

CHAPTER I: GENERAL INTRODUCTION

1.1. Definition and Classification of Taxes

TAX is defined in many ways. Commonly heard definitions include:

- Tax is compulsory levy by state on persons without quad pro quo obligation. It is obligatory contribution from individuals/entities out of their private property for the maintenance and defense of government, so that it may perform its functions and provisions of public goods and services.
- It is the process by which the sovereign/ state, through its law making body, generates revenues to defray expenses of government/ expenditure. It is a means of government in increasing its revenue under the authority of the law, purposely used to promote welfare and protection of its citizenry.

From this definitions we can identify the following **characteristics of Tax includes:**

1. Tax is levied for provisions public goods and services. Taxes or imposed to support the government for implementation of projects and programs.

It is portion of private wealth, exacted from individuals by the State for the purpose of Provision of public goods.

2. Tax is enforced contribution. Its payment is not voluntary nature, and the imposition is not dependent upon the will of the person taxed.

3. Tax is proportionate in character. Payment of taxes should be base on the ability to pay principle; the higher income of the tax payer the bigger amount of the tax paid.

4. Tax is levied (to impose; collect) on person or property. There are taxes that are imposed or levied on acts, rights or privileges. Ex. Documentary tax.

5. It is levied by the state which has jurisdiction over the person or property. As a general rule, only persons, properties, acts, right or transaction within the jurisdiction of the taxing state are subject for taxation. Plus, **tax is levied by the law making body of the state.**

This means that the base of tax is mainly determined by the legislator.

• ***DISTINCTION OF TAX (WITH OTHER RELATED CONCEPTS)***

1. Tax distinguished from Penalty

- **A tax is intended** to raise revenue, while penalty is designed to regulate conduct.
- A tax may be imposed by the **government** only **while** a penalty may be imposed by the government or a **private individual**.

2. Tax distinguished from Debt

- **A tax obligation is imposed by** law, **while** a debt is based on **contract**.

- A tax may not be assignable, while a debt is assignable.
- A tax is generally payable in cash, while debt is payable in cash or in kind.
- A person may be imprisoned for a non-payment of taxes, but any person may not be imprisoned for non-payment of debt.

3. Tax distinguished from other Terms

- **Revenue.** This refers funds or income derived by the government whether from tax or any other source in another sense.
- **Customs Duties.** These are taxes imposed on goods exported into a country.

• **CLASSIFICATION OF TAXES**

✓ **As to subject matter**

- Personal, Corporate tax(ex. Residence Tax)
- Property Tax. (ex. Real State Tax)
- Excise Tax
- Business profit tax

✓ **As to who bears the burden**

Direct Tax (ex. Income Tax, Rental, Dividend, royalty) :It is one for which the formal and economic incidence are essentially the same, i.e. the taxpayer is not able to pass the burden to someone else. Accordingly, direct taxes are paid entirely by those persons on whom they are imposed.

Indirect Tax (ex. VAT, Custom duty, stamp duty, Turn over Tax) :Is a tax whereby the taxpayer's burden to pay the tax can easily be passed on to another person. Generally, the tax incidence of an indirect tax is on the ultimate consumer.

✓ **As to determination of account**

- **Withholding Tax.**
- Self assessments
- Standard/ presumptive assessment

1.2. **Theories and Principles of Taxation**

Theories of taxation

Questions such as who is to be taxed, how much the tax shall be, and for what purpose gives rise to theories of taxation.

I. Benefit Principle: according to this principle tax must concentrate on those who, somehow, benefit from the government services. The theory purports to create a link between tax and benefit received. But this idea has been subject of critics.

- ✓ Firstly, it is difficult for the government to **identify who benefited how much**. Thus it would be too difficult to levy a proportionate tax burden.
- ✓ Secondly, even if it was possible to compute and levy tax accordingly, this scheme will **concentrate more on the poor as they are recipient of more governmental services**. This, in turn, would widen inequality and creates inefficiency.



Ability to Pay Principle: This principle opposes the first principle of taxation, and **relies much on fairness in levying tax**. Accordingly, it holds that *justice will be maintained if amount of tax is determined by the ability of the payers. It obviously is supporting the progressive taxation, i.e. tax burden increases with the increase of income*. The **theory has already got a momentous support in the majority of legal systems due to its merits**.

Basic Principles of a Sound Tax System

1. **Equality:** *As per this principle, a good tax system is which strives to maintain equality among taxpayers. Here, you have to bear in mind that equality is being considered from the perspective of ability to pay.* Thus, tax should burden its subjects in proportion to their ability to pay. **This can also mean that persons should be taxed in proportion to the revenue they generated under the protection of the state.**
2. **Certainty:** ***This principle suggests that tax laws must make the obligation of every taxpayer certain.*** This is manifested in the mode, amount, and time of payment. The principle is essential to fight corruption and to save taxpayers from being under the mercy of tax officers. *Certainty is achieved mainly by employing a plain and clear language in the tax laws to an average taxpayer.* Unfortunately, nowadays due to the complexity of business and advancement of technology, tax laws are getting complex than ever.
3. **Convenience:** ***Tax system, according to this principle, must be designed in such a way that it occasions as little inconvenience as possible to the taxpayer.***

Time: For instance, it has to consider the time a group of taxpayers can generate some income to pay from. In case of tax on farm products, tax must be collected during autumn when farmers usually harvest.

Location of payment: ***This must, to the extent possible, be at a convenient place to the majority of the taxpayers.***

Manner: ***The tax system should look in to the possibility of installment payment to ease taxpayer's burden of paying the whole some at once.***

4. **Economy:** A tax system, to be a good one, must be crafted in such a way that it is economical to implement. This relates to **Administrative Feasibility** and **costs of compliance**.

***Administrative Feasibility:** signifies that the cost to be incurred by the government in the course of implementing the taxation including assessment, collection, and auditing the tax must be as minimal as possible.*

*It connotes that in a successful tax system, such tax should be clear and plain to taxpayers, capable of **enforcement** by an adequate and well-trained staff of public office, convenient as to the time and manner payment, and not unduly burdensome upon on discouraging to business activity.*

***Costs of compliance:** means the additional expense, which taxpayers are to incur as attendant to the tax. These include costs for keeping books and records for tax purposes. The principle states that the tax law should keep these costs low so that it will be economic.*

The Importance of Taxation

Taxation has four main purposes or: i.e., **Revenue rising, Redistribution wealth, Re-pricing, and Representation.**

The main purpose is revenue rising: taxes raise money to spend on the construction and maintenance of roads, schools and hospitals, and on other government functions like regulation of justice systems. This is the most widely known function. **Taxation is the most important source of revenue for modern governments accounting for 90 percent or more of their income.** The remainder of government revenue comes from borrowing and fees for services. Countries differ considerably in the amount of taxes they collect. In the United States, about 30 percent of the gross domestic product (GDP), a measure of economic output, went for tax payments in 2000 for instance. In Ethiopia, the ratio in 2003 was about 13% and is expected to have developed by now.

The second is redistribution. **Redistribution** is about transferring wealth from the richer to the poorer sections of society and this function is widely accepted in most **democracies**, although the extent to which this should happen is always controversial.

The third purpose of taxation is re-pricing. Taxes are levied to address externalities. Tobacco is taxed, for example, to discourage smoking, and many people advocate policies such as implementing a carbon tax to discourage the degree of carbon emission.

1.4. HISTORY OF TAXATION IN ETHIOPIA

It is presumed that in Ethiopia, as is the case in other kingdoms, the different kings and local chiefs have been levying and collecting tax, albeit the variety of its forms from the antiquity. For

instance, the constitutional writer and expert Fasil Nahom stated that the Axumite Kingdom had tax laws as found in some inscriptions.

- But analytically, the history of tax in Ethiopia can be seen in three phases, i.e. (I) prior to 1941, (II) 1941-2002, (III) 2002-now. Let's briefly see each of these intervals.

1. **Traditional tax system prior to 1941**

Generally speaking, this period was a period where an arbitrary, abusive, and subjective tax system prevailed, and it was closely related with land, especially in the high land areas. In these period there had been a system called the Gabar System. 'Gebar' is just an Amharic term to mean a taxpayer, and gradually equated with a farmer. But as a system, the Gebar system connotes its abusive nature in which the peasant bears all the burdens of taxation. In the time under consideration, the Gebar supported to all emperors/princes, imperial court, nobility, local officials, clergy, and the military.

According to some earlier Ethiopian scholars including Mahtemesselassie and Gebrehiwot Baykedagn, **in this time, taxation was imposed "in kind" and was incredibly numerous.** It is recorded that cultivation of state land, erection of houses for provincial officials, court tax, carrying army baggage in war time, acting as prison guard, building churches, looking after telephone posts (in latter periods), and clergy taxes were among the forms of tax. One vivid development of this time in the area of taxation was the foundation of Ministry of Finance in 1908, which was responsible, among other things, on issues of taxes

2. **Period of fragmented gradualism (Time from 1941 to 2002)**

By oblishing the gebar system HH began to modernase the tax system by enacting a land tax in 1942 (Proclamation No.70/42). According to this law, tax rate (percentage of tax per fixed item) varied mainly based on fertility of the lands. Then after, excise tax, custom duties in 1943; income tax in 1944 (Proc. No.60/44), education tax in 1947, and health tax in 1959 were added. This way, tax laws proliferated from time to time one replacing or amending the other. The Ethiopian tax system assumed its present feature in the period 1941-2002.

Beginning from the down fall of the Derg regime, the country needed a huge economic reform to change the existed command economy. Thus with the help of some international donor institutions, Ethiopia carried out a tax reform as part of the Economic Reform Program (ERP). As a result, lots of changes have been made and new kinds of tax have been introduced. Here follows an account on the Ethiopian Tax Reform of 2002.

1.5. TAX REFORM

The Rest of the World and the Ethiopian Tax Reform of 2002/ and 2016

1. Approaches to Tax Reform

1. The Macro Economic Approach: focuses on the macro-economic fundamentals of tax reform: its impact on aggregate demand and supply, on creating full employment, and reducing inflation or on stimulating economic growth.

2. The Administrative Approach: emphasizes the administrative side of taxation; focuses on what can be done given the administrative capacity of the tax system.

3. The Political Approach: views tax reform as a product of political bargaining between the government and voters; as an exercise in political legitimating.

In practice, tax reform is often interplay of all of the approaches, and seldom about one of them. They are too ideal, and discount the messy and sometimes chaotic nature of tax reform.

2. Bases for the Tax Reform

Why tax reform?

A. Complex and outdated tax law

The tax law No. 173/61 was put into practice for more than 40 years without major changes (only with minor amendments). Actually, it was only formally repealed by Art.119 of the current Income Proclamation No.286/2002 as modified by Proclamation No. 979/2016 . As a result it could not serve for the current economic setup of the country and also could not go with the current world economic system of Globalization and automation. The tax system before the reform had extremely high rates and many brackets (groups of income to be taxed differently).

This resulted in complex structure such that neither the tax collector nor taxpayers could easily determine the taxes owed in a particular set of circumstances. High tax rates and narrow tax base, which were reinforced each other, were the major feature of the tax system prior to the reform measures. The law did not furnish legal ground for tax administration to enforce tax collection. As a result, the tax administration could not collect tax due that has been accumulated over the years. The Government was excessively relied on the distorting excise and duty taxes for indirect tax revenue. These were frequently tied to the purchase of productive inputs and led to significant cascading (repetition) of taxes and distortion of trade and investment decisions. For instance it is recorded that in the early years of 1990s IMF delegates in Ethiopia found that there has been 13 different tax legislations solely on income tax. This shows how difficult and complex the tax system was begging a reform thus, drove the

government to consolidate the scattered and fragmented laws into a single comprehensive tax law.

B. Weak Tax Administration

The tax administration has constrained with skilled manpower, modern equipment and work-procedure. *The administration was very much weak in the area of tax assessment, collection, follow up and enforcement.* The administration did not even know the exact number of active taxpayers. *Therefore, one key area of the reform was tax administration. This was made possible by rearranging the institutions, which have to do with tax and introduction of a new tax assessment mechanism, as it will be dealt with later.*

C. Failure of the Tax System to Generate Adequate Revenues for Government Expenditure

Resulting from the above, the tax revenue failed to meet government expenditure for many years. This resulted in fiscal imbalance and instability in the economy. For instance, tax revenue to GDP ratio in 1991/92 and 1992/93 was 7.8 and 10.9 percent respectively. At the same time the total expenditure of the Government (recurrent plus Capital expenditure) was at the higher side 20 percent of GDP. *Therefore, generating revenue to finance government expenditure was one of the reasons for the Tax Reform. To fill this gap the broadening of the tax base (sources which can be taxed) was the primary action taken. Currently, to address the wide range of gaps and problems in the tax administration comprehensive tax law has been introduced.*

- The above factors created macroeconomic imbalances such as falling export earnings, worsening balance of payments, mounting debts and declining economic growth
- Thus, in the fiscal front, the aim is to **expand the tax base** and allow government expenditure to grow moderately so that the level of budget deficit could be reduced to a reasonable level.

3. The areas of reform

As a result, the reform introduced, among others the following changes:

- It came up with single and comprehensive tax laws including the Income Tax Proclamation No. 286/2002 which is substantially modified by the new tax proclamation in 2016, Value Added Tax Proclamation No. 285/2002 (which replaced sales tax) and Excise Tax Proclamation No. 149/1999.

- Besides, as stated above, the tax base (jurisdiction) of Ethiopia was broadened; uniformity of tax rates in the different tax brackets and schedules was tried; and self-assessment was introduced. Moreover, the tax officers are empowered to execute tax liabilities efficiently without the need to go to court for execution purpose after the liability is proven.
- In addition to this in 1999 the then “Revenue Board” scaled up to the level of Ministry as “Ministry of Revenue” as part of the reform.
- New comprehensive tax administration proclamation no 983/2016 has been enacted.

