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Lecture 15 HawF

Basic components are taxpayers, definition of tax structure and tax jurisdiction. There are various types of taxation like business taxation (Schedule C taxation), Employment income taxation (Schedule A taxation), Rental Income taxation (Schedule B taxation) and Residual (Schedule D).

Introduction of Income tax

It is direct form of taxation. There are **two** important purposes; **equitable distribution of wealth and revenue generation** (high yield). Progressive taxation is equitable. Almost all countries have IT. Different definitions are given to Income tax. It pertains to individual, corporate and also social entity. As long as they derive income, they will be appropriate bodies that would be subjected to taxation. So, unless there is a specific reference towards individuals, the discussion incorporates both.

Relevant Income tax laws in Ethiopia are found in;

- Federal income tax proclamation 979/2016
- Federal income tax regulation 410/2017

When a new tax system comes to replace a long running law or provisions, there is a need for transitory period because of the vitality of tax.

- Federal tax administration proclamation 983/2016 defines person in a way to identify who the taxpayer is and identify corporate bodies, company, partnership, fair market value, related person and arm's length transaction.

Income tax jurisdiction - (Where)

Why income tax jurisdiction? Governments compete for the right to tax whether that is the individual, transactions or other economic items especially in this era of globalized economy. **Twin principles** have been coined to avoid conflict; the principle of residence and the principle of source.

Principle of Residence (Who) is about the connection the taxpayer has with the country and the taxpaying units or entities (who taxpayer is)

Principle of Source (Where) is the origin of the particular item of income on the basis of where the income is generated, it is territorial with a reference to the source of the particular item of income.

Jurisdictional limits that are under the Ethiopian law are defined in Art. 7 of the Income tax proclamation. Income Tax Proclamation applies to (Art. 7):

- (1) to residents of Ethiopia with respect to their worldwide income (Art. 5)
- (2) to non-residents **only** with respect to their Ethiopian source income (Art.6)

Source is defined under Art.5

Art.5 (Residence rules) (1-7)

Rules to govern when a person is Ethiopian resident and non-resident

There are **three** broad types of entities that are residents of Ethiopia

- (1) a resident individual Art 5(2,3,4),
- (2) a resident body (5,5) and
- (3) the government of FDRE and any regional state or city Government in Ethiopia

There are various tests to determine which is which;

For the individual there are **three** alternate tests, under art 5.2

- a. Where an individual is a domiciliary of Ethiopia, a **domicile** is the place where a person has a permanent home, there is a degree of permanency
- b. A citizen of Ethiopia who is a consular or diplomatic or similar official posted abroad. E.g. trade representatives: - in the foreign country they have tax immunity on the assumption that they will be taxed in their home country as they are considered as residents of Ethiopia and aren't considered residents of host country in accordance with principles of diplomatic relations.
- c. If an individual is present in Ethiopia for 183+ days in one-year-period which can be consecutive or intermittent. Exception (3,4) and not the tax year itself

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Art.5(5) resident body

It provides **two** alternative tests for body resident:

- 1. place of incorporation or formation in Ethiopia, and
- 2. Has its place of effective management in Ethiopia.

1. To determine whether body is resident or not we have to check if it is incorporated or formed in Ethiopia. Since formation precedes incorporation it is enough to determine residence of body for purpose of taxation. **Even legal personality is not required.**

2. effective management. What does it mean? It is a place where high managerial decisions are made, for example Place where board of directors meets for companies, a place where meeting of partners takes place for partnership. The body may have many day-to-day management activity places, but only have one place of effective management.

When two different countries use this test differently there may be conflict of jurisdiction, and often it is solved by international treaty.

The fact that a person is resident for this year doesn't mean that he will be automatically be resident for the next year because circumstances may be changed. **Effect of being a resident** for a particular year is liability for Ethiopian tax jurisdiction on its worldwide income (article 7).

Who is non-resident?

Non-resident is defined in Article 5(7) to mean any person who is not a resident of Ethiopia. "Resident of Ethiopia" is defined in Article 5(1) to mean a resident individual, resident body, the Government of Ethiopia, or a regional or local government in Ethiopia. The effect of the Article 5(7) definition of "non-resident" is that any person who is not a resident of Ethiopia is treated as a non-resident person.

Non-resident:

- Non-citizen not present in Ethiopia more than 180 days in any one-year-period.
- Body not formed or incorporated in Ethiopia and doesn't have its place of effective management in Ethiopia
- Foreign government
- International organizations, i.e., AU, EU, UN, etc.

Source principle

It is provided under article 6 in relation to specific item of income. The idea of source is that countries are entitled to tax income obtained in their territories. It is morally justifiable to tax in their territories. **Source Principle is called principle of territoriality.** In order to determine whether income is generated in that country or not some countries use brick-and-mortar approach, it means

tangible link between income and country. For example, contract signed in Ethiopia, factory located in Ethiopia. But, in this case with respect to e-commerce it is difficult to determine where the contract is concluded. And some other countries of source principle use nationality or citizenship. Example USA, Philippines and Eritrea.

Concept of permanent establishment (PE)

This is important specially in international taxation. It is somehow it is related to source principle.

PE is modified application of source principle because of ordinary source rules are not enough. PE rule is about foreign enterprise come to Ethiopia and doing business through various forms and some of these forms might not be readily available or easy to Ethiopian gov't to tax otherwise. If it is **subsidiary** set up, there is no problem because it is a resident formed or incorporated in Ethiopia. While in relation to **branches or project offices** it is difficult to tax them based up on residence because they are not bodies in the first place and they don't have that status to apply residence rule. So, the only choice you have is source principle. **And PE is about how to use source principle, because it is difficult to know income of the branch** (multinational enterprises not account separately the income they get from branches, it is difficult to trace their income). So, if we apply source principle it won't be effective therefore this is the reason why it is important to modify the source principle.

What is PE? Article 4 of the proclamation

It is a fixed place of business through which business of an enterprise is carried on wholly or partly. PE rule part of unilateral action by a single state through tax law and also it may be bilateral tax agreement. So, PE is universal concept, in the interest of international economic community a compromise has been reached and the modified application of source principle is developed.

Permanent establishment is a fixed place of business through which the business of a person is wholly or partly conducted. (Art 4). There should be certain space available to it to carry on business and the business must be conducted in that place, (cumulative requirement.)

Why PE?

Profit attributable to for example branch business activity should only subject to income taxation in source country when that branch has become an enduring part of the economic life of the country as to warrant the conclusion that it **should contribute to the cost of the public infrastructure** of the

country. In short it is specific application of the **benefit received principle** (the idea that taxation represents the price paid for public goods and services). Thus, when the branch is established in a particular country as to regularly drawing up on those public goods and services it should contribute to their cost.

The above is the basic definition or general concept of PE rule, this general concept is then elaborated by specific rules or specific elaborative paragraphs that give you specific insight to the concept of PE. First the general rule is elaborated by **inclusive lists of specific inclusions** (inclusive inclusions) in this case the law is trying to exemplify what constitutes PE. What are these?

Article 4(2a), a place of management, branch, office, factory, warehouse, or workshop, but does not include an office that has representation of the person's business as its sole activity.

Article 4(2b), a mine site, oil or gas well, quarry, or other place of exploration for, or extraction of, natural resources.

Article 4(2c), furnishing services, consultancy services.

Again, the above basic concept of PE provides specific rules comprising **exclusive list of specific exclusions** from concept of PE. In short it makes clear what is not PE.

Examples

- actives on preparatory character (for feasibility study and collection of information). Broker, other commission agent, or any agent of independent status when the agent is acting in the ordinary course of his business are excluded. They are excluded because their major business is different even though they are working for foreign enterprise. So, they are residents.

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- Under Art. 4(2a), the law provides an exception. That exception is **Liaison Office**. An activity of liaison office is too remote from derivation of income for an amount to be accurately allocated in the country. They will not represent the foreign company in negotiation of contract, however, if they do, they become permanent establishment.
- Art. 4(2c), it introduces a new item with a time requirement. The new item is the furnishing of service personally or through employees or through another person (independent contractor). When the service continues for the same or connected project for a period aggregating more

than 183 days with any **one-year-period**. **Note:** it says any one-year-period. **It's not talking about tax year**. Here we found the word “connected project”. The word is not defined. How connected is “connected project”.

- Art. 4(3), in addition to building site, construction, assembly or installation which constitutes PE, art. 4(3) also includes **supervisory service** connected to building site, construction, assembly or installation. Ex. Service of consulting engineer.

Again here, for both building site, construction, assembly or installation and **supervisory service** connected to building site, construction, assembly or installation there is the 183+ days requirement.

- Art. 4(4) – agents of independent status: these are brokers, commission agents and the like. They are agents solely or principally negotiating contracts on behalf of the non-resident principal. **This is a permanent establishment, however, if its decision has to be influenced by the non-resident principal it is not a PE.**

The implication of a person conducting business through a permanent establishment in Ethiopia

Let's compare two lines of interpretation under two treaties:

- The OECD models
- The UN models

According to the OECD interpretation it is only the income attributable to the particular PE that can be taxed in the source country. Some consider this line of interpretation as a **very biased and in favor of capital exporting countries or developed countries**.

- Art. 6(3a) is in line with the OECD interpretation. The difference emerges when it comes to Art.6 (3b) and (3c). These provisions are in line with the UN line of interpretation.

Conflict of tax jurisdiction

The consequence is double taxation. It happens because of the use of different principles in different ways leads to **overlapping claims over the same income of the same person for the same tax period**. This is called **international double taxation** (this is referring to legal double taxation). There is also an economic double taxation that is broader than legal double taxation).

- What leads to double taxation? There are three reasons:
 1. Residence-Source conflict

2. Residence-residence conflict
3. Source-source conflict

1. Residence-source conflict

This is the **most common** reason for double taxation.

2. Resident-resident conflict

When both countries tax the income of the taxpayer because they both claim that a person is a resident of their country. It happens due to a **dual resident taxpayer**.

3. Source-source conflict

When both countries assert the income generated by the taxpayer is generated in their country. It happens due to different source rules.

- Double taxation can occur due to reasons outside of conflict of jurisdiction.
 - They way countries define income
 - Time of taxation

International double non-taxation

- **When a taxpayer pays no tax at all.** This happens when the countries choose not to assert their taxing right.
- It also happens due to bilateral duty between the two countries.
 - Exemption- in the source country
 - Tax sparing credit- in the resident country
- But this should be prevented by the countries because international double non-taxation **favors international investment over domestic investment.**

Relief from international double taxation

- They may come as part of unilateral measures and bilateral measures.
 - Unilateral- by their respective domestic tax law
 - Bilateral- through treaties
- Three common relief methods
 - Exemption method
 - Deduction method

- Credit method
- Ethiopia uses the credit method

a. Exemption method

Fully reliefs income taxed in a foreign country. A complete relief on income obtained and taxed in the foreign country. It is a resident (home) country that provides this relief.

b. Deduction method

Allows the deduction of the income tax that has been paid in a foreign country from the taxable income of the taxpayer.

c. Credit method

Reducing the amount of the domestic tax by the amount of the foreign tax

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Principles of tax jurisdiction

The exemption, deduction and tax credit method

These principles work especially in the context of residence-source conflict.

Exemption method: it provides **total relief** on the amount of any foreign income of a resident on which foreign income tax is paid. It is **often** the **resident country** that gives the exemption principles. It takes the form of a source country taxing the income of the taxpayer generated in the source country and the resident country taxes that person on the world-wide income and this causes double taxation. It is the residence country that is supposed to provide or give the relief on the foreign tax paid on the income of its resident. This works for the deduction and credit method also. The total amount of the income on which foreign tax is paid is relieved from the taxation of the residence country. The amount of income generated in a source country or foreign income is totally exempted. It is the residence country that provides this relief. In this case potential of double taxation is totally eliminated.

Deduction method: it provides relief on a foreign tax by allowing **reduction of taxable income by the amount of tax paid** in a foreign country or in the source country. Net taxable income in a country of residence is;

Taxable income – the foreign tax

And net taxable income is that amount of income which you obtain after reducing the foreign tax and taxable income is net income after deductions. The final taxable income is reduced by the tax.

This doesn't provide a total relief.

Credit method: offers relief by allowing reduction of the tax payable in the country of residence by the amount of tax paid in a country source. Here you reduce the amount of tax payable in a residence country by a tax paid in a source country. The person pays the tax in a country of residence on the difference. What if the difference is negative? This suggests a refund and refund is not obtainable. If you offer refund it has the consequence of a double non-taxation. This is not the objective of tax credit. The objective of tax credit is delimitation of double taxation and not allowing an amount of income to escape taxation all together. If the amount of foreign tax is equal or greater than the amount of residence tax, then that person doesn't pay any tax in the country of residence. And if the amount of residence tax is greater than the amount of source tax, the person is required to pay the difference to the country of residence.

- Which one is advantageous to the tax authority and to the taxpayer?

From the view of the taxpayer it is the one that provides him or her with a better relief (exemption method). This is so because exemption always provides for a total relief on any amount of foreign tax. It provides for the maximum that a person could obtain in the form of relief. If the foreign tax is very high it is based on the rate of foreign tax for a deduction method or it might provide a better relief. For credit and deduction method tax rate of source income is very important. If the rate of foreign tax is equal or greater than that of residence country, both exemptions and credit method generate the same effect. This is so because there is no payment of tax in the country of residence. If on the other hand the residence tax is greater than the foreign tax the exemption method is beneficial to the taxpayer.

From the view point of the tax authority, generation of good tax revenue is preferable (deduction method). This is because it guarantees some amount of tax to the country of residence regardless of the rates in the two countries.

Unilateral measures under Ethiopian tax law concerning the issue of double taxation resulting from residence-source conflict: - art. 6 (5), 45, 64 (3 &4) of ITP and from the regulation art 20 (2, 3, 4) & 25

- What is the relief method?

Tax credit method is applicable under Ethiopian law. In the above articles a tax credit is available on a foreign tax that has been paid by an Ethiopian resident. **Refund is not possible and credit is given for a specific tax year alone, you cannot reduce the amount of foreign tax from the previous tax year or to the future tax year. Or tax carry forward or backward is not allowed.** A tax credit method allows you to a reduction of a tax payable in the country of residence. Here it is the taxable payable that is reduced.

The international consequence of income taxation is taken care of unilaterally by Ethiopian tax system by itself. This works regardless of whether there is a treaty with another country where a residence with foreign income. What if there is a treaty? Treaties normally provide relief from the three major types of international double taxation and these are:

- ✓ Residence-source
- ✓ Source-source and
- ✓ residence- residence

Sometimes they also provide a relief from other forms of double taxation.

Source-source conflict: treaties provide relief through explicit provision of source rules (e.g. Art 11 paragraph five of both the OECD and UN model conventions provide that interest is deemed to have its source in the country in which the payer is resident). There are no explicit provisions in treaties (their weakness).

Source-source double taxation cases, if not resolved by explicit double taxation rules in treaty provisions may be resolved through consultation between the competent authorities of the two contracting states under the treaties by what is called “**mutual agreement procedure**”. Treaties often have mutual agreement procedures. Often there is a natural reluctance to give up taxation power between countries. For this there are also dispute resolution mechanisms under treaties.

Regarding dual residence problems, treaties provide relief by providing for what is called “**tiebreaker rules**” both with respect to individual and legal entities. Good examples are article 4 (2&3) of the UN and OECD conventions.

OECD: stands for organization of economic cooperation and development and it is an economic union of industrialized countries like US, EU, Australia and Japan. The OECD has model tax convention that serves as a template. Their common name is model tax convention for the avoidance of double taxation and the prevention of fiscal evasion.

UN model: it goes by the name the United Nations model tax convention between developed and developing countries for the elimination and fiscal evasion irrespective of income taxation. When a developing country engages with a developed country it uses the UN model and it is a little bit better than the OECD. But their fundamental elements are the same. First, Ethiopia was using the OECD one and now the UN model is preferable.

With respect of individual’s art 4 paragraph 2 and with respect to bodies paragraph 3 of OECD and UN models provides for a tie breaker rule. Sometimes residence- residence conflict can also be solved by mutual agreement procedures.

Major source of double taxation: Residence-source conflict;

Ordinarily under tax treaties it is the resident country that grants relief again. **The source countries right to tax the taxable income often have priority right over resident countries.** The duty of providing relief often rests with the resident country. Here too the three methods are used alternatively. The deduction, credit and exemption method.

Income taxpayers

- Who are taxpayers? (the who aspect)

A person subject to pay income tax. Basically, there are two broad categories: -

An **individual** or a **legal entity** that is obligated to make tax payment to the tax authority. In some countries they also include the family as a separate unit for imposition of taxation. But in most countries, it is the individual that is the taxpayer. In most countries business entities are taxpayers. For tax purposes additional requirements are set for bodies. The field of legal entities for the purpose of income tax liabilities is broad and it is not limited to the corporate entities that might

come to your life like corporations, companies and partnerships. Even NGO's might be required to pay tax when they receive income which might not be related to their day today activities. Government enterprises, agencies, cooperatives, small and micro enterprises fulfill the element of legal entities.

Taxation of legal entities is generally based on the assumption of increased capacity resulting from privilege and benefits they receive from the state. Like privilege of getting protection from the government. The existence of such form of entities results in the increase of tax paying ability which would not otherwise be attributable to individuals.

In business income taxation corporate bodies are known by different names and have different categories in different countries and with different consequences of tax treatment. Example in the US the word company is a generic name for any entity that engages in business. There are three forms under this: [sole proprietorship](#), [partnership](#) and [company](#). Corporation is any separately incorporated entity with limited liability excluding sole proprietorship and partnerships (companies). There is also a concept of limited liability partnerships like law offices, accountancy and actuarial services. Actuarial means insurance or determination and calculation of risk. In UK and South Africa, the name Public company is the equivalent of the US Corporation. Companies can also be residents or non-residents with different tax consequences. In other business association either there is no separate existence from the owners or there is no limited liability.

The Ethiopian case

An individual excluding the family and a legal person (it has an expansive meaning and it is not limited to commercial activities it also includes civil associations that could drive income taxable under the law).

Art 2 (22) of ITP defines taxpayer as *a person liable for income tax under the proclamation*. Article 9 also imposes an obligation to pay income tax on every person deriving income. The income tax proc cross refers to tax administration proc mainly on certain basic terms (found in art 2 of the ITP). Art 2 (36) of tax administration proclamation also sets its applicability to all tax laws. This key term defined under TAP are: Person, body, company and partnership. Person is defined under art 2(26) of TAP. Person refers to *individual, body, government, local government or international organization*.

- Do you think every person is an income taxpayer?

The word person is used here not just for the purpose of a taxpayer proper but it is also in other capacities. Every taxpayer is a person but every person is not a taxpayer. **The concept of person is wider than the concept of taxpayer.** The expansive meaning of a taxpayer other than the individual is rather found in the definition of body. Our conception of taxpayers is basically about individuals and bodies. Body is defined under 2 (5) of TAP as *a company, a partnership, public enterprise or public financial agency or other body of persons whether found in Ethiopia or elsewhere.* **Incorporation is not a necessary requirement here except for companies.** They could be residents or non-resident entities.

