Chapter 2

Income tax

Proclamation 979/2016

I. Definitions

Income

Income is defined as "every form of economic benefit including non recurring gains in cash or in kind, from whatever source derived and in whatever form paid credited or received" art 2(14).

Gross income Vs. Taxable 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**" shall mean the amount of income subject to tax after ***deduction*** of all ***expenses*** and ***other deductible items*** allowed under tax laws

II. Sources of Income subject to taxation. Art 6

- ***Employment;***
- ***Business activity***;
- Entertainment, music and personal activities of a sports person;
- Insurance premium
- Winning from game of chance
- Entrepreneurial activities of a non-resident through a permanent establishment in the country;
- Movable property attributable to a permanent establishment in Ethiopia;
- Immovable property and apparatuses thereof,
- Livestock and inventory in agriculture and forestry;
- Alienation of property;
- Dividends of a resident company;
- Profit shares paid by a resident registered partnership; interest; and license fees.

Income Tax Jurisdiction:

Global Jurisdiction on Residents and Source Jurisdiction on non-residents

- A look at the Income Tax Proclamation of 2016 reveals that, in Ethiopia, income tax has ***global jurisdiction*** on residents whereas it has a ***source jurisdiction*** on non-residents.
- Accordingly, the income tax law is applicable to residents of the Federal Democratic Republic of Ethiopia with respect to their worldwide income. Therefore, wherever a resident earns his/her income from, he/she is bound by the provisions of the proclamation.
- On the other hand, the proclamation has applicability ***on non-residents*** of the country to the extent that the source of their income is in Ethiopia. Therefore, where the source of a portion of a certain non-resident's income is in Ethiopia, he/she will be liable to pay tax according to Ethiopian income tax laws on that portion the source of which is in Ethiopia.

The Foreign Tax Credit

- The concept of foreign tax credit deals with the administration of taxes on income that is derived from a ***foreign source***. Article 45 of the Income Tax Proclamation is devoted to foreign tax credit.
- Accordingly, 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

- However, the reduction of the Income Tax shall not exceed the tax payable in Ethiopia that would otherwise be payable on the foreign source income. In the case of a taxpayer subject to Income Tax on Schedule C income, any such reduction of tax shall be limited to the tax that would otherwise be payable in Ethiopia computed as if Article 28 (loss carry forward) of the Income Tax Proclamation applied separately to each foreign country in respect of profit and losses derived from sources therein. The reduction of tax shall be calculated separately in respect of each foreign country from which income or profit is derived.

Income Tax Structures in General: Global and Schedular

- There are two important systems of income taxation that have been adopted by countries around the world. These are the global and the schedular systems of taxation.
- The basic ***feature*** of the global system of income taxation is that the tax is imposed on the ***total income*** *of an individual regardless of the types of activities that he/she pursues and regardless of the sources from which he/she obtained his/her income.* Accordingly, under the global system of taxation, an individual has to declare his/her ***aggregate income*** for the purpose of taxation.

- On the other hand, the scheduler system of income taxation, which is the system adopted in Ethiopia, ***takes the different sources of income of an individual into consideration for the purpose of taxation***.
- Accordingly, income is identified by its ***sources*** and each source has its own ***procedures*** and ***rates*** for the determination of income tax; thereby requiring an individual to declare his/her income from each source **separately**.
- Under this system, each source of income is considered to have its own identifying unique features for the purposes of taxation. Therefore, before taxation, sources of income have to be properly identified according to the correct schedule set by the system.

- In its purest form, global income taxation requires ***aggregation*** of all incomes of individual or any other “taxable unit” without any exceptions, and applies a single progressive income tax rate upon the taxable income.
- Global income tax model, again in its purest form, allows **deductions for all expenses regardless of the source of income**. The difference between total income from all diverse sources and total expenses from all activities makes up the taxable income, upon which the progressive income tax is then imposed.

The advantages of a global income tax structure are many.