1.5. SOURCES OF ETHIOPIAN TAXATION

Tax laws basically emanate from three sources; *legislative, administrative and judicial sources*.

The major sources of Ethiopian tax laws are legislative sources. There are a number of laws that have been adopted by the legislature of the country to deal with the different types of taxes in the country and their administration. *The first law that can be taken as a source is the FDRE*

Constitution which has numerous provisions dealing with the administration of taxes.

Then after, there are a number of proclamations and regulations dealing with taxes in the country, the most prominent of which include Income Tax Proclamation No. 286/2002; Council of Ministers Income Tax Regulation No. 78/2002; Value Added Tax Proclamation No. 285/2002; Council of Ministers Value Added Tax Regulation No. 79/2002; Turnover Tax Proclamation No. 308/2002; and Excise Tax Proclamation No. 307/2002.

1.6. MAJOR TYPES OF TAXES IN ETHIOPIA

The major types of taxes that exist in Ethiopia, their meaning, rates and conditions, as provided by the Federal Inland Revenue Authority, are presented as follows:

1. Value Added Tax (VAT)

This is a sales tax based on the increase in value or price of product at each stage in its manufacture and distribution. The cost of the tax is added to the final price and is eventually paid by the consumer. (Proc no 285/2002 and reg No 79/2002)

1. Excise Tax

This is imposed and payable on selected goods, such as, luxury goods and basic goods which are demand inelastic. In addition, it is believed that imposing the tax on goods that are hazardous to health and which are cause to social problems will reduce the consumption thereof. Excise tax shall be paid on goods mentioned under the schedule of 'Excise Tax Proclamation No. 307/2002' (a) when imported and (b) when produced locally at the rate prescribed in the schedule.

Computation of excise tax is applied (a) in the case of goods produced locally, production cost and (b) in the case of imported goods, cost, insurance and freight /C.I.F.

Payment of excise tax for locally produced goods is by the producer and for imported goods by the importer. Time of payment of excise tax for imported goods is at the time of clearing the goods from the customs area, and for locally produced goods it is not later than 30 days from the date of production.

2. Turnover Tax

This is an equalisation tax imposed on persons not registered for value-added tax to fulfil their obligations and also to enhance fairness in commercial relations and to complete the coverage of the tax system. Administrative feasibility considerations limit the registration of persons under the value-added tax to those with annual transactions to the total value exceeding 500,000 Birr.

Rate of turnover tax is 2% on goods sold locally and 10% on others; as provided by the 'Excise Tax Proclamation No. 307/2002'

CHAPTER TWO: INCOME TAX

(Income Tax Proclamation No. 979/2016 and some parts of Income Tax Proclamation No. 286/2016, Tax administration proclamation no. 983 /2016 and Income Tax Regulation No 78/2002 and various Directives)

2.1. Brief History of Income Taxes in Ethiopia

The concept of taxing income is a modern innovation and presupposes several things. Among others a money economy, reasonably accurate accounts, a common understanding of receipts, expenses and profits, and an orderly society with reliable records are believed to be crucial for the existence of income tax.

For most of the history of civilization, these preconditions did not exist, and taxes were based on other factors. Taxes on wealth, social position, and ownership of the means of production (typically land and slaves) were all common. Practices such as tithing, or an offering of first fruits, existed from ancient times, and can be regarded as a precursor of the income tax, but they lacked precision and certainly as they were not based on the concept of net increase.

A true income tax was first implemented in Britain by William Pitt, the Younger in his budget of December 1798 to pay for weapons and equipment in preparation for the Napoleonic war. The first United States income tax was imposed in July 1861, 3% of all incomes over 600 dollars 0(later rescinded in 1872).

- In Ethiopia, the first income tax law was introduced in 1944 through Proclamation No.60/44.

- Although this law latter amended by Proclamation No.173/61, most of its features subsisted till 2002. This law is famous in introducing the schedular Tax system in Ethiopia. Accordingly, there were three schedules i.e, schedule A, income from employment, Schedule B, rental income, and Schedule C, business income.
- In 1967, Agricultural income tax came into being under Proclamation No.255/67 with additional schedule, Schedule D on incomes generated from agricultural products. Mind you, each schedule has its own rates of income, time of payment, exemptions and the like. As the materialization of Derg's central economy, almost all the urban extra houses were nationalized in 1976. This was actually expected as the regime has explicitly endorsed the socialist ideology. As a result of this, Schedule B (rental income) was removed forthwith.

After the downfall of the military junta in 1991, the 4th schedule was restored

- The FDRE Constitution (Art 97(3)) provided agricultural tax to be devolved to the states. This caused the Schedule D to be composed of collection of different taxes. Latter in 2002, the development of our income tax showed a remarkable achievement by introducing a wholesome and complete income tax law i.e. Proclamation No.286/2002 (herein after the income proclamation).
- Currently (2016) , the above law was Modified by **Income Tax Proclamation No. 979/2016**. This law increased the schedules to 5 by including schedule E exempt incomes. Further it made substantial changes in tax payers category, included income from mining and petroleum in its base, come up with detailed anti avoidance rules and made some changes in tax on international transactions.
- Further, tax administration was regulated by independent proclamation No **983 /2016**

2.2. Major Components of the 2002/ 2016 Income Tax Reform in Ethiopia

In this section we will try to consider the major changes/achievements as a result of the massive income tax reform of 2002/ 2016.

A. Consolidation of the Scattered and Fragmented Tax Legislations

- Before the tax reform program, there had been many and contradicting tax laws in Ethiopia. As has been stated earlier, in the late 1990s a team from IMF found out 13 different but still operational laws pertaining to income tax in Ethiopia. This was also the main source of pain and anxiety to both the government and the taxpayers. It further is

argued that due to the then prevailing absurdity of these laws, even repealed laws might have been applied. Considering this all, the IMF, which was one of the notorious partners in the reform project, recommended that the government should have a single consolidated income tax law. This is helpful in different aspects. It was a response to this that Income Tax Proclamation No. 286/2002 as modified by proclamation No 979/2016 .

B. Tax Jurisdiction: *Generally speaking, the issue of tax jurisdiction relates to the question on what incomes do a given tax law is levied.*

- *We have three common principles of tax jurisdiction, i.e, the source, residence, and the mixture of both.*
- *The first principle focuses on the place where a given income is generated. This means before 2002 Ethiopia had tax jurisdiction only if a given income was accrued within the borders of Ethiopia.*
- *The residence principle, on the other hand, allows the respective country to impose and collect income tax on its residents with respect to their worldwide incomes. This, obviously, is of broader base than the first one. Countries may also combine and utilize both principles.*
- *The income proclamation changed the tax jurisdiction of Ethiopia from the source principle to the use of both the source and residence principles.*

C. Introduction of Self-assessment:

- *Under this system taxpayers are presumed to be honest in telling their exact incomes unless otherwise proven.*
- *This system has two advantages, first it reduces cost of tax administration and by employing effective audit system tax evasion can decry.*

D. Adoption of Self-executing of Judgments:

- *Tax authorities used to go first to the court to get a decision on the tax liability of individual taxpayer, and if this worked right, the authority used to come again to the court for the same case to ask for execution.*
- *Due to the backlogs of cases, applying the above procedures in the tax system would evidently entail a great lose. i.e. the government could not collect the necessary revenue on time. This in turn has a negative implication on the governmental activities and thus public service. Moreover, it has been contributing for the ineffective budgeting system (allocation).*

- The previous income tax law and the current tax administration proclamation empowered the tax authorities to attach and sale, through auction, the assets of the tax liable person to cover the same after the lapse of some fixed time after judgment.
- Simply stated, as a result of the reform, the tax authority now after getting the court judgment will simply wait the individual pay what is due on him/her/it within the time fixed in judgment.
- However, if the individual fails to pay within the deadline, the authority can directly attach and sale some belongings of the person so as to meet the liability. This actually saves the time that has been spent awaiting the lengthy execution process with the help of the judiciary. It also mitigates the tasks of the latter.

E. Introduction of Anti-Avoidance Provisions in the Tax Law:

As commonly called, there are two sins in taxation, namely tax evasion and tax avoidance.

- Tax evasion, being a failure to pay once tax liability, is always punishable as a crime. This is also the case in Ethiopia, as we will see it latter.
- Tax avoidance, on the other hand, as it is true in all legal systems, is regarded as legitimate act in Ethiopia though it harms the government coffers. This act of escaping tax is undertaken through various techniques, and mostly by multinational enterprises (MNE) having branches working in different corners of the world. The respective governments need to close the various loopholes in their tax system to get rid of tax avoidance problems.
- One of the mechanisms they use to escape tax obligation is through **Transfer Pricing**. This method uses the difference in tax rates of different states by adding or subtracting the price of goods as they deem it appropriate in lessening the tax. Let's take the following instance to elucidate the issue at hand. Assume there is one UK parent pharmaceutical company (X), which produces drug and has a subsidiary enterprise (y) in Ethiopia engaged in selling the same. As sister companies, they normally try to manipulate their relation for the sake of lessening down the companies tax liability. This is a common trick they usually use. The UK parent company may sale the drug to its sister company situated in Ethiopia in a simulated contract, which doesn't show the real transaction. For instance, the real price being 1 million Eth. Birr, the contract may state (pretend) as if the drug is bought for 1.3 million Eth. Birr, let's assume. What would this mean from the

tax perspective? As you might know, tax liability is imposed after reducing all the expenses incurred in accruing the gross income from the latter. This, in other words means,

$$\text{Tax Liability} = \text{Gross Income} - \text{Expense}$$

- In our example ‘y’ will be subjected to tax in Ethiopia. But in assessing the tax amount, it will deduct, among other things, 1.3 million Eth. Birr and not the actual price (expense) 1 million Eth. Birr. This in effect harms the legitimate amount of tax Ethiopia deserves from ‘y’.
- The other common tactic used to avoid tax is what’s called **‘Tick Capitalization Strategy’**. *To better understand the notion let’s first consider the two ways of financing a given company. These methods are called debt financing and liability financing.* If a company opts to the first method, it will finance itself by taking loans. The second method relies on contribution of the shareholders. In assessing tax liability, interest paid on loans is deductible. Thus to benefit out of this scheme business organizations may incline to rely much on debt financing as one legitimate way of avoiding (lessening) tax liability. It is to this strategy that literatures name it “tick capitalization.”

F. Introduction of standard /presumptive Tax Assessment:

2.3. Meaning of income and income tax payers (proclamation No 979/16)

A. What type of Income attracts income tax?

The definition for income is provided under Art. 2(14) of the proclamation which states:

Income shall mean every sort of economic benefit including nonrecurring gains in cash or in kind, from whatever source derived and in whatever form paid, credited or received.

- Along with this definition the legislators has classified income by reference to the respective source from which such income may be derived. (see art 8 and 6)
- Art 8 on its part limits the application of art 2 (14) ,by classifying the sources of income to 5 schedules.
- The source of income is separated into different schedules and income computed under each source of income is separated into different heads and income computed under each head is separately taxed. The principle followed by the proclamation is that “tax is charged only so long as a taxpayer possesses the source of income”.

There are structural and administrative limitations that stand in the way of applying the definition in practice.

- The schedular system imposes its own limitations b/c the definition provided under article 2 (14) seems to be narrowed down by operation of art 8 of the proclamation, since taxable sources of income are categorized into 5 schedules Making the wording “every economic gain “ as provided by the former art superfluous.
- Problems of valuation make it difficult to capture many forms of income-in-kind.
- There are also express exemptions for some types of income.

B. Categories of Taxpayer

1/ for the purposes of this Proclamation there shall be the following categories of business taxpayers.

A) Category “A” taxpayer being (two types)

1/ A company

2/ any other person having an annual gross income of Birr 1,000,000 or more;

b) category “B” taxpayer being a person, other than a Company, having an annual gross income of Birr 500,000 or more but less than 1,000,000

c) Category “C” taxpayer being a person other than a Company, having an annual gross income of less than Birr 500,000

C. Taxable income and gross income

- **Gross income** Is taken to mean the total or aggregate income received by an individual. Whatever their sources may be, any types of income that an individual collects constitute his/her gross income.
- **Taxable income** refers to the amount of income on which actual income is charged, levied and collected after all deductions have been made in accordance with the relevant laws.

2.4 Income Tax Jurisdiction: Global Jurisdiction on Residents and Source

Jurisdiction on Non-Residents

What factors should be considered to subject a person/transaction to certain tax jurisdiction? What are the grounds (connecting factors) are worth noting in levying a tax?

A writer named Barry Spitz in his book entitled ‘International Tax Planning’ explained this as follows:

Liability to tax is dependent upon the existence of a connecting factor between a taxing jurisdiction on the one hand and a taxpayer or taxable event on the other.

- He then proceeded to assert that in the case of an **individual taxpayer**, the principal factors are residence, domicile and/or citizenship.
- Whereas in the case of **companies**, according to the writer, it could be their management and control, beneficial ownership, place of incorporation, and location of the registered office.
- With regard to **taxable event**, the principal connecting factor can be the deemed or the real source. For example, in the case of profits deriving from the sale of goods, the source might be the place of the formation or the execution of the contract.

What criteria have been opted in the Ethiopian income tax law?

Article 7. Scope of Application

1/ *This Proclamation shall apply to residents of Ethiopia with respect to their worldwide income.*

2/ *This Proclamation shall apply to non-residents with respect to their Ethiopian source income.*

Thus:

- Ethiopia uses the combination of both the **source and residence** principles in levying income tax.
- **Ethiopia can impose tax on residents with respect to their worldwide income and to non-residents with respect to their Ethiopian source.** Thus, it really makes use of both principles- residence and source.

A. Application of residence for tax purposes

So, who is/are resident/s?

