Tax lecture note;

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Lecture 1-Sep31, 2019.

What is "taxation"? How many of you have ever paid tax? Well, you're indebted with what is that scheme called "cost sharing". You're given a loan by government so that you will pay when you go out and get jobs-if you ever get jobs. Anyway, this is one form of taxation. Whether it is taxation or not is another question altogether; but it is taxation in the sense that when you join the labor force, a part of your salary is reduced involuntarily. Because, you've already signed up to it to be paid from your salary to the financing of education. So, you've already paid taxes even though you have not directly paid taxes.

There are so many kinds of taxes that reach your pocket without your knowledge. For example, whenever you drink coffee or tea somewhere, you're likely to pay the "value added tax". But, you don't directly pay it; therefore, you don't notice it. The tax that is really painful to pay is the tax that you go to the tax authority to pay. So, in a very reductionist sense, this is what "taxation" is. Taxation is all about the taxes that you pay to the government. But, it is more fundamental than that; it is interaction between the state and you through the prison of taxation.

Then, in taxation, you have to ask three questions. 1. Why am I paying taxes? Or why is anyone paying taxes? We have to address that why is taxation absolutely necessary. There is a saying that there are two things that you cannot avoid in life. One is taxes and the other is death. We cannot avoid taxes though so many peoples try to avoid it. Some people even try very hard to

evade taxes so that they live under world of criminality. But, whatever you do or whoever you may be; whether you are mafia or a legitimate member of a society, you cannot avoid taxes. So, taxes are given things. But, even if they are given things, it needs to be asked that why we are paying taxes to this institution called government. Here, I've not defined 'taxes'. "I hate definitions; because, when peoples define things, they start out by saying: "it is very difficult to define..." and it is very inconclusive. For instance, do you have a 'definitive definition' of law'? Do you? If it is impossible to define, why do we start the definition? "This is my question".

One of the essential elements of taxation is that it is a compulsory levy; which means that without the sanction of the state or without the threat of use of force, there is no taxation. Even we are patriotic to pay taxes, without the threat of use of force, taxation doesn't make sense. I will explain why this use of force is necessary. We don't have to violate anything; the fact that you live in the state, the fact that you are a member of the society means that you have to pay the taxes. In fact, it is the people who produce or who earn income that pay taxes. Whereas if you take the example of the criminal law, it is designed for the people who break the law. Generally, the criminal law doesn't target those who don't violate the law. But, in taxation, the violation of the law is a precondition. In fact, it is precisely because you are perfectly doing some legitimate business that you're paying taxes. So, you violate taxation law when you refuse to pay taxes and hence become criminal. Beyond that, the nature of taxation is always debatable like the nature of anything. "There is no conclusive definitive answer as to what taxation is or why taxation is levied". As we speak, there are debates about whether taxation should be levied or not. There are people who say, "Oh, taxation is robbery". But, you cannot say the state "you're a robber". With the robber, you can call the police and say, "somebody stole my property" and the police would be willing to cooperate with you. But if you call the police and say "the government has taken something out of my income", the police would just say: "that is why the states! I'm the representative of the state! How can you oppose this?!" That is the difference between the taxation and the criminal law.

The rest two questions are the questions of "what" and "how". What taxes does the government impose and how it does so. All of them are very important to the students of law who are very serious about studying taxes. As you can imagine, you've limitless options from the menu to impose taxes. But, obviously, the state is not arbitrary in imposing taxes. It doesn't look at the

color of your eyes, your height, your size, gender or ethnicity. It looks at certain things; but why those things are necessary for taxation as opposed to the others is the question that we are going to address. Obviously, if the taxation is based on gender, everybody in this class would be horrified. Because, it is very unnatural to base taxation on gender, ethnicity, political affiliation or even doing certain kinds of business; although there are certain kinds of business which are singled out for taxation. For example, if you manufacture cigarette, there is a special kind of tax which is imposed on cigarette manufacturers. But, there is a reason for it; the state doesn't consider the business itself, rather it considers the nature of the business of cigarette.

On the other hand, if you drink bottle water, it means that you have some money in your pocket. So, the government is trying to reach your ability that way. In contrast, if the water is pipe water, the excise taxation doesn't apply to you; because, you should be pitied rather than being taxed. In any case, there is a theory behind all those. It does not mean, however, that the narrative behind that theory is always perfect. For example, I can dispute whether it is appropriate to tax people because they are drinking bottle water. But, I can also explain why the government is justified in levying excise tax (special kind of tax) on bottle water. So, the "why" is necessary in understanding taxation.

The other thing is "how". Even if you answered the question as to why it is necessary to impose taxes, you have to also respond to very important question of the "how". But, the how question comes after the question of the "what". There is no universal answer which is good and valid for every country. What is good for the United States may not be good for Ethiopia. Just to give you one example, the United States relies very heavily on income tax. On the other hand, Ethiopia relies heavily on import duties in tax. There is a reason for that; Ethiopia has administrative limitation for that. So, it cannot afford to rely as heavily as the United States on income taxation. Income taxation is more difficult to tax than taxation on importation of goods.

Lecture2-Oct2, 2019.

Today, I want to make a case for taxation. Why taxation is not only unavoidable, but necessary. By now, you're familiar with that saying; there are two things that we cannot avoid in life, one is death and the other is taxes. In order to demonstrate that, it is important to understand the

institution which exists to do taxation, which is the state. It is the purpose of our class to deal with the question as to why does the state need to impose taxes, why is taxation important. But before that, we need to show why the state is necessary in the first place.

This is like the fable of the frogs in the pond. The frogs are very noisy particularly in the middle of the summer. The frogs were really sick and tired so they would prey to their god in their noisy way. “Please, god, send us a king that will make us quite!” God, listening to their prey, cut a twig from the tree and dropped it in the pond. The frogs were very happy and reacted, “oh, thank god! Now, we’ve a king!” Later, days went by weeks and weeks became months-everything is quite. The frogs were not sure that why was this king so quiet, silent and not moving. One of the frogs bravely crocked again and the twig as a twig was not saying anything. So, the frogs went back to their noise. “Oh, god, the king is so silent. Please, bring us another king!” This time, god was annoyed by their persistent noise. As a result, god brought them a snake. Then, the snake ate all of them. “So, sometimes, don’t prey too much!”

If you really think about the metaphor of the frog as humans in a pond, you will see that human beings are also very noisy when they are left with themselves. So, the state is necessary; of course, remember that it has long been debatable whether we need the state or not. There are some small communities which have been created without the state. But, if we think in terms of large size of group of population, the state is necessary. So, the question is not about we need the state or not; the question is what kind of the state do we need, how much the state do we need and what should the state do. Basically, when we think about the state, we are referring to its most fundamental symbol. The prime function of the state is defending a country. I told you last time that the state is intimately related with two things; one is making war and the other is collecting taxes. So let’s take the two main functions; national defense and law and order. Some people take very seriously the case of enforcement of a contract to be primary as well. Contract is the law that binds the two or more contracting parties. But, we can see the state concealed and undesignated in the contract. The state is a silent partner in every contract between people.

Although we don’t study about the state in contract, regardless of its simplicity, the state is a silent signatory to every contract. Because, you will not seat down and sign a contract unless you’ve assurance that the contract is going to be enforced and obviously you will not enforce it by yourself. Of course, there are certain ways of self-enforcement; but it doesn’t function well

without the state. So, we need to restate the definition of a contract as: “a contract is an agreement between two parties with the state or government [as a silent party]”. Without law, there is no such thing as contract. Of course, in simple communities, there is trust where the assurance is an oath taken by the contracting parties. These are the traditional functions of the state. In addition, in the modern sense, we need the judiciary, police, the public prosecutor (which is part of police) of course defense to protect a country from external aggressors. On the other hand, the state should defend itself. The state that can’t defend itself from internal or external forces cannot function as a state. These are almost the traditional or first-generation functions of the state. Everything else including infrastructure, education, health services, provision of affordable housing, social security, creating an employment opportunities, Stabilizing the economy ETC are the second and third-generation functions of the state.

In taxation, the theory of public goods is very important. Public goods are contrasted very often with private goods. Private goods are assigned to the market. Remember: this is a thought experiment; it is not reality. In reality, if I ask anybody why the state exists, then the actual answer would be that because it has always existed. This means, the previous ideals are not theoretical justifications. When you imagine the state, it is a thought experiment that you are engaged in. The traditional function of the state is the provision of public goods. We’ve already discussed about national defense. National defense is a classic example of a public good. Law and order and enforcement of a contract are other examples of public good. The negative definition of public good is that it is a good which cannot be provided by market. Because, these goods have characteristics which make it unsuitable for the market to provide them. By ‘market’, I’m just referring to the private economy. There is very clear line between the market and the state.

Why would the market be unable to provide public good? Let’s think about a hotel. When you go to hotel, there are certain things that you’ve to make sure. For instance, you need to check your pocket. Even in the case of beggars, there is no guarantee that they will get food. So, when you go to the hotel, if you want to the drink or food on the table, you have to pay for it. But, you pay for them, whether you like it or not, as a matter of human nature, only because you’re assured that nobody is going to come in and eat your lunch unless you are willing to share. The guarantee is that when you go to that hotel, you know that you’re paying for something that you

[exclusively] enjoy. Thus, this is the none-exclusive character of public goods. Because of this character, the private sector has no incentive; there will be no consumer for it. A consumer is someone who is willing to pay for the products (goods) in the market. There is no market without the flow of a consumer.