Company is defined under art 2(7) of TAP as a commercial business organization formed in accordance with the commercial code of Ethiopia and having legal personality and includes any equivalent foreign entity incorporated or formed under foreign law. There are six business organizations under the commercial code (see art 212 of the commercial code for details). Any business organization other than ordinary partnerships can be commercial business organizations under art 10 (1) of the com. Code if the objects of the organization under its M.O.A or the actual activity of the organization is one of the activities specified under art 5 of the code (art 213). Art 10 (2) provides that S.C and PLC will always be considered as commercial business organizations. **A joint venture doesn't have a legal personality; therefore, it cannot be a company** here. Definition given under tax law maybe fully, partially or different from the general law. The way definitions provided under the tax law is partially.

There are two important components under the definition of company law; legal personality and being commercial. Two lines of interpretation here. One is in so far as these two factors are fulfilled the definition under tax law is not limited to P.L.C and S.C, it can also include general and limited partnerships. Second the definition of company law only includes P.L. Cs and S.Cs. the drafter of the tax law professor LIBERNS of the University of Sidney the definition of company could include general and limited partnerships in so far as they engage in one of the activities provided under art 5 whether in practice or under their M.O.A and if they maintain legal personality. There are certain rules that applies to companies and not to partnerships.

- Can limited liability partnerships be companies under Ethiopian law?

At the present there is no clear law for their formation and regulation in Ethiopia. Legal activities are not commercial activities rather they are civil with their own economic consequences. They don't fulfill the two requirements set above. A foreign business organization can also be a company.

Its incorporation rather than mere formation that leads to legal personality. If the formation doesn't bring legal personality in to picture, it is not relevant here. A formation that gives rise to acquisition of legal personality is considered here. If a foreign law confers acquisition of legal personality upon mere formation, that is not relevant here. The formation should lead to legal personality.

Partnership is defined under art 2(23) of TAP as *a partnership formed under the commercial code and includes an equivalent entity formed under a foreign law*. Art 212 of the commercial code recognizes 3 forms of partnerships; Ordinary, general and limited partnerships. Joint ventures are not partnerships rather they are associations of persons. Prf. LIBERN'S says the definition of partnerships must be aligned with the definition of companies. Meaning it shouldn't include the exclusions set under company law. Partnership under the income tax law includes an ordinary partnership and general and limited partnerships provided that the partnership doesn't conduct a trade as defined under article 5 of the commercial code.

- Is limited liability a distinguishing feature for companies and partnerships under the income tax law?

Under the commercial code yes, it is a distinguishing feature and that is the case under many tax systems and in Ethiopia as well. The definition of partnerships has not been expressly excluded from the definition of company. This entity would be partnerships for the purpose of income tax law if and only if they engage in activities other than those activities listed under article 5 of the commercial code.

There are other aspects of bodies not mentioned here yet. We will see them in the future.

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The definition of body as income taxpayer, is something very broad and it includes partnerships, companies, and government owned public enterprise. Government owned enterprise is something which is common, in natural monopolies and governmental infrastructure

like telecom, railways etc. So, this public enterprise is equivalent with companies in private sector for a tax purpose. The only thing that makes them different is ownership, except that their business purpose is commercial and profit making like other private owned companies.

Person includes the government, but body doesn't include government. So, you should have to distinguish this state-owned bodies from the administrative agencies {they are not bodies}. The function of administrative agencies is mainly regulatory, like licensing, registration and assessing conformity etc. So, the mere engagement of government in some economic aspect doesn't necessarily make it a body, what makes it a body is when government through its enterprise engages in derivation of profit and making economic fortunes. So, you should have to distinguish between the administrative function of the state from its active fortunes of its economic pursuit.

The government agencies are not bodies but they are persons and their participation in tax process is in some other capacity rather than just a taxpayer. For example, they could be withholding agents and collect tax from their employees. In order to be a person, you don't need to be a taxpayer. The existence of state-owned enterprise is also recognized by constitution [articles 96 97 98 and 99]

There is **catch-the-rest phrase in the definition** “any other body of person whether formed in Ethiopia or elsewhere” **a problematic phrase “any other body of person.”**

What are the possibilities anticipated by this phrase? This is obviously broad terminology “other body of person” as we are already seen in previous lesson incorporation is not necessary, just formation suffice. So, can u think of this possibility regardless of profit motivation? This possibility could be associations, trade unions, NGO'S, civil societies and other organization. Most of this are either interested in the protection of interest of their members or they are committed to helping the members of the communities rather than, driving profits,

So, in that respect taxing this kind of entities as a matter of principle wouldn't be justifiable, so this catching the rest phrase is a bit problematic since taxing all bodies formed in Ethiopia or else were regardless of their activity and profit motive is unjustifiable.

But in other countries like USA there is a concept called **unrelated business income**. Meaning if those above-mentioned bodies derives income from activities other than they engaged in principally, they are taxable. Other than this, even if they have separate legal existence doesn't mean that it is qualified for income tax.

Non-business entity sometimes might generate income from unrelated business, in this case they have to pay tax on that particular income.

Now in the context of Ethiopia, we can raise a lot of question, think of religious institutions, although they are destined to fulfill the spiritual demand of their followers, what if they engage in profit making activity. Although they have to be taxed under the concept unrelated business income, **in Ethiopia there is no such concept, so they are left untaxed**. But this entity often drives their income from the contribution of their members and donation, this income is exempted from tax because there is no any additional economic fortune that increase their taxing ability.

So, generally, the designation as non-profit entities do not automatically mean that the organization does not intend to make profit, they are taxable on the income they drive from engaging in unrelated business.

Joint venture: are they taxable under Ethiopian tax legislation? There are two kinds of joint venture

- One is that found under investment law and the well-known nature of joint venture; this type of joint venture is created when two or more entities collaborated in some fields to work together {the joint venture between the government and private entities} this kind of joint venture is taxable.
- The second is the one that found under commercial code: this type of joint venture is very difficult to tax them practically, since identifying or tracing them for tax purpose very difficult.

Small and micro enterprise: often in other countries they do their job either as sole proprietorship or as partnership and when they operate as proprietorship it is taxed as individuals, but when they operate as partnership it is taxed as a pass through{ the concept of pass through will be discussed in the future}. **But in Ethiopia they are entirely treated as individuals and they are subject to progressive tax rate 0-35%.**

The definition of income: basically, there are **three** approaches of definition of income

- The **economic** approach: this provides with substance of what income is
- The **accounting** approach: this is about providing procedures, for example time.
- And **legal** approach; this provides form or formalism to make it bind or official.

These three approaches don't overlap just as a principle but legal definition of income accompanied by economic perspectives and accounting principles is highly desirable for designing a sound tax system.

Issue of economic substance by Henry Simons: - The economic notion of income according to Simons "income contains both consumption and saving". According to him income is the algebraic sum of:

1. The **market value of consumption** during the tax period, whether this consumption is financed from a person's inflow of work, transfers or capital gains, inheritance or even from accumulation of wealth is irrelevant;
2. The **use value of goods produced by the person for his own use and the use value of durable goods processed by the person**. For example, farmers produce for their consumption, So, the value of this is included in consumption, not only this the value of durable goods like a house (owner occupied house). So, the rental value could be taken as a value of consumption; and
3. **Thirdly the market value of the change in the person's net worth (this means saving)**. An increase during the tax period resulting from net saving or the appreciation of the property already possessed.

This definition of income from the perspective of ability to pay is very appealing because it's based on goods and services which is objectively measured from the market force. Again, this definition tells you that self-produced goods and services (imputed income) is included.

The notion of transfer income i.e. income from gifts and bequest and also capital gains (the part of definition above, that indicates increase in net worth or appreciation is attributed to the notion of capital gain).

So, this conception includes all kinds of accretion to wealth and income and includes them in the tax base and subject them under the same treatment of tax system. This is very good for horizontal equity. But the debate doesn't end there, there are practical limitations. This is theoretical and from theoretical point of view, its sound but practically it ignores certain fundamental elements. By the way the reason for the failure to totally transform this definition in to legal definition are not limited to practice related issues they do also raise the issue of

➤ Vertical equity

- Efficiency in administration
- And also, economic and social policy it ignores

For example, the taxation of saving; every aspect of saving including the one that result from appreciation is going be taxed, so when we see this from the economic policy of developing countries, it is detrimental. Developing countries needs saving for capital purpose, so taxing them by progressive rate as one's saving is increase could cause dead weight loss or cost on the whole economy and it's against the will to work and invest.

With regard to vertical equity, take capital gains transfers it is earned by others and the income is called lazy income, so taxing them equally with active income is against vertical equity.

NB transfers (inheritance and gifts) and capital gains are called passive income or lazy income, but income derived from labor and employment is active income. The circumstance of deriving this income from these two sources of income is different, so taxing them under the same rate is not fair and against the principle of vertical equity.

Although transfers and capital gains are favored to be taxed heavily in comparison to other income items, there is another factor that plays in their favors, that is efficiency in administration.

When we look at “imputed income” they are really difficult to assess and tax them.

Lecture 21 Mulk

The global and schedular income tax structure

Yesterday we said the legal definition of income is a product of superimposing definitional structure. So, the accretion or source-based definition of income, legally, is not standalone kind of definition because it is supplemented by a definitional structure. We said we have two theoretical models of definitional structure. They are: global structure and schedular structure.

Features of archetypal/pure/benchmark global tax system

- Tax is imposed on an aggregate income of a person.
- Category of income is irrelevant. No distinction between different kinds or types of income.

- A single tax rate scale, usually progressive/graduated is adopted.
- It employs a single definition of income.
- There is no need to match expenses with a particular type of income. Aggregate expenses are deducted from the aggregate income.
- The method of determining taxable amount of income, whether on the gross basis or net basis, is the same for all types of income.

If Simons economic definition of income is adopted by a country, it would most certainly superimpose the global structure. This is so because the concept of horizontal equity in the Henry Simons definition of income requires the taxation of whatever kinds of income without discrimination. So, if a country were to adopt only Simons economic notion of income into its legal definition, it would certainly superimpose a global structure rather than schedular structure. This all about an archetypal global system. It is ideal.

Features of archetypal/pure/benchmark Schedular tax system

- Different kinds of incomes and corresponding expenses are determined separately.
- Procedures for reporting, assessment, and collection are different for different kinds of income.
 - a- Reporting: self-reporting annually for business income and reporting through withholding agent monthly for employment income.
 - b- Assessment: on gross basis for most of investment income and net basis for business income
 - c- Period or timing could be annually, monthly, or transaction-based.
 - d- Collection: direct payment to the authority and withholding scheme.

- Different tax rate might be applied to different kinds of income: it could be progressive or flat.

Under both the global and schedular structure we have basic legal definition of income. Now, when schedular structure is introduced what happens to that definition? Under each category of income, you are providing a kind of supplementary definition. For instance, employment income and business income are defined separately. Often this supplementary definition overlaps the basic definition of income.

Remember, both pure global and schedular structure is ideal. They are not practical. No country has ever adopted a pure global or schedular structure. So, in practice countries adopt a mixture or composite of the two system. Often this takes form of global structure with schedular element and schedular structure with global element. A basically global structure having some elements of schedular structure or a basically schedular structure with some elements of global structure.

Countries often differ on the degree of schedularization. A country may or may not include taxation of a residual category of income. If a country includes taxation of residual category of income, the structure is said to be schedular with some elements of global taxation. Residual category of income has characteristics of global taxation. Taxation of residual category of income is said to be violating the canon of certainty because canon of certainty requires the determination of basic components of tax such as tax base and rate in advance. But this is not true always. Certainty can be achieved with regard to taxation of the residual income in some circumstances.

We said that global structure is superior in terms of insuring equity and neutrality in tax. But we cannot entirely adopt pure global structure. Here also a break away from global tax structure toward some schedularization is required for some pragmatic reasons. What are these reasons?

These reasons involve three things: principle, policy and administration.

With regard to principle for instance there are inherent differences between earned and unearned income. Earned or active income is gained by personal efforts. Unearned income or passive income encompasses investment income which doesn't require much effort. Investment income has two additional benefits: 1) it takes a little time and efforts of a recipient and 2) it provides a sense of security and power over and above that of the job of working men. Labor income is less pure than capital income. Impurity of labor income should be treated via distinct schedules.

With regard to policy, only some kinds of income might be suitable for achievement of some policy. If you lump sum them, as it is the case under global structure, the achievement of some policy could be impossible or difficult. So, if you think of investment, or pension, etc., there is economic and social policy reason behind them.

Lastly, administration: withholding scheme is easy in respect of employment income. Different accounting rules based on feasibility for administration are adopted if some of schedular element is introduced. Differences in time of payment is offered with some degree of schedularization.

To summarize our discussion, we said that the basic legal definition of income is not a standalone definition. Thus, countries can be categorized into two classes:

1. countries adopting a relatively broad definition of income concept in the core definitional provisions then modified by specific rules which effectively narrow down the income tax base with regard to particular type of income. We can call these countries **top-down approach**.

2. countries adopting a narrow definition of income concept in the core provision and then the income tax base is eventually broadened or extended by subsequent provisions. We call this approach **bottom-up approach**.

Do you see any correlation between accretion/source and the basic global/schedular and top-down/bottom-up? Think of it!

Merits and demerits of schedular structure!! Think of it from both view point of taxpayer and tax authority. Take into account the issue of equity and compliance and collection costs and difficulties.

Ethiopian ITP approach

EIT adopts the broadest core definition of income and substantially schedular system. Income is taxed only if it falls within specific schedule.

Let us briefly see the features of the Ethiopian schedular structure.

- **The doctrine of mutual exclusivity**, art 8. The schedules are mutually exclusive. This means if income item is defined and taxed in one schedule it can never fall in another schedule. The rules and procedures that apply to one schedule do not apply to another schedule unless explicit cross reference is made.
- **Is there a global structure element?** See if there is a residual category (prize money, honorarium, income of whistle blowers, etc.). **Yes**. See art 63 of ITP. Is the residual category open-ended or close-ended? **It is open-ended** which is significant element of

global structure. So, the Ethiopian IT is characterized by a significant global element on basically schedular structure.

- Is it top-down or bottom-up? If we see the overall structure of income tax, it is difficult to say it is top-down or bottom-up.

Exceptional features of schedule D

1. Incomes under this schedule are not related.
2. Rules and rates are different.
3. Each income is defined separately.
4. The rate is flat/proportional.
5. Each of them is final in respect of that particular income tax. It cannot be aggregated with other income under this schedule even though it is earned by the same person.
6. If you look at the reporting mechanism, often it relies on withholding scheme.

Lecture 22 MulK

Art. 8(2) together with Art. 64(2)

Under the Ethiopian income tax system, art. 8(2) together with 64(2), is the only consolidation or aggregation rule. For instance, if we take employment tax and I have two employment relationships, are my incomes taxed separately or should they be added up and taxed? Or in the business income context, if an individual earns different business income, should that different business incomes be added up and taxed or should they be taxed separately? Taxing them separately or on the aggregated basis has different outcomes under progressive tax rate. **Income is parted and escapes chance of falling into higher brackets or bands which are taxed by higher rates. More than one times exemption of birr 600.** But if the rate is flat it doesn't matter whether they are taxed separately or on the aggregated basis because the outcome is similar. Art. 8(2) and 64(2) answer the above questions. Of course, the consolidation rule under art. 8(2) and for schedule D items art. 64(2) is an exception to the schedular income tax.

Even though income under all schedules satisfy the basic definition under art. 2.14, every supplementary definition under each schedule are totally different. The rules for determination of income are different and the rules for determination of expenses, if any, are different. Each of the taxes are final taxes in respect of that particular schedule. Final, one cannot be aggregated with the other. For example, if you have a business and drive profits, also get employed and receive employment income and write a book and receive royalty, even though it is the same person, you, who is earning all items of income, under schedular system they are defined and taxed separately. They [income under different schedules] cannot be added together, the doctrine of mutual exclusivity. They are mutually exclusive. Hence, the Ethiopian income tax system purely exhibits or incorporates the doctrine of mutual exclusivity. But there is one consolidation rule. It is found under art. 8(2). How do you reconcile the consolidation rule under art. 8(2) with the doctrine of mutual exclusivity of the schedular income tax system? Do they conflict? Mutual exclusivity is about the fact that income items falling under different schedules cannot be aggregated. But we have an aggregation rule under art. 8(2). Let us take income under schedule C. Think of a sole proprietor running Laundry, Restaurant and Car rental businesses. All of these incomes fall under schedule C. As per Art. 8(2), all of the above incomes are aggregated and tax is imposed on the total income. So, the aggregation rule under art. 8(2) talks about summing up or aggregating or consolidating different income items earned by the same person falling under the same schedule. Exception under schedule D.

My comment!!

1. All different incomes derived by a person from different sources that fall under the same schedule shall be added up and taxed subject to progressive taxation, if any. Art.8(2) ...this is a consolidation or an aggregation of incomes under the same schedule.
2. Income tax under schedule D is final, income from different sources as defined under this schedule shall not be consolidated or aggregated. Art. 64(2)
3. Incomes that fall under different schedules shall not be aggregated. This is the doctrine of mutual exclusivity under schedular income tax system.

Schedule A: Employment Income tax

EIT operates upon fulfilment of **two cumulative conditions: existence of employment relationship and derivation of income from the employment**. These two conditions can be inferred from art. 10(1) and art. 12(1).

The first condition, the existence of employment relationship: the status of the person called the employee is the focal point not the employer. **Employee bears the substantive tax liability**. The employee is often defined by tax laws. Look at art. 2(7). **Employee is an individual. EIT is always and only paid by a natural person. There is no EIT of legal person. Employees are individual personally undertaking the performance of a certain work for another person, the employer.** Let us talk about the features of employee.

1. Employee is an individual who undertakes personally to perform services. Personally, no substitution by another individual. **Performance of services is personal, substitution of another individual is not permissible**. The activities of employees are performance of services. Engagement term could be temporary or permanent, it doesn't matter.
2. **There is direction and control by somebody else (the employer**, it could be individual or legal person). **Employment service is a dependent personal service** because there is direction and control of employer. This element helps you to distinguish employees from persons who are called independent contractors. **Independent contractors** are engaged to somebody else to perform services but they **retain substantial authority** regarding the manner of the work. Employer determines the time and manner of performance of services by employee. He also provides tools and equipment to employee and he directs and controls the performance of the services. However, independent contractors retain the authority in respect of all these things. **So, independent contractors are not employees**. Employees perform dependent personal services. Independent contractors provide independent personal services. **So, the activities of independent contractors are taxed under schedule C, not schedule A. They are taxed as a business person.**

The scope of employees under employment income tax is much broader than that of labor and civil servant laws. Let us move to the next prerequisite...

Lecture 23 Jama

Two important conditions for employment income

1 the existence of employment bond and

2 the derivation of income from employment relationship.

These are cumulative requirements.

Employment income tax applies when income is derived from the employment bond.

We have Supplementary definition under art 12.1 of ITP, employment income contemplates every kind of payment, any payment or benefit received by employee in respect of **current, future or past employment**. Employment income tax base is comprehensive it includes salaries, wages, allowance, bonus, commission, gratuity or any kind of remuneration for services undertaken. The legal scope of employment income captures **emoluments** (fee from holding office or executive work) as well. The legal scope of employment income is so broad. It could also include **honorarium** (an ex gratia payment to professionals), but this does not mean all kind of **honorarium** arise from employment relation. **Stipend** (a fixed amount of money or a form of salary paid at regular interval to learners or learners in internship to cover living expenses). Under Ethiopian labor law the period of apprenticeship is not considered as labor relationship but up on the expire of 45 days it is considered as labor relationship.

12(a).....in respect of past, current or future employment.