1. Physical persons

Article 5(1-2) addresses the issue of individuals and reads as follows:

5. Residence

1) An individual shall be resident in Ethiopia, if he:

(a) Has a domicile within 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.

2) An individual, who stays in Ethiopia for more than 183 days in a period of twelve (12) calendar months, either continuously or intermittently, shall be resident for the entire tax period.

The law takes various approaches to determine the residence of an individual for tax purpose.

- The second way opted is to use the *definition given to residence under non-tax law*. Therefore, as stated under sub-Article (a) residence is defined in respect of domicile as defined under the civil code (Art.183ff). (**Art 5(2)(a)**)
- The other method of deciding residence with a better objectivity is the **physical presence test** It employs a certain **fixed number of days to determine whether some body is resident of Ethiopia or not**. Thus anyone who happens to be **in Ethiopia for 183 days** consecutively or intermittently (with interruption) in a 12 months period will be considered a resident for the tax year under consideration. (see **Art 5 sub-Article 2 c and sub article 4 and 5**.
- Lastly, Ethiopians *holding diplomatic or consular posts abroad are also specifically made to be residents of Ethiopia despite their physical absence from the country*. This is so important in that these individuals are mostly freed from taxation in the receiving states due to their privilege (fiscal immunity). Thus they need to pay tax from their income to the sending state Ethiopia. (**Art 5 sub-Article 1(b)**)

2. Juridical Persons

Concerning the juridical persons their residence is determined in the following way. Here follows Art.5 (5-7):

5/ A resident body is a body that:

- a) Is incorporated or formed in Ethiopia; or
- b) Has its place of effective management in Ethiopia.

6/ a resident company is a company that is a resident body.

7/ a non-resident is any person who is not a resident of Ethiopia.

Thus, to attribute an Ethiopian residence to a juridical person, **it must be established in Ethiopia or its principal office must be in Ethiopia, or it is being effectively managed from Ethiopia** or else it must be registered in Ethiopia. The effective management can be reached by inquiring where do the members of the board frequently meet or from where is the chief executive manager administering it or the like. The item envisaged under sub Article 4 includes such cases like when a foreign company opens a branch in Ethiopia. The branch, though it's under the control of the foreign company, is being considered as a permanent establishment of the non-resident company. For tax purpose, the law considers it as a separate entity residing in Ethiopia.

B. Source principle for tax purposes

1/ Employment income derived by an employee shall be Ethiopian source income:

**a) To the extent that it is derived in respect of employment exercised in Ethiopia, wherever paid;
or (The employment is conducted in Ethiopia)**

b) If it is paid to the employee by, or on behalf of, the Government of Ethiopia, wherever the employment is exercised. (Any payment made by Ethiopian government)

2/ Business income derived by a resident of Ethiopia shall be Ethiopian source income except to the extent that it is attributable to a business conducted by the resident through a permanent establishment outside Ethiopia. (Business income from whatever source save to income derived by non permanent establishment)

3/ Business income derived by a non-resident shall be Ethiopian source income to the extent that it is attributable to:

- a) a business conducted by the non-resident through a permanent establishment in Ethiopia;**
- b) sales in Ethiopia by the non-resident of goods or merchandise of the same or similar kind as those sold by the non-resident through a permanent establishment in Ethiopia; or**
- c) any other business activity conducted by the non-resident in Ethiopia of the same or similar kind as that conducted by the non-resident through a permanent establishment in Ethiopia.**

If the source is Ethiopia either derived by the parent company or via its permanent establishment

4/ Despite sub-articles (1), (2), and (3) of this Article, income derived by a person shall be Ethiopian source income if it is

a) A dividend paid to the person by a resident body;

b) Rental income from the lease of:

(1) Immovable property located in Ethiopia; or

(2) Movable property located in Ethiopia subject to tax under Article 57 of this Proclamation;

c) A gain arising from the disposal of the following:

(1) Immovable property located in Ethiopia;

(2) a membership interest in a body, if more than 50% of the value of the interest is derived, directly or indirectly through one or more interposed bodies, from immovable property located in Ethiopia;

(3) Shares in, or bonds issued by, a resident company;

d) An insurance premium relating to the insurance of a risk in Ethiopia;

e) Income from a performance or sporting event taking place in Ethiopia;

f) Winnings from a game of chance held in Ethiopia;

g) Interest, a royalty, management fee, technical fee, or other income subject to tax under this Proclamation:

(1) paid to the person by a resident of Ethiopia, other than as an expenditure of a business conducted by the resident through a permanent establishment outside Ethiopia; or

(2) paid to the person by a non-resident as an expenditure of a business conducted by the non-resident through a permanent establishment in Ethiopia.

2.5. Income Tax Systems

There are two tax systems with regard to the structure of the **personal income tax** in the world: schedular and global. Under

- **Schedular taxation** the source of income is divided into different heads and income computed under each head is separately taxed. **Each schedule has its own rules for determining the amount of income, the rate, exemption and the available deductions if any.**
- **Global tax system** on the other hand involves imposition of single income tax on a person for every source of income. Unlike Schedular taxation, there is only one base and rate of income taxation.
- **Intermediate Tax strictures**

In between are those tax systems in which the elements of both global and schedular systems are combined, although one type is predominant. US, Canada and Australia are countries with global income tax structures but they have many schedular features. E.g., capital gains in these countries are subject to a separate and preferential tax rate structures. Certain losses are subject to restrictive deduction rules. On the other hand, some countries with predominantly schedular structures have some global elements: European countries and Japan. These countries allow losses from one category to offset income from other categories.

- **Which one tax structure does Ethiopian Tax system represent?**

Issues in Structural Design

1. If the tax rates among different sources differ, they provide an incentive for tax planning to cast the income as one falling under a lower tax rate schedule.
2. Schedular systems make it difficult to implement the aims of progressive income taxation.
3. Global income tax structures require a strong tax administration with the capacity to aggregate and compute the income of the individual as a whole.

2.1. The Schedular System of Ethiopian Income Taxation

2.1.1.1. Major Schedules of the Income Tax

**2.1.1.2. SCHEDULE (A) INCOME (EMPLOYMENT INCOME) (ART. 10-12 and article 62
PROC. & ART. 3, 4 REG, if needed.)**

- **Who is an employee according to the tax law? Art.2 (7) :**

“Employee” means an individual engaged, whether on a permanent or temporary basis, to perform services under the direction and control of another person, other than as an independent contractor, and includes a director or other holder of an office in the management of a body, and government appointees and elected persons holding public offices.

- **An employee is contrasted with a contractor, who in turn is defined as :**

An individual who is engaged to perform services under an agreement by which the individual retains substantial authority to direct and control the manner in which the services are to be performed (Art.2(15)) of the same proclamation.

Thus the difference lies on who has the authority to direct and control the task. If the one who is undertaking the activity enjoys a freedom how to accomplish the same, he/ she is a contractor and hence regulated under schedule ‘C’ than ‘A’.

- **Which sorts of incomes are included under this schedule?**

The Base

Article 12: Employment Income

1/ Subject to sub-articles (2) and (3) of this Article, employment income means the following:

a) salary, wages, an allowance, bonus, commission, gratuity, or other remuneration received by an employee in respect of a past, current, or future employment;

b) The value of fringe benefits received by an employee in respect of a past, current, or future employment;

c) An amount received by an employee on termination of employment, whether paid voluntarily, under an agreement, or as a result of legal proceedings, including any compensation for redundancy or loss of employment, or a golden handshake payment.

2/ Employment income shall not include exempt income.

3/ If an employer pays the employment income tax payable by an employee, in whole or part, without withholding tax from the employment income of the employee, the amount of tax paid by the employer shall be included in the employment income of the employee.

- *4/ The Council of Ministers shall make Regulations for determining the value and taxation of fringe benefits.*
- *Income from former employment as envisaged under sub-art 2 includes incomes like severance payment or deferred compensation paid after quitting the work.*

- And income from prospective employment takes into consideration like advance payment by a soon-to-be employer. Thus we can safely conclude that actual rendition of service by the employee is not a condition for the income to be of employment.

Exclusion

This being the principle, the proclamation and regulation has also contained a long list of exemptions from employment income tax.

Article 62: Exempt Income

1/ the following amounts are exempt income for the purposes of this Proclamation:

a) The following provided to an employee to the extent provided for in a Directive issued by the Minister:

- (1) *An amount paid by an employer to cover the actual cost of medical treatment of an employee;*
 - (2) *An allowance in lieu of means of transportation granted under a contract of employment;*
 - (3) *A hardship allowance;*
 - (4) *An amount as reimbursement of travelling expenses incurred in the course of employment;*
 - (5) *Travelling expenses paid to an employee recruited from place other than the place of employment on joining or completion of employment, including, in the case of a foreign employee, travel expenses from and to their country of origin, but only if the travel expenses have been paid pursuant to specific provisions of the employee's contract of employment;*
 6. *Allowances paid to members and secretaries of boards of public enterprises, public bodies, or study groups established by the Federal or a State Government or City administration*
- In addition to this the income tax regulation exempts income of persons employed for domestic duties.*

Tax Rate for Schedule 'A'

- It is only after the deduction of these exemptions from the gross income that the resultant will be subject to the different tax rates provided for the schedule. Art.11 regulates the different tax rates applicable to different tax brackets. Here you have the diagram.

Employment Income (per month) Birr	Employment Income Ta
0 – 585	0%
586-1,650	10%
1,651-3,145	15%
3,146-5,195	20%
5,196-7,758	25%
7,759-10,833	30%

Mode of payment**Article 10. Imposition of Employment Income Tax**

1/ Employment income tax shall be imposed for each calendar month at the rate or rates specified in Article 11 of this Proclamation on an employee who receives employment income during the month.

2/ the employment income tax imposed on an employee under sub-article (1) of this Article for a month shall be calculated by applying the rate or rates of tax applicable to the employee under Article 11 of this Proclamation to the total employment income received by the employee for the month.

3/ an employee shall not be allowed a deduction for any expenditure incurred in deriving employment income.

4/ For the purposes of this Schedule and Article 85 of this Proclamation, the employment income attributable to the months of Nehassie and Pagumen shall be aggregated and treated as the employment income of a single calendar month.

5/ If Article 80(1) applies to an employee, the employment income tax payable by the employee shall be a final tax on the employment income of the employee and the tax shall be discharged if the employer has withheld tax from the income in accordance with Article 85 of this Proclamation.

- Schedule 'A' income tax is enforced by using a withholding system in that the employer is obliged, by law, to deduct and retain the deserved amount of tax and then pass it to the government. It is also called **Pay as You Earn (PAYE)** signifying that it is collected before it reaches the employee.

3.8.2. SCHEDULE B INCOME (INCOME FROM RENTAL OF BUILDINGS) (ART.14-16 OF THE PROCLAMATION & ART. 5-7 OF THE REGULATION)

- Why the schedule is only confined to incomes from renting of buildings and why not the land also? What is prohibited under the FDRE Constitution is the sale or similar ways of exchange of the land (Art.40 (3)). Renting land is thus possible. But it has its own legal regime to govern and not by this law.

The Base

Does schedule 'B' include all persons who get income from renting buildings?

- The answer is in the negative. Art. 7 of the regulation governing business lease reads: ***"income from the lease of business, including goods, equipments and buildings which***

are part of the normal operation of a business, shall be taxable under Schedule 'C.'

For instance, it is a well-known fact that the Commercial Bank of Ethiopia has some buildings for rent. But renting such houses is not part of its normal operation (business), it's rather incidental one. Thus such incomes need to be treated under schedule 'B'. Whereas Ayat Real Estate Company in which one of its main operations is being mortgaging and renting houses, such incomes from renting its buildings would fall under schedule 'C' and not 'B'.

- What such an income consists of. Art.5 of the regulation tells us how to go about the calculation of the gross income under schedule 'B'. Accordingly, taxable income from sources chargeable under Schedule 'B' shall be calculated as follows:

1) Gross income shall include:

- (a) All payments in cash and all benefits in kind received by the lessor from the lessee;*
- (b) All payments made by the lessee on behalf of the lessor according to the contract of lease;*
- (c) the value of any renovation or improvement made under the 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 lessor;*

- Thus, the rental fee be directly given to the lessor, some costs incurred by the lessee in the renovation of the building as per their agreement beyond the rent, or else a payment effected by the lessee to a third party according to a prior agreement with the lessor will all account as an income to the lessor.

Deductions

- Art. 16 (1(c))
- As it is the principle in all income taxes, costs incurred by the lessor, for instance, in building, renovating and other attendant activities on the building can be deducted from the gross income before computing the amount of tax due.

The following amounts shall be deducted from income in computing taxable income:

- (i) Taxes paid with respect to the land and buildings being leased; except income taxes; and*
- (ii) for taxpayers not maintaining books of account, one fifth (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;*
- (iii) for taxpayers maintaining books of account, the expenses incurred in earning, securing, and maintaining rental income, to the extent that the expenses can be proven by the taxpayer and subject to the limitations specified by this Proclamation; deductible expenses include (but are not*

limited to) the cost of lease (rent) of land, repairs, maintenance, and depreciation of buildings, furniture and equipment premiums....

- There is a difference in the deductible expenses between lessors keeping the required books and accounts and those who don't do so.
- For the latter group, 1/5 of the gross income will be deducted from the same as an expense, whereas for those who produce the required books a deduction based on their records is available. Thus it is highly advised to keep proper books and accounts and record the expenses.