In the public economy, the demand and supply is completely broken because of attribute of public goods which is none-exclusive and none-rivalry. None-exclusive means, once the good is available, it becomes available for all. So, payment is not a necessary condition to acquire them. None-rivalries means, the consumption by one doesn't reduce the other's consumption. For instance, when we consume certain amount of food, we are in effect reducing the available size of it; in contrast, in national defense, there will be no less-defended party. The quality of law and order in the country matters. For example, the greater the geographic area, the greater the police force should be. In this case, the fact that we are using a police force doesn't reduce its consumption.

This is the economic justification for the existence of the state. It is 'post-state economic justification'. So, in all and all, the market needs the state. However neoliberal market fundamentals you may get, the market cannot breeze without the state; the state is the lung with which the market can breeze. We may establish a company because we have the assurance that company will be recognized as legal person to have a limited liability as promised by the law. The profits made by our company are recognized to be our private property as long as we pay taxes. So, all of those things are premised on the understanding that there is a body (the state) that will ensure our rights. Of course, the state may exist without market. There are times when the market is virtually disappeared as a private economy like in the cases of command economies of the communist states like North Korea. But, there is no way that the market can operate without the state because of absolute necessity of public goods.

Now, what does that mean for taxes? If the state has to provide public goods, how does it provide? Obviously, the state cannot charge the people individually. Because, if you want to assign a price to a national defense, what would be the price. Let's assume that the government demanded the voluntary contribution to maintain the provision of national defense. What do you expect? You have to defend yourself; if you have to defend yourself, you need revenue. The

most acceptable and efficient way of raising this revenue is taxation. People are not voluntarily and individually willing to pay for these public services. Here is where we need coercion

Otherwise, although there may be few people who may cooperate with the state, the majority will be free riders. If I ask individually to contribute something, your thinking will be the other person next to you may pay for it. But, the person next you is also exactly thinking like you and in this way, nobody will pay. In some countries, governments even provide income to their citizens. Nowadays, they are even thinking about what they call UBI (universal basic income). Essentially, that means everybody gets to have a minimum income to live. But in other countries, (this is where a huge difference arises), the state may be limited to national defense and law and order ETC. So, we need taxes and the state is the only institution that can impose taxes; because, the state has the monopoly of violence. It monopolizes the coercive institutions like the defense force, the police and ETC.

Because of this monopoly of violence, the state has the power to impose levy. This levy is what we call tax. Now, this is the very realistic case for the state. There is also a more philosophical case. Thus, we have to go back to certain philosophers or economists to understand what the state ought to do or not to do. So, we go to the second and third generation of the state. I'm not talking about 'generation' in real terms; rather it is in theoretical evolutionary terms of the state- how the state emerge from the very beginning of the modest 18th century to the 20th century. So, we find the person named Adam Smith. Adam Smith is a Scottish economist who lived in the 18th century about 250 years ago. He was the one who laid down the basic framework for a capitalist state. The state we have today, whether in the eastern or western, is more or less a capitalist state. We have an alternative socialist state, but it has crumbled.

With the fall of the Soviet Union in 1889, the whole eastern socialist block fell apart. So, socialism is no longer considered to be a viable alternative to capitalism. There may be various forms of capitalist states; the Chinese capitalism where the politics is communist and the economy is capitalist. Adam Smith wrote a very important book which is appropriately titled the wealth of nations (an inquiry in to the nature and sources of the wealth of nations). In those days, even today, one of the primary preoccupations of humans is how do we make a country wealthy. Meles Zenawi was talking about developmental state; specifically about the achievement of middle income by 2025. But, the whole preoccupation is how to join the club of the middle

income countries. There is the hierarchy of state on the basis of their economic capacity. Countries like the United States, UK, Germany, and France ETC are developed nations in terms of their economy. On the other hand, there are more than 100 countries within the category of middle income countries. Ethiopia is not among both blocks. So, the preoccupation of a human society from the earliest time is the enhancement of its economy and the search for Eldorado, (a country of gold or rich of metals). It is still the case how to get rich.

Some suggest that we have to be well educated, other advice to have very creative and innovative people, others say that we need to be very working hard, the rest say that we pray that underground we have natural resources like oil. The title of the book of Adam Smith expresses the preoccupation of his time. Smith wrote this book in 1776. There were different theories of creating wealth. One of these theories was the theory of mercantilism. The mercantilist believed that the states would be wealthy if they can accumulate a huge stock of gold. The best way to do that was to increase export exponentially and limit import. But, this was essentially 0-sum game. If one state follows this kind of policy, other countries will also follow the same and it would be the arrest to the bottom. Adam Smith understood the inefficiency of this theory and came with an alternative theory which basically stated that the wealth of metals does not come from the shining metals (gold). According to Smith, the wealth of nations comes from the enterprise of its all people.

It was very anthropocentric definition of the source of wealth. It is not the metals that bring wealth to a country; it is the creative spirit of the people. So, people need to have a free enterprise. That is why Smith is considered as the father of the modern capitalism. Because, he said that in the market, everything is determined by demand and supply. He appealed to one human nature which was not popular at that time; the nature of self-love. Smith articulated that basically human beings love themselves. They are good to others only because they love themselves. So, the public good that human beings do to others comes actually from the self-love. The market exists not because people need to good for others; but because they want to make profit. So, Adam Smith was saying “we should not appeal to the benevolence of the butcher or the baker”. When we go to the butcher, we have to be ready to pay. He also developed important idea that the state is run by invisible hands (although it remains debatable these days across the board). What he meant by ‘invisible hands’ were demand and supply that regulate the

market. You supply what people demand; you demand what you want. Of course, nowadays, demand is modern creation. Demand can be created out of nothing. There are so many things you have now that you knew you wanted. For example, mobile phone has been created very recently. Before it was created, people didn't know that they needed mobile phone. There are certain things goods which are created and become part of the demand after a while. Because, people usually tend to act fashionable or in a mimetic desire (the need to be like someone). In a psychological term, we do certain things largely because the others do it.

The reason why Smith created this metaphor is that he didn't want the state to be the invisible hand. In those days, in the mercantilist state, the state was acting paternalistic; which means, it had the desire to create favorable rent-seeking policies in order to stimulate the mercantilist type of economy which was very exploitative. Consequently, Adam Smith insisted that the market does not need the intervention of the state. Because, it regulates itself by demand and supply (the invisible hands). He initiated the Laissez-faire (let alone). Laissez-faire-based economy states that the market should remain unregulated by the intervention of the state. Accordingly, the state should be limited to its traditional roles like defense, law and order ETC.

In any case, this limited the scope of the state to impose taxes only for its traditional functions. So, that defines the scope of taxation as well; because, if the scope of the state was limited, so should the taxation. Then the crises came. Usually, great theories are blessing disguises in some cases because they bring people in to a different kind of awareness. An awareness that may be the old way of doing of things is not correct so we have to reassess our thinking. In 1929, the economic depression struck the Europe and the United States. Particularly, in the post-first world war, the crises heightened to such extent that the Eurocentric world needed to have a different kind of theory. The British economist John Menner Kenes came in response to that crisis of great depression. The great depression was characterized by a huge unemployment so many people losing their jobs. So, the economy was completely falling. The traditional economists were saying, "Laissez-fare-the market will regulate itself. Even if it became hard now, we would survive". Kenes on his part imagined going to a doctor when someone is seriously ill. The doctor says, "Don't worry! Immunity will take care of it; you will get better in the long run". Kenes rejected such thought; rather he insisted that in the long run, we are all dead. Kenes argued that the markets may not always regulate themselves. The invisible hand may not be there. So next

time, I will talk about why the state has suddenly become very important institution when the invisible hands (the demand and supply) are not working.

Lecture 3-Oct4, 2019.

In our last session, we've been discussing different economic theories regarding state intervention in to the market operation. In the aftermath of great economic depression, John Menard Kenes argued that the state must use its tremendous fiscal power to regulate the economy. There are two principal fiscal policy instruments that every state does; spending (expenditure) and tax (revenue). Metaphorically, if somebody has diabetic disease, he/she has to regulate the glucose. Similarly, the economy also needs that kind of glucose. So, Kenes essentially argued that the state should manage the economy by extending its taxation powers. He prompted that the state should reduce unemployment by creating employment opportunities by constructing its enterprises. Unemployment is disease. Sometimes it can create inflation; which means, rising cost of goods and services in the economy. The state usually functions in the aggregate level.

The fiscal policy is an aggregate economic management. When I say 'aggregate economic management', what I mean is that the government does not intervene in individual cases; it is the management of the overall economy. Unemployment happens because of mismatch between aggregate demand and aggregate supply. If the aggregate supply is equal to aggregate demand (which is rare case), it implies that there is a perfect employment. Now, what do we mean by 'aggregate supply'? It is aggregate of all goods and services in the economy; the aggregate demand for those goods and services is aggregate demand. This means, every good that is supplied in the market is sold and every demand is satisfied. However, such level of economy does not exist in realistic market. When the aggregate demand is higher than aggregate supply, there will be inflation. Because, if there is the scarcity of goods in the market, the price would go up. On the other hand, when the aggregate supply is higher than the aggregate demand, there will be unemployment (deflation). This is because, when the firms, manufacturers, producers or suppliers are unable to sell their products, they go bankrupt; as a result, they lay off their employees.