- One advantage is that the global income tax structure is more amenable to achieving the goals of vertical (and horizontal) equity **than schedular income tax structures**.
- A global income tax structure is able to pierce the thicket of sources of income and apportion income tax liability on the basis of the aggregate income derived by individuals and overcomes the problems of fixing tax liability on the basis of sources – which are not important considerations in ensuring tax equity.
- Individuals who earn income from multiple sources and individuals who earn income from a single source are more likely to bear identical or at least comparable burdens of income tax liability under a global income tax structure than a schedular income tax structure.

- Besides, while many countries are apprehensive about the administrative burdens of a global income tax system, the proponents of a global income tax structure have argued that a global income tax structure is ***administratively simpler*** for taxpayers who obtain income from multiple sources, as these individuals are required to file a single tax return (usually at the end of the tax year) instead of having to comply with multiple income taxes under typical schedular income tax structures.
- It is also argued that global income tax systems **are less susceptible to tax planning**, providing thereby less temptation for lots of administrative expenses spent in trying to place income under one heading rather than another.

- ***Scheduler income tax***
- ***Schedular income tax*** systems stand in direct theoretical opposition to the underlying notion of the global income tax structures. ***Schedular income tax systems partition income into specific sources of income and impose separate income tax rules and rates upon these individual sources of income***.
- The extreme forms of schedular income tax structures treat each source of income as if it were different, and completely disregard the fact that the individual or the taxable unit in general is one person deriving income from multiple sources.

- Each separate source (which may be labeled and identified under a “schedule,” or a “box,” or a “category” or a “part” in different income tax systems), has its internal rules of income tax computation and separate income tax brackets and tax rates. The separate rules determine the amounts to be included as income in each category and amounts to be excluded from that category as well as determining whether certain expenses are deductible and to what extent.

Characteristics of scheduler income tax structure

I) Amounts included in income (and at times excluded from income) and deductions are determined separately;

ii) Any amount, not included in any schedule, box, category or part, generally remains un-taxable unless there is a separate schedule with a catch-all phrase that seeks to capture all other “undesignated” income;

iii) Deduction of expenses for certain sources or categories of income is either prohibited or extremely limited;

IV) A loss incurred in connection with one category of income is often not allowed to be offset against any other category of income;

V) The income brackets and tax rates are developed for each category of income, and sometimes these brackets and tax rates may not even be comparable with one another ; and

VI) The assessment and collection measures are often different for each source of income.

In terms of major heads of income, the Ethiopian income tax system is at the moment composed of four major bodies of income tax laws:

- a. Agricultural Income Taxes
- b. Petroleum income Taxes
- c. Mining Income Taxes; and
- d. The Main Income Tax System
- Petroleum and mining income tax laws exhibit substantial affinities with each other in content, in administration, etc., a fact that justifies their treatment together.

Major Schedules of the Income Tax, Art 8

The working law on income taxation in Ethiopia, the Income Tax Proclamation No. 979/2016, has classified sources of income into five schedules. Therefore, income taxation in the country is undertaken based on these schedules, which have been systematically classified as:

- Schedule A Income from Employment
- Schedule B Income from Rental of Buildings
- Schedule C Income from Business
- Schedule D other income and
- schedule E. exempt income

Schedule A Income

- The first schedule of our income tax law, as provided in the Income Tax Proclamation of 2016, i.e. schedule A provides for the tax rate and modality of assessment of income tax collected from employment. Articles 10-12 of the proclamation govern the modalities and rates of taxation on such income.

a. The Definition of 'Employment' for Tax Purposes
b. Tax Rate and Tax Base
c. Exclusions from Gross Income
d. Exemptions

- As can be inferred from Articles 2(12) and 12 of the Income Tax Proclamation, employment is any arrangement, whether contractual or otherwise, whereby an individual to be called the employee is engaged, whether on a permanent or on a temporary basis, to perform services under the direction and control of another person to be called the employer.
- Contractors are excluded from the ambit of employees by way of Article 2(12), which in (b) defines a contractor 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.
- Looking to the whole picture, employment income tax is tax that is imposed upon ***any payments or gains in cash or in kind received from employment by an individual, including income from former employment or otherwise from prospective employment.***