Past employment

Payment on account of past employment like severance payment and compensation which is result of illegal termination by the employer and back-pay-sums not paid are income on account of past employment. The payment could be voluntarily by employer, contractual or as a result of court decision but this doesn't matter and this doesn't make any difference. For executive employee differed compensation considered as employment income, severance payment for redundancy is also considered as employment income. Payment for loss of employment which is **golden-handshakes** is also employment income.

Future or prospect employment: - usually for important workers.

Employment which is not yet entered in to force but given rise to benefit to the employee currently, like **golden-handcuff** payment is income from prospective employment.

Fringe benefit

Employment income includes in-kind benefits which are fringe benefits under art 12.1b and art 12.4. Why benefit in kind (fringe benefit) is taxed? Why do we need to tax them?

This is **because this benefit provides additional tax paying capability** for the employee. So, **horizontal equity demands** that the employee receiving the majority of their benefit in the form of in-kind fringe benefits should be similarly taxed just like employee that receive the majority of their income in the form of salaries and wages; otherwise it will be discrimination. If they are not taxed it will also encourage tax planning because people would try to convert their cash wage and salary to form of fringe benefit. So, the theoretical justification for the inclusion is based on the notion that the benefit results in increased ability to pay tax because the employee saves an expense she would otherwise incur.

There are also arguments that counter taxation of fringe benefits **because of practical problems** in valuation of such benefits since taxation require quantification. There are problems in administration.

Look at article 8 of the regulation (410/217)

- a) **Debt waiver** fringe benefit article 8 sub 1(a) and 9 of the regulation

The employer might have forwarded certain funds in the form of loans previously now on the account of ongoing employment relationship the employer decides to waive the debt. This waiver is a new benefit and it is regarded as taxable fringe benefit because increased tax paying capacity is created. The value of this benefit is the amount waived or the amount of debt cancelled.

- b) **Household personnel** fringe benefit article 8 sub 1 (B) with 10 of the regulation.

Household personnel are domestic servant being employed by the employer to the benefit of the employee. Like housekeepers, guard, cook.... The value of this fringe benefit is total employment

income paid to household personnel in that month for the service reduced by any payment made by employee to the domestic servant.

C) **Housing or Accommodation** Fringe Benefit article 8 sub 1 (c) with 11 of the regulation

Here we can think of two scenarios, the accommodation could be owned by the employer or the employer could be lease or rent the accommodation. The fair market rent of the month is the value of the fringe benefit reduced by any payment made by the employee to the domestic servant. For the accommodation or housing leased by the employer, the rent or the lease paid by the employer for the month for that accommodation reduced by any payment made by the employee in respect of that accommodation is the value of the fringe benefit.

D) **Discounted Interest Loan** Fringe Benefit 8 sub 1(d) with 12 of the regulation.

This would constitute fringe benefit if the loan is provided at a rate of interest less than the market lending rate and the difference is fringe benefit.

E) **Meal or Refreshment** Fringe Benefit 8 1(E) with 13 of the regulation

Generally, in principle meal or refreshment provided by employer to employee is taxable fringe benefit and the value is the total cost of employer for providing the meal or refreshment to the employee reduced by any payment made by the employee for that meal or refreshment.

F) **Vehicle Fringe** Benefit article 14 of the regulation.

Vehicle is defined in article 7 sub 1(g) of the regulation “vehicle” means a motor vehicle designed to carry a load of less than one tone and fewer than nine passengers. Value is determined according to article 14 sub 2 of the regulation.

G). **Private Expenditure** Fringe Benefit article 15 of the regulation

This constitute fringe benefit to the extent that the expenditure gives rise to a private benefit to the employee and the value is the amount of the expenditure.

Property or Services Fringe Benefit article 16 of the regulation

This is about transfer of property or provision of service to the employee by the employer. Service is defined under article 7 sub 1 (F) of the regulation “services” include the use of property and the making available of any facility. The value is determined as, 75% of normal selling price if the employer supplies the property or service to employee which provide for customer in the ordinary course of its business in another cases cost of the property or service.

Employees’ Share Scheme Fringe Benefit article 17 of the regulation

It is a means to make the employee the shareholder in the company instead of direct benefit to the employee. Employees’ share scheme is defined under article 7 sub 1 (a) of the regulation “employee share scheme” means an agreement or arrangement under which an employer company or a related company may allot shares to an employee of the employer company.

It constitutes fringe benefit when shares are allotted to an employee including as a result of exercise of an option or right to acquire the shares and the value is the fair market value of the share at the date of allotment reduced by employee’s contribution for the share.

Lecture 24 YonT

Exempted Income

Pension benefit; art 65(1d) a pension to the extent exempt from tax under the public servant’s proclamation of private organization pension proclamation. Pension benefit up on retirement is exempt from taxation. But the contribution by employer in an amount that does not exceed 15% of the monthly basic salary of the employee is exempt. What about the contribution that is 7% from employee? It is under question. In practice it is not exempted but it looks like, under the two pension proclamations art 58 of proc 714 and art 56 of proc 715/2011 have exempted it from tax. See those with art 65(10) (because any income that is exempted by a law enforce in Ethiopia).

An amount that as a **compensation for the death or personal injury** of another person art 65(1i); there are two elements here;

- An amount paid as a compensation for the personal injury and
- An amount paid as a compensation for the death of another person.

On account for the death of the employee the family would be compensated with the employment relationship. But in the case of personal injury the employee him/herself has been awarded the compensation. So, the compensation from this is exempted because it is a payment for the damage occurred.

65(1j) a **gift out of employment relationship**; the contrary reading of this article indicates that gift in the employment r/ship is taxable. For example, a **wedding present** provided by an employer is exempted because it is not given with in the employment r/ship. You have to determine whether the gifts are provided in the employment r/ship to say it is exempted or not. E.g., gratuities bonus for good performance is employment income not exempted. Subject to art 59 of the proclamation (capital gains) a cash amount or the value of asset acquired by gift are legally taxed.

Scholarship or bursary payment art 65(1k); this payment given will when one student attends college or university. This implicitly includes a payment provided by the employer in the employment relationship. The payment provided to an employee (student) by the employer (school) is exempted.

Maintenance of child support payment; assume that the spouses are divorced and the custody of the child is given to one of the spouses and the other spouse has to contribute monthly as decided by court, this is not an employment income because it is family relationship. But when the employer gives child support to the employee this can be taken as maintenance given in the employment relationship is exempted. Maintenance of child support payment exemption is not only limited to the context of employment relationship. As we discussed schedule E is not only limited to employment it also extends for example income items of schedule C.

A cash indemnity allowance paid by employer to an employee but only to the extent that the allowance compensated to the employee for **short falls on money counts is exempted**. But if there is a d/c between actual short falls and the budgeted amount it should be taxable. e.g. in bank if the cashers make a short fall or give money by mistake to the customers above, he required the bank indemnify the cashier so if the indemnity given is equal with the short fall or loss it is exempted but if there is excess/ positive d/ce it is taxable.

Exemption related to persons

Domestic workers art 65(1b); domestic workers are a worker who are engaged in residential area like gardeners, cooks, child protectors (kidders). So, those domestic workers are exempt from employment income taxation. As we discussed before, the domestic servant fringe benefit given to the employee by the employer is exempt from income. So, what if the employer employs the domestic servants to the employee? Can the result vary? And also, what if the agency employs domestic servants (gardeners) to other person or in the condominium area? Are the salaries of those guards exempted? (This is the assignment we have done before).

Diplomatic workers art 65(1f); they are exempted from employment income taxation. They Are Exempted by International Treaties. Especially according to Vienna convention on diplomatic and consular relations in 1966/9 diplomatic workers are exempted from any kind of income taxation (including indirect tax). Art 2(4) defines tax treaties. They are exempted because of the immunity given to them by those treaties. **But it has based up on reciprocity**, i.e. if the one country taxes diplomatic workers of the other country the country whose diplomats was taxed may also tax the diplomats of that country.

Finally, nonresidents are also exempt from employment income taxation. Not only exempt but also fall outside of Ethiopian tax jurisdiction because the Ethiopian tax jurisdiction applies on the residents of their worldwide income and nonresidents of their Ethiopian source income. So, nonresidents who do not have Ethiopian source income are exempted automatically.

Income exempted in other laws

We mentioned some of them above like pension benefit but for additional purpose let us see another.

- Under the labor law **disablement benefits paid to injured employees are exempt.**
- **Investment incentives.** For example, investors who work/invest in remote areas have given tax holidays of five years. And who works around Addis have been given 3 years of tax holidays. So, this is tax exemptions. **This is not really in the employment context but in business context.**

Art 65(2) says the council of ministers may by their regulations may exempt any income for **economic, administrative or social reasons**. So, the council of ministers has been given the power to exempt any income for those reasons.

According to this the council of ministers provided exemption under art 8(1a-j) of the regulation which is about Exemptions of fringe benefit: -

- a) Exempted income under schedule “E”. this is irrelevant provision because it is already provided.
- b) A benefit that is very small for accounting purposes and is administratively difficult.
- c) Subsidy to a meal or Refreshment provided in canteens, cafeterias and dining rooms operated by or on behalf of the employer solely for the benefit of the employees and that available to all non-casual employees in equal terms. Non-casual employees mean an employee who works only a piece of works for a short period of time. e.g. kenserategna is a casual worker. Solely for the benefit of the employees means without including third parties the benefit should be given only to the employees.
- d) The provision of Accommodation or housing provided for non-managerial employees in remote areas if the usual place of employment is the remote area and if it very likely for the employee to move from one residential location to another or there is insufficient residential area in the remote area
- e) Provision of mobile phone to an employee by the employer. This does not apply to home phones
- f) Provision of mobile cards.
- g) Tuition fees paid by an employer for attendance at university, college or other educational institutions
- h) The provision of Security services for the benefit of the employee
- i) Provisions of food and beverage for employees of restaurants, hotels or other similar establishments. So, what is the difference between 8(1c) and this? (This is also the assignment given to us).
- j) Uniforms and other work-related materials. This is about foreign employment income obtained by a resident employee. So, it is very broad. It includes foreign employment incomes that are taxable under schedule A. see art 20(4b) of the regulation for why the foreign employment income includes the employment income under schedule A. Ethiopian source income is not subject to foreign tax credit but only to foreign employment income derived by an Ethiopian resident always.

Identifying Ethiopian source income is important to know foreign source income. So, Ethiopian source income according to art 6(1a and b) have **two** alternative tests:

- **Income obtained or derived from the employment exercised in Ethiopia.** This is regardless of the place of payment of wage or salaries of an employee. Employment exercised in Ethiopia refers the place of the performance of the employment contract. **Place of formation, payment of wage is irrelevant.** And also, to the extent refers to apportionment.
- **Income paid on behalf of the FDRE gov't** from wherever it comes.

Foreign tax credit is available on only foreign income from foreign employment.

See art 20(2) of the regulation for how tax credit has to be calculated. If there is excess to which taxpayer paid in foreign country it should be taxable. i.e. the tax rate in which the taxpayer has been taxed in foreign country is lower than the tax rate of Ethiopia, he has to be taxable to the extent of the remaining percentage.

Average tax rate is used to tax the foreign employment income. I think the instructor was given the sheet to us on this for how it should be calculated.

Lecture 24 KiyF

Pension benefits upon retirement are also exempted under Art. 65(1)(d). Pension contribution that doesn't exceed 15% of the basic salary by employer is exempted. The contribution by the employee that doesn't exceed 7% of the basic salary is not practically exempted. But the two pension proclamations Proc. No. 714/2011 of Art.58 and Proc. No 725/2011 of Art.56 exempts it. Art. 65(1) (o) states that any income that is exempted by any law in Ethiopia is also seen as exempted under the income tax law of Ethiopia. **But practically, the contribution by the employee is taxable and not exempted.**

Art.65(1) (i), An amount paid as compensation for personal injury of the employee sustained during work and death of another person, when the employee is already dead possibly because of injury sustained during work and the family is compensated. The employee's family is the one being compensated. It got fairness element in it as it exempts an already injured employee.

Art. 65(1) (j) **exempts a gift other than gift of employment.** For example, **a wedding present** provided by an employer to an employee. Under Art.65 (1) (k) a **scholarship or bursary attendance**

at an educational institution of an employee provided by an employer is exempted. [Maintenance or child support payments](#) given by the employer to an employee is also exempted under Art.65 (1) (l).

An allowance paid by an employer to an employee on [shortfalls of money counts](#) is also exempted under Art.65 (1) (n). But when there is a [positive difference](#) between actual shortfall and the amount given for the payment of those shortfalls will be taxed. But the actual paid amount will be exempted.

Under Art.65 (1) (p) [domestic workers](#) (gardeners, maids, cooks...) are exempted from paying employment income tax. Art. 65(1)(o), as mentioned above exempts incomes that are also exempted under other Ethiopian laws. For example: under labor law if an [employee is being paid his income while being in an injury, the income will be exempted](#). Under investment laws, there [are exemptions and tax holidays provided for investors](#).

Art.65 (2) gives power for council of ministers to [exempt any income for economic, administrative or social reasons](#).

Exemptions of fringe under Art. 8(4) of the regulation: -

- a) Exempted income under schedule “E”.
- b) A benefit that is very small for accounting purposes and is administratively difficult.
- c) Refreshment for all non-casual employees provided by canteens, cafeterias and dining rooms operated by or on behalf of the employer.
- d) Accommodation or housing provided for non-managerial employees in remote areas if the usual place of employment is the remote area and if it very likely for the employee to move from one residential location to another or there is insufficient residential area in the remote area
- e) Provision of mobile phone to an employee by the employer
- f) Provision of mobile cards
- g) Tuition fees paid by an employer for attendance at university, college or other educational institutions
- h) Security services for the benefit of the employee
- i) Provisions of food and beverage for employees of restaurants, hotels or other similar establishments

j) Uniforms and other work-related materials

- Foreign employment income is derived by a resident of Ethiopia (Art. 20(4) (b) of the regulation but the source is not Ethiopia (Art.6 (5)).
- Ethiopian source income derived by a nonresident is not subjected to foreign employment income and not subjected to tax credit. As stated under Art. 6(1) (a) and (b) it is when the place at which the employment is exercised and when the income is paid by the FDRE government.

Lecture 25 HerB

Actual Calculation of income tax liability

Once we assess the gross income upon which the tax liability falls, the next step is calculating the actual tax liability. Employment income is assessed on **gross basis, meaning deductions aren't allowed and exemptions don't form part of employment income**. Of the two methods of calculating income tax liability, the first is the **addition method** (not included here) while the second is the progression method (see below). We have seven income brackets and corresponding seven tax rate scales on a progressive basis. **Tax rates fall on marginal income or the additional income**.

Adjustment tells you that tax is charged on marginal income and portions of income taxed under previous brackets are not taxed again. Question here if an employee is penalized with a wedge deduction, how is income tax calculated? Is it on actual income received after penalty or on the full income? What is the practice?

Part two: schedule C tax (business income taxation)

This is discussed before schedule B (rental business tax) because schedule C is the rule and schedule B, taxation of income received from rental of buildings is the exception to the rule. Generally, substantial business income tax law is to be found under part four of the income tax proclamation ranging from articles 18-27 to 34-50 and section five of the regulation. Articles 27-44 and 48 &49.

Though some differences exist, majority rules governing business income taxation apply to all business regardless of the legal form under which the business is conducted be it sole proprietorship, partnerships or company. The scope of this tax is business income as it is imposed

on income of a person realized from the conduct of business. The source of this tax is a business therefore it is important to first define what business is. Generally, **business** is defined as an **independent profession** which takes a considerable time, attention and resources of a person with an **intention of making profit**. We should note here, for the purpose of tax the concept of business is construed wider than the concept of business under commercial law.

Article 2(2) of the income tax proclamation defines business. This definition has three inclusions. First business is defined as an industrial, commercial, professional or vocational activity conducted for profit whether or not it is done continuously or for short term. Examples of industrial activities are manufacturing, processing of minerals, of refining of petroleum while commercial activity is defined widely as any activity conducted for financial gain (its indicators being profit motive and the existence of an organized system of conducting the activity meaning its more than a hobby). Examples given are provision of services, handicraft, fishery, horticultural activities etc. On the other hand, professional activity involves the application of skill acquired through theoretical knowledge, examples are legal, medical or architectural services.

Lecture 26 RihJ

A business definition has been given under the commercial code, so to see the definition of business or trade as under the commercial code has been carried over to the tax law so, art 5 of the commercial code contain activities that are treated as trade this are automatically becomes business for the purpose of tax law virtually any kind be regarded as business as far as it has. 'C' provides that any activity of a share company or a P.L.C. is a business regardless of whatever it might engage in regardless of its activity its irrelevant if the share company engage in civil non-trade activity. The presumption under the commercial code companies are always commercial business organization that presume to take activities under art.5 even if they don't practical engage in those activities, they are still commercial business organizations so, activities of share companies and P.L.C automatically qualifies as business. **There is an exception** which is an activity by Share Company or by a P.L.C which involves the **rental of immovable property is excluded from business** why? **Because it falls upon Schedule B** simple reason, just like employment has been excluded from the definition of services. Under B of Art.5 sub article 2 of the commercial code refer only rental of movables, rentable of immovable's have not been mentioned under this article no need to worry about excluding it from the definition. The definition given as to business immovable

property is not a trade because of this article. So, if the activities involve the rental of buildings it doesn't qualify as business it's taxed under schedule B that is why we found the exception under C. So, we saw that the definition of business is so broad. There is an apparent competition with schedule B and Schedule D. Let's exemplify what falls under Schedule B, what kind of business activities fall upon Schedule B what doesn't fall upon at Schedule B, what falls upon schedule D. For example, those Schedule D that may raise the issue of schedule C 1. dividends 2. rental income 3. interest, those are found in schedule D. The point of dividend taxation may be raised under schedule C. How? it might be by hold company so the business of the holding company is to take care its stocks, shares, interests in companies under it no other business so, what is income its critical, it incomes from the dividends of the holding company so, it got dividends the question is where should it be is it gone taxed? it will be answered by defining where its business or not, this reflects the competition of Schedule d and schedule c. In short, the dividend is an income from the business activity it's a business activity not a dividend tax so this is schedule C this is an active income. Mostly dividends are passive income those are Schedule D. There are also rules on schedule D.

Interests; not been earned as part active business of a bank rather than a passive investment it's an active business income taxed under Schedule C. because its business this is how it can be solved the completion between schedule C and Schedule D. What make the difference is that where it's an active income or passive income. When its passive income as regarded to interest it will be taxed under schedule D. The dividend interest that come as active income is taxed under schedule C. The activities of credit and saving associations an activity under taking it's an active income which is taxed under schedule C.

Rental; Income from Casual rental of property both movable and immovable schedule D. This might also be raised in Schedule B. Schedule B taxes active business of renting building. It the difference between schedule B and schedule C is that both are active what differentiate them is that the type of business. FOR example, if the rental of house is on that of real estate it falls upon schedule B. If the real estate company-built houses and sale this will be taxed under Schedule C. Those, the activities or real estate may be splinted in two for tax purpose.

Example 2; Rental of Car it's an active and movable property so, taxed under schedule C.

Example3; Hotel Business renting rooms where is it taxed? the also rent conference malls it's taxed under so it looks like that the rental components it's also integrated from the other services it looks onerous and difficult that for business owner to tax rental of the rooms separately. If it's like pension only for the rental of the room no other services this is taxed under schedule B. when coming to hotel business its only part of the business it's one component from the entire part so integrated. In practice as taxed under part of the hotel.