Here is the juncture where Kenes insists the state to do something to save the economy. But, we have not answered one question. That question is: why didn't the Adam Smith's prediction (the invisible hand) work? Remember; this 'invisible hand is within the mind of every individual. When the people engage in business activities, the decisions they make influence the economy. Individuals make a decision on their own; thus, they take a risk. When they take a risk, they may not have complete information about situations. This is the problem of information asymmetry; asymmetrical information is inadequate information about the market. Many people like to save too much refraining from conducting business with their financial capacity. This on the other hand does not employ people. In this way, individuals may destabilize the economy by their decision making. Human beings are psychological beings; they have irrational hopes or irrational fears. Sometimes, they become exuberant when they hope too much.

So, the proposition of the invisible hand wrongly assumed that all individuals make rational decisions. However, that amounts to ignoring the psychology of human beings. Kenes thus proposed that the relationship between the demand and supply as well as the employment rate can be regulated by taxation power of the state. For instance, it can nationalize industries. When there are companies that employ a huge number of employees, the government may rescue it when it faces crises. For example, the American government rescued the General Motors car manufacturing company with a view to maintaining the job of its workers. In another example, if Boing becomes insolvent, the government will buy its stocks and share to keep it afloat and ones the company recovers, and it will depart the American government engages in such regulatory measures by using the tax payers many.

In other times, it helps the infrastructure develop. Infrastructure is the vein of the Economy; whether it is rail, highways, energy dams ETC. This suggests that the state should play a bigger role than a Laissez-Faire state. The other version of fiscal policy is the monetary policy. Monetary policy states that the state should use its monetary power to regulate the market. It should use power of supply money and credit. Typically, in modern economies, the state uses both. In simpler terms, the monetary policy means the regulation of the market through the supply of money. In such a situation, currency is not the medium of exchange; it is the oil of exchange. The government has to use its central bank (national bank in our case). The role of central (national) bank in almost all country is controlling the supply of money in the market.

Because, the state is the only institution that has the power to print money. Of course, due to the development of technologies, this monopoly of the state is being challenged this days; some crypto-currencies floating around the world.

But, the fate of crypto-currency is not settled (not recognized as legitimate business). So, what we have now is that the state controls the supply of money. The state can also regulate the interest rate. For example, there are banks that charge in order to lend money to the private economy. The state can thus take a necessary measure in such circumstance as it is usually intended for inflation. The supply of money is very important factor in the investment decision of the people. If the cost of raising money in the market is high, people will be reluctant to invest. The government can determine the maximum amount of interest that applies to every bank. This means, every bank would be obligated to charge lower interest that what it would otherwise. On the other side, the government, through its national bank, can issue a directive that keeps the interest high. This is also useful because of the fact that people become too much exuberant (over optimistic) about the business. This in turn may result in evil consequence on smooth operation of the market economy.

In the post-world war II, most countries have adopted both monetary and fiscal policies not only to raise revenues for the traditional roles of the government, but also to regulate the economy. This gave a significant re-definition of traditional function of the state. So, these days, taxation is not considered as a compulsory levy for social services. It is also an instrument-I repeat an instrument of public policy. Taxation is not an instrument for raising revenue to provide public good; it is means of balancing between the aggregate supply and aggregate demand. By the way, when we talk about taxation, we are talking about fiscal policy; it is part of the budgetary policy. Every budget has two parts; one is taxes and the other is expenditure. The spending power does not work without taxation. So, the state can raise or reduce taxes to regulate the economy. When there is unemployment, the government reduces taxes. By reducing, it allows businesses to keep money with them so that they will use it to reinvest it in the economy. This can create higher employment opportunities. For example, in the Ethiopian investment laws, we find rules granting some tax incentives to the new investor's for5 years, 6 or even 15 years with the intention to attract foreign investment in to the country. Because, the Ethiopian economy suffers from a lot of unemployment.

Sometimes, the state may even go beyond and use its spending powers. For instance, in Ethiopia, although the result proved to be crises, the initiation behind some state enterprise like Metek was that the government was using its revenue powers to engage in capital-intensive kinds of investment. The problem was, however, (this was where Adam Smith was right), the paternalistic state often leads to the opposite problem, Metek being one very good example; which is creating more jobs and leading to insolvency. The state suffers from a lot of problems like corruptions, rent-seeking and so on. Even in countries where Laissez-faire (minimalist) state is trumpeted, the role of state is expanding; the idea of Laissez-faire government exists in the figment of imagination of the people. So, Kenes is still a dominant figure in the post-modern world. But governments, because of the taint of Kenes, they don't call it Kenes; they call it 'developmental state', 'executive state' or Chinese version of state (where the type of state is communist and the economy is capitalist).

There are some pushbacks. Particularly after 1970s, because of the oil crises, there was a call for more limited role of the government in the economy. As a result, there were some conservative-minimalist states like Margret Thatcher of England and Ronald Raigon of the United States. The other is equality. The invisible hand theory presupposes that markets regulate themselves. However, there is one aspect where the markets don't regulate themselves, which is equality. Of course, Kenes does not talk about this feature; other scholars like John rawls emphasize it. Rawls, in theory of justice says that if we live everything to the market, the results will be undesirable. When the market is left unregulated, there will be huge inequality among the population; the rich will get richer and the poor will also get poorer. So, the markets do not distribute wealth equally among the members of the population. The economists and philosophers stressed that since the government is the human institution, it should be moral agent for the ideals and aspirations of the society. Like unemployment and inflation, inequality is also the disease of the market.

Why is inequality the bi-product of the invisible hand? John Rawls talks about different kinds of lotteries. One of these lotteries is genetic lottery. Genetic lottery simply means an innate ability that we are endowed naturally from our birth and this 'genetic lottery' is not distributed equally so that it makes difference among people.

According to Rawls, there is also the family lottery. There are so many studies conducted over the years which show that the students who get in to the top universities tend to come from parents that have been educated enough. Even the first borne people tend to be more successful than their successors. Some people are borne with the simple spoon in their mouth; most people are borne with a lot of teeth in their mouth. Family may also serve as vital source of information with which it can equip individuals with some relevant insights to engage in profitable businesses. The other thing is the society in which a person is borne. Think about Haile Gebresillasie or Kenenisa Bekele in the sense of 75 years ago. They might have been herdsmen as athletics had been alien trend to the Ethiopian society. This suggests that there is no equitable talent for abilities. For example, authorship is futile effort in a society where there is no one who reads literary works.

As a society, we need to have some moral ideals. One moral ideal is freedom. The other vital moral ideal is equality. The state, in this post-modern world, has assumed this role of ensuring that there is some modicum of Equality. For instance, in the twenty-first century in general, many governments have started the extensive role of providing education. Last time, we were talking about education as a public good. Education is not exactly a public good; it is a merit good. Education is an important equalizer. The other is health. Despite the fact that it is not always the same in every state, it is generally accepted that the state should provide free and equal health service for its citizens. The downtrodden and destitute section of the people must be safeguarded by provision of shelter. This comes out of the conclusion that inequality among the citizens is not morally worth. Freedom, in the Amartyas Sen's (the great Indian economist) version, is not only political freedom; economic freedom is also important as well. Here, my drift of associating inequality with taxation is to indicate that the government bears the responsibility to ensure some level of equality in the society. Because, it has financial resources from taxation.

Provision of the universal education is the constitutional duty of the state. So, at the primary level, government has imposed up on themselves to the obligation to provide the education to all their citizens. There is another way where taxation may be important factor in metric of equality. The state has the power to impose higher burdens of taxation up on the wealthy in order to redistribute that income to the less-wealth. This is the use of 'progressive taxation'. Thus, essentially, equality means, unequal tax distribution burden in order to ensure equality. So,

people with higher income will be subject to higher burden of taxation; the government uses the money it collects in this manner for redistributing that income wealth to the people with lower income. It can even be in the form of income transfers. In some countries, when people get unemployed, they get ‘unemployment income’. All other forms of social securities including pension services are part of expansive state engagement in the business of equality.

In Europe, for example, there is high tax rate; but, education is largely free. Many immigrants are flooding the European continent because of this income transfer. They choose it for this minimum income that they will be paid without employment. The huge flow of immigrant is, however, the externality effect of the income transfer policy; because, the European states did not intend it for foreign citizens. In the book of Richard Musgrave and PeggyMusgrave, it is stated that the state has three functions. One is allocation function. The second is the redistribution function, and the third is the stabilization function.

