] is not registered for VAT is not allowed to issue a VAT invoice.

According to Art. 22(3) of the Proclamation (as amended), a registered recipient who/which has not received a tax invoice may request the supplier in writing within 60 (sixty) days after the date of the supply to provide a tax invoice in respect of the taxable transaction. In this case, the supplier is obliged to comply with the request within 14 days after receiving the request. Where the registered recipient claims to have lost the original tax invoice for a taxable transaction, the registered supplier may provide a copy clearly marked “copy”.

4.12. Collection Enforcement, Administrative Penalties, Tax Offences and Appeal Procedures

4.12.1. Collection Enforcement

In order to give meaning to the provisions of the VAT Proclamation which have been introduced to generate revenues, the VAT law has incorporated some key provisions which deal with collection enforcement of VAT. These collection enforcement provisions are to be applied by the Tax Authority. To this end, the Tax Authority has been entrusted with the duty of the implementation

of this proclamation and the regulation issued to supplement this proclamation. Therefore, the Authority has been, in black and white, authorized to investigate any statements, records and books of account submitted by any person at any time. The Authority can do this by sending duly accredited inspectors to check the statements, records, and books of account, or any vouchers, stocks or other material items at the person's place of business or practice, requiring the person or any employee who has access to produce the same and to attend (during normal office hours at any reasonable convenient tax office and answer any questions relating thereto. The Authority is also empowered to require any person including a municipality, body, financial institution, department or agency of Federal or Regional Governments to disclose particulars of any information or transaction.

In addition to the above enforcement mechanisms, the law has empowered the Authority to seize property of a default taxpayer as the case may be to enforce collection of VAT. If any person liable to pay tax imposed by the VAT Proclamation is in default, the Authority can collect tax by seizing the property which belongs to such person. For the purpose of implementing the VAT law, the term "seizure" includes seizure by any means, as well as collection from a person who owes money or property to the person liable for VAT. The purpose of such seizure is to enable the authority to sell the property seized through public auction or in any other manner approved by the Authority and collect the proceeds of the sale. The other relevant enforcement mechanism incorporated under the law of VAT is the fact that the Authority has a preferential claim upon the assets of the person who is liable to pay the tax until the tax is paid. But the right to preferential claim does not affect the priority right of secured creditors of the person liable to the Authority. In other words, the preferential right of the authority is applicable as against rank and file (ordinary) creditors:

Furthermore, the Authority is also empowered to collect the tax due to it even from recipients of the supply of goods and services. This is possible where, in consequence of fraudulent action or misrepresentation by the recipient of taxable transaction from registered person, the registered person incorrectly treated the transaction as an exempt or zero-rated transaction. In this case, the authority may raise an assessment upon the recipient for the amount of unpaid tax in respect of the transaction, together with any interest or penalty that has become payable. Is there any period of limitation to this?

The VAT Proclamation does not talk about period of limitation. However, there must be period of limitation to it as the Authority cannot enjoy this right everlastingly.

4.12.2. Administrative Penalties

These are penalties imposed by the Authority when a taxpayer fails to discharge his obligations in accordance with the law. The law, for instance, requires those persons who are identified to be value-added taxpayers to be registered, to file their tax returns within the time stipulated by law. Failure to meet requirements of the use of sales register machine, and to pay the tax within the time required by law. Failure to meet those obligations obviously entails administrative penalties. (Read Arts. 45-47 of Proc. No 285/2002 as amended by proc. No 609(2008))

4.12.3. Tax Offences

One of the distinctive features of the recent Ethiopian tax laws is the fact that virtually all of them have included provisions dealing with tax offences. These tax offences are basically tax evasion, making false or misleading statements, obstruction of tax administration, failure to notify, and other tax offences. As to the procedure regarding tax offences, Art. 48 of the proclamation provides that a tax offence is a violation of the criminal law of Ethiopia and such offences are charged, prosecuted and appealed in accordance with the Ethiopian Criminal Procedure Code. Coming to the offences, tax evasion is one of such offences. A person who evades the declaration or payment of tax, or a person who with the intention to defraud the government applies for a refund he is not entitled to, may be prosecuted and be subject to a term of imprisonment of not less than five years if he is convicted by a court of law. The above penalty is imposed on tax evaders because tax evasion is the most common problem of almost all governments. Taxes by their nature are involuntary contributions of taxpayers to the basket of government. Because of this, taxpayers are always reluctant to pay their taxes- they always aspire to escape their tax burdens. This may be further enhanced by levying a tax which does not fit with the social, economic and cultural set up of the community. Under such circumstances, it is not uncommon to see people resorting to evasion and avoidance of taxes.

It spite of the fact that tax evasion is an arduous problem in tax administration, many tax laws are silent as to the definition of such a concept. The Ethiopian tax laws do not also define as to what is meant by tax evasion. They simply stimulate that tax evasion is a criminal offence. So, coming

up with a precise definition and showing elements that constitute tax evasion is an indispensable task. However, for the purpose of making the discussion easier, let us take the following definition given by Black's Law Dictionary as a working definition. This dictionary tries to define the term as illegally paying fewer taxes than the law permits; committing fraud in filing or paying taxes; and the dictionary further provides that intentional reporting of less income than actually received or deducting fictitious expenses.

From the wording of the dictionary, it is possible to identify two elements. First, the taxpayer has a malafide (bad faith) intention and second, he does a certain undesirable action or he deliberately fails to act to bring that undesirable effect. An individual who engages in a certain transaction, which under the law is taxable, in carrying out the transaction, he may endeavor to cover up its real purposes by deceptive language in contemporaneous documents, or he complicates his affairs by any available means so as to hide the real character of the transaction. He does all these to withhold the material facts and thus to evade the payment of tax. Here the existence of intent is a material fact for the individual's conviction. Such action constitutes fraud or evasion, since there is an intention to mislead, and accordingly an intention to escape a burden. In relation to the second element, the individual does some positive unlawful actions to mislead tax authorities in assessing his tax burden. But, it should be noted tax evasion can be accomplished without doing any positive act i.e. by omission.

To sum up, tax evasion can be summarized in the following words. Evasion is either an understatement by the taxpayer or his agent of the tax due or simply of the quantity or value of the taxable objects or failure to pay a tax on time, unless these actions or failures result from ignorance. Accordingly, tax evasion is an intentional failure or escaping of payment of tax burden through the instrumentality of certain unlawful devices. In view of the explanation regarding tax evasion, we can understand that most of the offences included under the Proclamation (particularly from Art. 49-50) can safely be considered as tax evasion. The punishments provided under these articles are a combination of fine and imprisonment. The gravity of the punishment varies depending on whether the offences are committed intentionally or negligently. Obviously, offences committed intentionally entail severer

punishment than those offences committed negligently (recklessly).(See also the amendments made to Art. 50 of the Proclamation by Proc. No 609/2008)

The law also has made obstruction of the tax administration a criminal offence. The Proclamation under Art.51 (2), tries to enumerate acts that constitute act of obstruction. These actions are: refusal to satisfy a request of the authority for inspection of documents, reports, or other information related to a taxpayer's income-producing activities, non-compliance with the Authority's request to report for an interview and interference with a tax officer's right to enter the taxpayer's business premises. A taxpayer is also held criminally liable where he fails to notify the Authority of a change of the name, address, the place of business, constitution, or nature of the principal taxable activity or activities of the person and any change of address from which, or name in which a taxable activity is carried on by the registered person. The penalty attached to this tax offence is both fine and imprisonment. In addition, unauthorized tax collection, aiding and abetting and offences committed by entities also entail various criminal penalties. Although the offences are committed by entities, when you have a look at Art. 56 of the proclamation, you can understand that managers of such entities are jointly and severally liable with that entity and that other person to the authority for the amount.

4.12.4. Appeal Procedures

The law on value-added tax has also incorporated some provisions which are instrumental for the taxpayer to air his voice when he feels that his interest has been jeopardized by the Tax Authority. This means that the taxpayer who is aggrieved by the acts of the Tax Authority may lodge his complaints to a body established to hear and decide such complaints. Such remedy can be sought, according to the proclamation, from a committee established by the Ethiopian Revenues and Customs Authority and the Regional Bodies Concerned, Tax Appeal Commission (a sort of quasi-judicial body) and a court of law which is competent to hear and decide such disputes.

By virtue of the cross-reference made under Art. 43(4) the Value-Added Proclamation (Proclamation No. 285/2002), the provisions of the Income Tax Proclamation, concerning appeals shall, *mutatis Mutandis* (the necessary changes having been made) be applicable to appeals regarding taxes imposed by the Value-Added Tax Proclamation. Hence, we are

authorized to use those provisions of the Income Tax Law when we entertain cases of value-added tax concerning appeal.

4.13. Turnover Tax (TOT)

4.13.1 General Remarks

Dear students, what do you understand by turnover tax?

Important legal terms may be defined either under the statute in which they are enshrined or in a legal literature which is devoted to propound legal concepts and legal theories. But this does not mean that it is always possible to define legal terminologies under all circumstances. Some legal concepts, although they are generally understood, are difficult to be defined. Even if it may be possible to define, it is hard to come up with universally accepted definitions. When we come to the issue at hand, the term “turnover tax” is defined nowhere under proclamation No. 308/2002. In spite of the above difficulty, we can understand what turnover tax is all about when we read the proclamation in its entirety. Particularly, we can have a fair understanding of turnover tax when we compare and contrast this tax with value-added tax which has been dealt with in our previous discussions.