Q1. Land can be leased; can land be leased as a business legally? Its right it's a possession right, not an ownership. It's not a common business land in nature is a commodity in short supply its difficult lease it as a business but practical there are circumstances that land are leased as a business agricultural land leased may be leased for two years as said it's an agricultural land for agricultural purpose, its causal not always. Which it falls upon the state's authority, seeing it from the state context as of being causal rental this can be taxed under schedule D.

Example 4; Lease of business as a property can be leased. Business is an incorporeal movable property there is no any probability to be taxed under Schedule B, even if there are immovable properties those are components under the business what need to be seen is the overall nature or definition of business. If it's casual and based on circumstances it could fall in schedule D.

On the case of Royalty schedule D income. Royalty it's technically the use or the right to use intellectual property rights. Big Technology companies in developed countries that doesn't exist in Ethiopia the royalties they acquire on the assignment specially licensing on the intellectual property right is one of the major sources of income for their business, if they exist in Ethiopia the royalties, they derive will be taxed under schedule C part of their active business. Those big companies are like that of software companies that develop software.

As to insurance actually, Insurance Premiums are taxed under schedule D **if they are earned by non-resident; if it's earned by resident, they are schedule C it's a business**. Those are a high light were different incomes may be taxed in different schedules under different circumstances

Q2. **Think of a private educational institute so it's a business that provide education**, it has a conference hall so it rent this conference halls for meeting it rent it causally not often so in which schedule is it taxed? How is it income going to be taxed? It's different from the case of the hotel. As regard to its rental income it's should be taxed separately under Schedule D because when

thinking of schools, the rental room is not part of its business and as to the others income it should be taxed under Schedule C.

The determination of Gross income and taxable income

Business income is including often comes as a product of various expenses incurred in its acquisition. So, it needs to be purified. So, **gross income is the not the proper base** for the computation of actual tax liability unlike the case of employment. Schedule C tax base isn't the gross amount of receipts; **it's based on net bases not on gross basis**. This suggests that there need to be a room for deductions of expenses. First there need to be determination for the gross income which one is the business income we need to determine then there are rules for the deduction of legitimate expenses so the main component of business income is this so thing will be easy. The determination of taxable income for business income taxable purposes requires characterization of amounts as income or expenses and there timing, the question of timing raised this is so important because business tax is annualizing affair so it must be defined by tax year this will answer in which tax year does it falls. For example, if the business has been registered this year but to be paid the next year in which year is it gone be taxed? Time rules answer this question. This is often determined by financial accounting records. **Accounting is two kind** of when it comes to tax financial accounting and tax law-based accounting. Most of the time tax accounting and financial accounting there need to be relation. The more there is a departure of tax accounting from financial accounting the more there are expenses for the taxpayer for record keeping is one possible explanation. The cost of expenses of maintain this separate records or different records is going to be higher so in order to reduce this cost it's good to align it. But alignment is not perfect because in order to fight abuse there are matters that tax accounting doesn't allow but that are allowed by financial accounting not always the case that everything under financial accounting would be admissible for tax accounting.

Generally, the tendency is that to align the two.

Tax accounting two basic models especially they answer the question of timing. The two basic models the receipts and outgoings. Tax accounting will be later discussed as to the procedural matters.

How income is treated as income, how receipts are treated as gross income for tax purposes under the Ethiopian tax law and whether its treatment departs from financial accounting (records) Art.20 (2) of the federal income tax proclamation; it provides that the taxable income of a taxpayer

must be determined in accordance with the profit and loss account of income statement of the taxpayer for the year prepared in accordance with financial recording standards stipulated under the financial reporting proclamation. It seems to align very much, it puts the rule, **the rule is tax accounting is based on financial accounting**. Of course, there are departure rules. The financial reporting proclamation that came in into effect in 2014 art. 5 of this proclamation says that IFRS (International financial reporting standards) by the way the new thing that the income proclamation came up is with the switch from GAS to IFRS. According to the financial reporting proclamation every business is supposed to record expense and income in accordance with IFRS and the IFRS are those insured by international accounting standard board. So, when preparing financial statements business in Ethiopia use IFRS rules that are ensured by international accounting boards. It is intended to achieve a close alignment with taxable income in financial accounting so as to is compliance and administrative burdensome.

As to GAS it's so how far from the purpose of tax often tax accounting doesn't that much accept GAS accounting its far. So, introducing a new tax accounting tends to fill the gap that was previously seen which is a good thing. This is not absolute its subject to modifications and exceptions made under the Federal Income tax Proclamations itself, Federal tax Regulations and ministers' directives (MOFEC). As to this topic what is raised is art. 21 of the proclamation talks about specific inclusions in business income is be specific canon of certainty, canon of simplicity requires this. But tax rules often provide as to following the general rule that calls for preparation financial statements income and expense statements based on general accounting rules, the rules often provide for specific inclusions in business income this article shows this.

Next will be As to Art.21 the substances that what incomes may be are taxable under schedule. art. 21 have three elements.

A) Business income includes in broad terms the gross amount derived by the taxpayer during the year from the conduct of business, this are gains from ongoing business commercial activities which means ordinary proceeds. For example; incomes or amounts obtained from disposal of trading stocks (inventory Art.2.24). Trading stocks applied for goods not for services for example if there is a shoe company the trading stock is the shoe. By disposing this, the income got is a business income.

Details about inventory or trading stocks; is something that is turned over in the ordinary course of business. A thing in which the business trades. It may be bred (**livestock**) or grow. Inventory can be **manufactured** as of goods for example if it's a car manufacturing the cars are inventory. It may also be **purchased** or otherwise acquired. It's not confined to **finished** goods; it includes goods on the **process of production** (intermediate goods) and supply of its **raw materials**. Trading stocks **aren't limited to tangible** properties. In particular circumstances **intangible and immovable** properties can be trading stocks. So, there is nothing in the intrinsic nature in a particular item that gives it the character of inventory. The same item can be inventory, the same business and capital assets composition based on circumstances. A Private vehicle of a motor vehicle dealer will not be the inventory of the dealer. A vehicle up ride to deliver a part or to pick up customers isn't an inventory. It's possible that an asset may change a statue, motor vehicle dealer may take her private motor vehicle to inventory or vice versa. So, we are talking about the income over here.

The other point on art. 21.1a **gross fees obtained on the provision of services other than employment income. It's clear that employment incomes are excluded.** As to the timing; An amount is included in business income of a taxpayer in a tax year in which it is derived. The tax year in which it is derived a critical point. Art 2(5) of the proclamation have defined what derive is. The order is very critical for the income tax proclamation because it define when income is taken into account for tax purpose especially for schedule B and schedule C. **The word derive is receivable (the tax base is accrual) or received.** For schedule C purposes it may be receivable. The word received have been defined under art 2(19) of the same proclamation. The word derives and receive are very important, **the word derive is broader than the word received** cause the word derive show what is said to be receivable.

B) **Amounts or gains on disposal of business assets** for example is car dealer company those cars that are used for picking up customer are business assets one they are disposed the gain is part of business income the word gain is so important. The word business asset should be defined clear in this point. Business assets this are assets permanent attached to the business, they stay with the business for more than a year. Business asset is defined under art.2 sub art.3 of the income tax proclamation.

Lecture 27 NahG

Business asset

What is business asset? The determination of the amount exactly (How)? Accordingly, **any asset used or held in the conduct of a business wholly or partly to derive business income is a business asset**. While asset is something which could be easily determined and whose value can be determined to commercial asset. The term asset is wider concept in a sense it **incorporates both tangible and intangible property**. A business asset could be either of **recurrent or capital nature**. Recurrent asset, refers to for example capital gains which are supposed to be part of the annual turnover of the tax payer. Example trading stock or inventory which are part of the annual affair of the taxpayer are recurrent assets. On the other hand, **assets associated with the business for more one year are capital assets**.

Examples of business asset include; trading stock, depreciable and amortizable assets. Depreciable assets are physical assets that are subject to ordinary wear and tear or properties which become worthless as they are used in business. Amortizable assets refer to intangible assets that are subject to decline in value over a period. For e.g. Intellectual properties as their period of protection gets shorter and shorter. There are also assets which will not be necessarily subject to deterioration or amortization, e.g. good will, bond, land.

The determining factor of business asset; first, it is the characterization of a person's activity as business. Second, the asset is used/held in the conduct or utilization of business income. Business asset includes both active and passive assets. The assets might not necessarily be used in the business, like financial assets; shares, bonds, debentures, treasury bills. Third, the asset is used wholly or partly to derive business income. Based on these we exclude assets which are used to derive exempt income; any schedule C related income that is exempted under schedule E is not part of business income. E.g. An asset used for the purpose of contributing clarity. (See, Art. 21(2))

The determination of the value of a gain on the disposal of business asset. (See Art 21 (3), (4) and Art 59.)

As capital assets are committed to the business and their value decline over time. And for the decline in value, tax laws often provide allowance for these costs. These assets could be disposed,

and when it is disposed its value/consideration may exceed the amount of the net book value. The difference is a gain so it is subjected to business tax. (See art. 21(3))

Net book value, refers to the cost deductible for the deterioration of the asset as it is used for the business. The net book value is revised every year. When the assets are worthless, they will depart from the business by accounting concept; salvage value or scrap value. Worthless assets could be sold or disposed. And when the asset is sold, its value could exceed its net book value or even its cost.

If the value exceeds the cost of the asset, it is capital gain and if taxable (building, shares and bonds) are taxable by Art. 59 of the ITP.

When the value exceeds the net book value, the deduction made in the tax would be refunded through business income tax. So, any amount that exceeds net book value but less than capital cost is subject to business income tax. Art.21, 1(b) together with Art.21 (3).

Then see Art 21(c), which reads as “any other amount included in business income of the tax payer for the tax year under this proclamation”. Can we exemplify this? One example could be a gift in business (gift related to business), from a *contrario* reading of Art. 65, 1(j); cancellation of debt could be considered as gift.

Deductible expenses

Business tax is a tax on a net basis. So, we have to determine deductible expense. Art. 22 of the ITP sets rules for deduction, however it is not the only one income tax regulations and directives also set rules for deduction.

Design of deductive rules including the Ethiopian tax system; 1st there will be a broad nonrestrictive language often containing apportioning element is used. (See Art 22, 1(a) of the ITP). 2nd the law included particular enumeration of deductible expense; these are positive limbs of the broad rule of deductibility. The purpose of such enumeration is to clarify the general deduction provision.

One example is Art. 22, 1(b), according to the article **cost of trading stock is deductible** when it is disposed of. Then the issue is how do we determine cost of the trading stock? There are three methods to determine cost of the trading stock;

LIFO method; *Last In, First Out* method. This method expects one door stock. So, **the unit cost of the last item which inter the inventory** will be used as representative cost for determining the cost of the inventory disposed of during the tax year. So, the cost inventory disposed of during the tax year is (equals to), the unit cost of the last item multiplied by items disposed of during the tax year.

FIFO method; first in, first out method. This method assumes two door stock. So, **the unit cost of the first item which inter the inventory** will be used as representative cost for determining the cost of the inventory disposed of during the tax year. So, the cost inventory disposed of during the tax year is (equals to), the unit cost of the first item multiplied by items disposed of during the tax year.

Average cost method; these is a method which determines cost of inventory disposed of during the tax year taking the average of the larger and smaller cost during the year as a representative.

How do we distinguish items which are disposed and not? By doing beginning inventory cost and ending inventory cost, then determining their difference.

Average unit cost= total cost of inventory/ total number items in the inventory. Total number items in the inventory = beginning inventory quantity + quantity of purchase. Total cost of inventory= beginning inventory cost + the cost of net purchase (new purchases).

Ending inventory cost= Average unit cost x ending inventory quantity

Cost of inventory disposed during the tax year= Total inventory cost – Ending inventory cost.

The other specific deduction is found under Art.22,1(c), these is **depreciation allowance**; total amount by which depreciable assets and business intangibles have declined in value during the year from use in deriving business income. Art 25 of the ITP is applied to determine the value of depreciation.

See Art, 1, (d); **Loss on disposal of business asset**. Disposal of asset is defined under Art. 67 of the proclamation. There are three tests in relation to loss on disposal of business asset;

1. Art. 22, 1(D), loss on disposal of business asset during the tax year. Art 67 of the proclamation defines disposal of asset. There are three alternative tests in the proclamation in relation to loss on disposal;
2. Art. 35; In relation to merger or reorganization of a company there could be transfer of asset and there may or may not be loss, in either of the cases loss is not recognized.

3. Art. 59; In relation to taxable capital asset. Such capital assets could be disposed for less value to the amount of their acquisition; capital loss. This capital loss could be offset against gain of similar nature.

Art.22, 1(d) (together with 22(3)); When the amount in the net book value exceeds the consideration or value of disposal, then this loss will be offset with business income.

Then see Art.22, 1(e); these is an open-ended provision, one example in this provision could be charitable donation according to Art. 24 of the ITP proclamation and Art 21 and 30 of the regulation. The recipients of the charitable donation shall be: 1. Ethiopian charities and Ethiopian societies. (See Art, 24(3) 2. The payer himself. (See Art. 33(1) of the regulation 3. The government, (see Art 33(2) of the regulation. The deduction of the donation would be in the year in which the donation is given to recipient. And the deductible amount is up to 10% of the tax payer's taxable income from the tax year.

Lecture 28 YosG

- **General rule for deductibility:** - expenses incurred for acquiring, securing and maintaining business income should be deductible.

Supplemented by positive limbs and negative limbs.

- Some points on lease payments on the context of business
 - (are positive limbs of deduction) from the reading of art. 32 and 34 of the regulation together. Here 2 important concepts of lease (unrelated to deduction). 1. Operating lease and 2. Finance lease.

1. Operating lease: - is a normal lease. (what do you expect from a concept of lease?)

The effect of a normal lease is that both legal and economic ownership of the leased asset stay/retained by the lessor. The lessee just makes periodic payments for the service he/she acquired from the use of the property. These payments are called either rents or just lease dues. The period of use is often short like could be a year or extended by just by renewal of the contract of lease.

2. Finance lease: - are arrangements were by the economic ownership of the property leased is effectively transferred to the lessee while bare ownership just legal ownership is still retained by the lessor. Often at the end of the lease period the legal ownership also be transferred to the lessee. e.g.: - **hire purchase** (when ET airline buys an airplane doesn't automatically pay the price rather

engage in a hire purchase. Price is effectively converted into periodic rental payment. Then, after some installments are paid the ownership will be transferred to the airlines. This is used because of the lack of funds on purchasing this kind of assets.

But finance lease is different from hire purchase. **In finance lease there are 3 parties** the bank, A (party who is a borrower and also a lessee) a **borrower** in a sense is using the funds that have been made available by the bank to purchase the property and a **seller**. Then the bank will purchase the property on behalf of A and leases to A for a long term. **This is called a finance lease.**

The distinction between finance lease and operating lease is the transfer of economic ownership (risk) to the lessee; only bare ownership is retained by the lessor in finance lease. In financial accounting terms this kind of lease is assimilated to sale. Meaning the owner is the buyer. So, if the buyer is a trader, in this particular asset bought not in deduction concept but by depreciation should get the deduction.

Art. 32 of the regulation together with art.34 doesn't distinguish the 2 kinds of leases. It is obvious that are included here but not clear if it also includes finance lease. But in other tax systems

➤ **Deductible Interests**- an expense related to the business so it's deductible. Art.23.

Is deductible on conditions on caps for tax purpose. Art.23 and 28.

Conditions: - sub 1 of art.23 just the principle. should incur to drive business income. Sub 2 specifies the conditions. 2 conditions.

A. ONLY for interest in amount used by rates used by NBE and CBEs increased by 2%. Intended to prevent the use of excessive rate of interest to shift profit. 2 exceptions for this condition.

1. financial organizations recognized by the NBE and permitted foreign banks by NBE
2. interest paid to related person (art. of TAP) of the taxpayer/borrower and if it is included in the business income of the related person. It is regardless of cap meaning these conditions should be fulfilled in order to enjoy deduction.

All other business expenses incurred at driving, securing and maintaining business income are deductible. Art. 22(1) of the proc.

➤ **Negative limbs:** - prohibit deduction for certain expenses. (Deduction denial rules)

Justified by as expenses that are not related with acquiring, maintaining and securing business income. And as tax laws should be as specific as possible and better if no further interpretations are needed. Also, not to be considered as expenses by the taxpayers. For these reasons this rule is needed. Can be categorized into 3.

1. Capital expenditures: - deductions are made by considering depreciation rules. So doesn't mean they are totally free from deduction. Do not obey the normal rules of deductibility. Art.22(1a) cum 27(1a) and 25 of the proc.

2. Personal (consumption) expenditures: -art. 27(1a) relevant in unincorporated sole proprietorship b/c **incorporated business are incapable of incurring personal expenses**. Is when the trader uses the business asset for both personal and business purposes. That portion of expenditure used for personal expense can't be deducted. e.g. paying for employer's golf club membership etc.

3. Policy motivated expenditures: - includes expenses that can be justified by positive limbs. But for policy reasons chosen to be not deductible. e.g. **penalties, punitive damages**.... etc. **not to benefit from wrong doings**.art.27(1f). surety, indemnity, insurance guarantee contracts are also not deductible 27(1e) b/c presumed to be already compensated and not to amount over compensation. Denial of deduction for income taxes or other taxes (e.g. recoverable VAT) paid to foreign jurisdictions 27(1f) and local jurisdictions in federal system. It could be creditable. Entertainment (27(1j) visa vis art 27 of regulation) and refreshment expenses. Representation expense. A gift made directly or indirectly to individual. Also increase in capital is not deductible art. 27(1). See art.27(1) of the proclamation.

Amortization: - for intangibles

Depreciation: - for physical assets

Depletion: - for natural resources

Lecture 29 HewE

A systematic allocation of the cost of business asset through the income generating gears of the business asset.

So, the income generating gears

When you think of depreciation or amortization, depletion in the case of natural resources, you have to always remember that the connection that the asset has with the business is **for more than one year**. This is the starting point. The asset is not one in which the business trades, it is not part of the inventory composition of the business. This is the asset that is used like “**a candle melting**” to generate income. So, it has a connection with the business for more than a year unlike inventory which is to be turned over usually annually. The word business assets under Ethiopian tax law includes every kind of asset, including inventory. Here we are referring to **capital assets or fixed assets** whose association with the business is usually for longer than a year, it could be many years. In the case of buildings, it could be a number of years; it could be twenty years for example, twenty fifty years.

Now what you have to remember when you think about depreciation is that it is a cost/ expense. This cost should be deducted somehow, but it cannot be deducted in a way we allow deduction for inventory composition of a business. This is because these assets have a connection with the business for more than a year, we have to take into account the longevity of connection with the business that they have. So, you cannot allow total deduction in a single year.