The rate

Regarding the tax rates, Art. 15 of the proclamation read:

The tax payable on rented houses shall be charged, levied and collected at the following rates:

(a) on income of bodies thirty percent (30%) of taxable income,

(b) on income of persons according to the Schedule B (hereunder)

Tax Rate for Schedule 'B'

Taxable Income from Rental Per Year		Income Tax Payable
Over Birr	To Birr	
0	1800	Exempt threshold
1,801	7,801	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

3.8.3. SCHEDULE C INCOME (BUSINESS INCOME TAX) (ART. 17-30 PROC & ART.8-14)

A. THE BASE

As the terminology indicates the tax under the current schedule focuses on incomes derived from business activities. Thus we need to see how the term business is construed under the pertinent laws and thereby try to understand what really these incomes are.

- *Under the income tax proclamation (Art.2 (6)), business is defined as “any industrial, commercial, professional or vocational activity or any other activity recognized as trade by the Commercial Code of Ethiopia and carried on by any person for profit.” Thus, one needs to refer to Art. 5 of the said Code, which lists the activities regarded as trade to understand what constitutes income from business and thus is to be taxed under schedule ‘C’. The proclamation also makes it clear that the person engaged in one of such activities must set out to get a profit so that the same activity is to be regarded as business or trade.*
- *Hence, it seems commendable to construe that business incomes are those incomes earned from those activities deemed as ‘trade’ under the pertinent laws and which do not fall under the ambit of other schedules.*

B. DEDUCTIONS AND DEPRECIATION

Deduction refers exclusion of expenses (usually non capital) from gross income of a tax payer.

Why deduction?

- *To arrive at taxable income. Only the taxable income of a person really shows that person’s ability to pay. The general principle is to allow deduction of business related expenses and deny personal expenses. Personal expenses are income.*
- **Ethiopian tax law follows/has followed this approach: not only is there a general provision, there are detailed additional rules which sometimes permit certain specific expenses (positive limb) and in other cases, the rules are there to deny deductions of specific expenses.**
- *The basic difference b/n global and schedular systems in this regard are that the schedular systems restrict deductions of expenses to those expenses incurred in connection with a schedule. That is the case too in Ethiopia. But global tax systems have some schedular elements in this regard.*
- Many of the tax systems have special rules for deduction or otherwise of employee expenses due to administrative problems associated with these expenses. Some allow standard deductions, others deny deductions for employees. Ethiopia denies employee deductions completely and instead uses exclusions as proxies for these expenses. This approach is not satisfactory because the exclusions come into effect only if employers provide additional benefits regarding these employee expenses.

Deductable Expenses

- **General Requirement: Article 20 of ITP**
- **Positive Limb Deductions: Article 8 of ITR, Art. 22 ITP, etc.**
 - ✓ Above line deduction or business related expenses Article 8 of ITR, Art. 22 ITP, etc.

- ✓ Below line deduction (non business related) Charitable contributions – Article 10 ITR , Participation deduction – Article 27 ITP, Article 14 ITP
- **Negative Limb Deductions or non deductible expenses: Article 21 of ITP, Article 9 of ITR.**
 - ✓ Capital Expenditures – Article 21(1)(a)
 - ✓ Personal Expenditures – Article 21 (1) (k)
 - ✓ Policy motivated denials – Article 21(1) (d),(g) – punitive damages and penalties; dividends.

Depreciation

- **Depreciation in tax, it is simply a cost recovery scheme in place for capital expenditures.**
The depreciation allowances, while tagged against the assets on the ground, are not really related to the physical condition of the business asset. So an asset may depreciate several times in the hands of several businesses.

1. What are capital assets?

We don't have a definition of capital assets. But we have lists – Articles 23(3)-(5) of ITP (four)

- Buildings – straight line – 5%
- Intangible assets – straight line – 10%
- Information Technology pool – straight line – 25%
- All other assets pool – straight line 20%

2. What are expenditures?

- Direct expenses: costs of acquisition, renewal, improvement, reconstruction – Article 23(7)(a)
- Indirect expenses? Insurance costs, title costs, legal costs, etc.

3. Methods

- **Straight line method: applies flat rate upon the depreciation base, so that the amount of depreciation allowance every year is constant.**
- Ethiopian income tax law applies straight line method for all categories of capital assets, although in practice there is grave misunderstanding about the impact of pooling depreciation upon the method of depreciation.

4. Individual and Pool depreciation

- Some assets depreciate individually – buildings and intangible assets

- Most business assets depreciate in a pool (group) – information technology assets (computers, scanners, photocopiers, printers, computer software); other business assets (vehicles, furniture, machinery, tools and implements).

Application: Individual Depreciation

- Building original cost = 1 million
- Year of acquisition = 1990
- Maintenance = 300, 000
- Year of maintenance = 2000
 - 1 million x 5% = 50, 000.
 - Until 2000, the depreciation base is 1 million.
 - Since 2000, the depreciation base is adjusted by the cost of maintenance = 1.3 million (the cost capitalizes the base because it exceeds 20% of the DB).
 - Assume similar fact situations, except that the building is now sold in 2000 for 6 million. What is the tax consequence? (**income from sale –original cost of building + previously considered DA = Imposition of capital gain tax**)
- Computers = 50, 000
- Photocopier = 20, 000
- Scanner = 10, 000
- Printer = 15, 000
- Year of acquisition: 2005

Assume the following

- Additional computers purchased in 2006 for \$20, 000; printers for 10, 000.
- Some of the computers are sold for 10, 000.
- Some are destroyed due to electricity failures. The cost of destroyed/damaged computers is 5000.

C. Exemptions

See art 30 of the proclamation

D. The rate

See art 19

E. Typical income tax Form

- **Gross Income (aggregate income from all schedule C sources except category C [see Article 70]).**

- Deductions, depreciation and exemptions:
 - Above the line deductions = the sum of ordinary expenses (administrative and general expenses, commissions, cost of trading stocks sold (CoTS), insurance premiums, commissions, etc) + total depreciation allowance (buildings, intangibles, IT pool, other business assets pool).
 - Deduct above the line deductions from Gross Income = AGI
 - Below the Line deductions = charitable deductions (maximum 10% of AGI) + participation deductions (see the limitations in Article 27 ITP and Article 14 ITR)
 - Deduct Below-the-Line Deductions from AGI = Taxable Income (TI)
- **Tax Due = Tax Rate x Taxable Income**
- **If Taxable Income is negative = It is a Net Operating Loss (NOL)**
- **NOL = no tax due and the taxpayer is entitled to carry forward of the loss to future tax years (see Article 28)**

3.8.4. SCHEDULE D (OTHER INCOMES) (ART. 31-37 PROC. & ART. 15-17 REG.)

- Schedule 'D', which is entitled as 'other income', is thus provided to address these gaps of a scheduler system of taxation.
- As the title tells, schedule '*D*' *composes of various incomes which do not fall in the other three schedules. Accordingly it provides different exemptions, ways of calculations, rates and etc for these incomes.*
- The bundles of incomes falling under this schedule include royalties e.g income authors gained from their writings; income from rendering some technical services like advocates or accountants fee; income from games of chance; dividends (from shares); income from rental of property; interest income on deposits (e.g on interest banks pay on deposits) ; and gain on transfer of certain investment property (e.g, income derived from sale of a building, a capital gain). Here follows the pertinent provisions on the different sources of incomes allotted under the schedule.

Art 31. Royalties

- 1) *Royalties shall be liable to tax at a flat rate of five percent (5%).*
- 2) *The withholding Agent who effects payment shall withhold the foregoing tax and account to the Tax Authority within the time limit set out in this Proclamation.*
- 3) *Where the payer resides abroad and the recipient is a resident, the recipient shall pay tax on the royalty income within the time limit set out in this Proclamation.*
- 4) *This tax is a final tax in lieu of a net income tax.*

5) The term "royalty" means a payment of any kind received as a consideration for the use of, or the right to use, any copyright of literary, artistic or scientific work, including cinematography films, and films or tapes for radio or television broadcasting, any patent, trade work, design or model, plan, secret formula or process, or for the use or for the right to use of any industrial, commercial or scientific equipment, or for information concerning industrial, commercial or scientific experience.

Art.32. Income from Rendering of Technical Services

1) 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 a flat rate of ten percent (10%) which shall be withheld and paid to the Tax Authority by the payer.

2) The term "technical service" means any kind of expert advice or technological service rendered.

Art. 33. Income from Games of Chance

1) Every person deriving income from winning at games of chance (for example, lotteries, tombolas, and other similar activities) shall be subject to tax at the rate of fifteen percent (15%), except for winnings of less than 100 Birr.

2) The payer shall withhold or collect the tax and account to the Tax Authority in the manner provided in Article 67.

3) This tax is a final tax in lieu of income tax.

Art. 34. Dividends

1) Every person deriving income from dividends from a share company or withdrawals of profits from a private limited company shall be subject to tax at the rate of ten percent (10%).

2) The withholding Agent shall withhold or collect the tax and account to the Tax Authority.

3) This tax is a final tax in lieu of income tax.

Art. 35. Income from Rental of Property:

Every person deriving income from the casual rental of property (including any land, building, or moveable asset) not related to a business activity taxable under Article 17 shall pay tax on the annual gross income at the rate of fifteen percent (15%). This tax is a final tax in lieu of a net income tax.

Art. 36. Interest Income on Deposits

1) Every person deriving income from interest on deposits shall pay tax at the rate of five percent (5%).

2) The payer shall withhold the tax and account to the Tax Authority in the manner provided in Article 67.

3) This tax is a final tax in lieu of income tax.

Art. 37. Gain on Transfer of Certain Investment Property

1) Income Tax shall be payable on **gains** obtained from the transfer (sale or gift) of property described in this Article at the following rates:

(a) Building held for business, factory, and office 15% (fifteen percent)

(b) Shares of companies 30% (thirty percent)

2) Gains obtained from the transfer of building held for residence shall be exempt.

3) The basis for computation of gains obtained from the transfer of properties described in this Article shall be determined by Regulations to be issued by the Council of Ministers.

4) Any exchange of shares in a resident company which is a party to a **reorganization** - as defined in Article 24(4) - in exchange for share in another resident **company** which is also a party is not a disposal of the shares.

5) The value of the shares given in exchange under Sub-Article (4) shall be equal to the value of the original shares.

6) Loss on the transfer of such property shall be recognized and be available to offset gain subject to the following limitations:

(a) Loss on transfers under this Article may be used to offset gain on transfers under this Article, but may not be used to offset any other income or gain. Unused losses may be carried forward indefinitely.

(b) No loss shall be recognized on transfer to associates within the meaning of Article 2(4).

7) Any person authorized by law to accept, register or in any way approve the transfer of capital assets shall not accept, register or approve the transfer before ascertaining that the payment of the tax has been duly effected in accordance with this Article.

- As you can see from the reading of Art.31 (1), royalties are taxed at a flat rate of 5%. But this provision is currently amended and elevated to 30%.
- The other provision which needs some considerations is Art.35 given its resemblance and confusion with Art.7 of the regulation and still with Art.14 of the proclamation. According to Art.14 of the proclamation, income derived from rental of buildings is to be taxed under schedule 'B', whereas if the renting buildings forms part of the formal operation of some person the income would be treated under schedule 'C' as per Art.7 of the regulation. But still Art 35 talks of incomes from casual rental of property among which building is listed as one to fall under a third schedule 'D'

- This is because it is a big deal when income is taxed under schedule ‘D’ or ‘B/C’. Under schedule as the rate flat one there is no deduction. However, if the same income is treated either under schedule ‘B’ or ‘C’ the taxpayer will be entitled to deduction of at least for expenses. You have the clear deduction of depreciations for schedule ‘C’ and similar deductions are found under Art.16 (1(c)) of the proclamation with Art.5 (2) of the regulation. This, in turn, creates a considerable difference in the amount to be paid as a tax. Thus on a situation where it is difficult to identify an income whether it falls under schedule ‘B’ or ‘D’, tax payers need to be aware of the consequences and try to pay under the preferable schedule
- Article 37 is all about gains resulted from the transfer of business buildings and shares. Here transfer signifies sale of the indicated items. But as we have already considered it, the issue of depreciation also needs to be taken into account in calculating the income gained in such transactions. But gain from the sale of residence building is exempted from taxation. But this will be so only if *according to Art.16 “such building is fully used for dwelling for two years prior to the date of alienation”*.

2.6. Foreign Tax Credit

Foreign tax credit deals with **the administration of taxes on income that is derived from a foreign source**. (Art 7 (1, 2), Art 7 (3) **cum with art 28 (Loss carry forward)**).

- A person can reduce tax paid outside Ethiopia, to the extent the reduction is allowed only as far as it doesn’t exceed the tax that would be paid in Ethiopia. (Art 7 sub 1 and 2)

- If the tax payer paid excess tax after reduction is made he is allowed to carry the loss forward to the next tax periods. (sub 3 and 4)
- 1) *If during the tax period a resident derives foreign source income, the Income Tax payable by that resident in respect of that income shall be reduced **by the amount of foreign tax payable on such income**. The amount of foreign tax payable shall be substantiated by appropriate evidence such as a tax assessment, a withholding certificate or any other similar document accepted by the Tax Authority.*
 - 2) *However, the reduction of the Income Tax provided by Sub-Article (1) shall **not exceed the tax payable in Ethiopia that would otherwise be payable on the foreign source income**.*
 - 3) *In the case of a taxpayer subject to Income Tax on Schedule C income, any reduction of tax prescribed by Sub-Article (1) shall be limited to the tax that would otherwise be payable in Ethiopia computed as if Article 28 (loss carry forward) of this Proclamation applied separately to each foreign country in respect of profit and losses derived from sources therein.*
 - 4) *The reduction of tax prescribed by this Article shall be calculated separately in respect of each foreign country from which income or profit is derived.*

As can be seen from the reading of sub-article 1, **tax credit method deducts the tax paid to a foreign country from the tax due,** and not from the taxable income as it is the case in the deduction method. This makes it more attractive. The formula in computing tax payable of an income involving tax credit goes as follows:

First we determine the taxable income, which is Gross Income – Expenses, then we go to the actual tax to be paid (Total Tax Due), which is Taxable Income × Tax Rate.