Turnover tax is, like a VAT, an indirect tax imposed on persons who supply goods and services and who are not registered for value-added tax. Pursuant to the VAT proclamation, it is only those persons whose total annual turnover is more than 500,000.00 Birr are subject to pay VAT. Previously, we have said that VAT is a sales tax imposed on sales transaction which is measured as a percentage of the product or the services rendered. Like all other sales tax VAT is imposed on consumption which is to be paid ultimately by consumers. In this sense, turnover tax is similar to VAT and hence it belongs to the family of sales tax as the ultimate burden of turnover tax is borne by consumers. This can be understood when we have a look at Art. 2(11) of Proclamation 308/2002 which provides that turnover tax is a tax payable whenever transaction of sales of goods or services is carried out. From this sub-article, one can further understand that there is no turnover tax in the absence of transaction of sale of goods and services.

By now it is clear that transactions involving above 500,000.00 Birr are governed by the Value-added tax Proclamations and transactions below this figure are dealt with the turnover tax proclamation. So, can it be concluded that VAT and turnover tax are the same except they are

different in the annual turnover they involve? VAT, as the name indicates, is imposed at any stage when a supply of goods or services adds value. How about Turnover Tax? It is generally understood that turnover tax is imposed on every sale transaction as goods and services pass from their production until they reach their final consumer. However it is not possible to conclude that turnover tax is a sort of value-added tax as there are a number of distinctive features of value-added tax which make VAT different from turnover tax although the latter is, under the Ethiopian context, designed to regulate kinds of sales taxes which are not covered by the VAT proclamation. We can gather that when we have a glance at the preamble of the Turnover Tax proclamation which reads:

Whereas, administrative feasibility considerations limit the registration of persons under the value-added tax to those with annual taxable transactions the total value of which exceeds 500,000 Birr, whereas, an equalization turnover tax imposed on persons not registered for valued-added tax allows them to fulfill their obligations and also enhances fairness in commercial relations and makes complete of the tax system [the Turnover Tax Proclamation has been passed].

From the above-cited preamble of the Turnover Tax Proclamation, it is possible to understand that the division of such family of sales taxes is (VAT and TOT) is created for feasibility of administration. Had it not been for such considerations, all sales transactions would have been covered under the VAT Proclamation. In order to ease the administration of such sales taxes, the legislature has consciously passed two proclamations one covering transactions exceeding 500,000.00 Birr and the other covering transactions below this amount. The other thing that we can gather from the preamble is that in addition to being means of generating revenue, turnover tax is aimed at achieving commercial fairness by subjecting those transactions below 500,000.00 to pay a turnover tax. Therefore, from the preamble and these explanations, it must be clear that turnover tax is akin to value-added tax although VAT is imposed on value-added while turnover tax is imposed on the whole amount at every stage of transaction. To sum up, despite the fact that there are similarities between VAT and TOT, there are also glaring differences.

4.13.2. Scope of Turnover Tax

As we can understand from the preamble of Proclamation No 308/2002 and Art. 3 the same proclamation, the Turnover Tax Law has been passed to cover taxes payable on goods supplied

and services rendered by persons not registered for value-added tax. Therefore, the scope of application of this proclamation can be understood in terms of the following elements.

- a) supply of goods
- b) rendition of services
- c) persons not registered for VAT.

Let us see these elements one by one as follows:

a) Supply of goods

Turnover tax cannot be imagined without the supply of goods and rendition of services. At this juncture, we have to bear in mind the meaning of the two words (supply and goods). Although the word supply is not defined under the Turnover Tax Proclamation, we can understand the word as defined under Art. 2 (17) of the Value-add Tax Proclamation as we are allowed to use the definitions provided under the VAT law to the turnover tax law by virtue of Art. 2(1) of Proclamation No. 308/2002. Therefore, the word supply is understood to mean the sales of goods and or rendition of services or both. Coming to the meaning of goods, the term is defined under Art. 2(7) of the Turnover Tax proclamation. According to his sub-article “goods” means any type of goods or commodity that has exchange value, utility and brings about satisfaction and includes animals.

b) Rendition of services

From Art. 3 of the Proclamation on turnover tax, we can realize that the rendition of services is also brought under the ambit of turnover tax. We need to understand the word supply and service as defined under the VAT proclamation and as further explained under the previous discussions.

c) Persons not registered for VAT

As we have said previously, the turnover tax is applicable to those persons (who supply goods and services) who are not registered for value-added tax. However, turnover tax is not applicable to import of goods and import of services as provided under Art. 3(1(c) and Art. 23 of the Value-added Tax Proclamation. In general, the scope of application of the turnover tax can be clearly understood where it is compared and contrasted with the scope of application of the VAT Proclamation.

4.13.3. Rate of Turnover Tax and Exemptions

The rate applied to turnover tax is provided under Art. 4 of the Turnover Tax Proclamation. The rate applicable on goods sold locally and on services like contractors, grain mills, tractors and combine harvesters is 2% (two percent) while the rate applicable to other services is 10% (ten percent). When we discussed VAT, we have said that VAT is characterized by regressiveness in nature. You can also notice from the above discussions that turnover tax is also of regressive character. This is because a flat rate of 2% (two percent) is applied to all sales of goods and services involving grain mills, contractors, tractors and combine-harvesters and a flat rate of 10% (ten percent) is applied to all other services.

In all the above transactions, the base of computation of the turnover tax is the gross receipts of goods and services rendered. According to Art. 2(2) of Proclamation No 308/2002 by gross receipts is meant income without reduction of expenses, including the cost of goods sold. Let us see the following example for better understanding. A certain contractor who was not registered for VAT, rendered service to a real estate developer and received 100,000.00 Birr as a gross payment. In this case, the contractor is required to collect additional two percent as a turnover tax from the person who is duty-bound to effect the payment. This means that, the contractor will collect additional $(100,000 \times /100) 2000.00$ Birr as a turnover tax.

Under the TOT Proclamation, although in principle all persons making supply of goods and rendering of services are required to collect turnover tax, there are some transactions which are exempted from turnover tax. This is because exemptions are typical components of every turnover tax system whereby certain goods or services are excluded from the ambit of the turnover tax regime. Nearly all countries exempt some supplies for distributional objectives whereby some social services that are basic consumers' necessity, such as health care, education, welfare and cultural activities are exempted. It could be for these reasons that the Turnover Tax Proclamation has provided lists of exemptions under Art. 7 of the same Proclamation. According to this article, the following transactions are exempted from turnover tax:

- the sale or transfer of a dwelling house used for a minimum of two years, or the lease of a dwelling;
- the rendering of financial services;

- the supply of national or foreign currency and securities except for that used for numismatic purposes.
- the rendering by religious organizations of religious or other related services;
- the supply of prescription drugs specified by directives issued by the relevant government agency, and the rendering of medical services;
- the rendering of educational services provided by educational institutions, as well as child care services for childcare at pre-school institutions;
- supply of goods and rendering of services in the form of humanitarian aid;
- the supply of electricity, kerosene, and water, the provisions of transport permits and license fees, the supply of goods or services by a workshop employing disabled individuals if more than 60% of the employees are disabled and the supply of books.

But it must be borne in mind that the above exemptions may not be the only exemptions. Other goods and services may be exempted from the payment of turnover tax where such is provided by a directive issued by the Minister of Finance and Economic Development by virtue of the power vested in him. In addition, the Minister of Revenue is empowered to determine the scope and manner of exemptions by a directive to be issued by same.

4.13.4. Administrative procedures, Collection Enforcement, Administrative Penalties and Appeal procedures

The important procedures which guide administration of tax pertain to responsibility for the administration and reporting of tax, maintaining records, filing of turnover tax and payment of same and assessment of such tax. The Tax Authority administers the turnover tax. The taxpayer is also responsible for the correct calculation and timely payment of turnover tax and presentation of a return to the Authority by the prescribed deadline. The taxpayer is duty-bound to maintain records required for the determining of turnover tax. The other procedure pertains to filing and payment of turnover tax. According Art. 10(1(a) of the Turnover Tax proclamation (as amended by Art. 2(2) of proc. No 610/2008 taxpayers subject to this tax are required to file a turnover tax return and simultaneously pay to the Tax Authority or to a financial institution

delegated by the Tax Authority or through electronic filing and payment system within one month after the end of every accounting period.

For the purpose of turnover tax, “accounting period” means, for taxpayers classified as category A under the Income Tax Proclamation and Income Tax Regulation, but not registered for VAT, the calendar month. For category ‘B’ taxpayers who are required to keep records under the Income Tax Proclamation and Regulation, accounting period means every three month commencing from the first day of the Ethiopian Fiscal Year or, when approved by the Tax Authority, the first day of the Gregorian Calendar year. This means that the accounting period may commence from Hamle 1 to the end of Meskerem or where it is approved by the Tax Authority it may start on the 1st of January and may step up to the end of March. For category ‘C’ taxpayers, who are not required to keep records under the Income Tax Proclamation and regulation the accounting period pertains to the fiscal year.

The other administrative procedures pertain to the assessment of the turnover tax. Turnover tax is characterized by self-assessment of tax obligation just like value-added tax. However, if it appears to the Authority that a person has understated his tax obligation, the authority is empowered to issue an additional assessment. The authority can do this after it has made a thorough review of the tax declared by the taxpayer. If for any reason, the books of account are unacceptable to the Tax Authority, or if the taxpayer fails to submit same when requested by the tax authority, or if no books of account and supporting documents are maintained, the Tax Authority shall assess the tax on the basis of information available to it or on the basis of market price of such goods or services or if the price of such goods or services is unknown, on the basis of the market price of an equivalent good or service. As regards category ‘C’ taxpayers who are not required to keep records, they shall pay a presumptive turnover tax, a tax which is to be paid on the basis of the assessment made by estimation or presumption.