Allocation defines the role of the public sector in the provision of public goods which is the traditional function for any state. As discussed earlier, redistribution function is the dispensation of income using fiscal and sometimes monetary policy. The Stabilization function refers to the role of the state in regulating the economy by balancing between the aggregate demand and aggregate supply in the market. So, this summarizes the proper universe of the role of the state in the economy. So far, I have defined, more or less, what the role of the state should be; and, what the role of taxation can be in that framework. Now, the next question is; how should we impose taxes? So, next time, I’m going to talk about principles of taxation. By ‘principles of taxation’, I’m referring to the just distribution of tax burden in the population; how do we distribute taxes, why do we distribute taxes in certain manners and what kinds of taxes do we have. Remember: principles are principles; they are inspirations for the actual tax system. But, they do not necessarily translate well in to the actual tax system.

Lecture4-oct 7, 2019.

Last time, we were talking about the role of government in the market operation changing over time from 18th century to the present. As we have tried to analyze some of them in our previous discussions, there are different expressions regarding this controversy changing from time to time. One expression that we frequently find in this literature is the expression of market failure. There are certain areas in which markets fail and it is appropriate for the state to intervene. Market fails in the provision of public goods, provision of merit goods and on the number of other areas. Market also fails in the regulation of externality effects. Externality effects refer to the spill-over effects of the operating market. A very good example in this regard would be environmental pollution. Taxation is not the only way that the government may intervene to tackle such externality effects. Externalities arise from private contract; that is why the state cannot usually intervene in the form of taxation. The externality effects in the market exist mainly because the private contracts do not necessarily absorb the external costs.

The government should assume the role of coercing the private parties to have a regard to this situation. In this regard, regulation turns out to be solution; for example the government may ensure that the manufacturers do not have emissions above certain level to mitigate environmental damage. On the other hand, several writers have suggested that taxation can also be used. For example, although there is no such experience in Ethiopia, there are certain countries which levy pollution taxes. They force manufacturers to adopt more conducive systems of production by imposing punitive taxes. There is also another type of externality; which is called positive externality. The provision of goods and services by market can have beneficial effects on third parties. For example, certain services like education and health are positive externalities. So, it is possible to mix taxation with the education system; that is why we have cost sharing methods in universities. The other area of market failure is monopolies. Natural monopolies are economic sectors which should be monopolized by certain providers. For example, utilities in general including the provision of energy, renting water, electricity and telephone are natural monopolies. The rationale behind natural monopoly is that once the cost of production is borne, the cost of provision will be low. For instance, imagine in Addis Ababa several water providers having their own taps. Once the infrastructure is constructed, it can be provided to all; it doesn't make sense to have competition.

But, monopoly can be abused. For this reason, the state should provide these utilities. In Ethiopia, for Example, the power is almost exclusively dominated by the state. The other option is that the private sector should be allowed to provide certain services under the supervision of the state. So, a strong public regulator is necessary to ensure that tariffs that are imposed by these monopolies are properly regulated. In some countries, the private sector provides it under heavy control. It must be noted that this doesn't mean that the state is always positive agent in its all interventions. There are many different inefficiencies of the state itself. One of these problems is state failure. Then the question is: why does the state fail? One significant difference between the state and public and private sector is the notion of 'consumer autonomy'. In a competitive environment, the private sector is not prone to corruption. The consumer has the autonomy over what to consume, how to consume and when to consume. Because the market is subject to this consumer test, the market is regulated by the consumer. With to the state, there is one element; which the consumer does not have decision making power. Taxation can be a solution to for market failure; however, it can also be a problem. Because, it is a compulsory levy. The mere fact that taxation is a compulsory levy gives the government the opportunity to abuse its power. This disconnects the association between what public sector provides and what it imposes in the form of taxes. The next question is, however, how do we resolve the problem of the state failure to conduct such responsibilities. We've agreed that the state should assume the roles in maintaining social security, provision of public goods ETC; now, what if it fails to do all these activities?

One solution is democracy; in different historical occasions, we have heard a slogan "no taxation without representation". That looks like a simple or rhetorical slogan that people chant when they are dissatisfied with the state. But, it actually means that by representation, you're trying to vote for the government that you want. So, the government imposes tax if you only vote it "A". Through our vote, we are signaling that it is the kind of government to rule us; if it is the government we like, we are obligating ourselves to pay taxes it imposes. When we go to a restaurant, we vote (purchase goods and services thereof) with our dollars; in democracy, we vote with the ballot and that is an expression of our free consent for the state. Thus, to mitigate the problem of forced riding that the state does, the process of periodic, free and fair election is very necessary. As mentioned earlier, taxation by itself is a compulsory levy. But, as a political

process, it is also a consensual process; because, we vote for the government which then has the power to impose taxes.

Another way of mitigating the compulsory nature of taxation is legal principles. Principles are the precepts that describe the good attributes of tax system anywhere in the world. Principles dictate that when we impose taxes, we need to follow certain rules. This is like "ten commandments" (although they are not 10 in number). Such principles should be observed not because they are legal requirements; but they are moral commandments. Now, let me take you back to Adam Smith who, in his book of "wealth of nations", laid 4 principles of taxation. Adam called them "maxims of taxation". They are: equality, certainty, convenience and economy.

Let's start with equality. Here is what Adam Smith has to say: "the subjects of every state ought to contribute towards the support of the government as nearly as possible in proportion to their ability". So, for Adam smith, equality means the distribution of tax burden in proportion to the abilities of the tax payers. So, we might say that this is the beginning of the concept of 'ability to pay'. The question is what is the relevant ability for the tax payer? The most important ability in taxation is income. In the old days, taxation is not necessarily paid in the form of money. It was in the form of forced labor, free provision of services or the total income derived from whatever activity in which the payer may engage. In this modern world, money is the unit of ability. The other serious concern that we have to address regarding the ability to pay taxes is how do we measure the income of individuals. Do we measure the person's income-what they get in the form of cash? Or by counting what someone has in kind? Can we measure a persons' income by what they consume?

Basically, with the above questions, we are referring to three sources of income. The classic definition of income is the sum of consumption plus saving. Consumption is the difference between the incomes minus savings. Wealth is an accumulated savings. Time is an important unit in calculation or computation of taxes. There are numerous debates among the economists as to how to measure the ability of the tax payers. But, generally, the idea in taxation is that unequal tax burden distribution is important in order to achieve equality. Those with greater ability should pay more than those with lower ability. However, in practice, it is difficult to implement in actual tax system. This is termed as 'progressive taxation'. Thus, it is "treating equals equally and treating unequals unequally".

There is another notion which is not well-accepted in the modern world. This theory is the benefits principle. The benefit principle tries to import market principle in to the calculation of tax. Because, in market, pricing is based on benefit. However, in taxation, it is difficult to apply the benefit principle. Because, it is almost impossible to estimate the benefit that each tax payer can get from the government in exchange of his/her contribution. Moreover, the reason why we have taxation is because of inestimable nature of the benefits that each individual enjoy from the public goods provided by the government. Besides, it may also have undesirable consequences. It may suggest that the government need to impose a heavier burden up on the poor than the rich. Karl Marx argues that the state should protect the rich from the poor as the poor has nothing to lose. There are some certain facilities of the state which are overwhelmingly used by the poor like public schools. If we measure such utility level of the poor against what the rich gets from the state, we might say that the poor should pay more. It must be noted that this principle is not entirely considered to be useless. It is applied in certain kinds of taxes like excise taxes on petroleum; which is used to defray the costs of construction maintenance of highways.

The second principle is the principle of certainty. Adam Smith states in respect of this principle: "the tax which each individual is bound to pay ought to be certain and not arbitrary". The manner of payment, the manual of payment and the quantity to be paid ought to be clear and plain to the contributor and every other person. So, certainty means, in the legislations, we need to have clear idea about when the tax is paid, how the tax is paid and how much one has to pay. For Adam smith, inequality is more important than uncertainty. Because, in the tax system, uncertainty has some undesirable consequences. For instance, it promotes or advances corruption; it makes the whole tax system arbitrary, it places the tax payers at the mercy of abusive tax administrators and much more. Adam Smith has to say: "Where the tax system is uncertain, every person subject to tax is put more or less in the power of the tax gatherer, who can ease or aggravate the tax up on any obnoxious contributor or extort by the terror of such aggravation, some present or perquisite to himself". Thus, he disapproves uncertainty that much because it is fertile ground for corruption and rent-seeking.

Adam Smith continues: "The uncertainty of taxation encourages the insolence and favors the corruption of an order of men who are naturally unpopular, even when they are neither insolent nor corrupt. The certainty of what each individual ought to pay is a manner of so great

importance that a very considerable degree of equality it appears, I believe from the experience of all nations is not near so great an evil as very small degree of uncertainty". In the modern precepts, this is termed as simplicity of taxation. The tax commentators often use this term because of an incredible complexity of modern taxation. In countries like the United States, taxation is the source of so much pain to the average tax payer. It is said that the tax law of the country is 66,000 pages long. The idea is that the language used in the tax laws should be the language of the average tax payer. But, this is easy said than done; the practice is on the contrary.

The other principle is convenience. It is more or less similar with the principle of certainty; but it is a little bit different. Every tax ought to be levied at the time or in a manner in which it is most likely to be convenient to the contributors. If it is agricultural tax, it must be imposed during the time of harvest. Consumption taxes are the most popular simply because consumption is the most convenient time for payment of taxes. Once, three of us went to a hotel to consume Kitfo. We've eaten three plate of Kitfo. When we looked at the vat on the bill, we've learned that the payment of vat tax for three plate of Kitfo was equivalent to one more Kitfo so that we thought the government (through Vat) had already consumed another additional Kitfo with us. So, we usually pay consumption taxes every time we consume things. Because, when we become willing to pay for the goods, we are simultaneously accepting the inevitable tax contribution. But, consumption is not necessarily a good index or indicator of our ability to pay.