How do we exactly do that? Usually, it is determined through what is called **anticipated useful life or useful economic life**. You can't really determine the life of a business asset with an exact accuracy, at the end of the day; it is just an approximation of this anticipated useful life. The useful economic life of an asset is determined approximately, but we know that for example cars depreciate faster than buildings. So, the useful economic life of cars is often set lower than that of a building, based on the physical wear and tear they are subjected to. But at the end of the day, the number we are going to choose is just arbitrary as there is no sign that can accurately tell you the number of years that the asset will be finished up, so it's just from the purpose of letting the taxpayer recover the expenses incurred on acquisition of the business, where the business asset is committed to the business that useful economic life is set. It is just to let the taxpayer to recover those expenses, because without setting economic useful life, it won't be possible to fully recover the costs so to make that a reality often useful economic life is determined

Laws often borrow the useful economic life set in accounting records. They use what is determined as useful economic life in accounting records for tax purposes as well so if you read the income tax regulation, it provides for a detailed method of depreciation. But you don't find the useful

economic life clearly set. It relies on accounting records. Useful economic life for some of the assets might be implicitly determined. You might know it from the rate for example building depreciates at a rate of 5%; so, it ends in 20 years. Thus, we can understand that it ends in 20 years we see the methods.

So, the anticipated useful economic life is basically the useful income generated by it. This means at the end of this useful economic life, the cost that has been incurred on the asset while the asset was committed to the business is fully recovered at the end of the useful economic life the cost, we had transferred by saying it's not deductible will be fully recovered

Hence at the end of the useful economic life the cost would be recovered. [At the end of this useful economic life the asset is supposed to finish up](#). It is supposed to be worthless. At least the theoretical consequence is the asset becomes worthless, because it has been consumed in business, completely at the end of its economic life. Even if it's sold afterwards it is sold by "kurale" price, scarp or salvage value.

It is sold not because it will add additional value but because the material it is made of may be useful. For example, car may be used to get scrap metal.

Practically, when the economic value written on the account records end, the asset is often still useful. So, the asset may continue giving valuable service. But if the cost is recovered at the end of useful economic, the deduction allowed wouldn't be there anymore, because basically he finished his cost.

Another question would be if the business after finishing the years would go to another business. What would happen if the previous owner transfers, not by scrap value, but relatively good value? This is possible because anticipated economic life in accounting records may not exactly correspond to practical life. It may be still valuable. [Then the price of the transferred asset will be the base and again have deductions for depreciation for the new owner](#). The asset that was deemed to be worthless then will be a new base for depreciation for the new owner. [This won't apply if the transaction is made between related parties](#), because it is questionable. It may be assumed that the transaction was made in order to get a benefit once more. [They have to be independent parties](#), the new buyer would, in accordance with the costs he incurred will get the benefit.

Depreciation is available to the legal or more accurately economic owner of the asset, the capital asset. This means in relation to for example, finance leases, legal owners might not always be the accurate reflection of financial records. For tax purposes, economic ownership is also taken into account. Legal ownership follows title; the business operator has the title of that property which isn't always the case. This is done to avoid two people asking for a deduction at the same time. Whereby substantively the risk, the economic control, of the asset is turned to the lessee and the end of the payment of installments the lessee gains ownership. The lessor has no intention of reclaiming the property back. Until then the ownership is basically a bare ownership. In substance the ownership is transferred to the lessee. Financial accounting records recognize this kind of ownership as real ownership and therefore provide the benefits allowance to the lessee.

Does our law recognize this? Yes, financial lease agreements are common usually in the construction asset sector. Additionally, the accusation of planes by the Ethiopian airline through Boeing arrangement

But does economic ownership allow depreciation allowance? I have not studied its economic practice, but I think so. When you look at the laws, no clear answer, the good thing is the taxes relay on accounting records, so it is possible to argue that economic ownership giving rise to allowance in asset depreciation is possible for tax purpose. It is safe to argue as such.

Finance lease arrangement gives rise to allowance for depreciation for lessee. Ownership isn't taken into account.

Having said this let's identify physical property that could be regarded as capital assets. Natural resources may include in depletion physical assets. Of course, generally we can identify business assets that don't depreciate, even where they are committed to the business those that do are vehicles, furniture, computers and equipment, buildings and other immovable structures such as fences, pavements. Additionally, antiques, jewelry and artifacts may be included, in museums. This is because these things in nature are ancient, archeological and culturally valuable that obviously 'does not wear down. These have sustained from so to speak time immemorial. Artifacts are ornamental, collectable and decorative valuable things. These also do not undergo deprecation. Jewels are also ornamental items made from precious metals and gemstones. These don't undergo wear and tear as well, for example diamonds and sapphires.

Land in the context of agriculture use is depreciable. But land as such, for example. Where one erects buildings on it, the value does not depreciate, if any only the market value/ price decrease not its actual value. This is because the value doesn't decrease because of use otherwise. At the end of the day, when the land is separated from the business, it will still have the same value. Hence, **we must separate land as such and land as an agricultural asset**. In the case of natural exploitation, the more we extract, it will get depleted.

The possibility that land will be part of inventory is very limited. Maybe through lease, it is more probable. This is because it is a commodity in very short supply. It may become part of inventory in the case of a broker for example.

Of course, in property context, inventory and other consumables are included in the broader understanding of assets, but they are not capital assets. Rather they are consumable business assets, in the broader context.

But not all are subject to physical wear and tear, depreciation. The allowance is allowed only for those that value decline over time. If the asset continues by more or less maintaining its value for years, it is not a depreciable asset. From the list above those that **don't undergone depreciation are antiques and artifacts**, **In the case of buildings and other structures, they do depreciate**.

Non-physical properties are also part of the assets. Broadly speaking, that could be associated with the business. **These are IP rights, good will, contractual rights (for example long term leases over a building), shares, bonds, debentures, treasury bills** (last three are often the same what differs is their sources) you can think of franchises are more. These are the major ones.

In the case of intangible properties, from the ones listed above, **those who are not suitable to amortization are good will** (it is based on the market force; over time necessarily we can't say the value will decrease, based on circumstance it might even increase. The values are based on market force. **The same logic applies to shares**.

In the case of IP rights, there's a time limit; so, we can say that it is depreciable. The value of the intellectual property keeps on declining because of the limit imposed which will affect its values. The same goes for contractual rights. As the expiry date nears, the value of the property keeps on declining. This is taking into account the concept of renewal.

Technological obsolescence affects it as well. This means outdate-ness of the knowhow, because of technological changes. This also includes trade secrets... etc.

The decrease in value doesn't necessarily come from use rather it may simply come with time.

All of them could come as part of inventory but for it to be a capital asset, there has to be a connection with the business for more than one year. Otherwise the allowance won't apply.

At this point it should be clear that the allowance is the recovery of the cost that has been incurred when they are committed to the business.

So, the main point is that not all capital assets are depreciable. Only those that can either undergo physical wear and tear or that undergo expiry of duration/ term limits or technology obsolete-ness.

Then, that takes us to the methods.

1. Straight line method
2. Declining balance method
3. Sum of digits method
4. Pulling method

Are they really part of the law is another question?

In straight line method, every asset is individually depreciated, equally every year. **The cost is equally or evenly distributed over the useful economic life of that asset.** Each cost of the asset is held/tracked separately, through even distribution.

Declining balance method, the basis the rate is held on declines every year. This base is called depreciation basis. For example, if the base is 100,000, if we apply ten percent rate. 10,000 is the annually allowed allowance. The year after the base will be 90,000 which will also be subjected 10% rate. The depreciation basis at which the rate falls on, decline every year.

The above two are recognized by the law.

Sum of digits method has some elements of declining balance method and is a little complicated. The useful economic life is determined then. For example, if the life is 20 years. You would sum the useful years of life. If 20 we would compute it as $(20+19+18+17...1)$ which is 210. We will then divide 20, the useful economic number by the 210, the sum. Then, cost of the asset will be

multiplying it by cost of the asset. for example, in the case of the second year 19 will be divided by 210 and so on. This will give us the result to be used in the first year. This will be used along the year, by taking into account the declining years.

[The last one is an old method.](#) It is difficult in a developing country context. In straight line method, it is very onerous to track every asset, especially in developing country. This is difficult also because of the cost for taxpayers. So, what it does is put similar items together and apply same asset. They will be subjected to the same rate. Now, pulling method's base varies, because assets get in and put. Hence the base fluctuates, as assets get in and out of the pool. But it is difficult to ascertain cost because of said fluctuation. Hence, [this is abandoned by Ethiopian legislatures.](#)

[Now what's being used is straight line and declining method.](#) And that is defined in article 36, 37, 38 and 39 of the regulations, pursuant to 25(2) of the proclamation.

According to this article 36 of the regulations [recognize two methods, the straight-line method and the declining or as it calls it diminishing method.](#) Article 36 states that the taxpayers are allowed to [depreciate and amortize its capital assets](#) on the basis of its accounting basis. We can use the accounting methods for taxpayers. Hence, if we use accounting or balance method for our accounting records will use accounting or balance for tax purposes respectively.

But there are exceptions. [A structural improvement of an immovable property and intangibles are always declining in the rate of straight-line method.](#) Others are left to the choice of the taxpayer, based on its accounting records. This can be understood from 36(2).

Article 37 and 39 explain the straight-line method. [The deduction is known by applying the rate against the cost of the asset. The cost is constant throughout the years.](#) The rate is a flat rate as well. Hence the cost is evenly distributed throughout the useful economic life.

In the case of article 38 and 39 [diminishing value method.](#) We apply the rate against the net book value of the asset at the beginning of the year. The net book value declines every year. Hence the value continues to decline. This is why it is called declining/diminishing value method. So, the applicable rate is applied against the net book value in this case.

Now we will see the rates. The rate is prescribed for all. For the case of computers, software and data storage equipment it is 20%. So, the useful economic life is five years. In the case of greenhouse, it is 10% and life ends in 10 years. [A greenhouse](#) is a glass or transparent plastic

structure often in a wooden or metal frame in which plants that need heat, light and protection from the weather grows.

Structural improvements (any immovable other than land) which is any improvement on land, excluding land, the percentage here is 5% which means the useful economic life is 20 years.

Other depreciable assets are subject to the rate of 15%

Depreciable assets used in the mining and petroleum development operation is subjected to the rate of 25%, within 4 years it will be depleted.

The ones listed above are subject to straight line depreciation.

In the case of declining value method, as indicated in article 38 and 39 of the regulation, the rate of depreciation. The case of intangible, in the case of preliminary expenditures, it is 25%. Preliminary expenditure is defined in sub-article (3) and (4) for business intangible that end with in before the commencement of business, in preparation of the business incurred. These are included intangible expenditure. The rate is 25%.

For a business intangible that works for more than 10% year (which will be taken from the accounting records) other than the ones above it is 10%.

For any other, it is 100% divided by the useful life of the intangible. Hence of it is 5 years the rate will be 10%.

The rates in the table are applicable for both declining and straight-line method. As per article 38(1) states that subject to article 25(3 and 4) of the proclamation the depreciation allowed to a taxpayer for a tax year in respect of a depreciable asset under the diminishing value method shall be calculated by applying the rates under article 39 of this regulation against the net book value.

So, the rates in the table are applicable for both methods, as long as it is possible. For example, we can use this declining rate for computers and that category, but we cannot use it for greenhouses because it is an immovable asset. Any other depreciation assets are also included as long as they are physical. Declining balance method does not include business intangibles as indicated in article 36.

By applying these we can find the applicable depreciation. Article 36(4) has a rule that says no depreciation may be allowed for a transfer between related parties, when the transferor has fully

depreciated the asset. This means if you transfer it to a related party. It will be assumed that you're transferred it to yourself to get the advantage of overcompensation.

It will be assumed that you are taking from one pocket and putting into another pocket. Or the pocket of another that controls overcompensation. This is an integrity measures from the protection of the base.

The transfer between related parties does not entails loss. This means the book value will transfer entirely. It won't start over. Article 36(4) points out this concept.

If it's done between independent parties, the value that the new owner bought it for will be used as a depreciation base.

It should be noted that the accounting years and the actual years are not always the same. It may be assumed to be worthless in accounting years but may still have value in actuality.

Lecture 30 S-ON

Loss carryover rules

Losses can be carried not only forward but also backward. Income is subject to annual measurement but economic activities of business extends way over a year. The reconciliation of the two comes from the business activities fluctuating performance from year to year in terms of generation of income as the taxpayer making one-year huge profit and one year making losses. The justification behind this is the tax system shouldn't be contributing to the failing of the business which has already failed. The business affairs of a tax shall be reconciled with the annual affairs through loss carryover rules. A loss that is incurred can be carried forward to an income which would be generated next year and compensated, offset against that income. Sometimes a taxpayer might suffer net loss rather than income and the loss that is incurred this year could be carried backward to past years. This rule is about carrying forward or backward offsetting the income against coming or previous year. Theoretically, taxpayers have unlimited right to offset loss against an income but practically, it is limited because of the reason that it would bring unlimited tax planning opportunities to taxpayers. In order to protect the integrity of the tax base the losses carry forward or backward rules are subject to limitations. Usually the limitations take the form of in case of forward, the period of offsetting loss is limited usually to 3 to 10 years under different tax systems meaning that a loss that is incurred this year shall be compensated in the next

3 to 10 years. Whereas carry back rules are very limited under limited circumstances, the only case that a carry back rules are available is in long term contracts. Under Ethiopian law, as stated under Art 26 and Art 42 of the proclamation and regulation respectively, the loss carrying forward rules are subject to three conditions. The first one is the limitation imposed is for 5 years, a loss can only be carried forward for the next 5 years from the year the loss is suffered. The other condition is if the loss that is suffered by the taxpayer is more than one, earlier loss has to be compensated first. And the last condition is the taxpayer as a business person, has a life time limit of two losses which means that even though, the taxpayer is exempted from tax for the year suffering the loss, if the loss is suffered more than two times it cannot be offset against future incomes.

As it is indicated under the provisions business tax doesn't include exempted taxes. There are items that are related to business incomes had it not been exempted under art 65 of the proclamation e.g. under sub 1 (f) a tax treaty might exempt certain business incomes from the application of domestic income taxation without it being attributable to permanent establishment and the other could be sub 1 (o) an amount specifically exempted from income tax under the law in force in Ethiopia relating to investment incentives having tax holidays given to business persons (domestic or foreigners) based on the location of the operation of the business and based on sectors of the business up to 5 years from the commencement of the business. Taxable incomes can be reduced by allowable deductions including depreciations for business assets for the tax year. Charitable expenses are subject to deduction to the extent they do not exceed 10% of the taxable income of the taxpayer for the year. Determining the amount of deduction; taxable income is required in order to determine the amount of deduction and the amount of deduction is also required to determine the taxable income. Incentives of reconciliation of the two are regarded as the concepts of below and above the line deductions. In the above line deduction all kind of deductions are included except charitable incomes, whereas below the line deduction is applicable only when all the deductions have been determined and deducted to form "adjusted taxable income".

Tax rates as stated under Art. 19 for bodies the rate is 30% while for individuals including small and micro enterprises that are considered as individuals for the purpose of progressive taxation is from 0% to 35%. Equity difference between employment and business incomes can be raised as being advantageous to business income taxpayers in terms of time value of money that opportunities of using money at the time it is generated are closed to employees as compared to

business persons and the other is **over taxation of employees as compared to business persons having significant difference when calculated annually and monthly.**

Tax credit for foreign business income

In the case of conflicts of definition of permanent establishment and tax rates between international treaties and domestic laws, the **former prevails over the latter** based on the precedence rule as stated under Art 48 of the proclamation having **exceptions** as stated under sub (3) that the precedence rule doesn't apply to anti-avoidance rule and do not affect anti "treaty shopping" rule. In order for a tax credit to be available, the income that is generated has to be taxable under Ethiopian tax law. Conditions of documentary evidences that the tax has been paid in a foreign country has to be produced by the taxpayer in the application of foreign tax credit. An amended tax liability could be created in a way foreign tax could be paid after Ethiopian income tax has been paid on the same income which could result in the benefit of the taxpayer as the tax authority recalculated the tax liability and return the amount that would have been credited to begin with to the taxpayer. The other condition that is applied for foreign tax credit is the **taxpayer must ask for the credit within 2 years** from paying foreign income tax in Ethiopia (in addition, the tax authority has a jurisdiction to extend the period based on different circumstances). **Tax credit only applies to the amount of tax due paid in the source country, other things like interests and administrative penalties for filing late etc... are not included under foreign tax credit. Expenses on foreign income is only deductible on foreign incomes not on Ethiopian income.** For the purpose of **disallowing foreign expenses on domestic business income**, foreign income is treated as a separate class of income. **Net foreign loss can also be carried forward just as domestic loss but only in respect of foreign income** as indicated under Art. 46. **Consolidation of foreign income to different foreign business expenses is also possible** under this rule as per Art 8(2). Exceptions can be raised in relation to related persons in a company.

Schedule "B" tax structure: taxation of income from the rental of buildings

It is treated under Art 13-17 of the proclamation and under Art 21-26 of the regulation. The taxpayer indicated under this schedule is an individual or a body renting out a building or buildings who has taxable rental income for the year. **Incomes derived from casual rental of buildings are excluded from schedule "B" tax** as per Art.13(3) of the but rather business rentals are included under schedule 'B' with having an income tax base of net concept rather than a gross concept.

Taxable rental income can be indicated by identifying gross income and reducing it by allowable deduction Art. (15). The periodic basis of the tax is annual. Rental income is reported for tax purposes in the tax year in which it is derived. The word “derived” is defined as the arising of right to receive (earning or accrual basis) or received (cash basis accounting method) including constructive receiving. Gross rental income deduction is allowed as stated under Art. 15 sub (5 &7) and the gross income is taxed under art 15(2) including

- An amount derived by a lease agreement including in kind payment, actual lease payment or any lease premium (payment for not use but the right to use) or similar amounts.
- All payments made by the lessee on behalf of the lessor during the year under the lease agreement including taxes and charges. (having a form of constructive receipt).
- An amount paid as bond or security (in cases where the building is damaged, if part of the amounts is used for repairs and part is retained, the retained amount is assimilated to gross rental income).
- Value of renovation or improvements to the building, costs being borne by the lessee under the lease agreement in addition to the duty to pay rent.

Movable items like furniture’s that are immovable by destination must be reflected in the lease price, and income from renting them out jointly with immovable is taxed by schedule B. Thus, the lease payment is not only limited to empty buildings but also furnished buildings.

Lease of a business as a going concern, being an incorporeal property cannot be part of schedule B taxation rather it is regulated under schedule C and under Art.22 of the regulation.

Exempt incomes are not also included under schedule B taxation.

Gross rental income deduction indicated under 15 (5 &7) includes

Under sub 5, deductions allowed for taxpayers that don’t keep accounting records includes

- Fees and charges paid on land or building (excluding tax which can only be credited).
- 50% standard deduction of gross rental income as allowance for repair, maintenance or depreciation of immovable, furniture and equipment.

Notional amount for taxpayers who keeps accounting methods.

Under sub 7, deductions allowed for taxpayers who keep accounting records includes,

- Fees & charges, but not tax;
- Cost of the lease of land on which the building is situated;
- Repair or maintenance costs; and
- Depreciation of building, furniture and equipment as determined from the accounting records.

In cases of sub-lease, **the difference would be taxed** as the lessee becomes the new taxpayer. If the lessee fails to pay, the lessor should be obliged to pay as per Art.16. In other cases of **advance payment**, as having the tax paid in the current year, pro rata distribution of taxation is applied to the years the income is going to be generated as per Art. 21 of the regulation.

Art 21. Rental Payment Covering More Than One Year

If a lessor or sub-lessor to whom Article 15(5) of the Proclamation applies receives an amount of rental income for a period in excess of one year, the total amount of rental income received shall be treated as having been derived in the tax year in which it was received but the tax payable on the amount shall be calculated by prorating the rental income over the number of tax years to which the payment relates.