It is at this juncture that the issue of tax credit appears. The taxpayer who, in Ethiopia, enjoys tax credit will pay to the Ethiopian government the amount that we find after deducting the amount the taxpayer paid to a foreign country from the Total Tax Due.

Let's exemplify this. Assume an Ethiopian resident obtained an income of birr 10000 in Ethiopia and birr 50000 in his Kenyan based business. In Ethiopia he has to pay on both incomes (Art 3). Assuming his income falls to 10% tax rate, he pays the following amount:

$10000 \times 10\% + 5000 \times 10\% == \text{birr } 1500$. The Kenyan government, assume, only has a tax claim on the birr 5000 with 5% tax rate thus $5000 \times 5\% == \text{birr } 250$.

Thanks to the tax credit method the birr 250 will be deducted from the birr 1500 while paying the Ethiopian government. Thus he pays $1500 - 250 =$ birr 1250.

Art.7 sub Art.2 tells us that the maximum amount which can be deducted by credit method is what the Ethiopian government could collect on the foreign source income. This in other words means that the utmost, Ethiopia, can do under this scheme is to completely waive its right of taxing the foreign-based income.

Taking the above instance, assume that in Kenya birr 5000 income is taxed at 30%, thus $5000 \times 30\% =$ birr 1500. But in Ethiopia, adopting the 10 % rate, the tax payable would be $5000 \times 10\% =$ birr 500. Thus according to Art 7(2), the taxpayer can't claim the deduction of birr 1500. The maximum he can demand for deduction is birr 500.

So far we have been trying to elucidate the unilateral approach of combating double taxation. But as pointed out above, states also apply bilateral agreements, commonly called double taxation treaties, to achieve the same goal (i.e. alleviating and if possible, eliminating double taxation). Ethiopia has entered into such treaties with Yemen, Russia, and Turkey. The treaty we have with Yemen, for instance, states that both countries have agreed to exempt citizens of respective countries from taxation against incomes obtained in the other. Hence, a Yemeni working and earning income in Ethiopia is exempted from the income tax system of Ethiopia. But authorities who wrote these bilateral treaties do not command the required degree of cooperation for its implementation.

2.6. Double Taxation and its Relief Mechanisms

Double taxation can occur at domestic or international level.

- **Domestic double taxation** happens where one tax jurisdiction imposes tax twice in respect of the same taxable event and person. Illustrated, if an income was to accrue in one year and be subjected to tax, but payment was only to be effected in the following year, the taxpayer would not in most cases be subject to tax twice on the same amount. If this is violated and s/he is subject to tax the first year without getting the payment and in the second year after payment, we say there is domestic double taxation.
- **'Domestic double taxation'** does not refer to the case where jurisdictions which are at different levels in a country's constitutional structure (e.g. in federal states like Ethiopia) enjoy concurrent or overlapping taxing power. Nor does it connote to the case where an item is subject to two different types of tax, e.g. income and value added. Thus it only applies to the same tax law administered by a single organ.

- **International double (or multiple) taxation**, on the other hand, occurs *where the tax authorities of two or more countries concurrently impose taxes having the same bases and incidence, in such a way that a person incurs a heavier tax burden than if he were subject to one tax jurisdiction only.*
- Why double taxation? *The fact that the various possible connecting factors between taxing jurisdictions on the one hand and taxpayers on the other are not mutually exclusive.* This in other words means that different states may apply different approaches in levying income tax and this difference might subject the same income to double or multiple taxation.
- **Overlapping tax jurisdiction is result of usage of combination of residence and source taxation.**
- In Ethiopia there exists double taxation. This is due to the fact that our law follows a wide basis of tax jurisdiction combining both the source and residence principles.
- Double taxation would have a negative effect on development of states by restricting the movement of trade and people. That's why also states have been trying to limit its effect to the possible extent.
- ***There two widely used mechanisms to tackle the problems of double taxation, namely, unilateral and bilateral approach.*** To begin with the first, states may unilaterally try to avoid double taxation by using any or combination of the following unilateral devices.
 - ❖ *Tax Exemption*, whereby all or part of the taxpayer's foreign source income is excluded from the tax base. This is so if that income was subjected to tax in the foreign country.
 - ❖ *Tax Credit*, whereby foreign tax, paid or payable is credited against the taxpayer's domestic tax amount.
 - ❖ *Tax Deduction*, whereby foreign tax, paid or payable, is deductible from the domestic tax base, and
 - ❖ *Reduction in the Rate of Tax*, whereby foreign income or assets are taxed domestically at lower rate.

Which of the mechanisms mentioned above, do you think, are available in Ethiopia?

- In the income tax proclamation, its supplementing regulation, and other tax laws, *exemptions, deductions and foreign tax credit* methods are available to tackle double taxation problems in Ethiopia. **There is also tax holiday available to foreign investors. Foreign investors are exempted from income tax for five years.** Thus Ethiopia is surrendering its legitimate domestically sourced income in favor of the resident country of a foreign investor, of course, this

is to attract investment. This tax holiday privilege, although it only stays for limited period and is conditioned upon the fulfillment of some criteria, it is still a unilateral relief mechanism.

- Similarly, despite the fact that it is less attractive than the above, *deduction is also available*. Accordingly, a tax paid to a foreign jurisdiction is deductible from the gross income as if it were an expense incurred in the process of earning the same income. Thus,

$$\text{Taxable income} = \text{Gross Income} - \text{Foreign Tax Paid}$$

Frankly speaking, this does not eliminate the effect of double taxation. It only offers a partial relief. This is so because it is only the amount paid as tax, which is being deducted, and not the tax base used in the foreign country. For instance, Mr. X, an American trader doing business in Ethiopia has gained birr 1 million gross incomes in a certain tax year. Let's further assume that the American tax authorities demanded X to pay 10% of the income as tax. Thus, he pays 10% of 1000000 = birr 100000. Then the Ethiopian government will ask payment of 35% (as we will see it later) as income tax.

This amounts 35% of (1000000-100000), where the 1000000 is the gross income and 1 the 100000 amount paid to the American government. Thus 35% of 900000 = birr 315,000. Here we note that the 900000 is being taxed two times. That's why we say that deduction only provides a partial relief.

The third unilateral form of relief adopted in our law is the tax credit method. To better understand its computation let us reproduce Art 7 of the proclamation, which reads as follows:

2.2. Income Tax Administration

Administration of income tax involves establishment and operation of administrative machinery which assesses and collects income tax in accordance with the law. Generally the administration of income tax is conducted by the Federal Inland Revenue Head Office or any of its branch offices established in any part of Ethiopia and the tax authorities of the Regional states.

- **Income tax administration involves:**
- *Income Tax Accounting* (Art. 58-63 of the Proclamation)
- *Procedures while dealing with Income Tax Administration*
 - ✓ Identification/Discovery
 - ✓ Assessment and Declaration

- ✓ Payment/Collection
- ✓ Taxpayers Complaint Hearing Mechanism (**Art 104-117**)
- ✓ Income Tax Law Enforcement Mechanisms

2.2.1. **Tax Accounting**

- *Tax accounting is about how a certain income or expense should be taken into account in dealing with determination of the tax liability. Specifically, it is about which income of which tax year is to be taxed and in which tax year. I.e. Taxable year and Accounting methods.*

Tax Year (Art 64)

- In principle income and expenses of taxpayers are measured by the annual accounting period.
- As a matter of fact in most states, it holds that annual accounting period coincides with the fiscal year. *This is also the case in Ethiopia. Fiscal year, as it's clearly defined under Art.2 (15) of the proclamation, "shall mean the budgetary year of the Ethiopian Government."*
- **For individual tax payers:** 64 (2) a) from 1st Hamle to 30th Sene.”
- **For bodies**, it is stated that the tax year of each body will follow the accounting year of the respective body (Art 64(2(b))). Thus, as long as bodies consistently follow a certain accounting period, the law recognizes it. But upon request and written approval of the Tax Authority this may be altered.

Accounting methods (59-63)

- Accounting methods determine the year in which income and expenses are recognized. Thus they are also named as years of attribution...deciding which income/expenses is attributable to which year.
- **The Ethiopian income tax law employs two commonly used methods of accounting system, namely, cash basis and accrual basis accounting systems.** This is stated under Art.58 of the proclamation.
- **Both methods are regulated under Art 59 and Art 60 respectively. Before moving to the details, it is stated that bodies shall always follow the accrual basis accounting methods (Art 58 (3)) whereas others can follow either of the two ways under sub-article 2 of the same unless it is clearly provided otherwise by the tax office. Having**

said these, let us see the following provision regarding Cash-Basis Accounting system.

Case

Assume A and B entered into a contract of sale where A would deliver some specified item to B on Megabit 5, 1999 E.C and B pay the agreed amount to A on Meskerem 5, 2000 E.C. If both of them are tax payers, which tax year will be applicable to A and B, as the period of transactions transverse two tax years. Please figure out the two tax years in the above scenario?

1. Cash-Basis Accounting (59)

When is income deemed to be received/ expense paid?

- Art. 59, incomes needs to be registered at the tax year in which the income is **received** or **made available** and expenses when they are incurred or **paid**.
- Thus in the above case between A and B, A would register the income and B his expense in the period between 1st Hamle of 1999 to 30th Sene of 2000. This is so because, it's within this period that A receives the income and B pay or incur the expense. B is already indebted as of Megabit 1999, but the crucial time in this method of accounting is the time the actual payment has been made. What does this phrase 'made available' mean? Assume B gives a cheque to A on Meskerem 5, 2000 E.C., the law consider this as if the payment is received on cash.

2. Accrual basis accounting (60)

When is income deemed to be received/ expense paid?

- When income ripe for tax if it's **receivable** and an expense **payable**.
- ***What matters is the existence of the entitlement or liability alone. One need not actually receive the income so that the income be registered, nor to make the actual payment for expenses to be accounted. As long as the entitlement for a certain income is there, then there will be taxation.***
- Thus in the above scenario between A and B, the period extending from 1st of Hamle 1998 to 30th Sene of 1999 the income will be the tax period.
- As it is stipulated under sub-article 5 of art.60, the inclusion of expenses is still subject to the satisfaction of some conditions.
- ***In order to include certain expenses in a given tax year, we need first to make sure whether liabilities can be ascertained with accuracy in that period. If that is possible even without the actual payment, we can move to the next issue.***

SPECIAL ACCOUNTING: CLAIM OF RIGHT (Art 63)

- Designed to arrest the uncertainty of reality, taxpayers may receive income or incur expenses but uncertainty may remain about whether the income is theirs to keep or the expense is theirs to incur.
- Claim of right refers to ‘money or property received as income that the recipient holds under a claim of right’ but he is required to restore in whole or in part in a later year, to the payer. Claim of right was originally developed by courts to accord finality to the tax year.
- Claim of right applies to both cash and accrual basis taxpayers.
- **Cash basis taxpayers are required to report as income or expense an item which they claim to be entitled to receive or legally obliged to pay even though they are not legally entitled to receive the amount or liable to incur the expense.**
- **Accrual basis taxpayers are required to report as income any receivable or as expense any outgoing payable if they claim to be legally entitled to receive or to be legally obliged to pay the amount even though they are not legally entitled to receive the amount or liable to make the payment.**

Example

- A, a cash basis taxpayer, sold property to B in exchange for the payment by the latter of 10, 000 ETB. B paid the cash during the 1st tax year but realized that the property is defective. The case went to the court and the court declared that the property is defective and ordered A to return the 10, 000 ETB during the 2nd tax year. A must report the 10, 000 ETB during the first tax year in spite of the ongoing dispute and deduct the same amount from the GI of the 2nd tax year when he has to return the money due to court order.

SPECIAL ACCOUNTING: Long term contracts (Art 64)

- Long term contracts pose special challenge to the annual accounting system of taxation. Taxpayers subject to long term contract may not be paid at the beginning of the contract and may not have the wherewithal to pay the tax.
- The income as well as the costs of a long term contract may not be ascertained until the end of the contract. Over all, a long term contract is fraught with uncertainties which may keep the tax system guessing until the end of the contract.

- Long term contracts are defined as ‘contract for manufacture, installation, or construction, or, in relation to each, the performance of related services, which is not completed within the tax period in which work under the contract commenced, other than a contract estimated to be completed within twelve (12) months of the date on which work under the contract commenced’. See Article 63(5).

Methods of accounting (64 (1,2,3))

- ▶ **A portion of the total contract price is recognized every tax year in proportion to the costs of the contract.**
- ▶ For example, if a construction company agrees to construct a road for one hundred million Birr and estimates that the total cost of construction will be 80 million Birr, the one hundred million Birr is recognized in portions every year in proportion to the costs of construction every year. If during the first year of construction, the company incurs a cost of 40 million Birr, the ratio of the cost to total cost is half, and therefore, half of the total contract price is recognized during the first year.
- ▶ Sometimes, the recognition of income and expenses under the percentage of completion method may lead to a situation where there is no longer income to be recognized – a loss. The long term accounting rules allow the company accounting in this way to carry-back the loss to the earlier years. This is because there is no income in the future from which the extra expenses may be deducted. Incidentally, this is the only situation where Ethiopian tax law allows loss carry-backing, instead of loss carry-forwarding.

2.2.2. PROCEDURES WHILE DEALING WITH INCOME TAX ADMINISTRATION

I. Identification/Discovery (Art 43 – 47))

- Our law requires tax payers to have Taxpayer Identification Number (TIN) as way of identifying them as tax payers. Taxpayer Identification Number (TIN) is introduced following 2002 tax reform.
- Thus every taxpayer has got a TIN registered at the office of the Tax Authority to simply check whether s/he is paying one’s tax liability or not. No one can have more than one TIN (Art.43 (a)).