The fourth principle is the principle of economy. Economy in taxation refers to the costs of taxation. Taxation takes out of us more than what we pay. Cost of compliance is one example of the sources of additional costs of taxation. There is a cost to maintain the books and records. There is also seeking for proper advice. The more the tax system becomes complex, the more advices the contributors will need. The ordinary man may even need someone to operate the cash register machine. The other cost is administrative cost. The government also bears some administrative cost to hire tax professionals, lawyers, tax auditors, tax collectors ETC. so, such costs of taxation must be kept to the minimum. The third and most important cost is efficiency cost of taxation or sometimes, it is called the dead weight loss. Efficiency cost discourages people from full engagement in the business activities due to onerous tax burden.

In modern times, there are other principles which have grown out of the above basic principles developed by Adam Smith. One is administrative feasibility. The government must import the

types of taxation up on the basis of its capacity of tax administration before adopting it. The other principle, which subsumes all other principles, is the principle of efficiency. It encompasses mitigating all costs of taxation that we have outlined above. Economists suggest that it is of two Es; equity and efficiency. Of course, economists tend to emphasize Efficiency over equality; because, they think that equality is not fully achievable in modern times. If we simply take income as an example, we will discover that it income is not a very good measure of equality. What we have does not actually show our ability in real terms. This is a difference between the potential ability to pay and actual ability to pay.

There are certain important factors that should be taken in to account before concluding the income to be a measure of taxation. This may include the size of family we subsidize. These conditions further complicate the tax system in general. That is why in United States, the tax law is about 66,000 pages; the government to satisfy the need of equality to such extent. The way we measure person's ability in terms of family, credit, dependence and even gender. Because of Equality of woman's, there is a 'child tax credit' in United States. The US government incentivizes the womans to go to work by giving them a credit for child care. However, the importation of such taxes may worsen the feasibility of the tax system partly for poors. The more complex it is, the more likely it is for the people who have the money to exploit the loopholes to reduce their tax burden. On the other hand, people who do not have the money may pay more tax than they should simply because they do not have the ability to use similar loopholes in the tax laws. Here is the juncture where the need for simplicity arises. The principles of taxation are inter-connected. One of the problems that the economists observe is that the more you have of one, the less you will have of the other. In other words, the more equitable the tax system is, the less efficient it will be or vice versa. This suggests that we need to have some balance between these various principles.

Taxonomy of taxation.

Taxes can be classified in to direct and indirect. When we talk about direct taxes, we are referring to those taxes which are imposed and collected from the tax payer who is also the bearer of the economic burden. So, income taxes are generally categorized under the direct taxes. Indirect taxes are usually those taxes which are imposed on goods or commodities and services in the intention that the bearer of the economic burden is somebody else. So, there are legal tax

payers and the bearers of economic burden of tax payers. All sales taxes including vat, customs, duties, excise taxes Etc. in general are indirect taxes. But, administratively, if you look at, for example, withholding taxes, you will find that they are employed against direct taxes. So, if you are an employee, it is the employer who collects the tax from you. This is not direct tax; the employer is shifting the burden on to the employee. But, we use the expression "withholding taxes". Because of the frequent use of such expression, it is no longer important to talk about direct or indirect taxes. Income, consumption plus savings are direct taxes. If it is to be applied on the consumer and saver at the same time, that is direct tax. Most people think that consumption taxes are indirect taxes; but we can have a direct consumption tax called expenditure tax.

It can be administered exactly like the income tax with the notable difference of deducting saving from the consumption. But, this expenditure tax has been experimented only by Sri Lanka for one year. However, it abandoned immediately. Indirect consumption taxes are favored by many countries. These are general sales taxes like vat and the turn over tax, single stake sales taxes, selective taxes like excise taxes or, consumption taxes, customs duties, and excise duties which are imposed on the point of importation. Such types of taxes are common and important sources of revenues partly for developing countries like Ethiopia. More 40 percent of the Ethiopia's federal tax revenue comes from taxation on imports. This is because; first, import taxes are very high, and second, import duties are generally very extremely easy to impose as the administrative costs are very low. This suggests that whenever we consume important goods, which is a lot in Ethiopia, there is a tax. Sometimes, it can go up to 150-60, or even to 200 percent of the basic value of the good.

When it comes to car, for Example, custom duties are 35 percent; excise duties [sometimes] 60 percent, vat 15 percent, sir tax 10 percent ETC. By now, I have answered certain questions; why taxes are not only unavoidable, but necessary; what taxes we should impose; and, how we should distribute tax burden. So, we have considered the general jurisprudencial understandings of taxation. The next discussion will be the Ethiopian taxation.

Lecture5-October 9, 2019.

So far, we have been discussing about general taxation. Our next subject would be the Ethiopian taxation. Accordingly, the first thing to be discussed is tax policy. Fiscal federalism is the second issue. So now, let's begin with the idea of tax policy. As you remember, last time, we were talking about principles. Where do those principles exist? Usually, it is good to study something. But, it is equivalently important to ask the point of dealing with what we studies; for instance, the reason why we need to know about the principles of taxation that we have seen in our previous classes like equality, certainty, administrative feasibility, neutrality or simplicity. What does it actually mean in your study of taxation? Think of yourself as a person who seats in a tax administration; or, a person who is litigating tax cases; or, a person who seating in a tax appeal commission or even in court. Why does it matter to you about the principles laid down by a person who lived about 250 years ago?

The very purpose of studying all of these principles is not to suggest that they are always valid and useful for all countries. Rather, it is to insist that they are vital in different context. More or less, almost all of those principles are somehow reflected in actual tax systems across different countries' including Ethiopia. It is the distillation of those precepts that we find in tax laws. But, every country distills those principles in its own way. The Ethiopian Arekei is different from the American Arekei because each country produces its Arekei in its own distinct way. However, there is no such thing as tax policy which completely unique. All countries are inter-connected. Hence, their tax policy becomes derivative of each other. So, there is no such thing as "Ethiopian concept of Equality". I'm obsessive with the term policy partly because I want to subvert the language of the law and the conventions of the lawyers. One of the cannon of interpretation of law which is used by every lawyer is the intention of the legislator which states that when everybody writes, he/she writes with intent. "But, that is fictitious rule".

We know that people tend to write while they sleep; parliamentarians are good examples. Factually honestly, who controls the game of making the legislations is what we need to think outside of these conventions. There is no valid reason why the latter law should prevail over the former or the special law of the general law; it is not scientifically true. These conventions do not stand under the scrutiny of factually honest person. Policy is one way out to such conventions. Because they are slaves of such languages, I see many people when they grossly misinterpret the

tax laws. I can give you a number of examples. For example, in income tax, there is a rule that dictates the entertainment expenses are none-deductible. Because, entertainment expenses are considered as personal expense. Then, entertainment expense is defined as an expense for food, beverage and accommodation. If we simply follow this definition, every kind of expense for food will qualify entertainment and hence none-deductible. This is what the tax authorities and the huge accounts of the communities do; because, they don't understand why the entertainment is none-deductible. It is none-deductible because of the definition of income. As you may remember, income is consumption plus saving. This is a classic definition given by the American economist Henry Calvert Simons.

But, business can spend money for food, beverages and accommodations. A very good example would be an engineering construction company in Ethiopia; flying engineers, technicians from elsewhere and accommodating them in Sheraton hotel. Now, these engineers may consume those things exempted from taxation by virtue of entertainment expense (foods, beverages and accommodation). Then, by looking at the usual language, it is possible to conclude that they are bearing entertainment expense. However, because of the fact that engineers are not in their home base, they have to accommodate; this makes it business. Thus, since business is not exempted from tax burden, the engineers should pay. That takes us to the question of tax policy. Tax policy is an objective that permeates the tax policy; it is a background of the tax system. It is the context in which the tax laws should be written, revised, rewritten, interpreted, implemented and executed. Thus, it is imperative to understand the tax policy to properly and appropriately interpret the tax laws. People think that interpretation comes only after the laws are written. That is another wrong assumption; interpretation starts when we are writing the laws. Because, you are writing what you are interpreting; we don't write before we think. We need to have certain kinds of objectives. There is marriage of politics with law. If we have to take our profession seriously, we need to take policy seriously. So, the study of tax policy is a serious concern about politics.

When I talk about politics, I'm not talking about 'electoral politics'; I'm talking about the legislative policy that transmutes itself in to the law. Tax policy is important in times of tax reform, in the study of the law, in times of writings of different subsidiary legislations, in the design of the whole tax system, in the administration of tax law, and obviously in the

interpretation of tax law. The other thing is the complete disconnect between the law and practice. There shouldn't be any disconnection between the two; the law should be the practice and vice versa. Of course, there is divergence between the two mainly due to the fact that we do not properly teach the practitioners.