The assessment made by the Authority shall be prepared in an assessment notification and be delivered to the taxpayer. Delivery of the assessment notification shall be made in accordance with the provisions of the Income Tax Proclamation. If the authority makes an additional assessment, and gives notice and demand payment and if the person assessed does not pay within

30 days of the notice, the taxpayer is in default and such default entails legal consequences. However, if the Authority fails to assess the tax and notify the taxpayer of the amount still due within five years from the date of declaration and payment of the tax by the taxpayer, the tax so paid shall be final and conclusive. In case where the taxpayer has not declared his income or has submitted a fraudulent declaration, no time limit provided in any other law will bar the assessment of the tax by the Tax Authority. Coming to collection enforcement of turnover tax, the articles of the Turnover Tax proclamation (Arts. 12-17) are essentially the same as the provisions of the VAT proclamation (Arts. 30-36) as amended by proclamation No 609/2008. Hence, the discussions made with regard to collection enforcement of VAT are also applicable to collection enforcement of turnover tax. Therefore, it is not necessary to repeat the same thing here.

The Turnover Tax Proclamation has contained some rules pertaining to administrative penalties. Such penalties are imposed by the Tax Authority when the taxpayers fail to discharge their obligations in accordance with the provisions of the law. Penalties are mainly result of late filing of one's tax obligation and late payment. Administrative penalties result in fine. They do not have the effect of affecting the liberty of the defaulted taxpayer. In order to understand the details, please read Art. 23 and 24 of the Turnover Tax Proclamation (Proclamation No 308/2002).

When we come to appeal procedures, although the Ethiopian tax laws seem to be rigorous, they have also designed ways through which taxpayers can air their grievances whenever they feel that they are aggrieved by the deeds of the tax collecting machinery of the state. Hence, the Turnover Tax Proclamation has made provisions which enable aggrieved taxpayers to take their case to a body which can hear the grievance and act upon it. To this end, there are three forms to which any grievance is lodged. The first one is a review committee. The other body is the Tax Appeal Commission. This is a sort of quasi-judicial organ to which tax cases are brought and which can decide the cases. Thirdly, any taxpayer, or the Tax Authority for that matter, who is not satisfied by the decision of the tax appeal commission has the right to lodge and appeal to the regular courts. (In this regard please read 3.7 of chapter three of this course).

4.13.5. Tax Offences

Section seven of the Turnover Tax Proclamation (Arts. 25-35 as amended by Proc. No 610/2008) contains a number of provisions prescribing penal liabilities. The offences listed under this section are basically committed by individual taxpayers, other persons who are not taxpayers, tax officers, receivers so on and so forth. The offences committed by individual taxpayers are mainly tax evasion and making misleading or false statements and failure to notify any change with regard to the matters provided under Art. 17 of the same Proclamation. Other persons even if they are not taxpayers may commit an offence by obstructing the tax administration. Tax officers may also commit tax offences by abusing and misusing their powers. The same is true with receivers. Different penalties have been prescribed for the above offences under the aforementioned part of the proclamation. In all these cases, the above cited section of this proclamation has prescribed stringent penalties which, in most cases, combine fine and deprivation of liberty (imprisonment).

Chapter Summary

Value-added tax (VAT) is imposed on sales transactions and is designed to tax private consumptions. As the name itself shows, it is a tax imposed at each step in the production of commodity and supply of services based on the value-added at each step taking into consideration the difference between the production cost and the selling price. VAT is an indirect tax because the ultimate burden of such tax is borne by consumers as persons who/which are brought under the ambit of the Value-added Tax Proclamation are mere collectors of tax from the consumers.

When we come to the historical development of this tax, it was first contemplated by the American fiscal experts at the dawn of the 20th century. In spite of this, however, value-added tax has never been introduced in America up to date. The first country which introduced VAT in the world was France. It was in 1954 that France introduced VAT. The purpose of introduction of this tax was to alleviate the acute financial problem faced by the country as a result of the crises of the Second World War. Today, a significant number of countries of the world have introduced this tax. In other words, both developing and developed countries have resorted to generating a remarkable portion of their tax revenue through value-added tax. Ethiopia has adopted value-added tax though the tax faced resistant from intellectuals and business persons. Intellectuals justified their resistance because of the complex nature of the tax. The same reason was forwarded by the business community. The business community tried to resist the adoption of such tax since they knew that VAT involves the maintenance of complicated books of account and records which in turn entails the incurring of cost. Despite the resistance, Ethiopia introduced VAT in 2002.

Because this tax was not assigned either to the Federal Government or the Regional States under the Constitution, the joint session of the House of Federation and the House of Peoples' Representatives held in April 2002 assigned the power of levying and collecting this tax to the Federal Government by virtue of Art. 99 of the FDRE Constitution. Therefore, the regional states do not have the power to exercise their power of taxation concerning value-added tax. VAT has been operative since January 2003.

There are three basic types of value-added tax. These are: gross product value-added tax, income type value-added tax and consumption type value-added tax. It is the consumption type of value-added tax which is adopted under the Ethiopian Value-Added Tax Law. There are also three methods of computing value-added tax is determined by deducting the amount of tax paid on the business input from the amount of tax that is collected from taxable supplies. The credit method of computing VAT liability is incorporated under the Ethiopian VAT.

Although value-added tax is reputed to be advantageous, there are also some negative consequences. As to the advantages, value-added tax is generally known to be neutral since it does not interfere in the decisions of firms on what to produce and how to produce. This is because value-added tax is a consumption tax. Because of this again value-added tax does not open wide rooms for tax evasion. In addition, value-added tax encourages export although this advantage is available to the type of tax operating under the destination principle. Above all, the revenue potential of value-added tax is its attractive feature. VAT has also some disadvantages. To begin with, it is not an easy and simple tax. This disadvantage is so acute particularly in developing countries where the tax administrative set up is poorly equipped with trained manpower and modern equipment. Because the success of VAT largely depends on the cooperation of the taxpayers and because it is highly uneconomical value-added tax is resented.

Coming specifically to the Ethiopian VAT, the Ethiopian VAT was tremendously influenced by the European VAT. As such, the Ethiopian VAT is characterized by the credit method, consumption type of VAT and destination principle. As far as taxpayers are concerned, three types of persons have been identified. These are registered persons, persons who import goods and persons who import services. In any case, VAT is collected when there are supply of goods and/or rendition of services. Where goods and services are supplied together, the supply is called a mixed supply. However, when the supply of goods is incidental to the supply of services, it is taken to be supply of services. Similarly, where supply of services is incidental to supply of goods, the supply is considered to be a supply of goods. According to the Ethiopian VAT, a supply of goods or rendition of services attracts VAT where it involves taxable activities although the exact meaning of the phrase “taxable activity” may invite different interpretations.

In Ethiopia, there are two VAT rates. These are the 15% normal rate and zero-rating. As a matter of rule, transactions subject to VAT are charged using the 15% normal rate by taking into

consideration the value of supply. This rate applies to both supply of goods and rendition of services indiscriminately. There are also certain transactions which are taxed at zero-rate. Transactions taxed at zero-rate are within the ambit of VAT although no tax is collected and remitted to the government. In this regard, zero-rated transactions are similar to exempt transactions although persons supplying exempt transactions are not required to register for VAT. In addition, they are not entitled to input tax crediting. In connection with VAT collection, place, time and value of supply are very much relevant since there are certain advantages of knowing the place where, the time when and the value at which a certain supply was made. That is why the VAT Proclamation has incorporated crucial provisions in this regard.

Other points which are necessarily crucial are registration for VAT, calculation of VAT liability and tax crediting. In Ethiopia, those persons who/which meet the legal threshold are duty-bound to register for VAT. There is also a condition in which there might be voluntary registration. Registration for VAT may not be perpetual as there might be deregistration for the reasons incorporated in the VAT Proclamation. In Ethiopia, VAT payable is calculated by deducting the input tax from output tax provided that the one who/which has collected output tax has the proof that he/she/it has paid input tax. In short, VAT liability in Ethiopia is calculated by the crediting mechanism. In addition to the above conspicuous points, the Ethiopian VAT Proclamation has contained provisions dealing with collection enforcement, administrative penalties, tax offences and appeal procedures.

The Ethiopian sales tax has become complete because those persons who/which are not required to pay VAT are duty-bound to pay turnover tax. Turnover tax, like VAT, is an indirect tax although there are some glaring differences between turnover tax and VAT. In Ethiopia, as the laws stand now, those persons whose annual turnover is 500,000.00 Birr and below are required to collect turnover tax. Turnover tax is applicable to goods or services supplied locally. The Turnover tax Proclamation has provided a 2% tax rate for all goods and some services like contractors, grain mills, tractors and combine harvesters. The rate applicable to all other services is 10%. In all transactions, the base of computation of the tax is the gross receipts of goods and services. Like the VAT proclamation, the Turnover Tax proclamation has provided several exemptions which are similar to the exemptions provided in the VAT Proclamation. In addition,

the TOT Proclamation has contained administrative procedures, enforcement mechanisms, administrative penalties, tax offences and appeal procedures.

Self-Assessment Questions

I. True or False Items

1. When we compare and contrast the European VAT with Ethiopian VAT, it is possible to conclude that the latter VAT was heavily influenced by the former VAT.
2. In order to determine the amount of VAT to be collected, knowing the place, value and time of supply is helpful.
3. Under the Ethiopian VAT, a person who/which supplies any goods or services which do have economic value is required to register for VAT and collect VAT from the consumers.
4. Destination principle, consumption type and crediting mechanisms are the features of Ethiopian VAT.
5. In Ethiopia, any transaction which comes under the ambit of the VAT law is taxed at a uniform rate of 15%.
6. When a person who/which carries on taxable activity, but whose annual turnover is below the legal minimum, applies to the Tax Authority for voluntary registration, the Authority may refuse to accept the application when it makes sure that the applicant has not satisfied the legal requirements for voluntary registration.
7. The basic difference between VAT and TOT is the fact that VAT is collected on the value-added while TOT is collected on the gross receipts of goods and services.
8. The Turnover Tax proclamation is not applicable to imported goods and services as well as exported goods and services.
9. The exemptions provided in the VAT Proclamation are essentially similar to the exemptions provided in the TOT Proclamation.
10. The Ethiopian VAT Proclamation has clearly defined, with no shadow of doubt, taxable activities.