Lecture 31 RuY

Schedule “D” tax structure (Taxation of other income)

Introduction

- This schedule is composed of miscellaneous income categories.
- It covers articles 51 – 64 of the proclamation and articles 50-53, 56 (1) and 57 of the regulation.
- This schedule is an assortment of income items that are distinct. **They are distinct** in the sense that it is difficult to speak of them sharing characteristics that would class them under the same schedule.
- It is a kind of “catch-the-rest” schedule. It includes a variety of income items including a residual category. It is **open ended** in that it allows the bringing in of incomes that haven’t been specifically mentioned. This characteristic is good as it ensures horizontal equity and relieves the legislator of the duty to amend the law every time a new income item arises for the purpose of taxation (it promotes administrative ease). It is practical.
- **There is no relationship between the items despite being in the same schedule.** There is no single treatment. The items found under this schedule are **taxed separately at different rates**. Although, this feature could be criticized, separate taxation is necessary in taxes such as capital gains tax. This tax could be considered as a **sub-schedular tax system** under the broad schedular income tax. Additionally, **the consolidation or aggregation rule under article 8(2) of the**

proclamation doesn't apply to schedule D as per article 64 (2) of the proclamation. But it may apply under particular circumstances.

- The schedule doesn't exhibit the features of a typical income tax structure.

Commonalities

Despite their disparate nature, the income items under this schedule exhibit some commonalities.

- ✓ Most of the income items constitute passive income.
- ✓ Most of the income items are not of regular occurrences i.e. they are not regularly derived. There is no regular periodicity in their derivation.
- ✓ Tax applies on a gross basis in respect of most of them. There is no deduction on any expense. As the ones above, this is true with regard to most not all. An exception being capital gains tax.
- ✓ Tax applies on a current receipt basis. This is based on article 2 (5) b and article 2 (19) of the proclamation.
- ✓ A withholding scheme rather than assessment applies for most as a result of difficulty in self-assessment and self-reporting. This results in administrative ease. The withholding scheme applicable is final i.e. no tax credit or refund is allowed and the tax is considered fully discharged. This is on the basis of article 64 (5) of the proclamation. A withholding scheme is more suited to a gross basis system as opposed to self-reporting. Self-reporting is on the other hand more suited to a net basis system.
- ✓ Tax applies only if the amount is not liable to tax under another schedule. This is as per article 64 (1) of the proclamation. It is usually found in international tax treaties especially ones between first world and second/third world countries. For example, the Ethio-Dutch double taxation treaty under article 10 (4) as related to dividends states that if a dividend is acquired as part of a business income, it is not the dividend provision that applies. There is also a similar exception in relation to interest (article 11 (5)) and royalty (article 12 (4)) of the treaty.
- ✓ Flat rate taxation of passive income unconnected with business especially for non-residents. It is applied for residents because of administrative ease and the unique feature of the schedule. For non-residents, in addition to the reasons mentioned, flat rates are preferred because the application of progressive rate of taxation is unworkable as the full personal circumstances of the non-residents are not known.

The above is not only based on the Ethiopian law rather they are also supported by the literature i.e. they also have a theoretical background. They are the embodiment of valid theoretical prescriptions.

Items of income

- 1) Technical fees;
- 2) Royalty
- 3) Dividend
- 4) Insurance premium
- 5) Interest
- 6) Management fee
- 7) Income from games of chance
- 8) Income from casual rentals
- 9) Wind falls
- 10) Capital gains
- 11) Undistributed profit
- 12) Repatriated Profit
- 13) Residual income

Taxpayers

1. Non- residents
2. Residents
3. Permanent establishment of non-residents

Taxes on income of non-residents exclusively:

The provisions applicable are article 51, 52 and 53 of the proclamation. The items include [technical fees, management fees, insurance premium and income of entertainers](#).

- Technical fees (art 51)
 - Source rule- art 6 (4) – g (1) – interest, a royalty, management fee, technical fee or other income subject to tax under this proclamation “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”. If such criterion is fulfilled, the technical fee is considered as Ethiopian sourced income.
 - Definition- art 2 (23) of the proclamation- “fee for professional, technical or consultancy services, including a fee for the provision of services of technical or other personnel”. [The services are thought to be provided by independent contractors rather than employees](#). By the provision of services of technical or other personnel, it is meant to refer to hiring out of labor. This includes “**secondment**” [which is the transfer of an](#)

employee (who is highly sought after) from one company to another for an amount of time upon request from the latter company (receiving company) along with a fee (this fee is a technical fee). This is often seen between a parent company and a subsidiary.

- Management fee – art 51
 - Source rule- art 6(4) – g (1) of the proclamation
 - Definition – article 2(17) of the proclamation – “an amount paid as consideration for the rendering of managerial or administrative service other than employment income”. An example of this is a fee paid for centralized management services by subsidiary to parent company. **Such fee is paid to the company rather than the person providing the managerial services.** It is distinguished from technical fee as it is about the provision of managerial services as opposed to the provision of professional services. It is similar in that both require the services of an individual.
- ❖ The tax rate applicable to the above is 15% of the gross income as per article 51 (2) c.
- ❖ **If the above were acquired by a resident or a non-resident through a permanent establishment, they would be taxed under schedule “C” as business income.**
- Insurance premium
 - Normally, foreign insurances are not allowed to engage in business in the Ethiopian insurance sector. But, as an exception, when the national bank of Ethiopia permits, foreign banks could insure risks in Ethiopia. In this case the non-resident insurance company would earn insurance premium. This is an income for the non-resident. **If residents obtain it, it will be taxed under schedule “C”.**
 - Source rule- art 6 (4) – d- “an insurance premium relating to the insurance of a risk in Ethiopia”. **The insurable risk is situated in Ethiopia.**
 - A definition has not been provided for under the proclamation. As such, the normal definition of insurance premium i.e. “an amount periodically paid to the insurer by the insured”.

Applicable rate- 5% of the gross income

Lecture 32 Mewd

Technical fees, the management fees and the insurance premiums *for non-residents*

One of the reasons for the source country imposition of non-resident tax only on technical management as well as insurance premiums is [to deal with cases where deductible expenses are used to reduce the taxable income of the payer](#). The payer is often an Ethiopian resident. We said that the income is sourced in Ethiopia. [The recipient is a nonresident](#). For the payers, these are often deductible expenses e.g. Management and technical fees, insurance premiums etc. and they are either nontaxable or deductible especially to a business in Ethiopia, and that reduces the tax base in the country of the paying enterprise without corresponding taxation by that country of the fees and premiums received by the nonresident.

[For the recipient, it is not taxable, in the absence of this non-resident tax under article 51](#). The technical fees, the management fees and the insurance premiums are going to be claimed as deductible expenses and at the same time they are going to escape taxation by the source country or these items of income received by the non-resident. So, it is important to have this kind of provision.

By the way, this is one of a few areas that the new income tax proclamation brought into the tax net. So, the ever-increasing expansion of the tax base has reached these items of income that had previously been escaping taxation.

[If the fees and the premiums are received by a resident then it will most definitely be taxable as part of business income under schedule C](#). For residents, there is no way that [technical fees, the management fees and the insurance premiums are taxable as part of Schedule D](#). By applying article 64/1, we can see that residents are taxed for these items of income under schedule C.

Article 52 is also part of taxation of non-residents. Conceptually, it is related to royalties – there is a component of that provision that deals with royalties. So, for now, let us skip this for now, look at article 53, then define royalties and return to article 52.

Article 53 – income received by *non-resident* entertainers

Business or, sometimes, employment income obtained by a non-resident from entertainment and from sporting activities can be taxed in a source country. Examples of such income include [Income received by sportspersons and musicians](#) for example. The source rule is often defined by the [place where the activity is carried out](#). So, if that place is Ethiopia i.e. If the activity is carried out in Ethiopia then we would consider that income as sourced in Ethiopia in accordance with article

6/4/e (source rule for these types of income). Why do we tax these people? Because very high income is earned in short periods without qualifying for residence rules or permanent establishment rules (in the business context). Think of a concert organized by some famous artist. You don't tax this under schedule C because net concept as per the source rule. **Foreigners are only taxed in their business income if they possess permanent establishment. This kind of business does not qualify as a permanent establishment because it has no fixed place of business.** Even the employment rule is not readily applicable because the entertainers or the sportspersons might come to Ethiopia and perform the sporting or musical act through another company and they might be paid through that company, not directly by us. So, **devising a specific source rule for taxing this income on a gross basis through a withholding scheme is often the most efficient mechanism** to capture this kind of income under the tax system. Source rules on employment may not be feasible because employment may not be directly related to the country as employment income is often received by an intermediary (a company), not by the employee. It is only very rarely that income accrues to the athlete/entertainer/artist directly; often, there is an intermediary such as an agent or a company. So, flat rate final withholding is clearly permitted in domestic law and international tax treaties and provides for a simple and effective method of collecting tax **via the promoter of the event. It is the promoter of the event that is required to withhold the tax and effect the payment to the authorities.** This is a new area captured by this very recent tax review. So, this applies regardless of whether the income accrues to the entertainer or the intermediary. That is not taken into account. So, this permits us to use entertainers as **"go throughs"**. The **definition of entertainer is basically an artist or a sportsperson.** The tax rate is 10% on gross income.

Royalties

Royalties, dividends and interest are found in 2 separate articles in schedule D: in article 51 and 54, 55, 56. The same definition applies in all these articles. In the case of dividends, the definition is found in article 2/6. For royalties, the definition is in article 2/20. In the case of interest, the definition is in 2/16. **The difference is that articles 54, 55 and 56 talk of these types of income being received by residents and permanent establishments of non-residents while article 51 talks of these types of income being received by other non-residents.**

The source rule for royalties is found in article 6/4/g.

Definition of royalties:

The term royalty has diverse meanings under different jurisdictions and even within the same jurisdiction, under different contexts. One common meaning is [payment for the use or the right to use a person's intellectual property](#) e.g. The author's intellectual property in respect of the printing or selling of books containing copyrighted material; musician for the right to produce and sell tapes or CDs containing the musical score; the rights of an inventor regarding the right to produce and sell the inventor's patented system; the trademark's owner's right to use the trademark in respect of goods and services; knowhow. It is also a payment for the [sale, assigning and licensing of intellectual property rights](#). This is the most common definition.

There is also a different contextual meaning. [Royalty is also an amount paid for the exploitation of natural resources](#) i.e. For being granted the right to explore and exploit natural resources e.g. Minerals, petroleum, natural gas, timber, gravel. This is usually done by the government i.e. Royalties are paid to the government. In jurisdictions where land and natural resources within the land are owned by private persons the royalty is paid to those private parties. This definition, though not common, is not rare either.

Sometimes royalty means payment for the use of some technical/physical goods i.e. Scientific property, industrial property, commercial goods. Instead of naming this payment for right to use "rent" or "hire", these may be called "royalty", because the right to use relates to equipment or knowledge which requires great amount of know how. The rationale, then, for using the term royalty in this context is that such knowledge should be governed by intellectual property law, not general property law. This is not a common definition. [Distinguishing such payments as royalties and not as rent has tax consequences: for normal rental it is either schedule C or article 58 that applies](#). In article 58, the tax rate on rental income is 15%. However, since this kind of payment is considered a royalty, the tax rate is 5%. [The tax rate is smaller here in order to encourage exchange of technological know-how](#).

In the Ethiopian law, proclamation 979 article 2/20 provides the definition. [This definition does not include the aspect of exploitation of natural resources](#). Also, in Ethiopia, [this type of royalty is a non-tax revenue that can only be obtained by the government](#), as per articles 96-98 of the FDRE constitution. Article 2/20 includes the aspect of payment for use of scientific knowledge/property as well as industrial/commercial equipment that requires technical knowledge – see 2/20/d. 2/20/e includes payment for the use of industrial, commercial, or scientific knowhow. If we see sub

articles a-d in article 20, payments for the transfer of the right, the use of the right and the right to use the right are taxable, not services. Services are taxable under sub article (f): payments for services ancillary to what is states in sub articles (a-e). E.g. When using a patented material, when the patent right holder may help the transferee use the patented material. Payment for that assistance is royalty, since the assistance is a kind of technical services.

2/20/f: the supply of assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of asset or a right referred to above – this is the only circumstance in which service fee is treated as royalty.

With the exception of consideration received for the exploitation of natural resources, every aspect of the definition of the modern definition royalty mentioned above (according to tax treaty and theory) is included. Thus, article 2/20 uses a broad definition. The tax rate for such royalties, whether derived by non-residents as per article 51 or by residents or permanent establishments of non-residents as per article 54, is the same: 5% of gross receipts.

Recharged technical fees/royalties – article 52

This is a non-resident tax. The term royalty here is in the narrow sense of payment for lease of equipment only i.e. Industrial, commercial and scientific property. Thus, royalty here has a narrower definition than in article 2/20. Here, technical fees refer to payments for technical services e.g. Professional and consultancy services. Technical fees here have the same definition as in the other articles. The receiver of the technical service/equipment is a resident or a PE of a non-resident. The payment was made by a 3rd party non-resident who is a related person to the supplier nonresident (also known as recipient nonresident, since this nonresident receives the payments). In this scenario, **the 3rd party nonresident recharges the payments from the residents** (he is demanding return of the money since he paid on the resident's behalf. This demand is known as **“recharging”**). The tax rate on this recharged amount is provided in article 51.

Rationale behind this provision: anti-avoidance provision to ensure integrity of tax base. Otherwise, the two nonresidents (the recipient of payment and the 3r party payer, who are related) would have claimed that the recharged amount is not income but merely reimbursement. This would have made it a deductible expense. However, since these persons are related, the recipient of payment will benefit from the recharged amount, which could escape taxation by being

disguised as a deductible expense. Such arrangements are often provided in multinational enterprises. To prevent such shifting of profits, this rule is provided.

Interest

This concept is critical for the concept of thin capitalization in article 47 and deductible interest in article 23 and many other areas.

When obtained by nonresidents, article 51 applies. When obtained by residents or permanent establishments, article 56 applies. **When interest is collected as the core business of a resident, it is taxed under schedule C.** For the purpose of 51, the applicable source rule is article 6/4/g, i.e. When payments arise in Ethiopia. The definition of interest in articles 51 and 56 is the same and is found under article 2/16: this definition is broad to reflect the enormous flexibility in the international market as to how financial instruments may be structured to give rise to payments. Thus, a functional definition is given; even if something is not explicitly described as interest, if it has the function of interest, it will be included in the definition, as follows: an amount as consideration for the use of money or for being given time to pay. When we borrow money, we are being given the use of money, and we pay for that use in the form of interest. We also have to pay for the value the money, for being given additional time to use it.

International definition:

- Interests paid by financial institutions on deposits i.e. Amounts deposited with the institutions. When we deposit money in the bank, we are giving it the use of our money, so we get paid interest
- Interest paid by companies on debentures issued by the company: debentures are instrument that evidence debt, the only difference being that they are issued by share companies. They are also known as bonds
- Or any other functional equivalent

The character/identity of the recipient and the lender is not important. What is important is the character of the return derived on the transaction. An amount is taxed whether it is received in lump sum or in installments, even though interest is usually paid in installments. And regardless of the way the interest is described, if it serves one of the 2 functions:

- consideration for use of money or for being given time to pay, it is interest. It includes discounts and premiums, as long as the discounts are considerations for the use of money/being given time to pay.

E.g. Of discount: bill of exchange. There is a drawer and a drawee. The drawer pays the drawee the value of the bill upon the maturity of the bill. At the time the bill was issued, it had a value of 9000 Birr. At the time of maturity, say, ten years later, the drawer pays the drawee 10,000 Birr ie. 1000 extra as payment for the time given to use the money. This is functionally interest.

Premium: debtors who have low creditworthiness can be requested to pay interest additional to the normal rate. That addition is called premium. The name may be premium but it is basically additional interest. This is an example of how economic equivalents of interest may be described differently.

Another e.g.: a guarantor paying interest on behalf of a debtor in default

Tax rate:

Article 51/2 provides a rate of 10% of gross receipts. Article 56 provides a tax rate of 5% on interest from deposits in the form of saving accounts. For all other interests taxed under article 56, the tax rate is 10%. [Rationale behind this differential treatment: encouraging savings.](#)

Dividend

Dividend taxation is special because it raises [issues of double taxation](#). It also requires [integration with corporate tax](#).

Dividends are distributed by bodies, often companies. It is a result of the income taxed at the corporate level. When it is taxed at the shareholder level, it often constitutes [double taxation – not legal but economic double taxation](#). Legally speaking, [the entities are separate – the bodies are separate from the shareholders](#). But economically, it is the same income that is being taxed twice – first at the corporate level and second upon distribution to the shareholders. Countries see this as a problem since it [disfavors incorporate business and favors unincorporated business](#), since the latter don't distribute dividend.

[Why do we need dividend taxation](#): since the taxpayers are individuals, they are subject to the [progressive rate scale for individuals](#), which taxes higher amounts more efficiently. At the same time, corporate taxation is also necessary, since there are amounts that are [always reserve to the company i.e. Remain undistributed and would escape taxation in the absence of corporate taxation](#). Economic double taxation only relates to distributed amounts i.e. Dividends.

Methods from relief from double taxation:

- classical method: no integration between corporation and shareholders i.e. “separate entity” notion, which denies the existence of double taxation because it considers company and shareholders as separate entities
- integration method: opposite of classical method
- imputation method: tax credit system: also known as attribution method

When tax is paid from an amount attributed to the dividend of a given shareholder, the amount that the dividend has paid in the form of tax due under corporate income tax is credited (aka deducted) from the tax due from the dividend under dividend tax

-e.g. A company makes birr 10m profit, from which 4m is distributed. Assume that the corporate income tax rate is 10%. If shareholder A gets 2m, the amount of corporate tax that has been imposed on the dividend is 10% of 2,000,000 which is 200,000 ETB. Then, the corporate tax due previously imposed on this amount is deducted from the dividend tax due. Therefore, shareholder A will pay dividend tax due minus the 200,000 ETB.

Lecture 33 EdG

- The basic notion of dividend is distribution of profit by a body to its members on account of membership interest.
- The term ‘body’ has already been discussed.
- On the phrase “distribution of profit by a body to its members”, what does the term members mean? Its definition is found under Article 2(20) of the tax administration proclamation. It means, “a shareholder in a company or a partner in a partnership or any other person with a membership interest in a body.”
- So, a member is a.) a share holder b.) a partner c.) Any other person who have a membership interest in a body. Here the term body tells us that this article works for other types of bodies as well.
- Membership interest simply means ownership interest.
- It can be seen that the notion of dividends is much wider than the concept which we normally associate it with. This is, it’s broader than shareholding in a company. It applies in respect of all bodies which obviously includes partnerships.
- The most obvious form of dividend is, when a company, after making profits and paying corporate taxes, decides to distribute the remaining balance to its shareholders. This is the most outward definition of dividends.

- Distinction should be made between the terms ‘distribution of profit’ and ‘return of capital’. Amounts returned by a company to its shareholders is not always distribution of profit.
- **Return of capital is not taxed** because the amount being returned is just capital, nothing else. It’s the previous income that parties have contributed that’s being returned. Example- when a company tries to raise its capital through debt financing, it will have to return the principal to the contributors after some time. The amount that is returned is not taxed because it’s not only equity, its return of capital.
- The effect of return of capital is the shareholder’s membership interest is going to be reduced or altogether terminated based on the amount returned and of course based on their initial investment.