So, the purpose of tax policy, first of all, is to give adequate attention to language; to articulate policy in the law itself so that it can be better regulated. In this regard, when we are involved in the tax law revision, we should articulate what we want to achieve by that law. When we say objective, it is not personal objective; it is the objective for the country. Because, nobody writes a law for him/herself. Where does that law come from? In general there are three sources of law. One is the policy documents. For example, the growth and transformation plan. Policy documents are necessary to understand the reason why the government collect revenues; because, taxation is the center of political economy. The other source of tax policy is the constitution and the third is tax legislations. It must be noted that reading tax laws as tax laws and policies as policies are completely different things. Tax laws should be read as the statements of tax policy.

Lecture6-October11, 2019.

Last time, we have considered that policy documents are significant to understand the nature of tax laws. In general, about 4 objectives of policy documents could be identified. One is revenue generation. For a while, we need to consider the nature of the Ethiopian government. The economy is state-led economy where there is no free and independent market. For a market to function there should be market infrastructure. The infrastructure for the market is energy, transportation, communication, education, health facilities Etc. The state is confident that it can play a leading role primarily because of taxation. For example, 70 to 80 percent of the GTP plan is to be accomplished through taxation. In different policy documents, there is usual target to raise the tax revenue by certain level of amount. The question is, however, if the tax revenue grows faster than the economy, where does the revenue come from? Whenever the government puts the tax revenue as its primary or sole objective, there is a danger that it may increase tax

burden up on the tax payers to achieve such goal. Because, it may put the tax administration under extreme pressure to raise its revenue in accordance with unrealistic tax revenue caveats

For instance, the tax base for customs revenues is cost insurance and frate (CIF). But, in practice, the customs authorities do not use this. They have their own assumption for every good by setting aside the existing and contractual price. So, if person byes a given good for 70 USD, the authority's presumptive price may be 100. The problem is, the customs authorities presume their presumptive price to be the cost of good. Therefore, when the tax payer reports his/her price of sale to be 90 USD, for example, they automatically reject it with the conviction that nobody sells anything for a loss unless there is the intention to avoid the tax payment. This creates disconnect between the presumptive price and the cost of the good. The other objective is economic development. Taxation is a vital instrument in the achievement of economic growth. First, as mentioned earlier, it raises revenue. Second, it initiates the investment through tax incentives. Tax holiday, for example, is an exemption from corporate tax for years. Those who invest in the industrial parks enjoy some 30 percent of their main profit. There are also exemptions from import duties. This is mainly to encourage the foreign investors to invest in Ethiopia. Employment, foreign currency and technology transfer are some the fruits that the country expects from economic growth.

The third objective is equity. I have placed equity as not important as other objectives. Because, Ethiopia is not at a stage where equity is a primary concern. Our tax laws are not actually equitable. Ethiopia raises about 44 percent of its annual tax revenue from import duties like excise duties, customs duties, Sur Taxes, vat ETC. But import duties are not equitable at all; they are regressive taxes. However, there is an aim to achieve equality in certain level. Equality is important in its procedural sense in Ethiopian tax system. Modernization is the fourth objective. This includes modernizing tax laws, the tax administration and so on. Tax policy is layer in the sense that there is multiple tax policies that the country wants to achieve at the same time. This poses a challenge to a tax system. There could be conflicts between these multiple objectives; it is impossible to be equitable and expect revenue generation at the same time. In the concept of trade-off, the more we have one thing, the less we expect from the others. So, we stipulate the lists of objectives, we are not necessarily putting them in hierarchical position.

Fiscal federalism and the Ethiopian tax system.

Fiscal constitution is different from fiscal federalism. The subject of fiscal constitution is not taxation. But it is part of tax policy. The fiscal landscape of Ethiopia is laid down in the constitution. Fiscal constitution thus refers to the aspect of the constitution which regulates the fiscal relationship between the federal government on one hand and between the government and the tax payers on the other. Fiscal constitution regulates four things in general. The first issue in the fiscal constitution is the issue of spending powers or what is known as expenditure powers. Defense, law and order, education, infrastructure, energy ETC are some of the spending powers. The second is the revenue powers. This is the tax powers of both levels of governments (the federal government and the regional government). It determines what the federal government can raise as opposed to the regional governments, what the regional governments can exclusively raise and what none of them can raise. The third question in fiscal constitution is the issue of imbalance. The fiscal architecture of a federal system usually results in two kinds of imbalances. One is vertical imbalance which means the federal government has more powers than the regional governments. The other is horizontal imbalance, which means unequal fiscal powers of the regional governments. This is a situation where the regions may not have equal fiscal endowment (the ability to raise revenues).

In Ethiopia, most regions depend up on the federal government for 80 percent of their spending (expenditure). We have some regional states which are characterized as “tadagi kililoch” which some people tend to erroneously translate it in English as “young states”. There are 4 categories of revenue powers in our constitution. The categories of powers indicated in the constitution under the provisions of articles 96-99 are: federal exclusive (art. 96), regional exclusive (art. 97), concurrent tax powers (art. 98) and undesignated tax powers (art. 99). But, on closer reading, (this is my closer reading), it is possible to identify two more powers from the constitution. The 5th category is the “related” taxation powers. This is derived from article 100/1 of the constitution. It is not explicit stipulation of the taxation power; but it is possible to label it as 5th category through the interpretation. The 6th power is the taxation powers which require the amendment of the constitution (art. 105).

In America, highways are identified by numbers. If we use it as metaphor, we can say there are 6 highways in the Ethiopian constitution. It is easy to confuse highway 99 with highway 105; because, amendment is not an easy task. If there is any undesignated power, the matter should be

brought before the joint session of the HOF and the HPR. “Undesignated power” means the power which is not mentioned in the articles 96-99 of the constitution. Vat was introduced in 2002 in Ethiopia. The constitution was of course promulgated in 1995. So, at the making of the constitution, there was no mention of the value added tax. The question back in 2002 was which layer of government had a power to impose Vat taxes. Put it differently, the question was, whether the Vat tax was designated or undesignated. Finally, the matter was brought before the joint session of the houses. [My] position is that it is already designated in the constitution not by name, but by nature; by substance. Although it does not stipulate Vat by name, articles 96-98 of the constitution speak of sales taxes which include Vat. Vat is one form of sales tax applied at multiple stages of supplies. So, the very introduction of the value added tax required the amendment of the constitution at least in the tax administration. In the tax administration in general, it is accepted that Vat should be centrally administered because of administrative inefficiency.

In this regard, the government faced a significant dilemma. On one hand, many international financial supporters like (IMF) have suggested that the government can increase its revenue by introducing the Vat. The government was already salivating at the expectation of the huge revenue to be raised with the introduction of value added tax. On the other hand, there is this constitutional challenge. So, the introduction of the Vat exemplifies the danger of using highway 99 (the constitutional provision that recognizes undesignated powers) when 100 is too steep to travel. Highway 105 (the amendment of the constitution) is not simple task for the government.

In our constitution, sales tax is married to history. It is the power of federal government in some cases; it is also the power of regional governments or joint revenue. For instance, sales tax on state-owned enterprises falls under the federal government. Sales on companies, on the other hand, is joint revenue while tax on sole proprietors is the power of the regional governments. So, there is no way for the central government to monopolize sales tax with the existing constitutional framework. In 2002, there were some complaints from the regional states. They complained that the introduction of the value added tax robbed them from their power of sales tax revenues. Of course, by virtue of the constitution, some of the revenues derived from Vat belonged to them.

The joint session decided that on the basis of article 97 of the constitution, the regional governments would get 100 percent of the taxes on sole proprietors. But, since article 98 of the constitution categorizes tax on companies under the joint revenue, the proceeds will be shared 70 percent to the federal government and 30 percent to the regional governments. However, the houses had no such power; they were trying to avoid constitutional amendment. The current Ethiopian constitution is too historical; in a sense, it may be useful in dividing the existing resources between the two levels of government, but it is [totally] inadequate to dispense out the future one. When we look at the distribution of employment tax, the constitution provides that the federal employees should pay for the federal, the regional employees to the regional states and the private employees to the region. This is simplistic consideration based on the level of entity that pays the salary of the employees (whether federal or regional). However, the question of a party who pays the salary is irrelevant in the literatures of fiscal federalism. Because, taxation and employer are two different things. This led to several disputes between the companies operating in regional states and the regional governments.

We can even identify the 7th category of the taxation power by constitutional interpretation of the house of federation. The other controversial thing is the provision of article 100/1. It reads: "In exercising their taxing powers, States and the Federal Government shall ensure that any tax is related to the source of revenue taxed and that it is determined following proper considerations". So, the "related taxes" could be derived from this provision. This implies that taxation does not have to be stated concretely in order to be exercised by the two layers of governments. Both governments can impose additional taxes which are not expressly mentioned in the constitution, but related to their respective powers. For example, customs duties are stated as the power of the federal government under article 96(1). In 2007, 12 years after the adoption of the constitution, the federal government introduced Sur Tax. Sur tax is an additional customs duty tax.