II. Choose the best Answer

1. Which one of the following is the common feature of both VAT and TOT in Ethiopia?

A. Exempt transactions	D. All of the above
B. Zero-rated transactions	E. None of the above
C. Reverse taxation.	
2. According to the TOT Proclamation, TOT is to be collected _____.

- A. when goods or services are supplied
 - B. by the suppliers of goods or services
 - C. directly from the consumers by the Tax Authority
 - D. all of the above
 - E. A and B
3. Which one of the following statements is not true under the VAT proclamation?
- A. An importer of goods is required to pay VAT, if the value of his/her/its import meets the minimum threshold stipulated under the law.
 - B. Reverse taxation is applicable to importation of services.
 - C. The VAT to be collected becomes positive when the output tax is greater than the input tax.
 - D. Adjustment of value of transaction becomes mandatory when the transaction is invalidated or cancelled.
 - E. Exports are zero-rated while imports are taxed.
4. A method of computing VAT liability adopted by the Ethiopian VAT is the _____.
- A. credit method
 - B. subtraction method
 - C. addition method
 - D. all of the above
 - E. none of the above
5. According to the destination principle, VAT is imposed on goods and services in areas of their _____.
- A. production
 - B. preparation
 - C. transformation
 - D. consumption
 - E. none of the above
6. Although VAT is appreciated for its crucial advantages, it is also seriously criticized because it _____.
- A. is not easy and simple to properly implement especially in developing countries
 - B. does not take into consideration the ability to pay of the taxpayers
 - C. discourages saving and investment
 - D. all of the above
 - E. A and B above
7. According to the VAT Proclamation, one of the following is a tax offence.

- A. tax evasion
 - B. tax avoidance
 - C. making of false statements
 - D. A and C above
 - E. all of the above
8. Which one of the following statements is true?
- A. Because VAT is uneconomical, a sizable number of countries of the world have discarded it.
 - B. Ethiopia is the only country which has adopted VAT in Africa.
 - C. In Europe, collection of VAT was started after WWII.
 - D. Those Persons who/which are required to register for VAT do not assume the real burden of VAT and they do not incur any cost in collecting such tax.
 - E. All of the above.
9. Assume that Mr. X is a lawyer who renders consultancy service. X's annual turnover is between 300,000-400,000 Birr. If his taxable supply is a , then the amount of TOT is _____.
- A. $\frac{10a}{100}$
 - B. $\frac{a}{100}$
 - C. $\frac{15a}{100}$
 - D. A and B
 - E. B and C
10. Which one of the following does **NOT** have anything to do with the Turnover Tax Proclamation?
- A. Category of taxpayers
 - B. Value of imported goods or services
 - C. Uniform rates of two types.
 - D. Appeal procedures
 - E. None of the above

III. Answer the following questions

1. Why do countries adopt VAT?
2. Why is understanding the meaning of taxable activities crucial?
3. What is turnover tax? What are the conspicuous differences between VAT and TOT?

IV. Case Analysis Questions

1. Zelalemawit Ethiopia is a private limited company established by three civic-minded Ethiopians; namely, Ato Cherra, Ato Edilu and Ato Otaro. The major business purpose of the

company is production of household furniture and equipment. The company has employed about 360 employees out of which 280 employees are disabled persons. Despite this, the company has become successful because of the concerted effort of the management and the employees. Therefore, the annual turnover of the company has become well above 10 million Birr. Recently, the company has bought machines, nails, varnish, glues and vehicles for transportation of goods and the staff. In all these transactions, the company paid VATs. In addition, the company obtained an intellectual service by e-mail from an English consultancy enterprise. In return to the service it obtained from the enterprise, it has paid 300,000.00 (three hundred thousand Birr) to the English enterprise.

- 1.1. Would it be lawful to collect VAT from the PLC?
 - 1.2. Is the PLC entitled to tax crediting in relation to the VAT it has paid to purchase the above goods?
 - 1.3. Is the PLC or the English enterprise which is required to pay VAT to the Ethiopian Government in relation to the transaction involving 300,000.00 Birr?
2. Ato Walelign was registered for VAT since his annual turnover met the legal minimum (threshold). In the 2002 E.C tax year, he paid 200,000 Birr VAT when he bought his inputs. However, he collected only 150,000.00 Birr VAT as an output tax.
What is the legal effect of such situation?
3. Haji Mohammed Negash is a successful businessman engaged in the export of oil seeds to the Middle East. Recently, he exported 2000 tons of oilseeds to Djibouti believing that the goods would be transported to other countries from Djibouti. However, because the price of the goods sharply failed in the world market, Haji Mohammed re-imported the goods to Ethiopia.
 - 3.1. When was Haji Mohammed expected to pay VAT- at the time of import or export?
 - 3.2. On the basis of your answer to 3.1. above, would Haji Mohammed be entitled to input tax crediting?
4. Ato Siraj has a supermarket in Dessie. Because his annual turnover was found to be above 500,000.00 Birr, he was registered for VAT. Ato Siraj agreed to supply about 500 use-and-throw glasses to Ato Tekeste Berhan since the latter would use the glasses in his wedding ceremony. The contract was concluded on the 30th of September 2010 and the whole payment was made by the buyer to the seller on the 6th of October 2010 although Ato Siraj

would deliver the items on the 30th of October 2010. It was also agreed that Ato Siraj would issue VAT invoice on the 30th of October, 2010. When was supply made as per the VAT Proclamation assuming that the seller issued VAT invoice when the goods were delivered?

CHAPTER FIVE

CUSTOMS DUTIES, EXCISE DUTIES AND STAMP DUTIES

Introduction

As our previous discussions demonstrate, VAT and turnover taxes are indirect taxes which have been important sources of public revenue in Ethiopia. The other important indirect taxes in Ethiopia are customs duties, excise duties and stamp duties which have been regulated by proc. No 622/2009, Proc. No 307/2002 and Proc. No 110/98 respectively. This chapter is devoted to the discussion of the salient features of these proclamations. To this end, the chapter has been divided into some relevant sections and sub-sections focusing on customs duties, excise duties and stamp duties. As regards customs duties, the scope of application of the law, customs procedures and control, customs formalities, customs warehouses, calculation of customs value, customs tariffs, determination of origin of goods, payment of tax, temporary exportation or importation, guaranties, duty free privileges, and other related matters will be touched upon. In this chapter, attempt has also been made to discuss the essence, rate, base and payment of excise duty. The meaning, instruments chargeable with stamp duty, applicable rates and mode of valuation and exemptions from stamp duty will be analyzed.

Objectives

Having completed this chapter, students should be able to:

- define what customs duties are;
- discuss the scope of application of the customs duties proclamation;
- analyze customs procedures and control
- discuss customs formalities;
- analyze the need to regulate customs warehouses;
- analyze the legal provisions applicable to calculation of customs values, customs tariffs and origin of goods;
- discuss rules dealing with payment of tax, temporary importation and exportation and duty free privileges;

- analyze the essence, applicable rates and payment of excise tax and
- grasp the meaning, applicable rates, instruments chargeable with stamp duty, mode of valuation and exemptions under the Stamp Duty Proclamation.

1.1. Customs Duties

1.1.1. General Remarks

What are customs duties? What kind of transactions are subject to customs duties? Are both goods and services subject to customs duties? Customs duties are taxes imposed on imported or exported commodity/ goods. Therefore, customs duties are related to international trade as international trade is related to importation or exportation of goods. Therefore, collection of customs duties is unthinkable in the absence of exportation or importation of goods from and to a given country. The collection of customs duties is practiced all over the world as such taxes are collected for various reasons. The reasons could generally be economic, social and political. Countries impose customs duties with a view to raising public revenues as the revenue collected in this manner is to be used by the government to meet its expenditure needs for various activities. Customs duties may also be utilized as trade barriers. For instance, if a country wants to curb the importation into its territories of certain goods, it will use high tariff rates and importers will be discouraged as the high customs duties will weaken the capacity to compete in the domestic market. This is, however, without prejudice to the rules and principles applied by the WTO to member countries. Therefore, it is good to relate this chapter with your course on “International Trade”. However, because Ethiopia has not yet acceded to the WTO, these rules are not applicable to Ethiopia.

In Ethiopia, customs duties are administered by the Ethiopian Revenues and Customs Authority. As far as the legal framework is concerned, the country has had for the last century customs laws. The current law is Customs Proclamation, Proc. No 622/2009 which has repealed all the previous laws. The Proclamation entered into force in 2009 and is functional throughout Ethiopia uniformly(Art.3(1). As such, the proclamation regulates import of goods, export of goods, goods in transit any goods subject to customs control including rights and obligations of persons who/which take part in customs formalities. Hence, by now it is possible to conclude that the application of the proclamation is confined to goods as services are not within the ambit of the

proclamation. As a last remark under this general part, it is important to have a glimpse about what goods are. According to Art. 2(1) of the proclamation “goods” means any kind of corporeal chattels and other incorporeal chattels deemed to be corporeal chattels by law including natural forces and resources of an economic value which are employed to use including money.

1.1.2. Principles of Customs Procedures

The customs proclamation has included relevant customs procedures. These procedures are meant to effect customs control in a manner assuring transparency and accountability. The principles of customs procedures are to be applied based on appropriate information and the principles of risk management and create conducive condition for trade facilitation. (Art. 4(1). Besides, the Ethiopian customs procedures are expected to be based on internationally accepted information technology standards. (Art. 4(2).