II. Assessment and Declaration

- In a nutshell we do have two strands of tax assessment namely, self and non-self assessments.
- The difference between the two systems lies on the degree of the involvements of the tax authority.
- **In the non-self method** taxpayers are required to submit appropriate books and accounts to the authority so that the latter can compute the tax liability.
- Thus, while taxpayer declares, the authority will assesses. But this is costly and time consuming.
- **In the self- assessment** regime the obligation of taxpayers go beyond submission of documents. Tax payers also compute their tax liability. Self- assessment thus relies on the honesty of the tax payers.
- The authority however should provide tax payers tax-forms, which is simple, logical and complete to help taxpayers compute the tax properly.
- Tax forms are supposed to contain items like: preliminary personal data (name, TIN, address.); gross income; possible deduction; tax rate; possible credits like the foreign credit under Art. 7, and the tax due that is payable to the government.

TYPES OF ASSESSMENT IN ETHIOPIA

1. THE WITHHOLDING SYSTEM

A. Art 51. Withholding of Tax on Employment income

B. Art 53. Withholding of Income Tax on Payments

What types of tax payers are listed here?

- ✓ *Organization, having legal personality, government agencies, private nonprofit institutions, and non-governmental organizations ("NGOs")*

To what types of transactions shall they with hold? (Art 24 ITR)

- 1) Supply of goods involving more than birr 10,000 in anyone transaction or one supply contract;**
- 2) Rendering of the following services involving more than birr 500 in one transaction or one service contract:**
 - (a) Consultancy service;**

- (b) Designs, written materials, lectures and dissemination of information;
- (c) Lawyers, accountants, auditors and other services of similar nature;
- (d) Sales persons, arts and sports professionals, and brokers including insurance brokers and other commission agents;
- (e) Advertisements and entertainment programs for television and radio broadcasts;
- (f) Construction services;
- (g) Advertisement services;
- (h) Patents .for scientific and intellectual works;
- (i) Rent for lease of machineries building and other goods including computers;
- U) Maintenance services
- (k) Tailoring;
- (l) printing;
- (m) Insurance,

3) The Minister or Finance and Economic Development may be directive increase or decrease the list of goods and services or the threshold.

4) Splitting procurements which otherwise should be made in a single transaction, with the intention of hindering the withholding of tax, shall be a criminal offence punishable under the Proclamation.

What is the obligation of the Withholding agent? (Art 25 ITR).

- (a) Issue serially numbered official receipt to persons. and organizations from whom tax is withheld;
- (b) fill in a form to be supplied by the Tax Authority, the name, the tax payer identification number (if supplied) of a person of organization to whom payment made, and the total amount of money paid and tax withheld;
- (c) Person and organization withholding the tax shall transfer to the Tax Authority the amount withheld within the month, together with the form indicated under Article (1) above.

2) The Tax Authority shall prepare and distribute the form mentioned,

C. Art 54. Withholding of Schedule' 'D" Income Tax on Payments

2. SELF ASSESSMENTS

What category of tax payers are included?

Category “A”, “B” and “C” taxpayer as envisaged under Art.2 (16) of the proclamation. Art.18 of the regulation has also provides the definition of these categories.

- **Self assessment applies to category A and B taxpayers**, this categories are duty bound to keep books and accounts. As result, self-assessment is allowed by the law for tax payers in these two categories. (**Art 48 and Art 66 ITP cum 19 ITR**)

3. PRESUMPTIVE / STANDARD ASSESSMENTS

Category C tax payers as they do not keep books and accounts, **Standard Assessment method are employed.**

- Standard assessment is used to ascertain the tax liability of individuals whose annual turnover is below birr 100,000. This form of assessment is also called Presumptive Taxation. Such taxes have been explained to “**involve the use of indirect means to ascertain tax liability, which differ from the usual rules based on a taxpayer’s accounts.**” It is a pragmatic but imperfect approach to the challenges of taxing small business.
- Given the low economic development in the country, category C forms the greatest majority of taxpayers in Ethiopia.
- Those small business runners do not keep books and other necessary documents in their transactions in most cases. That’s why also the standard assessment is being applied. Category C taxpayer if they keep books which is acceptable to the Tax Authority, their tax liability will be assessed accordingly (**art.21 (3) of the regulation**).

Why standard assessments?

- **Simplification**, particularly in relation to the compliance burden on taxpayers with very low turnover (and the corresponding administrative burden of auditing such taxpayers)
- **To combat tax avoidance or evasion** (which works only if the indicators on which the presumption is based are more difficult to hide than those forming the basis for accounting records)
- **By providing objective indicators for tax assessment, presumptive methods may lead to a more equitable distribution of the tax burden**, when normal accounts-based methods are unreliable because of problems of taxpayer compliance or administrative corruption
- **Rebuttable presumptions can encourage taxpayers to keep proper accounts**, because they subject taxpayers to a possibly higher tax burden in the absence of such accounts.

- **Presumptions of the exclusive type can be considered desirable because of their incentive effects**—a taxpayer who earns more income will not have to pay more tax

How then is presumptive taxation to be administered? Art.68

- Taxpayers therefore pay taxes according to a pre-fixed amount. While fixing the tax liability of those payers there would first be a survey by the appropriate organs taking into account the type of **the business, size and location of the same**. This because it is believed these factors can determine the taxable income.
- Last but not least, in relation to assessment and declaration, **aggregation is also allowed for those persons who derive income from different sources subject to the same schedule in the assessment process**. Thus one may sum the capital gain and the incomes obtained from dividends at that year and know on which category the taxpayers fall. This is stated under Art.70 of the proclamation.

III. Payment/Collection

- In our law and laws of most states, payment is effected simultaneously with assessment and declaration. This being the principle (Art.74), we still do have exceptions to this.
- Failure to make a timely payment results on the imposition of an interest and penalty for late payment. The interest rate is very elevated from the normal rate to achieve its punitive nature. Art.75

What if one is compelled to pay an amount in excess of what is required and this fact is discovered latter. The law envisaging such possible mistakes has provided a solution. **Art.76. Credit and Refund**

3.9.3. TAXPAYERS COMPLAINT HEARING MECHANISM (ART 104-117)

- As administration of tax involves issues which are economically sensitive and complex one, complaints are abundant. Thus, a good tax law provides a complaint settlement mechanism. Our income tax law affords different forums of justice to those taxpayers having complaints pertaining to tax.

There are three stages in compliant hearing mechanisms:

1. Review Committee

Who Appoints review committee? Art.104

- The Minister of Revenue or the competent authority of the regional government, as appropriate, upon the recommendation of the head of the Tax Authority.

What are the Powers and Duties of Review Committee? Art. 105(1).

- (a) To examine and decide on all applications submitted by tax payers for compromise of penalty, interest, and waiver of tax liability;
 - (b) To gather any written evidence or information relevant to the matter submitted;
 - (c) To summon any person, who directly or indirectly has dealt with the assessment, to appear before it for questioning him about the case under its investigation; and
 - (d) To review determination made by the Tax Authority for accuracy, completeness, and compliance with this Proclamation.
- 2) The committee shall only review applications submitted to it **within 10 days of receipt of tax assessment notification.**
- 3) The **Head of the Tax Authority may approve the recommendations or remand the case, with his observations, to the committee for further review.**

2. The Tax appeal commission (Art107-111)

- If taxpayers object the assessment made under the above provisions, they still do have a way to appeal to the next organ i.e. the Tax Appeal Commission.
- **Establishment(appointment) of the commission (Art 113 and 114)**
 - **Art.113** envisages the establishment of such commissions at the federal, regional, zonal, and werada levels being accountable to their respective executive organs. It is also stated that Members of Appeal Commission at every level shall be appointed from among persons having good reputation, acceptability, integrity, general and professional knowledge, and from among persons who have not committed any offense in connection with tax and tax administration (Art.114(1)).
- **Right and conditions for appeal**
 - Any taxpayer who objects to an assessment may appeal to the Tax Appeal Commission (Art 107 (1))
 - **Conditions**
 - (a) Deposition of (50%) of the disputed amount is made to the Tax Authority; and
 - (b) The appeal is lodged with the Appeal Commission **within thirty (30) days following the day of receipt of the Assessment Notice or from the date of decision of the Review Committee.**
- **Contents of the appeal (Art 109 ITP)**
- **Service of Documents (110)**
- **Powers and Duties of Appeal Commission and of its Chairperson (115)**

- 1) The Appeal Commission shall have the authority:

(a) To confirm, reduce, or annul any assessment appealed against on the basis of established factual grounds and the law, and make such further consequential order thereon as may seem just and necessary for the final disposition of the matter;

(b) To instruct the Tax Authority or the taxpayer to submit new facts, if any; and

(c) To order the Tax Authority or the taxpayer or any other person or governmental department or agency, as the case may be, to produce supporting evidence relevant to the taxpayer's allegation.

2) An Appeal Commission's Chairperson shall:

(a) Make preliminary examination of memoranda of appeal;

(b) Prepare the agenda for the panel;

(c) Preside over and guide the proceedings;

(d) Ensure that the arguments are properly recorded in the minutes and that the decision conforms to the prescribed form; and

(e) Submit an annual report about the accomplishment (performance) of the commission he presides over.

- **Decision of Appeal Commission (Art.111)**

1) After reviewing the case, the Appeal Commission shall issue a written decision setting out the TIN of the appellant and the date of decision, the names of the panel members and the panel's chair person, and a statement of the decision.

2) The statement of the Commission's decision shall include:

(a) The holding (whether the appellant's claim is justified and accepted partly or wholly, whether the claim is remanded with instructions to the Tax Authority; and the amount the appellant is required to pay, if any, and other necessary details of appellant's liabilities);

(b) The factual findings, citation to the applicable law, legal interpretation, a conclusion on each relevant issue presented; and any dissenting opinion.

(c) A summary of the appellant's appeal rights.

3) The decision shall be signed by the panel members present, and the Seal of the Appeal Commission shall be affixed thereon.

4) The Appeal Commission may decide, ex-parte where:

(a) Any appellant fails to give counter reply when necessary, or to appear before it on two occasions, after lodging appeal; or

(b) The Tax Authority, after receiving the memorandum of appeal, fails to give reply or to appear before it on two occasions.

3. Appeal to court (Art 112)

- The law further allows aggrieved taxpayers to take their cases from the commission to competent court of appeal, which seems to be **the high court, “on the grounds of error of law within 30 days from the date of receipt of the written decision of the Appeal Commission.”**
- The appeal however is allowed **only on the grounds of question of law and not fact.** The court then would hear and determine the existence of erroneous application of the law and return the case to the commission for its final decision accordingly.
- An appeal to the **next court of appeal from the decision of the lower court of appeal maybe made by either party, within thirty (30) days of the decision of the lower court of appeal (to Supreme court).**
- A taxpayer’s appeal **shall not be accepted by the court unless at the time the appeal is lodged, the taxpayer has paid the tax liability determined by the Appeal Commission (Art 112(3-4).**

3.9.4. INCOME TAX LAW ENFORCEMENT MECHANISMS

The enforcement of the income tax law relies much on the honesty of taxpayers and cooperation of other stakeholders. Thus the law should arrange some kind of incentives for those who cooperate for the effective implementation of the law. To begin with the first incentive the law arranged:

Art. 84 read:

1), Where a person provides a verifiable and objective information of tax evasion through concealment, under reporting, fraud or any other improper means, the informer shall be granted up to twenty percent (20) of the amount of tax evaded at the time of collection of the said tax.

2) The informer shall not be entitled to such a reward where:

- (a) he/she has participated in the tax evasion; or*
- (b) where such reporting is part of his/her employment duty.*
- 3) Details shall be provided by the directives of the Tax Authority*

A person who gives the appropriate tax organ a well founded information showing tax evasion will partake up to 20% of the evaded amount. There is also a possibility where taxpayers and tax officers, who scored an outstanding performance in discharging their responsibilities, will be awarded. Apart from the incentives, the law has provided different penalties for those who defaulted their tax obligation and responsibility

To begin with the first, late filing or non-filing; understatement (declaring income below the reality); late payments than the specified periods; failure to keep proper records required by the law; failure to withhold tax when one is supposed to; and failure to meet the TIN requirements results in penalties specifically provided for each. These all penalties are prescribed under Art. 86-91 and are reproduced below.

Art.86. Penalty for Late Filing or Non-Filing

A taxpayer who fails to file a timely tax declaration is liable for a penalty equal to:

- (a) 1,000 Birr for the first thirty (30) days (or part thereof) the declaration remains unfiled); (b) 2,000 Birr for the next thirty (30) days (or part thereof) the declaration remains unfiled);*
- (c) 1,500 Birr for each thirty (30) days (or part thereof) thereafter that the declaration remains unfiled.*

Art.87. Penalty for Understatement of Tax

1) If the amount of tax shown on a declaration understates the amount of tax required to be shown, the taxpayer is liable for a penalty in the amount of 10% (ten per cent) of the understatement or 50% (fifty per cent) if the understatement is considered substantial in accordance with Sub-Article (2) of this Article).

2) The understatement is considered substantial if it exceeds the smaller of the following two amounts:

- (a) twenty-five percent (25%) of tax required to be shown on the return; or*
- (b) 20,000 birr.*

3) The penalty shall continue to apply until, the Appeal Commission or a Court, as the case may be, shall have rendered its final decision.

Art.88. Penalty for Late Payment

A taxpayer who fails to pay tax liability on the due date is subject to:

(a) a penalty of 5% (five percent) of the amount of unpaid tax on the first day after the due date has passed: and

(b) an additional 2 % (two percent) of the amount of the tax that remains unpaid on the first day of each month thereafter.