If we look at the constitution, we don't find any mention of Sur Tax. Nevertheless, the federal government is justified in imposing it without going to the joint houses in accordance with the prior provision which impliedly makes Sur tax the species of customs duties. As long as it is within the limit of such implied power, whatever name we may give it is immaterial. What is pertinent is only the substance. This implied power is also reserved for the regional governments. The problem is, however, how we differentiate related taxes from unrelated taxes. So, there is

always danger. This danger could be extenuated by article 99 of the constitution. Such taxation powers are rebuttable. Coming back to the principles, they are articulated in two areas; the general and the specific areas. Principles like equality, property, none-discrimination and other general principles that are useful to regulate the fundamental human rights have also paramount importance in taxation. The specific principles are given under article 100 of the constitution which states as “directives on taxation”.

We can classify these principles in to two categories. There are certain principles which regulate the relationship between the federal government and the regions. Some other principles under the same provision (art. 100) regulate the relationship between the taxation of both governments and the tax payers. With respect to the first category, there is the principle of relatedness which we have already discussed. The second is the principle of adverse impact. The principle of adverse impact is stated under art 100/2 as; “They [the federal and the regional governments] shall ensure that the tax does not adversely affect their relationship and that the rate and amount of taxes shall be commensurate with services the taxes help deliver”. John Martial, a great American justice once said, “The power of taxation is the power to destroy”. The principle of adverse impact essentially dictates that when each layer of governments exercises its power, it should ensure that it does not adversely affect the power of the other.

So, it is intended to safeguard the federal structure. However, in Ethiopian federal system, the practice is that it is the federal government that gives tax incentives. In most instances, it gives such incentives from the revenue powers of the regions. For example, in the recent income tax proclamation, the power to exempt the foreign investors who invest in industrial parks from corporate taxes for 5 years is entrusted to the federal government. Although such revenue power is the power of regional estates power, it is proclaimed in the federal tax laws.

This can provoke disputes between the two governments. Because, the regional governments may claim that they are adversely affected by such practices as it lessen their revenue powers. The other principle is intergovernmental immunity. It states that both governments should refrain from imposing taxes on the properties of each other. But, it must be noted that this is not to mean the federal government cannot collect taxes from the regions or vice versa. For example, in the case of value added tax, since it is indirect tax, the federal government can collect from the regions. The federal government collects Vat from the regions pursuing to the tax rate imposed

on the average consumer. In other words, it cannot say, for instance, the regions should pay 30 percent for Vat tax which is beyond the normal amount (15 percent). So, the federal government cannot specifically target the property of the regional government through taxation.

There was a case between the Tigrai region and Ethiopian telecommunication. There was the municipality tax raised by municipal administrations which is called “business and professional services tax”. This tax was levied on certain indirect indicators like environmental impacts, total sales, capital ETC and other number of criteria used for the assessment of the taxes. Ethio-telecom, which is the federal state enterprise, was assessed tax in one of the municipalities located in the Tigrai region. Ethio-telocome argued that since it has already paid to the federal government, it wouldn’t pay to the region. The dispute was brought before the house of federation. Meles Zenawi, the then prime minister, illegitimately intervened and ordered the Tigrai region to stop the tax. The issue of the dispute was whether the regions can impose taxes up on federal government enterprises like Ethiopian telecommunication. Apparently, there is a conflict between the two provisions of the constitution (art. 96/3 and 100/3).

By virtue of article 96/3, the power to levy taxes up on the federal state enterprises is the exclusive power of the federal government. Article 96/3 provides: “It (the federal government) shall levy and collect income, profit, sales and excise taxes on enterprises owned by the Federal Government. Accordingly, the federal government argued that the Tigrai region had no constitutional power to tax Ethiopian telecommunication on the basis of the above provision. On the other hand, The Tigrai region has argued that in accordance with article 100/3 of the constitution, it can levy taxes on profit making enterprises. Article 100/3 states: “Neither States nor the Federal Government shall levy and collect taxes on each other’s property unless it is “a profit-making enterprise”. There are also other principles in the constitution which address the individual rights; for instance, there is the principle of due process of law or none-discrimination which is given under art. 100/1. The regions cannot discriminate against out of the states companies.

Lecture 7-October14, 2019.

Last time, we were discussing about fiscal constitution and the general outline of the fiscal federalism of Ethiopia. Today, we shall proceed and consider what [I] call "proper tax system of Ethiopia". Usually, our tax system starts with proclamations. In some cases, we may have to talk about the constitution; but mainly as a practitioner, our primary preoccupation is with tax laws which are below the constitution (proclamations, regulations, directives Etc). there are two terms that actually describe the Ethiopian tax system; excesses and gaps. On the article [I] wrote earlier reads the same as "excesses and gaps" (Kiftetuna kotetu). The quotation in the beginning of that article was the quotation that I have extracted from the short story authored by the Ethiopian writer Sebhat Gebre-Egziabher.

It was a social commentary on how the dogs view human beings. The story goes that there was a dog called Kombotir Which actually translates in to English a computer. A person who was drinking arekei (the Ethiopian wisky) gave the Arekei to the dog and the dog got intoxicated. It begun to observe the excesses in the homes of human beings. The dog talked: "you the humans, you have bulks of laws-criminal code, civil code commercial code Etc it is beyond what you need". Because it was drunk, the dog was making very honest assessment of how human beings love excesses and the way those exxesses are reflected in their laws. So, [I] made that sort of quotation to exemplify the fact that the Ethiopian tax system is excessive in some respect. By excesses, [I] mean repetitions and redundancies of laws and the reason has to do with the way the Ethiopian tax system is organized. So, basically, when I characterize the Ethiopian tax system as an organization, I can say it is disorganized and chaotic. But, the nature of such disorganization can be described in the connotation of exxesses and gaps.

Remember, this article was written back in 2012, 7 years ago. Since then, there have been some significant changes in the Ethiopian tax laws. But, many of the gaps and excesses still remain unchanged. Organizations of the laws. One of the striking things about the Ethiopian tax system is that laws are not well-consolidated. Unlike other laws , every type of tax has its own law; if we need to know about vat, we need to search for vat proclamations and Etc. Having several pieces of legislations creates critical problems including lack of simplicity, intelligibility, comprehensibility, dangers of conflicts between different hierarchical positions of laws Etc.

Emperor Hailesillasie didn't conscript the French men to adopt a modern tax laws in a codified way This was due to the fact that taxation was main political instrument in his emperial reign.

Among any other problems, there was widely held perception that the tax laws are extremely resistant to a comprehensive organization. Because, they are dynamic so that they couldn't be codified in to a single legal document. Another part of the problem was that the Ethiopian tax system has been heavily influenced by the British tax system due to their historical military relationship. The modern state of Ethiopia fell under two major influnces. The first is, as already mentioned, the British influence which was particularly powerful between the period of 1941 and 1950s. the British were the one who helped the emperor to dislodge the Italian troops from some strategic occupations. So, all of this factors have accounted to the absence of the codified tax law during the Ethiopian emperial reign. More strikingly, we inherited this legacy of excesses in our tax laws.

Proclamations.

Every tax law has its own proclamations. Although they tend to imitate the federal laws almost to the point of embarrassing plagerism, the regions also have their own respective tax laws. The problem that I usually stress with having multiple proclamations in our laws Is not the issue of their number; rather, the main problem is its repetitions of common terms, provisions, definitions, procedures Etc. prior to 2016, Ethiopia did not really have tax administration law. The tax administration laws were found along with the substantive laws in each piece of legislation. Tax administration laws are laws which regulate common administrative procedural issues regarding taxation such as registration, identification, forms, assessments, dispute settlements, penalties, interests, collection of taxes Etc. There are common issues or formalities in taxation; for example, we need to have a registry, tax identification number (TIN), certain identifiable documents that need to be maintained or recorded and other rituals.

There are also some common rules. For instance, rules forauditing, rules for investigation of the tax payers, rules for criminalization of certain activities against taxation like tax evasion, rules for competition of interests and penalties (whenever the tax payers do not comply). So, all of this rules call for one anker. There are people who believe that the codification of tax laws is virtually impossible. [I'm] not one of them. Like the civil code, we can have book of vat, excise duties,

income tax and so on. However, it does not mean we should reduce all the rules in to a code. There are permanent as well as none-permanent or ephemeral aspects of taxation. So, it is quite possible to imagine a codified tax law for Ethiopia. Sometimes, the exxesses might happen even when there is tax code. The impossibility to [me] is not the impossibility of codification of the major laws; the impossibility it seems to [me] is the impossibility of the codification of the subsidiary legislations

So far, it was only in 2016 that we had the tax administration proclamation in the form of booklet. It is proclamation no. 983 which is fairly small in size. This administration code has removed some of the excesses that [I] have complained in [my] article before it was issued. It has gathered the definition of common terms, procedures of registration, identification numbers, forms, assessment Etc in taxation. But, individual tax laws like Vat, excise duties, customs duties, stamp duties, Etc still remain each of having their own separate legislations. Whenever there is tax reform, there will be piecemeal revisions. This in turn results in an inconsistencies in the general tax rules. Below the proclamations, we find the regulations. For a long time, [I] have been wondering what the difference between the regulation and the proclamation is. In practice, a regulation is usually prepared along with the proclamation. This is mistake number1; because, if it is prepared with the proclamation, they should be taken to the parliament.