1.1.3. Customs Procedures and Control

With regard to customs procedure and control, the Ethiopian Customs Proclamation has contained seven articles each having its own reasonable detailed sub-articles. Generally, these articles are meant to deal with movement of goods across customs crossings and within customs frontier strips, customs ports and transit routes, import, export and transit goods. According to Art. 5(1) of the Proclamation, customs frontier strip and customs crossing shall be used for border crossing or transport of goods only by persons entitled to such activities on the basis of laws or international agreements. According to Art. 5(2) persons having real property within customs frontier strip are entitled to transport goods necessary for their living and work on their property as well as other things stipulated by international agreements. Likewise, doctors, veterinarians, other medical staff and rescue workers residing within the customs frontier strip may carry instruments and medications needed for their activities through frontier crossings when approved by pertinent authority.

As far as the routes of goods are concerned, Art. 6(1) of the proclamation has made it clear that import, export and transit goods should enter through prescribed customs ports or customs crossings and be transported through prescribed routes. In addition, import, export and transit goods are generally under customs supervision and control. The details of such control and

supervision are provided in Art. 8(1) of the proclamation. These goods are under the control and supervision of the Authority for the purpose of carrying out customs activities. The supervision and control of the Authority also extends to goods imported or exported through post office (Read Art. 9 of the Proclamation). The same is true with prohibited and restricted goods (Art. 10). In connection with customs control, the Authority is empowered to take any measure it deems necessary to ensure that customs rules are applied. The power should, however, be exercised in accordance with conditions laid down by the provisions of the law. In general, the Authority is duty-bound to ensure that goods remain the same in kind, form, quality and any other respect from their introduction into the customs territory till the end of customs procedures. (Art. 11 of the Proclamation). In the course of customs control, the Authority takes the following measures:

- f. examining, safeguarding and surveillance of goods
- g. re-examination of imported or exported goods based on information and risk management.
- h. Certification of exported items, affixing of customs seals, issuance and verification prescribed documents.
- i. taking samples, prospectus, photos and other data for the purpose of ascertaining non-alteration in kind and conditions of goods.
- j. examining luggage and other goods carried by travelers.

Customs control is necessary to prohibit those goods which are not allowed to enter in to Ethiopia, identify restricted goods and goods which can be imported to Ethiopia. The same is true with goods which are exported from Ethiopia. Most importantly, customs control is necessary to collect the appropriate customs duties and taxes in relation to imports and exports of goods.

1.1.4. Customs Formalities (Arts. 12-88 of the Proclamation)

Part three of the Customs Proclamation deals with many key provisions regarding customs formalities. It is possible to full-heartedly conclude that the provisions of the proclamation which fall under this part lie at the centre of the proclamation. This is so because part of three of the proclamation treats customs declaration and transit rules, customs ware houses, calculation of

customs have, determining origin of goods, customs tariffs, payment of customs duties and taxes, payment of service charges, temporary importation or exportation, re-exportation of imported goods, securities to guarantee payment of customs duties, duty free privileges and the like. In the following headings, we will discuss these points very briefly.

1.1.4.1. Customs Declaration and Transit Procedures

Customs declaration is a form or document prepared by the Authority in which the details of import, export or transit goods are described for the accomplishment of customs formalities. Customs declaration may be made in written form, orally, by bodily action or electronically. It must fulfill the requirements provided in sub-articles 2-4 of Art. 12 of the Proclamation so that it may be acceptable to the Authority. In addition, customs declaration should be accompanied by transportation documents, invoice, bank permit, packing list, certificate of origin and other necessary documents prescribed by directives to be issued by the Authority. Despite the fact that a customs declaration is required to comply with the above requirements, the Authority may permit simplified declaration in circumstances provided by Art. 14(1)a-c).

As a matter of rule, any import, export or transit goods are subject to customs declaration as stipulated by Art. 15(1) of the Proclamation. However, the Authority is empowered to issue directives by which certain goods may be exempted from written customs declaration. Customs declaration, once filled by the importer or exporter, are accepted when they have been found to have satisfied the requirements of the law. However, amendment of customs declaration is possible when the conditions provided in Art. 16(2) are satisfied. Let alone amendment, customs declaration may be cancelled in accordance with Art. 17 of the Proclamation (Read Arts. 15-18 of the proclamation) Coming to transit procedures, according to Art. 19(1) of the proclamation, goods registered under transit procedures are required to move through transit routes within the customs territory and under customs supervisions as determined by the proclamation. In this case, transit goods are not subject to payment of customs duties and other charges. In addition, transit goods should meet the conditions prescribed under Arts. 20 of the Proclamation.

1.1.4.2. Customs Warehouses

Dear students, what do you understand by customs warehouse? Why should customs warehouses be established? Customs warehouses, as the name indicates, are houses established in accordance with this proclamation for the deposit of import, export or transit goods. The goods are deposited in customs warehouse until the completion of customs formalities. This means that the establishment of customs warehouses facilitates the proper administration of the proclamation. To this end, customs warehouses may be established by the authority, business organizations, government enterprises or individuals. However, Art. 21(3) of the Proclamation stipulates that business organizations, government enterprises and individuals can establish customs warehouses when they are licensed by the Authority. (Read the Amharic version as the English version is not that much clear). Such customs warehouse may be established for general or private cargos. However, customs warehouses for general cargos are to be established only by business organizations engaged in freight transport; business organizations established to operate warehouse service and business organizations established to operate customs clearing services. From this, it is possible to understand that government enterprises and individuals cannot be licensed to establish customs warehouses for general cargos.

On the other hand, as per Art. 22(2) of the Proclamation, persons eligible to establish customs warehouses for private cargos are:

- k. international airlines engaged in transportation of passengers and cargo;
- l. enterprises established to sell duty free goods or
- m. other persons that may be authorized by the Authority.

At this juncture, the following issues are important: Are individuals /physical persons/ eligible to establish warehouses for private cargos? How about government enterprises? Which government enterprises are allowed to establish customs ware houses? How do we distinguish general cargos from private cargos?

A close scrutiny of the Proclamation reveals that physical persons may be allowed to establish warehouses for private goods. The same is true with government enterprises. However, it is not possible to conclude that all government enterprises can be allowed to establish customs warehouses for private goods. This might be determined by directives to be issued by the

Ethiopian Revenues and Customs Authority. The problem, however, is the Proclamation does not give us any hint regarding the distinction between private cargos and general cargos.

In addition to the afore-mentioned points, the Customs Proclamation has incorporated provisions regulating warehousing of goods, conditions of storage of goods in customs warehouse, goods to be deposited in the Authority's warehouses, supervision of customs warehouses, time limits of storage of goods in customs warehouses, warehouse fees and disposal of goods. These points have been dealt with by Art. 24 through Art. 31 of the proclamation. (Read Arts. 24-31)

1.1.4.3. Calculation of Customs Value (Arts. 32-44)

Customs valuation is extremely crucial because without customs valuation, it is not possible to determine the customs duties and other taxes which are payable when goods are imported or exported. To make this statement further clear, the understanding of the true customs duties helps us determine the amount of withholding income tax at the time of importation as indicated in Art. 51 of the Income Tax proclamation, the amount of VAT to be collected in relation to importation of goods (Art. 15 of the VAT Proclamation) sur tax on importation and excise duty. Therefore, giving proper attention to principles of valuation is significant. That is why the Customs Proclamation has introduced relevant principles of valuation that are internationally acknowledged.

Art. 32 of the Proclamation has laid down the general principles of customs value while Arts. 33-36 have been devoted to the valuation methods. According to these articles, in Ethiopia there are six methods of valuation which must be used one after another in the following order. These are:

- 1st Transaction value
- 2nd valuation of identical goods
- 3rd valuation of similar goods
- 4th deductive value method
- 5th Computed value method
- 6th fallback method

Let us discuss each one of them briefly as follows:

A) Transaction value

According to this principle, the customs value of imported goods shall be the price actually paid or payable for the goods and costs indicated by Art. 39 of the Proclamation. However, where the

buyer and the seller are related persons, the transaction value is considered as the basis of valuation if it is accepted by the Authority. When are a buyer and a seller deemed to be related? According to Art. 33(2) of the Proclamation, they are considered to be related if:

- one of them is an officer or a director of the other's business;
- they are legally recognized partners in business;
- they have employer-employee relationship;
- one of them owns at least 10% of the shares of other's business.
- one of them directly or indirectly controls the other;
- both of them are directly or indirectly, controlled by a third party.
- both of them directly or indirectly control a third party.
- they are related by consanguinity or affinity up to the second degree.

Why do we worry whether or not the seller and the buyer are related? If the seller and the buyer are related as described above, they may stipulate a simulated price so as to evade the actual customs duties and taxes to be paid to the government. That is why the law takes care of this situation. Despite this, however, the transaction value may be accepted where an examination of the circumstances surrounding a sale between a buyer and a seller who are related shows that the relationship did not influence the price. Let us see the following example in this regard.

Haji Mohammed Mustafa is an accomplished businessman in Dubai. He is an Ethiopian national who has been permitted to work in Dubai by the Government. He is also the father-in-law of Sheik Arage Mohammed who (the latter) imports used vehicles from Dubai to Ethiopia. In the middle of Meskerem 2003 E.C, Haji Mohammed and Sheik Arage concluded a contract of sale of vehicles. The sale contract involved the delivery of 5 Toyota land cruisers. In the contract, it was stipulated that the buyer would pay 60,000.00 Birr for each vehicle. From this hypothetical case, it is possible to realize that the seller and the buyer are related persons because Arage Mohamed is the son-in-law of Haji Mohammed. Despite this, if the Authority is convinced that the abovementioned price is the actual price, then the price can be accepted. However, if it is clear to the Authority that the affinity between the buyer and the seller has influenced the price of the vehicles; the Authority does not accept the price as the transaction value for customs

purpose. Then, the question that you need to ask is what can the authority do? The answer to this question is provided by Art. 34 of the Proclamation.