Employment income/month	Employment income tax rate
0- 600	0%
601- 1650	10%
1651- 3200	15%
3201- 5250	20%
5251- 7800	25%
7801-10900	30%
Above 10900	35%

Exclusions from Gross Income

As of principle, Schedule A applies to tax levied on employment income in the sense that income tax will be levied on any gains in cash or in kind which have been received from employment. However, certain exclusions have been provided by Council of Ministers Income Tax Regulations No. 78/2002. According to Article 3 of the regulation, the following categories of gains have been excluded from the ambit of taxable income and thus will not be subjected to income taxation.

a. amounts paid by employers to cover the actual cost of ***medical treatment*** of employees;
b. allowances in lieu of means of ***transportation*** granted to employees under contract of employment;
c. ***hardship allowance;***
d. amounts paid to employees in reimbursement of traveling expenses incurred on duty;
e. amounts of travelling expense paid to employees recruited from elsewhere than the place of employment on joining and completion of employment or in case of foreigners traveling expenses from or to their country, provided that such payments are made pursuant to specific provisions of the contract;

- allowances paid to members and secretaries of boards of public enterprises and public bodies as well as to members and secretaries of study groups set up by the Federal or Regional Government;
- income of persons employed for domestic duties;

Schedule B Income

- The second schedule under the Ethiopian Income Tax laws, Schedule B, provides for the taxation of income earned from ***rental of buildings***. Articles 13 -17 of the Income Tax Proclamation are devoted to the ***modalities*** and ***rates*** of taxation on income derived from the rental of buildings.

The Scope of Schedule B Income

- The income to be taxed under Schedule B of the Income Tax Proclamation is provided by Article 13 of the Proclamation, which states that "Income tax shall be imposed on the person driving income from ***renting building or buildings***."
- The income from the rental of buildings is to be ***computed*** based on the procedures, requirements and modalities set forth by Article 14 & 15 of the Proclamation.

Taxable Rental income/year	Rental income tax rate
0- 7200	0%
7201- 19800	10%
19801- 38400	15%
38401- 63000	20%
63001- 93600	25%
93601-130800	30%
Above 130800	35%

- **Taxable rental income art 15**

  TRI=GI-D

Gross income includes

a) All amounts derived by the tax payer during the year under the lease agreement

b) All payments made by the leasee during the year on behalf of the lessor according to the lease agreement.

c) The amount of any bond, security, or similar amount that, during the year, the tax payer is entitled to retain ***as a result of damage to the building*** and that has not been used by the tax payer to repair the damage to the building.

d) The value of any renovation or improvement made under lease agreement to the building when the cost was borne by the leasee in addition to the rent payable to the tax payer

Deduction of Expenses under Schedule B

- taxes paid with respect to the ***land*** and ***buildings*** being leased; except income taxes; and

for taxpayers ***not maintaining books of account***, half (1/2) of "the gross income received as an allowance for repairs, maintenance and depreciation of such buildings, furniture and equipment;

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 as well as *interest on bank loans*, *insurance* premiums. 15(7)

Schedule C Income {art 18_27]

- The third schedule of the Income Tax law of Ethiopia, Schedule C, provides for the taxation of ***income earned from businesses***, i.e. from entrepreneurial activities. Articles 17 – 27 of the Income Tax Proclamation are devoted to the modalities of assessment of taxation under Schedule C.

The Scope of Schedule C Income

- Business income tax or ***corporate tax*** as commonly referred to relates to ***direct tax levied by various jurisdictions on the profits made by companies or associations.***

- As Schedule C applies to business income tax, it is only proper to start this discussion by defining ***what a business*** is. According to Article 2[2(a-c)] of the Income Tax Proclamation, business refers to "any industrial, commercial or vocational activity or any other activity recognized as trade by the Commercial Code of Ethiopia and carried on by any person for profit."