Art.89. Penalty for Failure to Keep Proper Records

1) The taxpayer shall be liable for a penalty of 20% of the tax assessed if he failed to keep proper books of account, records, and other documents regarding a certain tax year

2) If the Tax Authority finds that a taxpayer has failed for two consecutive tax years, to keep proper books of account, records, and other documents:

(a) the licensing authority shall forthwith suspend the taxpayer's license on notification by the tax authority;

(b) if in a subsequent year the Tax Authority again finds that the taxpayer has failed to keep proper books, records, and documents, the licensing authority shall revoke the taxpayer's license on notification by the Tax Authority;

(c) A finding by the Tax Authority that the taxpayer's failure justifies notification of the licensing authority for purposes of suspension or revocation of the taxpayer's license shall for all purposes of this Proclamation be treated as an assessment and notification may not be sent to the licensing authority until the Tax Authority's finding is final.

Art.90, Penalty for Failure to Withhold Tax

1), A withholding agent who fails to withhold tax in accordance with this Proclamation is personally liable to pay to the Tax Authority the amount of tax which has not been withheld, but the withholding agent is entitled to recover this amount from the payee.

2) The tax withholding liability imposed by this Proclamation shall be treated as a tax liability for purposes of any Article providing taxpayers with the right to contest the amount of tax 'due or to recover tax paid. .

3) In addition to any amount for which a withholding agent is liable under Sub-Article (1), an agent who fails to withhold tax in accordance with this Proclamation shall be liable for a penalty of 1,000 Birr for each instance of failure to withhold the proper amount.

4) A penalty of Birr 1,000 is imposed on the following individuals:

(a) a manager who knew or should have known of the failure described in Sub-Article (1);

(b) a chief accountant or another senior officer who is responsible for supervision or control of withholding procedures and who knew or should have known of the failure described in Sub-Article (1), or whose improper supervision failed to prevent it.

Art.91. Penalty for Failure to Meet TIN Requirements

Taxpayers failing to meet the requirements for TIN are subject to the following penalties:

1) a withholding agent who makes a payment to a person who has not supplied a TIN is required to withhold thirty percent (30%) of the amount of the payment.

2) a taxpayer who has not supplied the TIN to the withholding agent, in addition to what is stipulated under Sub-Article (1) of this Article is liable to pay a fine of 5,000 Birr or the amount of the payment whichever is less.

Beyond the above penalties, the income tax law has also proscribed some acts as tax offences. The principle providing for these offences tell us that tax offences are part of the criminal law of Ethiopia, and the charging, prosecution, and appeals there from is governed by the Ethiopian Criminal Procedure Code. (Art.94). As you might recall laws like those governing corruption and vagrancy cases form part of the Ethiopian criminal law regime. Second, offences are an addition to them.

The acts/omissions that constitute tax offences relates with TIN, tax evasion, false/misleading statements during tax declaration, obstruction/hindrane of the tax administration, and the like. You can find the listing from the plain reading of the income tax proclamation Art. 95-102. Here you have the list of the major tax offences:

Art.95. TIN Violations

If a person subject to tax is convicted of obtaining more than one TIN, that person shall be liable to pay a fine of not less than 20,000 Birr and not more than 50,000 Birr and to imprisonment of five (5) years per additional TIN obtained.

Art.96. Tax Evasion

A taxpayer who evades the declaration or payment of tax commits an offense and, in addition to the penalty for the understatement of income referred to in Article 86, may be prosecuted and, on conviction, be subject to imprisonment for a term of not less than five (5) years.

Art.97. Making False or Misleading Statements

1) A tax payer who:

(a) makes a statement, to an officer of the Tax Authority, that is false or misleading in a material particular; or

(b) omits from a statement made to an officer of the Tax Authority any matter or thing without which the statement is misleading in a material particular; commits an offence and is liable on conviction.

2) Where the statement or omission is made without reasonable excuse,

(a) and if the inaccuracy of the statement undetected may result in the underpayment of tax by an amount not exceeding 1,000 Birr, the tax payer shall be liable to a fine of not less than 10,000 Birr and not more than 20,000 Birr, and imprisonment for a term of not less than one (1) year and not more than three (3) years, and

(b) if the underpayment of tax is in an amount exceeding Birr 1,000, he shall be liable to a fine of not less than twenty thousand Birr and not more than 100,000 Birr and imprisonment for a term of not less than three (3) years and not more than five (5) years.

3) Where the statement or omission is made knowingly or recklessly,

(a) and if the inaccuracy of the statement undetected may result in an underpayment of tax by an amount not exceeding 1,000 Birr, to a fine of not less than 50,000 Birr and not more than 100,000 Birr, or imprisonment for a term of not less than five (5) years and not more than ten (10) years; and

(b) if the underpayment of tax is in an amount exceeding Birr 1,000, to a fine of not less than 75,000 Birr and not more than 200,000 Birr, or imprisonment for a term of not less than ten (10) years and not more than fifteen (15) years.

Art.98. Obstruction of Tax Administration

1) A person who,

(a) obstructs or attempts to obstruct an officer of the Tax Authority in the performance of duties under this Proclamation, or

(b) otherwise impedes or attempts to impede the administration of the Proclamation, commits an offence and is liable on conviction to a fine of not less than 10,000 Birr and not more than 100,000 Birr, and imprisonment for a term of two (2) years.

2) The following and similar other actions are considered to constitute obstruction:

(a) refusal to satisfy a request of the Tax Authority for inspection of documents, reports, or other information related to a taxpayer's income-producing activities;

(b) non-compliance with a Tax Authority request to report for an interview;

(c) interference with a tax officer's right to enter the taxpayer's business premises.

Art.100. Unauthorized Tax Collection

Any person who is not authorized to collect tax under this Proclamation collects or attempts to collect tax (or an amount the person describes as tax) commits an offence and is liable, on conviction, to a fine of not less than 50,000 Birr and to imprisonment for a term of not less than five (5) years and not more than ten (10) years.

Art.101. Aiding or Abetting

A person who aids, abets, incites, or conspires with another person to commit a violation against this Proclamation also commits an offence under this proclamation and shall be subject to prosecution, and shall on conviction be liable to a fine and imprisonment not in excess of the amount of fine or period of imprisonment provided for the offence aided or abetted.

Most of the tax offences are punishable with both fines and imprisonments or either of them. This is just to discourage some potentially dangerous acts in the enforcement of tax administrations. Even an “attempt” in some cases, like as under Articles 98 and 100, constitute an offence. In addition to the above-mentioned tax offences, Art.99 puts serious crimes in relation to tax that can probably be committed by tax officers abusing their power.

Dear Learners! Can you cite the pertinent provisions which criminalize tax offences committed by omission?

Lastly, let's see some points in relation to how practically the tax enforcement bodies effect the tax liability of persons who fail to comply with their duties.

The tax authority wields a power to collect the required tax amount which is due on the tax payer by seizing any property belonging to such person. Even seizure may be made on the accrued salary or wages of any employee, including a government employee, by serving a notice of seizure on the officer who has the duty of paying the salary or wages. Art. 77(2-3) describes how this seizure is to be accomplished and the next steps to be carried out as follows.

2) For purposes of this Section; the term "Seizure" includes seizure by any means, as well as, collection from a person who owes money or property to the taxpayer, Except as provided in Sub-Articles (3) and (6), a seizure shall extend only to property possessed and obligations existing at the time the seizure is made. The Tax Authority may request a police officer to be present during seizure. Where the Authority seizes any property as provided hereinabove, it shall have the right to sell the seized goods at public auction or in any other manner approved by the Authority within not less than 10 days after the seizure, except that when the goods seized are perishable the Authority can sell the goods after any reasonable period having regard to the nature of the goods.

3) Whenever any property on which seizure had been made is not sufficient to satisfy the claim for which seizure is made, the Tax Authority may, thereafter and as may be necessary, proceed to seize other property, liable to seizure, of the person against whom the claim exists until the amount due, together with all expenses, is fully paid.

Seizure of remuneration or other property of any defaulting taxpayer is only possible after the Tax Authority has notified such person in writing of its intention to make such seizure. And the notice shall be delivered not less than thirty (30) days before the day of the seizure as per sub-article 4 of Art.77. Thus the seizure should not be conducted by surprise but only after a 30 days prior notice to this effect. In addition to this, the law excludes some items from being subject to of seizure. These, as exhaustively listed under the 7th sub-article of the same provision, are:

- (a) such amount of employee remuneration or other periodic income payable to an individual does not exceed the exempt amount according to Schedule A; and

(b) all other income and property that are not liable to attachment or lien under Ethiopian law.

It is clear that if the payment due to an employee does not exceed the amount s/he enjoys under the exemption of the respective schedule the income falls, no seizure will be made for there is nothing to be taxed. In addition, the items envisaged under (b) above take into account provisions like Art. 404 of the Civil Procedure Code, which lists things exempted from attachment.

The law also tries to safeguard taxpayer's interest whose property is seized. In so doing, it is provided under Art 83 that any property seized under this Section shall only be seized, held and accounted by the Tax Authority. No other agency of the government may require the property seized under this section to be transferred or given over to it for any cause whatsoever. If any property seized under this Section is sold, any portion of the proceeds in excess of the taxpayer's liabilities under this section shall be returned to the tax payer.

Anybody who happens to be the custody of the property of the defaulting taxpayer is, as per Art.78, duty bound to surrender the property. This is unless the indicated person has an already established right over the property or the same is encumbered with some judicial attachment.

Moreover the law unequivocally has given the authority a preferential claim on the property of the defaulting taxpayer over other creditors (Art.80). Thus creditors who hold the property of the taxpayer as a security for the debt entered after the time the debtor should have paid the tax. The tax authority is said to have the right to satisfy the tax liability prior to the creditors.

The law specifically singles out entities with an obligation to cooperate. This is found under Art.41 of the income tax proclamation which reads:

41. Co-operation of other Entities

1) All Federal and Regional government authorities and their agencies, Bodies, Kebele Administrations and Associations shall have the duty to co-operate with the Tax Authority in the enforcement of this Proclamation.

2) (a) No Ministry, Municipality, Department or Office of Federal or Regional Government shall issue or renew any license to any taxpayer unless the applicant produces a certificate from the Tax Authority to the effect that tax due in respect of the preceding year or years, have been paid

or where the taxpayer is seeking license for the first time that he has registered with the Tax Authority unless appeal is pending, or time for payment is extended by the Tax Authority.

(b) If the Tax Authority refuses to issue a certificate it shall, on demand by the applicant for the license, provide him or it with a written statement of its reasons therefore.

(c) Any applicant who is aggrieved by the reasons stated by the Tax Authority for refusing to issue a certificate or by the revocation of his or its license may appeal in writing to the Review Committee.

Chapter Three: VAT

3.1. Meaning

Direct taxes those taxes that are assessed upon the property, business or income of the individual who pays the tax.

- **Indirect Taxes** are levied upon commodities which are assumed to carry the burden through prices to be shifted upon the consumers.

General Sales Taxes: may be multiple-stage or single stage sales taxes.

Multiple Stage sales taxes: VAT, ToT

Single Stage Sales Taxes: Manufacturer's, Wholesaler's or Retailer's Sales Taxes.

Specific Sales Taxes: Excise Taxes

Taxes on international trade are also usually **classified among indirect taxes:** taxes on imports and exports.

VAT can be defined as *“A broad-based tax levied on commodity sales up to and including, at least, the manufacturing stage, with systematic offsetting of tax charged on commodities purchased as inputs – except perhaps on capital goods – against that due on outputs”*

The characterizing features of VAT as underlined in this definition are:

- Value added taxes are consumption taxes finally born by the last consumer.
- VAT is collected from broad base unlike taxes such as excise taxes that cover specific goods.
- The tax is levied and collected on every transaction from production to distribution process with the possibility of getting VAT on costs deducted or exempted.
- VAT is different from sales tax in various aspects. While sales tax is to be paid on the total value of the goods and services, VAT is levied on every exchange of the product, so that consumers do not have to carry the total cost of tax. However, VAT is generally not applied on export goods to avoid double taxation on the final product. However, if VAT is charged on export goods, the tax amount is usually refunded to the tax payer.
- VAT is collected in installments at successive stages of production and distribution. It is a multi - state tax rather than a single stage one like the retail sales tax, and in its deal form, is to be levied on all the states of production & distribution.

3.2. History of VAT

VAT was barely known half a century ago.

- It was first introduced in France 1954
- . The then European Community adopted it as a community tax and later on the European Union adopted it as a tax for the union.
- Since the 1980s, with the fiscal crises in many developing countries, International Financial Institutions – the IMF and the World Bank took up the pretext and spread the

‘gospel’ of VAT as a way of generating government revenues, and with their financial influence, VAT spread faster than any other form of tax in history.

- More than 150 countries all over the world claim VAT as one form of tax in their fiscal systems. There are different reasons to adopt VAT for different countries.
- However, there are certain similar reasons which contribute a lot for the expansion of VAT in almost all countries. One of the reasons is that VAT is by far better source of revenue than the other types of taxes as it is imposed on most transactions.
- It ensures neutrality of international trade by employing zero rated VAT on exported goods systems, and more than 40 African countries have adopted VAT as one of their taxes.
- In Ethiopia, value added tax (VAT) was introduced in the year 2003 as a replacement to sales tax. Sales taxes were at first introduced cautiously and tentatively in Ethiopia
- The introduction of VAT in Ethiopia was dominantly helped by the participation of the IMF. The IMF sent its technical personnel back in 2000 that made different recommendations among other things that Ethiopia introduce VAT.
- VAT was recommended because the technical committee forecasted that that Ethiopia would face huge shortage of revenues because of tariff reductions for the sake of trade liberalization. The team also elucidated some of the better qualities of VAT to entice the need of VAT to Ethiopia. Specifically the team recommended the following:
 - Ethiopia introduce VAT with a standard rate of 15% - agreed.
 - Ethiopia introduce VAT with a single VAT rate, and not multiple rates – agreed.
 - Ethiopia introduce VAT with initial registration threshold of 250, 000 ETB – disagreed. The government fixed the threshold at 500, 000 ETB.
 - Ethiopia limit exemptions to few transactions –agreed.
 - Ethiopia introduce the ToT as an equalizing/supplementary tax on small taxpayers – agreed.