B) Valuation of Identical goods

As we have mentioned above, to determine the customs value of goods, first we have to resort to the transaction value; however, the customs value of imported goods may not be determined on the basis of the transaction value. Hence, where the customs value of imported goods cannot be determined on the basis of value of transaction, it must be determined by taking the transaction value of identical goods sold for export to Ethiopia at the same commercial level and in substantially the same quantity at or about the same time as the goods being valued. However, what does that mean by identical goods? In order to properly apply this article, we need to understand the meaning of identical goods. That is why the Customs Proclamation has defined in Art. 2(20) identical goods as goods which are the same in all respects including physical characteristics, quality, reputations and country of origin. How is country of origin determined? Which country is taken to be the origin of a certain good? The issue of country of origin has been dealt with by Arts. 47-50 of the Proclamation. Accordingly, where two or more countries are involved in the production of a product, the origin of the product is the country in which the last substantial manufacturing or transformation process of economic value took place.

For instance, let us assume that Mr. X is engaged in production of leather product in Eastern African Region. He buys hides and skins in Tanzania and semi-processes them in Uganda. Then, he changes these semi-processed leather products into leather bags, wallets, belts, jackets and the like in Kenya. Finally, Mr. X imports these products to Ethiopia. In this scenario, the country of origin is Kenya because it is in Kenya that Mr. X substantially transforms the semi-processed leather products into final products (Read Arts. 47-50 with regard to origin of country)

C) Valuation of Similar Goods (Art. 35)

What would be the effect if it is not possible to calculate customs value of imported goods using the transaction value and identical goods by using them one after another? When this happens, the customs value is determined by taking the transaction value of similar goods sold for import to Ethiopia at the same commercial level and in substantially the same quantity at or about the

same time as goods being valued. What are similar goods? How do goods being valued. What are similar goods? How do we determine whether goods are similar or not? Similar goods are defined by Art. 20(2) of the proclamation as:

“Goods which, although not alike in all respects and component materials, perform the same function and to be commercially interchangeable, and the quality, origin, reputation and trade mark of which are the factors to be considered in determining their similarity.”

However, it may not possible to determine customs value of goods the test provided in Art. 35(1) of the Proclamation. Hen that happens, the transaction of value of similar goods sold at a different commercial level or in different quantities by making adjustments to take account of differences attributable to the commercial level or to the quality.

D) Deductive Value Method (Art. 36)

When it is not possible to calculate the customs value of imported goods using the foregoing methods according to the order they have appeared, customs value of imported goods can be determined by what is called the deductive value method provided under Art. 36 of the Proclamation. What is the deductive value method? According to this method, where the customs value of goods cannot be determined using the transaction value, identical goods or similar goods, customs value of goods can be determined by using the unit price of identical or similar goods imported at or about the same time and which are sold in Ethiopia in their original state in the greatest aggregate quantity to persons who are not related to the seller. However, the price must be reduced by:

- n. an amount of commission, expenses and profit equal to that usually reflected in sales within Ethiopia of identical or similar imported goods.
- o. The usual charges for the transport, insurance and other related costs to be incurred within Ethiopia for identical or similar imported goods.

(Read Art. 36(2-3) of the Proclamation.

E) Computed Value Method

What would happen if customs value of imported goods cannot be determined by the foregoing methods? The Ethiopian customs proclamation has contained another method called the computed value method. According to this method, the customs value of imported goods can be based on the sum of:

- p. the cost of manufacturing or processing of the goods in the country of origin.
- q. an amount representing the selling expenses and profit equal to that usually reflected in the sale of identical or similar goods by producers in the country of export; and
- r. the transport, loading, unloading, handling and insurance costs associated with the transport of goods to the port of entry into the customs territory of Ethiopia.

We need to bear in mind that the above elements should be met cumulatively. However, the worry is as to how the Ethiopian Government can know the above costs of the goods given the fact that these elements are beyond the jurisdictional limit of Ethiopia. Has Ethiopia put in place mechanisms which help the Authority to know the cost of manufacturing or processing of the goods in the country of origin? In sum, can the computed value method be applied by the Ethiopian Revenue and Customs Authority currently?

Although applying this method seems to be difficult currently, the Ethiopian Revenues and Customs Authority may apply in the future when it builds its capacity of tax administration.

F) The Fallback Method

If the customs value of imported goods cannot be determined by the afore-mentioned methods according to the order they have appeared in the Proclamation and this course material, it can be determined based on the data available in Ethiopia and using equitable methods. However, these methods should be consistent with the general principles of this Proclamation although there are certain worrisome and perplexing issues arising in relation to this method of determining the customs value of imported goods. For instance, it is doubtful that there are data which can be availed of by the Authority. Which organ of government is expected to maintain these data? What is the nature of these data? The other problem is that this method may open the door for corruption, mistreatment of the importer and the like since this method gives wide discretionary power to the Tax Authority.

1.1.4.4. Customs Tariff

Among the components of modern customs legislation, customs tariff is important. This is because once the customs value of imported goods is determined the amount of customs duties is determined by the relevant tariff. The Customs Proclamation, apart from laying down the general principles, has not provided the customs tariff as it would be extremely cumbersome to contain the tariff rates applicable to all imported goods into Ethiopia. According to Art. 45(1) of the Proclamation, customs duties on goods imported into the customs territory of Ethiopia are to be paid at the rates specified by the Customs Tariff Regulations.

1.1.4.5. Payment of Customs Duties, Taxes and Service Charges

Once the customs value of goods is determined and the tariff rate is known, import duties are payable. The same is true with other taxes which are intertwined with importation of goods. The applicable dates for determining customs duties and taxes are determined according to Art. 52 of the Proclamation. Accordingly, for goods imported, the date when the customs declaration is accepted; for goods carried by passengers, the date of customs clearance; for goods placed in consignment stock, the date of delivery to the buyer; for goods transferred from consignment stock to customs warehouse, the date when the goods are taken out from the consignment stock; for goods temporarily imported the date when the customs declaration presented for the second time is accepted if they are declared for home consumption.

In addition to the obligation of payment of customs duties and taxes, the Proclamation has made it clear that service charges are paid in relation to the application of customs formalities to import and export goods. Such service charges are to be determined by regulations to be issued by the Council of Ministers.

1.1.4.6. Temporary Importation, Exportation and Re-Exportation of Imported Goods

Sometimes, there are situations whereby goods may be temporarily imported to Ethiopia. Goods which may be temporarily imported are goods necessary for trade promotion, technology transfer, tourism and cultural exchange, construction works and consultancy services. When goods are temporarily imported for these purposes, the importers are not required to pay duties and taxes. However, temporarily imported goods are free from payment of duties and taxes provided that the goods are re-exported at the time of completion of the tasks that justified the

importation of the goods. In any case, spare parts and consumable goods shall not be temporarily imported because it is not possible to re-export such goods.

Where temporary importation is allowed by the Proclamation or the directives issued by Ministry of Finance and Economic Development, the person importing such goods is required to provide security equivalent to the duties and taxes payable with respect to such goods. In addition to this, such person is prohibited from using such goods other than the purpose for which they are imported or to use them out of the locality where the activities are carried out. Assume that certain machines were imported by a Chinese Road Construction Company to be used in Addis Ababa. In this case, the company cannot move such machines out of Addis Ababa.

Despite the above prohibition, the Authority may permit the transfer of temporarily imported goods for construction works or consultancy services, within the authorized period, to other duty free right holders with respect to similar goods. Any person who/which transfers temporarily imported goods to another person is duty-bound to pay duties and taxes on the depreciated value of the goods calculated for the period from the date of importation until the date of transfer. Customs duties and taxes are also paid on the depreciated values of temporarily imported goods upon their re-exportation based on the tariff currently available. According to Art. 55 of the Proclamation temporarily imported goods must be re-exported within the time limit since they cannot stay in Ethiopia perpetually. If they are not re-exported within the time limit, the security provided for temporarily imported goods shall be transferred to the government treasury.

According to Art. 56 of the Proclamation, goods may be exported temporarily by completing customs formality. Such goods may be:

- imported goods sent-abroad for repair and maintenance without repayment of duties and taxes provided that they cannot be repaired or maintained in Ethiopia.
- temporarily imported goods sent abroad for repair and maintenance without cancellation of guarantee given at the time of importation.
- personal effects, automobiles for personal use, machinery and equipment taken out by a person for the purpose of carrying out his work abroad.
- goods exported for trade fair, exhibition or cultural show.

Where goods are temporarily exported for the above purposes, such goods may be allowed to re-enter the country without payment of duties and taxes. However, goods returning to Ethiopia pursuant to Art. 56(1(a and b) are subject to duties and taxes on the cost of maintenance and repair incurred abroad.

Besides, goods imported and declared for consumption in Ethiopia (home consumption) that are not prohibited or the entrance of which is not contrary to the law may be re-exported at the request of the importer before completing customs formalities upon payment of 5% of the duties and taxes to be paid on the goods. By the same taken, exported domestic goods that have been returned within one year because of their failure to meet the quality standards specified by the contract of sale or business relation that has been the basis for their export shall be relieved from customs duties and taxes. However, the one year period may be extended at the request of the interested party on justifiable grounds. (For more detail read Art. 57). According to Art. 58 of the Proclamation, goods imported for home consumption may be re-exported and replaced without additional payment of duties and taxes upon the request of the importer within the time specified under the warranty certificate before their release for free circulation. This is possible when it is provide that the goods imported are incompatible to their intended purpose, defective, affected by error of consignment or incomplete.

1.1.4.7. Release of Goods for Free Circulation

Unless otherwise provided by law, goods are released when the payment of customs duties and taxes is effected. Any imported goods that have completed the necessary customs formalities and released for free circulation shall be considered as domestic goods. However, such goods lose the status of domestic goods where:

- the customs declaration for their release for free circulation is invalidated;
- they are imported for inward processing and treated under the drawback procedure.
- they have to be re-exported in accordance with the terms of the contract due to the fact that they are defective or fail to meet the required standards.
- they are re-exported or used only for the permitted purpose and subject to drawback system.