Circumstances where a company might return capital to its members-

- ✓ In case of **redemption of shares** where the company return the exact **nominal value** to the shareholders. **If it is more than the nominal value then it is going to be considered as a dividend and will be taxed.** So, any amount that is paid by the company in excess of the nominal value of the shareholding is in effect distribution of profit and therefore taxable. While an amount corresponding to the nominal value of the shares is a return of capital, and it is not taxed.
- ✓ Other example could be **reduction of capital of company**. Again, if the company returns the amount at the nominal value then it is return of capital but if it returns it at above the nominal value then the difference is considered as distribution of profits.
- ✓ **Liquidation** resulting from the dissolution of a company or termination of partnership.
- ✓ **Cancellation of debt owed by a member or a shareholder to the company**. This is in case where a company remits a debt owed by a shareholder. This is considered as a dividend and its taxed.
- ✓ **Provision of loan by the company to members at reduced interest rate**. The difference between the reduced interest and the market interest is dividend and will be taxed.

- ✓ **Payment by a company to members for assets or services provided to company for excessive payment.** The tax authority will be deciding its excessiveness by comparing it with the market value. Thus, the excessive amount is dividend and will be taxed. The payment could also be made in kind.

- So, it can be understood from this that the notion of dividends is a wider and broader concept as it incorporates different arrangements designed by companies and shareholders to shift profit and reduce liability. Afterall they are related parties as provided in article 4 of the tax administration proclamation.
- The rate of tax is 10 % of gross payments. It is paid through withholding on a gross basis.

❖ **Related notion of dividends.**

- Dividend taxation needs to control the escaping of taxation of retained or undistributed amounts.
- **Undistributed dividends or profits-** why do we need a rule on an amount which is not distributed by the company. Article 61 is about undistributed profits. Companies usually hold dividends without distributing them to avoid taxation. Normally dividend is taxed on realization basis rather than accrual or earning basis. So, this undistributed amount could be taxed if it fulfills the conditions provided by the ministry.
- **Repatriated profits-** profit repatriated by permanent establishments in Ethiopia to the foreign nonresident. Why is it taxed? It is taxed so as to avoid a situation where the unincorporated business is favored than incorporated business. So, if this type of profits where not taxed then foreign investors would choose to establish permanent establishment rather than incorporated business to avoid being taxed on the dividends. It would unfairly benefit unincorporated business. So, this rule is to equalize or balance the tax burden. Article 62 is about repatriated profits.

Capital gains tax- it is found under article 59 of the proclamation. It can be taxed for all recipient; residents, non-residents, PE. Both source and residence principle could be applied.

It targets certain property through which enforcement is easier. Art 6(4(c)) talks about source rule applicable to capital gains. Sub (1) talks about a gain arising from the disposal of immovable asset in Ethiopia. Here the capital gain is deemed to be sourced in Ethiopia by nonresidents. An immovable asset is defined under article 2(13) of the proclamation. Immovable asset includes a

mining or petroleum rights, or mining or petroleum information. So basically, immovable property means building, rights on buildings and land. Sub (2) here the immovable property is being disposed through directly or indirectly through one or more interposed bodies. Here the company is not disposing its immovable asset directly but rather through the mechanism of shareholding. Sub (3) a gain arising from the disposal of shares in or bonds issued by a resident company is deemed to be gain in Ethiopia. The share is issued by a resident company. The recipient is a nonresident.

General rules on capital gain

- Capital gain is taxed on net basis not gross. This is one of the exceptions in schedule D because historical and inflation index should be taken in to account.
- Net based taxation doesn't involve withholding. In capital gains some type of withholding is possible but it requires administrative infrastructure. But practically speaking, withholding in capital gain is less likely chosen because enforcement is feasible only in the case of registrable transaction like in land. So, usually if the tax is on net basis, it's imposed through self-assessment.
- To avoid an attempt to convert capital gain to dividends, the nature of the transaction should be looked into. This is let's say company A redeems a share from B and then sell it to 3rd party C if B and C are related, then there is a view that if there is a gain it should be treated as a capital gain. Normally speaking, gains or income from deals with a shareholding in a company will be taxed as part of dividends. For it to be taxed as a capital gain, there need to be a disposal to third parties.
- The rate of dividends and capital gains differ because in the former case there is a contribution while in the latter it is acquired without any effort.
- Article 56 of the regulation explains how capital gain is calculated.
- Donation of share is also realization event. Thus, is taxed upon transfer considering the market value. Even involuntary conversions could be considered as capital gains unless the amount with the gain is used to replace the lost or deteriorated asset. The receiver is the one pays the capital gain tax.
- Capital loss could be forwarded indefinitely unlike article 26. Another difference is in case capital gain, it can only offset a loss against a gain arising on similar classes of property.

- Article 64 sub 3 talks about instances where a resident acquires a gain from foreign country.
- Windfall profit is stated under article 60 of the proclamation
- Other incomes- it includes whistle blowing income and income for outstanding performance. Income for outstanding performance is exempted under article 65(1(h)). Whistle blowing is put under article 134 of the tax administration proclamation. a rticle 58 income from casual rentals could be other incomes . the rate on other incomes is 15 percent on gross amount of income. It is taxed though self assessment not through withholding.

Lecture 34 AbeG

Procedural rules that pertain to income taxation

Here we deal with those rules that are very particular in nature. There are procedural rules that are applicable across the border to all kinds of tax, that applies to VAT, TOT, EXCISE, custom duties and stamp duties. Those procedural rules are part of Federal Income Tax Administration. Here we deal with rules that are specifically related to income taxation. These rules have substantive consequence also. This rule includes [categories of taxpayers](#) under art. 3, [tax accounting rules](#) under art 28-33 (both general and specific tax accounting rules), [presumptive taxation](#) under 49 & 50, [record keeping](#) art. 82, art 83-87, [withholding rules](#) 88-98. And other administrative Matters of income taxation is governed by ITP that is part of tax administration generally. And after talking about this rule we will talk about [anti-avoidance](#) rules.

Categories of taxpayers

Art. 3 of ITP is applying in the [connection of schedule B and C taxpayers](#). This is usually made for the purpose of attaching different obligation to this d/t class of taxpayers based on the kind of business, type of business organization etc. [This is important to administrative prioritization](#). Certain kinds of taxpayers would have for example the obligation to keep the major books of accounts like balance sheet and profit and loss accounts. But another taxpayer may not be compelled to do so. So, you have to classify taxpayers based on this difference in obligation that have importance for tax purpose.

Under Ethiopian law we have 3 kinds of categories

[Categories of the payer is obviously different from schedules. Categories are ranks of taxpayers.](#)

Bodies are always category A taxpayers even if their gross income is less than one million.

For the purpose of categorization of taxpayers, we rely on gross income without deduction of expenditures. Art 2/12

Tax period is annual in the case of schedule B and C, based on their annual gross income taxpayer could move into the category and out the category. The fact that the taxpayer belongs to the certain category for specific tax year doesn't mean that the payer always belongs to that category. The tax authority could change the category of taxpayer on annual declaration. Because schedule B and C taxpayers are assessment taxpayers. The tax is assessed based on the declaration of the taxpayer. If the declaration is made in accordance with general international financial reporting standards that would be a good piece of information to rely on. The consequence are different obligations attached to them. The modification of this threshold could be changed by the minister based on economic analysis on every five year. Under the previous law there was no system like this. But in existing law the minister could change the threshold without going to amendment. Every 5 years often inflation is the determining factor.

Tax accounting

General tax accounting

This Includes tax year and accounting methods. Why we need the tax year

Because tax obligation is periodic obligations. So, we have to select some period. And schedule A is a kind of monthly, schedule D could also be taxpayers that don't follow specific timing because most of them generate income based on transaction basis. So, the timing is different for different taxpayers. But basically, the period determined on annual basis. The rule is here the others is the exceptions. So normally tax year could take three forms:

1. Fiscal year.

This is presumptive rule, in Ethiopia from 8 of July – 7 of July. This presumption is rebuttable. Under 28/1/a with 2/21/a. It defines one tax year as the presumptive fiscal year.

2. Accounting year of the taxpayer

The accounting year may overlap with fiscal year. It is basically the year that the taxpayer has adopted for financial accounting purposes. The good thing is tax system also permits the taxpayer

to use that year as a tax year. **Tax year as accounting year reduces cost of compliance** that comes from deviance from accounting year. 2/21/b with 28/2. **To use this accounting year, they need permission from the tax authority.** Bodies use accounting year, this is again rebuttable. They could use the fiscal year. But as a matter of rule, there tax year is there accounting year.

When a taxpayer changes its tax accounting year form, for example, if a person needs to change its tax year from Gregorian calendar to EC, often tax laws provides rules that **prevent a taxpayer from having an extended period**, through changing an accounting year to one from another. Tax laws always provided shorter tax year which is less than 12 months in case of changing an accounting year. For example, from GC to EC, if a person wants to change on May 1st to change to EC, **transitional tax period** is created. This is less than 12 months but it regards as a separate period, in the existing case, the transitional tax year would be from May 1, to September 10. So, this period will regard as an **independent tax year**. If he changed to fiscal year, from January 1 to July 7 would be the transitional year.

What if the person changes to Ethiopian fiscal year to Ethiopian calendar year, the transitional tax period would be to July 8 – September 10.

For ex. The commencement of the business is June the 1st, how we treat this kind of citation?

We don't have clear rules art 28 thinks changes only. Other tax system includes within transitional tax year purpose.

Tax period could also include, month for schedule A, for schedule D, for most of them not defined but some are annual like art 58. So, there are periods others than tax year.

Accounting method (2/29,2/5,2/19)

We have two accounting methods. We have already touched up this point. The next issue is the attribution of particular receipts and expenses to that specific tax year. This is carried out through the use of accounting method. So, for profit taxation

There are the **cash basis method** (also **called receipts and disbursements method** because it reports income and expenditure on a current basis. (when the income is received and expense is incurred) Income is reported at the particular tax period for tax purpose if they are paid in that particular tax period.

In case of cash basis accounting year, **the all receivable incomes are not subject to tax year** report if it turns out the income has not actually been received.

And accrual method: It is also called the **earnings methods**. It is not current and it is not realization. It is earnings based. **Income is reported in tax year when it is receivable and expenses report when they are payable**. This is when the right to receive the income arises. In the case of an expenses, when the obligation to pay arises. In accrual, the fact that right to receive the income arises is sufficient conditions for income to be reported in that tax year even if the income has not actually been received.

Accounting rule for bad debts

Is based on accounting method especially on accrual-based accounting method, you report an item of income for particular tax year just when the right to receive the income arises. But it turns out the income has not been received not only that it has been proved; that it is not receivable at all. So, you reported an item of income with expectation that you are going to receive it, but it has been proved that it is unrecoverable. So, what is the logical consequence of it?

Being unrecoverable should be determined on objective basis. The mere fact that the debt has become worthless, that doesn't mean it is debt bad. What makes the debt bad is the exhaustion of legal avenues. Deduction from the income of the year by which that debt has become bad.

If the unrecoverable becomes recoverable there will be re-inclusion of previous bad debt amount. Art. 73.

Conditions of bad debt (art. 30)

The amount the taxpayer deducted doesn't exceed the amount written of in to taxpayer financial accounts. Art.30/2

In the case of financial institutions (banks, insurers, micro financial institutions), the concept of **bad debt doesn't apply**. Because they have special circumstances and they obey the rules under art. 31. Financial institution is highly regulated. As part of that regulation they are required to create and sustain many types of reserves from their earning and it is difficult to determine their taxable income in accordance with art 21 and 22. So because of this reserve, financial institutions don't rules of deduction apply. Art 45-47 of the regulation provide the rules

Financial institution allowed a bad debt deduction for an outstanding loan before the debt is formally unrecoverable. Or when the debt becomes doubtful. Art. 31 with regulation 45-47.

Long term contract (art.32)

Accounting for taxation purposes in respect of income and expenditure arising under of long-term contract. This works for a taxpayer report on accrual basis. It applies when a taxpayer enters into contracts that extend beyond a year and that require both performance and payment over the life of the contract. There is a contract extending over a year it is often project, often the amount of the total income stated in the contract. This type of contract often has two kinds. 1. **Fixed price method** (the amount stated on the contract but payable based on the contract) 2. **Cost plus method**.

So, if you apply the accrual method, the taxpayer is entitled to pay, but nature of the contract provides that payment is a conditional up on performance. Allocation based on performance. So upfront recognition of payment doesn't apply to long term contracts

Methods

Percentage of completion method: based on percentage of accomplishment under the contract, the taxpayer is entitled to receive certain amount from the contract. It is adopted in many tax systems including ours. This measures periodic accomplishment on the life of the contract. Profit is recognized on the progress made during a year. 32/1. Art. 32/2 provides the percentage of a long-term contract completed by a taxpayer during a tax year shall be determined by comparing the total costs incurred by the taxpayer during year allocated to the contract with the total estimated contract costs, including any variations or fluctuations.

Ex, total contract cost 10 million 5 years project. For the 1st year cost = 500000. $T_c = 10,000,000$ then $500000/1000000$ multiply by 100. 5% so the

To determine Expense ex. If their contract of 5 years and the contractor expects expense of 500000, and to derive gross income of 1.5 million. The taxable net is 100000. In the first yr. of contract expense is 200000. So, the 1st yr. taxable profit will be

$200000/500000 * 100 = 40\%$ so 40% of 100000 (400000) is reported in the first year as income. Assume that in the second yr. incur 200000, then the profit will be 400000, in the 3rd year assume the expense is 100000 the income will be 200000.

Possibility of carrying the loss forward might not work so carrying back to the total expense. And refund claimed. Because this could be the only project for that contractor. This is the problem of fixed price tax unlike price plus method.

Art. 32/6, the field to which long term contract applies.

completed contract method

profit is not reported until the contract is substantially performed. But it has unwarranted deferral of tax.

Simplified tax accounting for category B taxpayers

Art 33.

Use of cash basis accounting method to determine timing of the business profit and expense. Depreciation of depreciable assets and business intangibles at 100 % rate. So basically, the cost of depreciable and amortizable assets is expensed at once. The cost of trading stock 22/1/b with art. 33, on acquisition in case of art. 33, not on disposal.

Shorter period of record keeping obligation. Basically 3 years. And amendment of assessment. 17/2 of TAP with 28/2 of TAP is 5 years. But in the case of category b taxpayers it is 3 years.

Presumptive taxation for category C taxpayers, art 49, there is no obligation to maintain financial records. But they may keep records on gross income. No information Report to category C taxpayers. This means tax liability arises on re determined income and expenditure patterns based on objective proceeds. Acc. to art. 49, subjected to presumptive taxation.

Theoretically Category c is both part of schedule B and C taxpayers. But in regulation area of business doesn't include renting building. So, practically they are part of schedule C taxpayers.

Lecture 35 AsnE

Taxation of category C taxpayers

Presumptive taxation for this category of tax payers, there is no obligation to keep financial records, Art. 49 of the income proclamation but they may maintain their records of gross income. There is no information reporting, there is no application of tax accounting rules or determination of tax. Tax liability arises on pre-determined basis on every taxable income and expenditure

patterns based on **objective indicators (proxies)**. Gross income and expenditure are presumed based on minimum tax liability is imposed otherwise this category tax payers would sleep taxation. There is a difficulty to tax this group of tax payers because they don't maintain books and accounts. These categories of tax payers are those make gross income less than 500,000 ETB. Small business-like sole proprietorship and micro enterprises provided annual turnover less than 500,000 is subject to presumptive taxation.

Theoretically category C tax payers are part of both schedule B and schedule C tax payer. The regulation has tried to address by annexed schedule based on the business area. Look at the schedule annexed to the regulation which includes 99 items based on the type of business (the area of business) for a better understanding. Expenses are deductible from their gross income. **Presumptive taxpayers are business tax payers**, meaning they incur expenses; this expense must be again deducted along as deduction on presumptive basis. Just like incomes are presumed expenses are also given on the basis of presumptive methods. **75% Of the gross income is considered as expenses and they pay tax on 25% of it.** Progressive rate under art 19 applies to individuals and micro enterprises. They are considered as individuals because take privilege of being individuals for income tax purpose. It's the progressive rate that often applies to individuals.

Its only 25% of their income that is considered as taxable income and the progressive rate applies on it. And taxable period is calculated based on this presumptive type. **The tax paid by this category of tax payers is insignificant and vary minimum**, it's even lesser than employment income. Techniques of accessing the gross income shall not be arbitrary; the indicators are the place of business, the type of business, daily income of the business and annual income of the business. The assessment could be near to approximate to the real income that the tax payers make over the course of the year. Art. 19(2) apply on the presumed amount of income. **The reason behind the application of presumptive taxation is tax payers don't maintain books and accounts to attach tax liability based on actual income and expenditures and equity demands that they must be subject to tax** and tax systems created presumptive techniques to do that. Art. 82(3) category C tax payers may keep records of their gross income while the commercial code releases small business of obligation to keep books and accounts because **cost of maintenance of those books is usually higher, it may undermine their profitability.** The presumptive gross amount is also used for the calculation of turn over tax. Category C tax payers are supposed to have a gross turnover of less than 500,000 birr. Under the previous threshold of VAT registration, they are outside of the VAT

system but that does not mean that they are outside of the indirect tax system generally, they are alternatively made part of the turn over tax system.

Art. 50 which is a nonresident tax a presumptive technique applies under this particular provision. A nonresident is deriving income from Ethiopia. Those airlines that depart from Ethiopia are subject to tax as source rule applies. Internationally it also applies to shipping but in Ethiopia as landlocked country shipping can't apply because source rule doesn't exist. The reason to tax those entities is that part of their income is obtained from Ethiopian sources. There is income that originates in Ethiopia and it's justifiable to tax this income. Ticket office may be considered as a permanent establishment but we can't attribute some net income to that permanent establishment because of the nature of the business itself so presumptive techniques are imposed. Three percent of gross income is imposed for the year. The tax concerns are the out bound flights that have place of departure in Ethiopia while the in bound flight are excluded. The rule also doesn't apply for domestic flight. [The presumptive rule doesn't apply to Ethiopian airlines because its resident in Ethiopia.](#) The rule applies to nonresident.

The rule also doesn't apply to transit flights and Trans-shipment. All treaties Ethiopia has signed with other countries exclude air transport from source country taxation they allocate the tax to the country of residence of the air lines.

Accounting rules for some residual matters (art.73 to 77)

[Tax treatment of recovered deduction](#)- art 73 applies where a tax payer has been allowed a deduction for an expenditure incurred or for a bad debt written off in a tax year and subsequently the tax payer has received in cash or in kind an amount as a reimbursement or a recovery of an indemnity for the expenditure of the bad debt. Amount received is treated as income derived by the tax payer in the tax year in which it is received and the income as the same character as the income to which the deduction related. [If the expenditure is related to derivation of business income then the reimbursed expenditure is treated as business income.](#) The effect of this treatment is deduction recapture. Art 74 is about the tax treatment of income derived after activity from which income is earned has ceased. Income received after the business has been dissolved. A person may derive an amount in a tax year from a business activity or investment that ceased before the amount was derived; if the amount would have been income subject to tax before the business

activity ceased then the income tax proclamation applies as if the business activity or investment has not ceased at the time the amount was derived. The rule also applies to expenditure.