VAT was introduced in Ethiopia as federal tax although the Federal Government later agreed to share the proceeds of VAT with the regions.

3.3. Advantage and Disadvantage of VAT

3.3.1. Advantages

A) Income generator for covering the government expenses

- Due to the vastness of tax basis of value added tax system which usually includes the majority of goods and services, this kind of taxation called by governments as a "money producing engine".
- Increasing the tax rates in income decreases the investment and production motivation leading to black-market and prepares the situation for tax evasion and ultimately decreases the government income.
- But due to the vastness of tax basis in value added tax system, the governments can use the lower rates of taxes on all the final sales related to all economic sectors and as a result can generate more income for covering their expenses without decreasing the investment motivation.

B) Minimizing the Tax evasion

- The invoice credit VAT makes taxpayers at different levels watchdogs of one another. It is in the best interest of a manufacturer to purchase with VAT in order to obtain tax credits, as it is of the wholesaler and the retailer.

C) Restructuring and improving the taxation system

- As the structure of economy growth and become more complicated, the necessity of keeping accounts in different small and big size business units increases.
- Thus, in value added tax system, each business unit required to keep its account in a comprehensive manner, so the use of computers for record keeping and processing data in order to produce timely information is more than the traditional tax system models and thus it will result the renewal and deep change in old and traditional taxation system and a dramatic improvement in times and jobs of tax system personnel.

D) The ease of auditing control

- Due to the fact that in value added tax system, the invoices of sales are the base of tax calculation and the amount of sales of goods and services recorded in the specified columns of invoice and according to that value added tax calculated and collected and also because the invoices recorded in the general journal and ledgers of the firms, so (especially in the case of unique tax rate) the system of auditing is simple and effective.

E) The minimum negative effect on allocation of resources

- From economical point of view, value added tax is a neutral tax; because it has no effects on production factors (investment, employment and etc..) and also has the minimum negative effects on economical decisions of the business units.

3.3.2. Disadvantages

The main disadvantages which have been identified in connection with the Value Added Tax are:

A) VAT is regressive

It is claimed that the tax is regressive, i.e. its burden falls disproportionately on the poor since the poor are likely to spend more of their income than the relatively rich person.

B) VAT is too difficult to operate from the position of both the administration and business.

Business

VAT is not an easy tax to comply with: compliance with VAT requires at least the use of invoices (which are not only costly but difficult to comprehend), sometimes sales register machines (which are difficult to handle even for technically savvy staff), Tax credits systems (which require taxpayers to do a fairly complex computation of the output VAT and input VAT), frequent accounting and reporting requirements (monthly accounting of VAT).

C) VAT is inflationary

Some businessmen seize almost any opportunity to raise prices, and the introduction of VAT certainly offers such an opportunity.

- However, temporary price controls, a careful setting of the rate of VAT and the significance of the taxes they replace should generally ensure that there is no increase if any in the cost of living.

D) VAT favors the capital intensive firm

It is also argued that VAT places a heavy direct impact of tax on the labor-intensive firm compared to the capital- intensive competitor, since the ratio of value added to selling price is greater for the former. This is a real problem for labor-intensive economies and industries.

1.5 Work out of VAT (calculating VAT)

- The value added tax collected in every stages of transaction, where successive taxpayers are allowed to deduct input tax on purchases and pay the output tax on sales.
- Every tax payer in the supply chain undertake the act of controlling and collecting the tax, remitting the amount of the tax corresponding to the margin obtained on each transaction, or the difference between the VAT paid out to suppliers as an input tax and

the VAT collected from customers. There are two main approaches for running this staged collection process:

1.5.1 The invoice credit method (“transaction based method”):

- The invoice credit method demands each business collects VAT at the fixed rate on each sale and gives the buyer an invoice certifying the portion of tax thus charged. Then the buyer can reduce the taxes paid to the supplier who supplied input against the tax collected from customers if his transaction is subject to VAT.
- Then the tax payer is liable to pay balance or refund is required from the tax authority if the credit is in excess. Generally, a registered tax payer is liable to pay aggregate output tax after subtracting input tax.

By dint of the invoices in the invoice-credit method looking into the tax credit on the invoices of the input taxes of the buyers and the output tax paid by the buyer, tax fraud can easily be identified.

A) VAT inclusive and exclusive

- VAT may be figured out inclusive or exclusive of the price of the good. If invoice credit method is applied, VAT is typically calculated on top of the price.
- This involves a simple application of the VAT rate to the basic price of the good.
- For example a producer sells tape for 1000 Birr, then the whole seller sells it for 1100, and then the retailer sells to consumer for 1200 Birr. The producer shall collect 150 Birr of VAT from the whole seller. The whole seller shall collect 165 Birr from the retailer and get credit for 150 Birr input VAT that s/he has paid to the manufacturer. The retailer shall collect 180 and get credit of 165 input VAT s/he has paid to the whole seller. The consumer cannot get credit for s/he is the last consumer and VAT is consumer tax.
- The VAT inclusive method aims at calculating the VAT subsumed in the price/value of the good.
- This method is used to compute VAT where the VAT was collected at the time of transaction or where VAT cannot be levied for the special feature of the transaction or if the tax system applies the subtraction method without the invoice credit system.
- The VAT inclusive method ensures that the amount of VAT collected through the exclusive method is equal to the VAT collected through the inclusive method. The VAT inclusive calculation has can be calculated according to the following formula:

Price (inclusive of VAT) x VAT R/100 + VAT R. Let us assume that the total sale is 230,000 birr in which VAT is subsumed. To figure out the VAT we apply the above formula.
 $230,000 \times 15 / 100 + 15 = 230,000 \times (15 / 115) = (230,000 \times 15) / 115 = 3,450,000 / 115 = 30,000$

B) The practical application of VAT inclusive in Ethiopia

- VAT inclusive can be applied in Post-facto transactions when a person who is not registered for VAT or a person who made supplies without issuing VAT exclusive invoices is required to pay VAT.
- Taxation of lottery: lottery is not accessible to the invoice credit VAT system. The VAT inclusive method is instead used to reach the value added in lottery.
- It may also have some applications in bank a foreclosure sale which is going to be discussed later. In practice, there is an unreasoning application of the VAT exclusive method upon taxpayers who have failed to charge transactions with VAT. ERCA applies the rate upon the total sale as if the VAT is yet to be transmitted to consumers. This is clearly a misunderstanding of how VAT works.

1.5.2 The Subtraction method (“Entity based method”):

- Registered tax payer subtracts the value of total non-labor inputs from their gross sales transaction to get the value added by them and then this is multiplied by the tax rate to figure out the tax on added value.

1.5.3 Addition Method:

- This method adds all the expenses incurred in adding value. The payable tax is equal to the value added defined as the sum of wages and profits multiplied by the tax rate.
- The addition method is not politically sound to apply the public, as taxpayers would simply consider the VAT as an additional layer of tax burden on top of corporate and personal income taxes. On the other hand, the structure of the tax implies that the VAT, theoretically, can be used to replace both personal income tax and corporate income tax.

1.6. Value added tax in international trade

There are two principles on the jurisdiction of VAT in International trade. These are the destination and origin principle.

- Destination Principle: VAT is imposed on goods or services on the basis of their destination of consumption. Imports subject to VAT and exports are zero-rated.
- Origin Principle: imposes VAT on the basis of the origin of the good, rather than its destination. Goods imposed where they are produced. Imports not subject to tax and exports are subject to tax.

2. The Legal Framework of VAT

2.1 Constitutional framework of VAT

- The constitution under Article 96 and 97 has provided the federal and state powers of taxation.
- Article 98 provides concurrent taxing power in which states and federal government can together exercise their taxing powers.
- Article 99 stipulates that the power of taxation of undesignated areas of taxation shall be determined by joint session of the House of Peoples of representatives and House of federation. This power does not refer to residual power of taxation unlike other residual powers.
- Although the constitution talks about sales tax, the taxation power of Value Added Tax is not clearly mentioned in name.
- Article 96 (3), Article 97 (4), and Article 98 (1) of the constitution clearly shows that sales tax can be under the exclusive jurisdiction of federal government, regional government, or under the concurrent jurisdiction of both federal and regional governments. Whether the taxable activities are under the territorial jurisdiction of Federal or regional government can be the important factor in determining tax jurisdiction.
- The taxation power of VAT has been designated by the House of Federation to be shared between the Federal and regional states in which 70% is going to be taken by the federal government and 30% by the regional Governments. Such sharing will happen on any taxable activities within the regional states provided that the tax will be VAT. The reason for adopting such sharing scheme emanates from the belief that VAT is undesignated kind of tax while VAT is arguably provided in substance as sales tax.

3.5. Scope of VAT

VAT is imposed (ART 7 (1))

1. Taxable transaction by Registered tax payer
2. On Imports
3. Import of service

3.5.1. Taxable Transactions (Art 7 (3), art 4 and art 6)

Five points shall be considered here

A. Supply of Goods or Services

- **Goods** – Article 2(7): corporeal movable or immovable property, thermal or electrical energy, heat, gas, refrigeration, air conditioning, water but not money.
- **Services – Article 2(16):** work done for others which does not involve transfer of goods.

Supply of goods and service can be

- **Conventional supplies** occur where the taxpayer supplies goods or services – sales supplies, or service contracts. (Art 4(1)
- **Unconventional notions of supplies of goods or services in VAT:** diversion of business goods for personal consumption, supplies of goods to employees, de-registration, termination of a taxable transaction. See Article 4(3), 4(4), 4(5) VATP, Article 3(2) of VATR.

B. Taxable activity

- **Taxable Activity** is defined in Article 6 of the VATP and Article 4 of VATR.

A taxable activity is an activity carried on continuously or regularly by any person in Ethiopia or partly in Ethiopia whether or not for pecuniary profit, in whole or in part, the supply of goods or services to another person for consideration.

- **What is continuous and regular activity?**
- Only domestic supplies of goods or services should meet the requirement of taxable activity. Imports are subject to VAT regardless of whether the activity is a taxable activity.
- Continuous or regular activity is primarily an administrative requirement. VAT requires registration and input tax crediting, which can only be instituted for continuous or regular activity.

- One time supplies by consumers do not attract VAT. For example, if a person sells precious jewelry for 2 million ETB, it does not attract VAT although technically, the transaction crosses the registration threshold (500, 000 ETB).

C. in the course or furtherance of taxable activity

The VAT laws enumerate instances in which supplies constitute supplies ‘in the course or furtherance of a taxable activity’.

VAT presumes that the application of goods or services to a use other than a use in the course of furtherance of a taxable activity is a supply in the course or furtherance of a taxable activity, and therefore taxable. For example, withdrawal of goods for personal consumption is a supply in the course or furtherance of a taxable activity (see Article 4(3) of VATP)). Similarly, the withdrawal of goods for consumption by employees is a supply in the course or furtherance of taxable activity (see Article 4(3) of VATP). If a taxpayer withdraws the goods as a gift, that too is a supply in the course or furtherance of a taxable activity. Sometimes, a supply is presumed to be in the course or furtherance of a taxable activity even though there is really no supply. See Article 4(4) of VATP. A registered taxpayer is presumed to have made a supply at the time of the cancellation of registration for transition from a VAT-mode to a no-VAT mode.

Although not clearly stated in the VAT laws, the supply is generally considered to be ‘in the course or furtherance of a taxable activity’ when it is somehow related to the taxable activity.

D. Consideration

VAT generally requires that there be consideration for VAT to attach. But consideration is not what it seems. There are many instances in which VAT assumes consideration when no money or property is received by the taxpayer. See Article 12 of VATP. For example, in the case of consumption of goods by the taxpayer or by employees of the taxpayer, the supply is assumed to have consideration equal to the cost price of the goods – see Article 12(4). See, however, Article 23(4) of the VATR. Donations to in kind to religious or church-related services is not subject to tax.

E. Link with Ethiopia

The Supply must occur in Ethiopia or at least in part in Ethiopia for VAT to attach. See Place of Supply rules for goods (Article 9 of VATP), for services (Article 10 of VATP). Both of these

rules are presumptive rules. If any of the presumptive rules works to place the supply in Ethiopia or partly in Ethiopia, VAT attaches to the supply of the goods or services.

Reverse VAT Application: See Article 23 VATP. Normally, VAT applies when the goods are supplied in Ethiopia or imported. Goods are reported through customs when they are imported and are typically accessible to VAT. Services are not imported through customs and may escape VAT unless a system exists to capture them any other way. Reverse taxation exists to overcome the problems import of services pose.

3.5.2. Taxable Transactions, Non-Taxable Transactions, Exempt Transactions

- Taxable Transactions: positive transactions are those transactions that are subject to the standard VAT rate – 15%. Then there are the zero rated transactions, which are zero-rated on their outputs and fully tax credited on their inputs.

Zero-Rated Transactions: three kinds in Ethiopia. 1) Exports; 2) A supply of Going Concern; and 3) A supply of Gold to the National Bank of Ethiopia.

- Non-Taxable Transactions are those transactions that are ignored by VAT even though there is a supply. These include supplies of goods by the principal to an agent, supplies of securities (collaterals) by borrowers/debtors to creditors, supplies of owners to custodians, bailees, etc.
- Exempt Transactions: these are transactions that typically involve a supply of goods or services for consideration but are exempted. Exempt transactions are input-taxed supplies. The outputs are zero, but the inputs are subject to VAT – in other words, the input taxes are not entitled to a tax credit.