1.1.4.8. Securities to Guarantee Payment of Duties and Taxes

What are securities? What securities are accepted by the Authority? Securities are cash deposits, bank guarantee, insurance bond or undertaking provided for the ensuring the fulfillment of an obligation to customs. (Art. 2(48). Securities are dealt with by Arts. 60-63 of the Proclamation. These articles of the Proclamation have stipulated the general principles of securities, conditions of securities and amount of securities. As per Art. 60(1) of the Proclamation, the Authority may require security to be provided in order to ensure the payment of customs duties and taxes. As provided in Art. 60(2), the Authority shall require only one security be provided in respect of one payment of customs duties, taxes and other charges. However, the Authority may permit comprehensive securities to be provided to cover payments arising from two or more customs operations. Under the Ethiopia Customs Proclamation, government institutions are not required to provide security in the form of cash deposit, bank guarantee or insurance bond. Instead, they may provide letter of guaranty. However, at this juncture, we have to bear in mind that the beneficiaries are only government institutions that are financed by government allocated budget. This means that government profit making enterprises are required to produce other securities.

When are securities required? The answer to this crucial query is provided by Art. 61 of the Proclamation. According to Art. 61(1) of the Proclamation, the Authority may release goods upon receiving securities for the following reasons:

- when additional time is required to produce complete documents necessary for the completion of customs formalities;
- to ensure the re-exportation of goods imported on temporary basis;
- to ensure transit goods exit through the approved customs routes or arrive at the predetermined customs point of destination;
- to ensure that goods which are produced by duty relieved imported raw materials are exported.

Art. 62 of the Proclamation has provided rights and obligations related to security while Art. 63 deals with amount of security. As per Art. 63(1) the amount of security is required to be equal to the precise amount of customs and taxes and other charges where the amount can be established with certainty at the time when the security is provided on the other hand, the amount security shall be equal to the maximum amount of as estimated by the Authority in case where the amount cannot be established with certainty. In addition, if the Authority establishes that the security does not fully cover the liability, it requires the debtor to provide additional security or

to replace the original security with a new one. Similarly, when the customs duty and tax liability has been extinguished in part, the security shall be reduced at the request of the debtor. Finally, any security is totally extinguished upon the full settlement of the debt and discharging of other obligations by the debtor.

1.1.4.9. Post Clearance Audit, Deferred payment and Repayment of Duties and Taxes

Normally, goods are released when the requirements of the law are satisfied. However, sometimes, there might be underpayment of customs and taxes because of mistake on the part of the customs officers or fraud on the part of debtor. It is for these are other reasons that there might be post clearance audit. According to Art. 64(1) of the Proclamation, the Authority may undertake a surprise inspection to ascertain the accuracy of the customs declaration. This surprise inspection is undertaken after the goods have been released. In addition, the Authority may inspect commercial documents and data relating to the import or export operations in respect of the goods. The Authority's inspection may be carried out at the premises of the person who is directly or indirectly involved in the business operations of the import or export of the goods or at the premises of any other person in the possession of the data and documents subject to the inspection. The Authority's inspection may be carried out within ten years from the date a customs declaration has been accepted.

Where the post clearance examination/inspection reveals that the amount of customs duties and taxes paid in respect of goods imported or exported is less than the actual amount that should have been paid, the difference must be collected within ten years of the date of such difference from the owner or his agent. On the other hand, if duties and taxes are overcharged as a result of incorrect commodity classification, tariff setting, valuation or other calculation mistakes, reimbursement claims are granted to the debtor. However, claims of reimbursement of duties and taxes are considered only if they are submitted within six months after the goods are imported or exported upon completion of customs formalities.

1.1.4.10. Relief Procedure

As a matter of rule, customs duties and taxes should be collected when goods are imported or exported. However, there might be duty free privileges. In other words, goods may be imported or exported without the payment of customs duties and taxes in some exceptional circumstances.

Such privilege may be granted by any special law in Ethiopia (for instance investment law), international agreements to which Ethiopia is a party or by directives to be issued by the Ministry of Finance and Economic Development. However, even if one may enjoy duty free privileges, there are certain limitations to such privilege. To begin with, it is not allowed to transfer duty free imported goods to a person who is not enjoying similar privileges or use them for a purpose other than which the duty free privilege is granted. Besides, it is prohibited to place such goods under the possession and service of others. Any duty free imported goods may be re-exported or transferred to a person who enjoyed similar privileges or transferred to any person upon payment of the duties and taxes. The duties and taxes are to be calculated at value of the goods and tariffs rate prevailing during the time the goods are transferred. When the duty free imported goods are lost or damaged, the importer should report forthwith to the Authority. Where the Authority accepts the report, the whole or part of the duties and taxes may be cancelled.

1.1.4.11. Offences against Customs Activities

All Ethiopian tax laws are characterized, among other things, by containing provisions regarding tax offences. The Ethiopian Customs Proclamation is not an exception. As such, it has devoted several articles for tax offences. (see Arts. 89-108). Generally, the offences are classified as those offences committed by customs officers and offences committed by other persons. Offences committed by tax officers include corrupt practices and abuse of power. Corrupt practices and abuse of power have been dealt with by Art. 89 and 90 respectively. Corrupt practices are punishable in accordance with the FDRE Criminal Code while abuse of power is punished with rigorous imprisonment from 3 up to 10 years as provided in Art. 90 of the Proclamation.

When we come to the second category of offences, the offences are:

- contraband
- fraudulent acts committed under the cover of legally declared goods;
- other fraudulent acts;
- falsification of documents and symbols of the Authority;
- opening of parcels and removal of marks;
- soliciting corrupt practices;
- obstruction of customs formalities;

- misuse of duty-free goods;
- possession of unlawful goods;
- failure to return samples;
- contraventions by the master of means of transport;
- contravention by the warehouse licensee;
- Contravention in relation to transit of goods.

In addition to enumerating the offences, the Proclamation has also contained corresponding punishments to each offence. Generally, the penalties are deprivation of liberty (imprisonment), forfeiture of the goods or proceeds and fines. The terms of imprisonment and the amount of fine to be levied vary from offence to offence.

1.2. Excise Duties

1.2.1. General Introduction

The other indirect tax prevailing in Ethiopia, as is the case elsewhere in the world, is an excise tax. It is an indirect tax because the ultimate burden of this tax falls on the final consumers being included in the price. Excise tax is tax imposed on the manufacture, sale or use of goods. However, such tax is not imposed on all goods. Inasmuch as this tax is imposed on only goods it is similar to customs duties although there are major differences between them. According to the preamble of the Excise Tax Proclamation, proc. No 307/2002 (as amended by proc. No 610/2009) excise tax is imposed with a view to improving the revenue of the government. In addition, the preamble has made it clear that this tax is imposed on luxury goods and basic goods which are demand inelastic. Moreover, from the preamble of the proclamation, we can realize that such tax is imposed on goods that are hazardous to health and which are causes to social problems. Generally, the purpose of imposing such tax is twofold one is raising government revenue and the second is reducing the consumption of hazardous goods thereby safeguarding public health.

1.2.2. Rate, Base and Payment of Excise Tax

These elements are crucial for the proper implementation of the Proclamation. This is because we cannot collect the exact amount of tax without the knowledge of the rate and the base. In fact,

determining the rate and the base of the tax is one important manifestation of a good tax system. Payment of the tax is also the ultimate objective of the law. These points are discussed as follows.

A. The Rate (Art. 4)

According to Art. 4 of the Proclamation, excise tax is paid on goods enumerated under the schedule attached to the Proclamation when imported or when produced locally at the prescribed rate in the schedule. As you can understand from the schedule, the rates differ from one good to another. There are also similarities of rates. For instance, perfumes and toilet waters are taxed at 100% rate while garments are taxed at 10% rate. In contradistinction to this, clocks and watches, dolls and toys, personal adornment made of gold, silver or other materials are taxed at 20% rate. For further understanding, look carefully at the excise tax schedule.

B. The Tax Base

Knowledge of the tax rate without the tax base is meaningless because the tax to be paid is determined by multiplying the tax base by the rate. Therefore, the Proclamation has given us the guidelines which help us determine the tax base. According to Art. 5(1) of the Proclamation, base of computation of excise tax is the cost of production in respect of goods produced locally. What is cost of production? The term has been defined by Art. 2(8) of the Proclamation as “direct labor and raw materials cost incurred in the production process, cost of indirect inputs and overhead costs without including depreciation costs of machinery.” Pursuant to Art. 5(2) of the Proclamation, in respect of imported goods, cost, insurance and freight (CIF) value is taken into consideration. Here, you need to bear in mind that the customs valuation methods that we discussed in 5.1 above are also relevant here as we cannot determine the CIF value of imported goods without being assisted by the Customs Proclamation. Then, having determined the CIF value of imported goods, we can apply the applicable rate provided in the proclamation. Assume that Ato Wagaye has imported whisky from England. If the CIF value of the whisky is 100,000.00 Birr, then the excise tax is $(100,000 \times 50/100)$ 50,000.00 Birr as the applicable rate to such goods is 50%.

C. Payment of Excise Tax

The excise Tax Proclamation is meant to ensure the payment of such tax. As a matter of rule, the excise tax on goods specified in the schedule shall be paid in accordance with Art. 6(a) of the Proclamation. Accordingly, when the tax relates to imported goods, it should be paid at the time of clearing goods from customs areas. When the tax is to be paid on goods produced locally, the tax should be paid not later than 30 days from the date of production. However, as per Art. 6(2(b) where a taxpayer requests for permission to deposit goods produced in a bonded warehouse without payment of tax and if the Authority approves the request, the payment of the tax on such goods shall be effected at the time when the goods are removed from the bonded warehouse.