- And when one looks to the Commercial Code for reference, we can find that Article ***5*** provides for a definition to be referred to.

The taxable income art 20

- **TBI= business income –deductions allowed by the law**
- ***Business income art 21***
- ***Deductions art 22***
- according to Article 20 of the Income Tax Proclamation, taxable business income is to be determined "***per tax period on the basis of the profit and loss account or income statement,*** which shall be drawn in compliance with the Generally Accepted Accounting Standards", subject to the ***provisions of the Income Tax Proclamation and subsequent directives to be issued by the Tax Authority***.

The tax rate of Schedule C Income

- The tax rate of Schedule C income is provided by article 19 of the Income Tax Proclamation.
- ***Accordingly, businesses (bodies) are required to pay 30%* flat rate** of business income tax; and other taxpayers under Schedule C, i.e., unincorporated or individual businesses are required to pay taxes ranging from 10% to 35% according to the following table:
- Birr 0 to 7200 0%
- Birr 7201 to 19,800 10%
- Birr 19,801 to 38,400 15%
- Birr 38,401 to 63,000 20%
- Birr 63,001to 93, 600 25%
- Birr 63, 601 to 130, 800 30%
- Over Birr 130, 800 35%

Deductions of Schedule C Expenses

- Article 20 of the Income Tax Proclamation provides that deductions of Schedule C expenses will be allowed for ***expenses incurred for the purpose of earning, securing, and maintaining that business income.***
- However, these deductions will be allowed **only provided that the taxpayer can prove the expenses and subject to the limitations specified by law.**

Deductible Expenses art 22

- The direct cost of ***producing*** the income. Good examples of such expenses are the expenses incurred in manufacturing, importation, selling, transportations etc
- General and ***administrative*** expenses connected with the business activity. These are expenses incurred for the maintaining of the business activity.
- Premiums payable on ***insurance*** directly connected with the business activity.
- Expenses incurred in connection with the ***promotion*** of the business inside and outside the country subject to the limits set by the directives issued by the Ministry of Revenue.
- ***Commissions*** paid for services rendered to the business provided.

- If the tax authority has reason to consider that the total amount of salaries and other personal emoluments payable to the manager or managers of a private limited company is exaggerated, it may reduce the said amount for taxation purposes to the limit which, in view of operations of the company, appears justifiable, either by disallowing the payments made, or in any other way which may be just and appropriate.
- Sums paid as salary, wages or other emoluments to the ***children of the proprietor or member of the partnership*** shall only be allowed as deduction if such employees have ***qualifications*** required by the post to which they are positioned

Interest on loan[art 23] provided that the interest charged by the business is paid

a) To lending institutions recognized by the National Bank of Ethiopia;
b) To foreign banks permitted to lend to enterprises in Ethiopia (note here that interest paid to foreign banks can only be deductible upon fulfilling); and
c) In excess of the rate used between the National Bank of Ethiopia and the commercial banks increased by 2 percentage points.

Gifts and donations [art 24] gifts and donations will be allowed as deductions provided that the following conditions are fulfilled:

a) To Ethiopian charities and Ethiopian societies;
b) The contribution is made in response to the emergency call carried by government to defend the sovereignty and integrity of the country, to prevent man made or natural catastrophe, epidemic or for any other similar cause; and
c) The deductions to be made per the above conditions can only be made where the amount of the donation or grant does not exceed ***10***% of the taxable income of the taxpayer.

- Non deductable expenses and losses [Art 27]
  - Schedule D_ Other income Art 51-64

➢ Income of non residents
➢ Taxation of recharged technical fees and royalties
➢ Taxation of non resident entertainers
➢ Royalties
➢ Dividends
➢ Interest
➢ Income from game of chance
➢ Income from causal rentals

- Schedule E_ Exempt Income ART 65