Art 75 **amounts received in kind**- the value of an amount derived or incurred as a benefit in kind is the fair market value at the time of its derivation or at the time of its incurrence if its expenditure. It's rule under Art. 3 of the tax administration proclamation. It resolves the debate on the assumption in-kind received amounts doesn't have cash value because the tax payer could arrange such kind of conversion.

Art. 76 apportionment of expenditure- how can this rule applies?

There are two classes of expenditure one is expenditure incurred to derive more than one class of income, for instance, exempt income for schedule A and gross income for schedule C an expenditure deducted here is expenditure incurred only for schedule C. we have to apportion to expenditure and allow deduction only that portion of incur to derive business income. Cross refer art. 22 (1) a and 21 (2). **The second class is expenditure incurred to derive a class of income and on some other purposes like private purpose of business entrepreneur, private expenditure is non-deductible.** Expenditure incurred partly to derive business income and partly for private purpose. Refer 22(1) A and 27 (1) L.

Art. 77 treatment of income or expenses denominated in foreign currency; the rule is all amounts income, gains, expenditures, costs and tax credit taking in to account the under income to proclamation must be express in birr terms. But contracts are drafted to be discharged in foreign currency this is possible also under contract law. For tax purposes this is translated in to birr. At the national bank of Ethiopia prevailing' exchange rate on the date the amount is accounted, if there is gain when it translates in to birr it's taxable if there is also loss it's taken as a loss. This rule gives rise to the recognition of foreign currency gain and losses. **Foreign currency gains or losses are treated for tax purposes when they realize not when they accrual.**

Record keeping for tax purposes art. 82; in respect to category A tax payers especially for business income tax the record keeping obligation involves keeping books of accounts prepared in accordance with IFRS detailing all the matters listed under 82(1) A to E. For category B tax payers for business income tax keep records of matters under art 82(2) A to D. It doesn't include balance sheet while it includes profit and loss account. They don't have the obligation to report on accrual basis but they may voluntary account on accrual basis. Category C tax payers under art. 59(2) of

the regulation tax payer employing worker must keep documents evidencing employment income and tax withheld. Schedule D tax payer its only capital gains tax payer has the obligation to keep records of the date of acquisition and cost of acquisition of the asset and costs of improvement and consideration received on disposal. Absence of proper documentation or recording may dis allow the tax payer from claiming deduction of expenditure and inclusion of an amount of expenditure in the cost of asset.

Declaration of payment; art. 83 the falling of tax return filing on standard forms and sending them to the tax authority, report of income and expenditure by the tax payer to the tax authority. This apply to self-declaration tax payers, doesn't apply to withholding tax payers. Under schedule a there is no requirement for declaration except for employees working for more than one employer and self-withholding employees. Category C tax payers within one-month period from the end of the tax period have to report. Schedule D for those not subject to final withholding tax year reported on transactional basis with in two months of the transactions.

Discharge of self-assessed taxes in accordance with fired declaration art. 84; advance payment of tax on imports art.85, it's not withholding this is made by the tax payer himself at a source. Advance tax from importers 3 % of the cost, insurance and freight (CRF) value of imported goods. Tax crediting is applying here, this tax is a direct tax not indirect tax. Payment at source (import) of finished goods for a commercial purpose. Payment of tax by installment, art.86 its advance payment. A tax system for a tax payer liable for business income tax and rental income tax, it's voluntary. 50% of previous year's tax can be payable in the first six months if the tax payers are voluntary.

Lecture 36 NSab

With holding taxation: Article 88 to 98 of proclamation 979/16

The concept of PAYE (pay as you earn)

It is an effective means of tax collection (tax payment) at source, by source here mean not as principle of tax jurisdiction rather it is tax payment immediately when the earner receives the income; the moment the person who obtains the income receives it. It is possible through withholding agents. Withholding agents are often smaller in number than the persons receiving income. For example; consider employment income tax:-the number of employers is much smaller

than the number of employees; a single employer could have hundreds of employees so rather than worrying about collecting tax from thousands of employees it would be much easier to effect the collection the tax of through a much smaller pool of employers and with that the PAYE rule helps a lot. So it is a rule (method) of effective tax collection.

The PAYE rule is applies on employment income (article 88), income of non-residents (article 89); withholding of dividends, undistributed dividends, interest, royalties, interests received by residents and permanent establishments of non residents (article 90); withholding of tax from games of chance (article 91) and domestic payments for goods and services (article 92). In principle schedule 'A' taxes are subject to PAYE rule and it is a final tax in which no credit is available and it won't be recalculated. Income of non residents under article 51 and income of residents and permanent establishment of non residents under article 54, 55, 56 and domestic supplies are withholding taxes and are final taxes.

Article 92: internal supply of goods and services

These are internal supplies. When we compare domestic supplies to imports, on imports 3% of CI value will apply and withholding will not be applicable because the tax payer will pay the tax himself. Withholding means where a third party that has been brought into the tax system by the law is required to deduct the amount of tax payable on the income. In internal supply the withholding is applicable. In substance both are equivalent payments the main difference is withholding at source be applicable on internal supplies whereas on imports the tax is paid when the person imports, it is based on the event of import. In internal supplies there is no importation involved and it is supply is entirely made in internal market. It is an advance tax in which the 2% tax on the value of supply could be creditable at the end of the year. It is not a final tax and it is kind of security where the tax payer comes at the end of the year and pays his overall tax liabilities the 2% tax be credited.

In imports only goods are subject to the tax but in internal supplies both goods and services are subject to the tax with this regard to this there are some conditions: - The value of supply in a single transaction should 10,000 ETB for goods and 3000 ETB for services. If the value is less than these thresholds the 2% won't be applicable. There could be chance of tax avoidance by classifying the transactions with this regard the tax authority consider related transactions will be considered as a single transaction. Article 92 defines single transaction as independent transaction

for the purpose of meeting the minimum threshold. If this is not fulfilled the withholding agents will be liable and it results in penalty interest and administrative consequences. The agents here are those stated under article 92. The main obligations of the agents are: -

- required to withhold the 2% advance tax on the suppliers and report the tax to the authority (the suppliers are schedule C tax payers),
- issuing legal receipt to the tax payer (important to tax credit and for documentation),
- 30% final tax might apply in advance, when the tax payer doesn't provide the information required (information reporting) to the agent like TIN or trade license or if the tax payer hides the 2% taxed income, 30% of final tax be applied instead of 2%.

➤ **Final withholding**

Final withholding taxes where there is no tax credit available are: - 30% on internal supplies, employment income tax, tax on income of non residents (article 51), tax on dividend, interest, royalties of residents and permanent establishments of non residents. Tax credit is available either if there are two payments in the domestic tax system (if the income is received twice in domestic market) or if a portion of income is received from a foreign country and a foreign tax has been charged on that income. But basically in final tax there is no tax credit.

➤ **Withholding that isn't final**

This are creditable withholdings, includes: - 2% tax on internal supplies (goods or services) meeting the threshold.

- Is installment tax a creditable withholding? No, it's creditable but not withholding. Creditable advance taxes are assessment taxes like installment tax, 3% tax on imports.

So as a matter of rule, the rest of taxes which are not subject to withholding are paid by assessment tax system. E.g. under schedule D: capital gains, casual rental and the like.

Article 94: There is no withholding on exempt income.

Article 95: Time of payment of withholding tax.

The obligation to withhold arises when the amount is paid or when the amount is received by the earner. It is a kind of cash basis also it is transactional based.

Article 96: The withholding agent must issue the receipt.

Article 97: Payment of withholding tax. It is the transfer of the withholding tax to the authority.

The concept of self withholding

It is not withholding technically speaking rather it is self payment. The term withholding is used to put an exception to withholding. It is stated under article 93; as a matter of principle employment income tax is subject to final withholding tax and the withholding agent is the employer but employees of organization with international immunity are required to make the payment by themselves.

Another exception to the withholding technique is where interest, dividends, royalties, and income from winning games of chance received by a non resident; the non-resident will directly pay the tax.

Anti-avoidance rules

Why anti-avoidance rules? Mostly entities won't conduct their tax planning within the law which means they are more likely to practice tax avoidance without directly contravening the tax law or without evading tax. Tax avoidance would jeopardize the integrity of tax payers so the law incorporates anti avoidance measures into the tax system. One of these rules is the concept of related parties. It is the basis of anti-avoidance rules.

Related parties or affiliated or associated persons/parties: - this is provided under article 4 of tax administration proclamation. It is more relevant for income tax purposes than other taxes. The notion of related parties is defined in closer connection with the notion of non arms length transactions and on the contrary the notion of unrelated parties is defined in relation to arms length transactions. Related parties have an affiliation that will provide them with incentives to structure deals in order to fix and transfer amounts of values between them often with the view to minimize the overall tax liability. In absence of prophylactic (preventing method) measures to redefine or

re-characterize deals between them related parties could engage in profit or value shifting transactions in order to minimize the overall tax saving.

The tax saving could involve minimizing the recognition of gain to differ taxes minimizing on the recognition of gain for example in transfer of assets or on disposal of asset, inflating the amount of gains to absorb losses that have been carried forward, value shifting to transfer gains to lower bracket or exempt bracket transferring assets to claim double depreciation allowance. Objectives unrelated to taxation could be an incentive to artificial death. So to prevent this manipulations and transfer of price rules for the treatment of non arms length transactions are needed.

Arms length transactions

It is a transaction that is made between two independent entities in which parties act completely independent of each other. The two parties are motivated by maximizing their respective advantage independently of one another. There is no relation between the two. It is deemed acceptable by the tax authority.

Non-arms length transactions

It is transaction that is made between two dependent parties. One or both of parties may be willing to subordinate their interest to that of the other party or a related third person for the purpose of achieving an overall tax saving. The effect of this rule results the existence of deeming rule. The deeming rule redefines the transaction and re-characterizes the amount of consideration being transferred on the transaction by notion of fair market value (article 3 of tax administration proclamation). It revalues the considerations.

Other complementary anti-avoidance rules under the income tax proclamation are; - article 2/6 of the definition of dividend, article 27/1/m deductibility or otherwise loss of disposal of business assets, article 34 denial of loss carry over, article 35 reorganization, article 47 thin capitalization, article 52 recharged technical fees and equipment rental, article 59/4/c recognition of losses on disposal of taxable assets, article 78 income splitting, article 79 transfer pricing.

Who are related parties?

Article 4/1 of tax administration proclamation puts the general principle. Sub article to puts an exception in which employee and an employer are not a related persons. Sub article 3 states

detailed supplementary deeming rules. It is a specific application of sub article 1. It has qualitative analysis for example individual and relative of that individual are deemed to be related parties. The term relative for natural person is defined under sub article 4, 5, 6 of the same article.

Body and a member of the body are related parties. The condition here is the member controls 25% or more of the voting rights, the dividend rights or the capital rights. These are alternative conditions. The 25% control could be direct or indirect. The indirect control could be effective through one or more interposed bodies. Two bodies are related persons if they have a common shareholder that exercises 25% or more by interposed bodies either directly or indirectly through one or more interposed bodies.

Lecture 37 EyaA

A change in underlying ownership (art. 34)

Carryforward of losses is permissible under art 26 and 46 in case of foreign losses for the next five years (subject to some exceptions). But art 34 imposes further limitations when the underlying ownership of a body changes by some percentage. The percentage is 50% under art.34.

What is the problem if there is change in ownership of a body for a loss carry forward?

It is an anti-avoidance measure to prevent the trading in entities that sustained loss entities. This is the reason behind this rule. This means without the anti-avoidance rule the companies will get incentive. There are two entities; loss sustained entity and the company who acquires the loss sustained entity and it acquires the loss benefits also. Without the existence of this anti-avoidance measure companies would hunt entities that have loss carryforward benefits and acquire them and try to take advantage of the loss carry forward benefit that has been made available to the company whose shares have been purchased.

The rule is basically “loss carryforward benefits should be available only to the company that sustained loss”. If the companies underlying ownership is changed, then that loss carryforward shouldn’t be available. The threshold in change of ownership is 50% or more of a company that sustained loss. Less than 50% change of ownership doesn’t trigger the anti-avoidance rule. This is basically what art 34 talks about. The same person or entity should continue to hold more than 50% of the underlying ownership through out of the loss, carryforward year and through all the

intervening tax years (for all of the 5 years in which loss carryforward is allowed). In order for the loss carryforward under art. 26 or 46 to continue to operate the same entity should continue to hold more than 50% and 50% is not enough by itself rather it needs more than 50%. It is an anti-avoidance measure to prevent a situation where by entities try to acquire entities that have sustained loss in order to take advantage of their loss carry forward benefits.

Underlying ownership means direct ownership or indirect ownership traceable through interposed companies. It is defined under art. 2(25) of ITP. Membership interest is defined under art 2 (21) of TAP and it means ownership interest. It means shareholder in a share company or an interest in partnership.

Corporate reorganization

This applies in the context of companies and the type of companies here are resident companies. Reorganization is a business decision. It is a legal and economic restructuring of a company with a view to profitability, efficiency, competitiveness, etc. basically it is a business motivated decision. The presumption is the significant reorganization of a company should be allowed without producing tax consequence or it should be tax free. This is because involvement of tax in business decisions can cause distortion of entities decision and hinder efficient decision making. If the reorganization has the purpose of avoiding tax, it is not permissible.

Forms of reorganization;

Not all reorganizations could lead to tax free consequences. Only those reorganizations that have been defined by law (whether it is tax law or general commercial law) could constitute reorganizations that have no tax consequence. Art. 35 defines reorganizations and these are the following;

Merger: the commercial code uses the term amalgamation. When two or more companies merge together and form a new entity. Amalgamation includes takeover (when one company is acquired by another company) under the commercial code. Under merger a new company is created with a new personality and personalities of the two companies would disappear. In case of takeover at least personality of one of the company disappears.

Example: A & B *merge to create a new company called C.*

Art 35 (3, a) defines merger.

Division: it is the opposite of merger in some ways. When one company splits up in to two or more companies which are going to be newly established. It can be in the form of distribution of shares to an existing companies. Personality of the original company disappears in both cases.

Acquisition: it is less than a takeover and that fulfills the minimum threshold. The threshold is often more than 50%. In takeover there is no threshold, it have to be 100%. It is between 50+1-100. Under Ethiopian law reorganization by acquisition is when one resident company transfers assets solely for shares in the other company otherwise acquiring shares for money. Acquisition of assets for assets could also be reorganization, but in this case shares should be acquired. This is tax free reorganization. The important thing here is acquiring of shares. Without this rule, the asset will be considered as sold and it will cause capital gains tax, business profit tax and depreciations will be started as a new also. In this case when assets are transferred, they are transferred having their book value and not tax, no loss and no gain.

Spin-off: the distribution by a parent company of its shareholding in a subsidiary to its shareholders or entities that hold its shares. Transfer of shares in this process do not give rise to tax consequence.

The effect of a reorganization that meets this conditions of the law uses the non-recognition principle; it is not deemed disposal and therefore no recognition of losses or gains on transfer of assets or shares. The non-recognition principle could avoid the possibility of double deduction allowances. If reorganization doesn't comply with the reorganization rule then the tax rule would fully applies. The original purpose of reorganization rule is not to interfere with business decisions. But it have an element of an anti-avoidance measure too.

Income splitting: this rule have the objective of preventing or countering income splitting practices with a related person. The general concept of income splitting focuses on splitting of an income by a person to different schedules and tax brackets. Like converting employment income in to dividend and employment tax. Art 78 specifically focuses on splitting of income related to transferring income to a related person. It controls attempts of a person to split income with a related person. The rule under art. 78 involves two persons; the tax payer and a person related to the tax payer. The splitting have the objective of overall achieving tax saving. For example the related person may be an exempted person or he may be subjected to a lower tax rate.

The usual circumstances in which a person as have been attempted to split income are:

- A person transfers income or right to income either directly or indirectly to a related person
- A person transfers property either directly or indirectly to a related person with the result that the related person receiver or enjoys the income from the property.

Under this circumstances the tax authority have the right to reject the transfer and adjust the income of the taxable person so as to prevent any kind of reduction of the tax payable as a result of the splitting in income. This is a specific application of the related party notion. The Ethiopian tax law tries to cover the other type of tax splitting by the aggregation rule which is provided under art 8.

The purpose of splitting can also be other than tax. It doesn't necessarily need to be tax saving alone. Tax saving could be one of the reasons for the split and that suffices for the tax authority to reject and adjust the splitting. This often occurs in respect of non-arm's length transactions especially in the international arena that shift income and gains from Ethiopian entity to a foreign entity. At the same time attempts to attribute losses, deductions and tax credits to the Ethiopian based entity. It could also occur in the domestic market also. It can be achieved by pricing arrangements or by transfer pricing that exist between the two related parties.

Example: Excessive fee payment for the employee one company by its parent company.

Its main purpose is shifting income from high tax jurisdiction to low tax jurisdiction in order to obtain an overall tax saving. Anti-avoidance rules often provide the readjustment of such transactions to reflect the amount that would have been realized in an arm's length transaction. Art 79 is basically about this. There is a directive for transfer pricing guideline also.

*Tin capitalization:* (art 47)

The rule under art. 47 is an anti-abuse rule that applies in international context. In the domestic context art. 23 applies which about interest deductions. This is applicable to foreign investment in Ethiopia when a non-resident invests in Ethiopia through a foreign controlled subsidiary company or a permanent establishment in Ethiopia. The shift comes in a form of taking a loan. The foreign entity gives a loan to residence entity with an excessive interest, the interest will be deductible and the income goes to the foreign entity. It is commonly used by multi-national enterprises to limit source country taxation. It involves taking advantage of the difference tax treatment between dividends and interest. It involves constituting the capital through debt financing. To avoid this tax systems impose debt equity ratio or they set a minimum debt equity cup.

When overall portion, the extent to which the capital of a company is financed through debt is called thin capitalization. To the extent a company's capital is financed through the debt it is called thinly capitalized. If the ratio of equity to debt is greater, the company is in a solid position and it is not thinly capitalized. Thin capitalization is caused by erosion of the tax base and it is avoidable by imposing a minimum debt-equity ratio.

Ethiopian minimum debt-equity ratio imposed under art 2 (2) is 2/3. Meaning this much amount of the capital can be financed through debt financing. 66.3 % of the company's capital can be financed through debt and interest payable on that debt is deductible. It is possible to finance a company through 100% debt financing but only 66.3% of the interest is deductible.

Debt obligation; an obligation to make a repayment of money to another person but not including account payable or repayment of money on which no interest is payable. (Sub art. 4)

Equity; equity of company determined according to international financial reporting standards and it expressly includes debt obligations on which no interest is payable. This is for the purpose of determining the debt to equity ratio.

Treaty shopping: art 48 (3); anti-treaty shopping rule

This involves tax treaties themselves becoming the object of tax avoidance. Most tax treaties expressly provide their objective or purpose as, the elimination of double taxation and prohibition of fiscal evasion. Unfortunately tax treaties themselves can be the object of tax avoidance attempts. This possibility of abuse emanates from two features of a tax treaty network;

- Its incomplete coverage of the world and
- Its bilateral feature or nature.

Resident of a 3rd country uses the treaty that exist between two countries. Art 48 (3) prohibits this.

Example:

A & B are countries that have a bilateral tax treaty. B has a bilateral treaty with C. residents of C can get some advantages from B but in principle they cannot gain advantages from country A. But they shop for opportunities. Residents of country C for the purpose of using the advantage of country A, establish resident entities in country B and use the advantages provided by the treaty of country A & B. this is treaty shopping.

END OF INCOME TAXATION!!!!