Bonded warehouse, according to Art. 2(7) of the Proclamation under consideration, means a building or place destined for storage of specified goods before tax is paid, secured in accordance with requirements of the Tax Authority. The next question is as who are taxpayers? The answer is provided by Art. 6 of the Proclamation. As per this article, taxes, in respect of goods produced locally, are paid by the producer and in respect of goods imported by the importer.

1.2.3. Other Procedures in Relation to Excise Duties

The Excise Tax Proclamation, just like the other tax proclamations, has incorporated crucial procedures for the proper implementation of the Proclamation. Points to be raised under this subsection are collection enforcement mechanisms (obligations of the taxpayer, powers of the Tax Authority, seizure of property to collect taxes and the like), appeal procedures administrative penalties and criminal offences. (Read Arts. 8-32 of the Proclamation). Almost all these points have been discussed in the previous chapters in relation to Income Tax Proclamation and the VAT Proclamation. Hence, since the points included in the Excise Tax Proclamation are essentially similar to the Income Tax Proclamation and the VAT Proclamation, no need to analyze these points here again for it would be mere repetition. Therefore, students should consult the discussions made in chapter three and four of this course material in respect of the points enumerated under this heading.

1.3. Stamp Duty

Stamp, according to Black's Law Dictionary, is an official mark or seal placed on a document especially to indicate that a required tax (such as duty or excise tax) has been paid. Stamp duty is a tax raised by requiring stamps sold by the government to be affixed to designated documents,

thus forming part of the perpetual revenue. Stamp duty is another example of indirect tax because its incidence and burden fall on different persons. Stamp duty was introduced in Ethiopia with a view to contributing to the development of art, the activities, of financial institutions and the transfer of capital assets. Currently stamp duty is governed by Proclamation No. 110/1998. As you can understand from the reading of the provisions of the afore-said proclamation, the subjects of stamp duty are various instruments (documents.) We will discuss the following items one by one depending on the relevant provisions of the Proclamation and the schedule attached thereto. The points to be discussed are:

- instruments chargeable with stamp duty
- rate of stamp duty
- mode of valuation
- liability, time and manner of payment
- exemptions

1.3.1. Instruments chargeable with stamp duty

As we have said above, stamp duty tax is applicable to documents of different kind and nature. We can understand this when look at Art.3 of the Proclamation. According to this article, the instruments chargeable with stamp duty are about 12 types of instruments. The first of such documents are the memorandum or articles of association of any business organization, cooperative society or any other form of association. Business organizations and other association cannot be granted legal personality unless they are registered with a competent registering authority. The registering authority, among other things, demands such entities to deposit their founding documents with it. In this case, such documents are affixed with stamps which are issued by the government bearing different amount of money.

Documents bearing awards are also chargeable under the stamp duty tax. An award is, as defined under Art. 2(1) of the same proclamation, a decision in writing rendered by an arbitrator or arbitrators on a reference made otherwise than by order of court in the course of suit by parties to a compromise, conciliation, arbitral submission or other similar matters. Bonds and collective agreements are also within the ambit of the stamp Duty Proclamation. Bonds include any instruments whereby a person obliges himself to pay money to another, if the principal debtor

fails to discharge his/its obligation. Look at the following example involving a financial guarantee bond.

Assume that Beshilo Insurance Company wants to borrow money from the Commercial Bank of Ethiopia. The Commercial Bank of Ethiopia requires Beshilo Insurance Company to produce a financial guarantee bond issued by any financial institution of sound financial position. Because of this, Beshilo Insurance Company requested the Development Bank of Ethiopia (DBE) to issue a financial guarantee bond which would secure the payment of the loan by the DBE provided that the actual borrower of the money fails to return the loan as agreed. Such financial guarantee bond (a document) is chargeable with the stamp duty. Collective agreements are documents relating to conditions of work, concluded in writing between employees on one hand and employers on the other. In addition, contracts and agreements and memoranda thereof, warehouse bonds, security deeds, contract of employment, lease documents including sub-lease, notarial acts, power of attorney and documents of title property are subject to stamp duty tax.

1.3.2. Rates of stamp duty and mode of valuation

The applicable rates of stamp duty for each instrument mentioned under Art. 3 of this proclamation are those specified in the schedule attached thereto and which forms an integral part of the proclamation. Here is the schedule stamp duty tax and the stamp duty on each instrument must be charged, levied and collected at the following rates.

No	Instruments chargeable with stamp duty	Basis of Valuation	Rates of stamp duty
1	Memorandum and article of		

	association of any business organization or any association: (a) Upon first execution (b) Upon any subsequent execution	Flat Flat	350.00 Birr 100.00 birr
2	Memorandum and articles of associations of cooperatives: (a) Upon 1 st execution (b) Upon any subsequent execution	Flat Flat	Birr 35 Birr 10
3	Award	On value	(a) with determinable value 1% (b) with undeterminable value Birr 35
4	Bonds	On value	1%
5	Warehouse bond	On value	1%
6	Contracts and agreements and memoranda thereof	Flat	Birr 5
7	Security deeds	On value	1%
8	Collective agreement: (a) on first execution (b) On any subsequent execution	Flat Flat	350 Birr 100 Birr
9	Contract of employment	Salary	1%
10	Lease including sub-lease and transfer thereof	On value	0.50 Birr
11	Notarial acts	Flat	5 Birr
12	Power of Attorney	Flat	35 Birr
13	Register title to property	On value	2%

N.B: In order to further understand the above schedule and rate of stamp duty tax, you are advised to read Art. 5 of the Proclamation under discussion.

1.3.3. Liability, time and manner of payment

Obviously, unless otherwise determined by this Proclamation, the beneficiary of an instrument is liable to pay the stamp duty thereon. The person making (drawing) or issuing an instrument in Ethiopia, is liable for the payment of the stamp duty upon the execution of the instrument. However, when an instrument is made (drawn) outside Ethiopia, the person who is first executing it in Ethiopia is liable for the payment of the stamp duty. Although the lesser and the lessee are entitled to agree otherwise (to the contrary), the lessee is required to pay the stamp duty tax. In the case of lender-borrower relationship, the borrower is required by law to pay the stamp duty tax chargeable on security deeds. With regard to documents transferring title to property, the transferee is in principle required to pay such tax though the transferor may agree that he will pay the same tax. In the case of contractual documents, parties to the contract are jointly and severally liable to the stamp duty.

In the case of employment contracts, the employer is liable to the payment of the stamp duty tax. Regarding an award, parties to it are jointly and severally liable for the payment of stamp duty thereon. As to collective agreement, the employer and employees are jointly and severally liable for the payment of stamp duty.

Coming to the time and manner of payment of the stamp duty tax, stamp duty on memorandum and articles of association are to be paid before or at the time of registration; on awards before or at the time of signature; on lease or sub-lease, before or at the time of the signature; on notarial acts, at the time of issuance; on security deeds, before or at the time of signature and on documents of title to property, before or at the time of issuance.

1.3.4. Exemptions

For a number of reasons, tax legislation provides for the exemption of some persons or items from tax obligations. The Stamp Duty Proclamation is not an exception to this principle. Hence, the following are exempted from stamp duty:

- public bodies on which the Federal Government of Ethiopia Financial Administration Proclamation applies.
- goods imported for sale by traders having import license when first registered in the name of the trader.

- documents may be exempted from payment of stamp duty in accordance with international agreements and conventions approved by the government.
- subject to reciprocity, embassies, consulates and missions of foreign states may be exempted.
- share certificates.

Chapter Summary

This chapter is devoted to the discussion of three indirect taxes applicable in Ethiopia. These are customs duties, excise tax and stamp duties. These three types of taxes have been dealt with by Proc. No 622/2009, Proc. No 307/2002 and Proc. No 110/1998 (as amended) respectively. According to the Customs Proclamation, customs duties and taxes are imposed on goods when goods are imported or exported. The Customs Proclamation has contained principles of customs procedures which are meant to create conducive environment for trade facilitation. The procedures are expected to be in accordance with internationally accepted information technology standards. Besides, the law has contained extremely helpful provisions with regard to customs control.

The Ethiopian Customs Proclamation has also dealt with customs formalities. In this regard, customs declaration, transit procedures and the conditions of warehouse establishment have also been regulated. The other crucial point in relation to customs formalities is calculation of customs value as this is important to determine customs duties and taxes which are due to the government. This end, the proclamation has incorporated modern valuation methods. These are the transaction value method, identical goods valuation method, the similar goods valuation method, deductive value method, computed value method and the fallback method. There are also provisions with regard to payment of customs duties, taxes and service charges. In Ethiopia, as a matter of rule, customs duties and taxes should be paid when goods are imported or exported. However, there might be temporary importation or exportation of goods without the payment of customs and taxes. This is allowed when temporary importation or exportations are

carried out for trade promotion, technology transfer, tourism and cultural exchange, construction works and consultancy services. The Ethiopian Customs Proclamation has also dealt with release of goods for free circulation, securities to guarantee the payment of customs duties and taxes, post clearance audit, deferred payments and repayment of duties and taxes. Included in the proclamation are also relief procedures, offences against customs activities and the like.

In addition to customs duties, this chapter has dealt with excise taxes and stamp duties. An excise tax is a tax imposed on goods produced locally or imported from abroad. Such tax is imposed on selected goods. In the Excise Tax Proclamation, various tax rates have been provided with a view to tax goods differently on the basis of their nature. In addition to rates, the Proclamation has also given general guidelines that are instrumental to determine the base of computation of excise tax. This Proclamation has further spelt out declaration and assessment of tax, enforcement mechanisms, appeal procedures and the like. Coming to stamp duties, it has been governed by proclamation No 110/1998 (as amended) According to this proclamation, stamp duty is a tax raised by requiring stamps sold by the government to be affixed to designated documents, thus forming perpetual revenue. The Stamp Duty Proclamation has incorporated such basic points as instruments (documents) chargeable with stamp duty, rates of stamp duty, mode of valuation, liability, time and manner of payment, exemptions and the like.