The other problem Is that nobody pays attention to the essential question why should the proclamation deal with the general rules and why the regulation should provide the details. Hence, there is no discernible difference of substance between the two types of documents. Sometimes, we may find the details in the proclamations and more substances in the regulations. When the income tax proclamation was issued, there were some fundamental issues which have been forgotten like foreign tax credit, world wide income taxation Etc. [I] was called to debate on the proclamation and [I] have asked why did they forget these things for schedule A and schedule B and provided for schedule C. their response was that it would be provided in the regulation. This showed [me] that they did not have concern about the content. Thus, the promulgation of regulations is to cover such loopholes which makes them totally different from the proclamations.

The only difference between them is that the proclamation has to be ratified by the parliament while the regulation is issued by the council of ministers. However, there should be some

difference between the two. Because, from the administrative law point of view, a regulation is there for a reason to give the executive time to think about the details, manner of execution and procedurally flexible guidelines to implement the proclamations. Below the regulations, we find directives. Directives or (memeriyawoch) are extremely important sources of tax laws in Ethiopia. The problem with these directives is that they are not published. They used to published during the emperial regimes, the days when the people condemn today. All kinds of were published in the Negarit Gazette. Nowadays, the only piece of legislations that we find in the Negarit Gazette are the regulations and the proclamations. We can find in the drawers an official who has taken asylum in a foreign country Etc. simply stated, it is very constraining to collect the directives. In some instances, the tax authorities strive to publish some of the directives on their respective websights. But, it is not possible to rely exclusively on such websights due to their restrictive access they provide to the bulks of directives.

There is one infamous case that [I] cite in [my] article. It was the case involving the national bank and a person who was convicted of smuggling gold. The citation of acrime against this convict was a directive apparently issued by the national bank in English and which was not published. The person claimed that he couldn't be convicted of violating this law. Because, first, he could not read and understand the English version of the directive and second, it was not published. Finally, the case was brought before the cassation division of the Supreme Court. The cassation has passed its last verdict that the law does not have to be published; as long as it is issued properly in accordance with the proclamation, not only is the directive valid, it has even the status of proclamation. In this holding, the bench highly disregarded the principle of legality by legitimizing unrestrained power of the executive. Proclamation no. 3/1995, a proclamation to re-establish negarit gazette clearly stipulates that all of the federal government should be published in the Negarit Gazette. Unfortunately, that is honored in its breach than its compliance.

The other problem is that it is not simple task to identify these directives from other documents. With respect to the proclamations and regulations, there is no similar challenge since they are more or less published. Of course, many of these documents identify themselves by the name of directive in English and memeriya in Amharic. But, the names are misleading. There are many documents which could be properly called directives though they are labeled directives or, there some other directives which are not identified as directives but as binding as directives. This can

be a memo or a different communication between two organs. Sometimes, it could also be minute (kaleguba'e). Circulars, a notice which circulates the whole department to inform a specific issue to be implemented or not to be implemented (masasebiya) are also another example. This could be prepared in the form of letters. For [me], law is a piece of document which has the nature and effect of binding.

The other thing is that directives are issued by several institutions. So, the issuing authorities vary from one directive to the other. Most of the directives are issued by the ministry of finance. But, there are many directives which are issued by the ministry of revenues itself. The investment commission is another authority that issues directives. Some other directives are issued even by the ministry of education (cost sharing in different universities for example). The other thing is when we read directives; we usually find them in an indistinguishable form. But, based on their nature, we can identify 3 types of directives. One is what [I] call the legislative directives. Legislative directives are directives which create, modify and extinguish rights and obligations. For instance, there are number of exemptive directives which exonerate specific category of economic center or certain groups of individuals. They are exemptive in the sense that they extinguish the obligation to pay tax. The second group of directives is the interpretative directives. These kinds of directives define, explain or elaborate certain provisions of the principal legislation (the proclamation or regulation).

The third category of directives is administrative or procedural directives. These are the directives which lay down detailed administrative procedures. These are the proper type of directives. Because such directives basically address the area where the directives are important. But remember: in a single piece of legislation, we can find all of these categories of directives. The other problem is the hierarchy of directives. Sometimes, directives can violate the principal direct legislations. We can observe irregular documents that have equal legal effect like other official legal documents.

Some laws have become custom. For example, There is the tax which is called assurance tax (ye ashura gibir) which was issued in 1947. When the immovable property is transferred from one another, 4 percent of the total value of the property is subject to the assurance tax. The problem is, however, there is no any legal record about the rules and regulations of this type of tax with the administration of municipalities. Thus, it is difficult to trace about substantive as well as

procedural content of this tax. So, [I] had to talk to octogenarians (senior citizens whose age is in the eighties) to discover the oral record retained in their memory. According to the oral informations, some 80 years ago, there was no cadastral system in which the land owners could guarantee their exclusive entitlement up on their plot of land. Consequently, the government levied the assurance tax which aimed at assuring the ownership right of individuals who own immovable properties up on discharging a specified amount of payment.

There was a dispute which involved the national bank of Ethiopia. The source of the dispute was the directive issued by the national bank which prohibits the appointment of a person as a board member of two financial institutions. Some people who were the board members in several financial institutions have fiercely objected and challenged the directive on the ground that it violates the rights of the shareholders. So, the matter was taken to the first instant court. The court decided in favor of the plaintiffs. Finally, the dispute was brought to the cassation division. The Supreme Court ruled that as long as they are properly issued along with the proclamation, the directives can have the status of proclamations even if they contravene the higher laws (including the proclamation). Actually, there was no any conflict between the directive and the commercial code. The judges in the division rendered such spontaneous decision based on their obstinate prejudices.

There is another unique body of rules in taxation which is called advance rulings. Advance rulings are administrative opinions given by the tax authorities with respect to contemplated transactions. They are called advance because it request for opinions in advance of the transactions usually. Such legislative tools are made by modern tax administrations because of the real need of the tax payers to get assurance about tax consequences of their transactions. Advance rulings are modern inventions of administration. In modern tax administrations, tax payers need to about certainty. It is sort of certainty of application of taxation with respect to their own transactions; it can be merger, restructuring, re-organization, joint ventures or it can even be about the investment in to the country. Thus, they usually consult lawyers about the tax laws in such circumstances, the lawyers may not be absolutely certain about tax laws and hence may give some wrong informations or; without sufficient notice about recent legal updates, they may equip the tax payers with the repealed or amended rules.

So, to get certainty what the tax payers have demanded in modern tax administration, the most appropriate mechanism is to ask the tax administration itself. More importantly, if the tax consequences are adverse, they may not enter in to such transactions. To satisfy this demand of tax payers, modern tax administrations have included these advance rulings in their substantive tax laws. Advance rulings dictate that the tax payers can request for explanations through the letters that discloses all relevant facts including their contemplated transactions and their interpretations of the law regarding that transaction. The tax authority is required to respond in writing to those questions. As a result, this opinion from the tax administration is binding up not on the tax payers, but upon the tax authority. Prior to 2016, Ethiopia did not have advance ruling provisions. But, there was practical experience of the advance rulings. The ministry of finance issued a number of documents containing opinions in response to request for clarifications by tax payers. The 2016 proclamation included two types of advance rulings. One is called public rulings. Public rulings are advance rulings that issued by the ministry of finance with respect to specific set of facts.

Unlike directives, public rulings look like a judgment. It is a logical placement of facts with the rulings. As we can observe from articles 68-76 of the federal income tax proclamation, proclamation no. 983/2016, the second type of advance rulings is private rulings. These are proper advance rulings. Because, the private advance rulings are issued in response to a private request of a tax payer. But, these responses are not confined to that individual tax payer. They also become applicable to third parties who have not requested for explanation. So, they are called 'private' only because they are initiated by a private tax payer. As mentioned earlier, the role of advance rulings is to ensure certainty in tax system. In addition, they play very important in the uniformity of the application of tax laws. Advance rulings are like certain kinds of medicines not because we are ill, but because we want to have some kind of better efficiency.

Lecture8-October18, 2019.

Last time, we were discussing about advance rulings. Ethiopia didn't have legislative framework for advance rulings prior to 2016. But, because of interaction between the tax payers and the tax

administration, the idea of advance ruling developed in practice. Tax payers have been asking for what is known as “mabrariya” (explanation). Mabrariya means, whenever the tax payers feel uncertain about the legal consequence of a certain contract or transactions, they request for clarification whereby the tax authority is expected to respond to those questions.

A very typical example that you can find in [my] article is an example of whether persons should be treated as employees or independent contractors. This becomes very important in cases of withholding taxes. If a person is considered as an employee, the tax rate is 35 percent. On the other hand, in case of withholding taxes, the tax rate is 2 percent. This arises in the situations of per-time jobs. For example, if somebody teaches in the evening programs, he undertakes a per-time work. Even full time employees sometimes do additional works like the preparation of teaching materials for the university students. They accomplish such additional tasks for consideration. Now, the question arises; whether those persons should be considered as employees or independent contractors. So, financial managers usually send letters to the higher tax administration organs in need of uniform order as to the way to treat such issue.

The tax authorities tend to respond to these questions in letters and overall, these letters were binding though their legality was persistently challenged. Thus, this exhibit the practical operation of the advance ruling even before the birth of the 2016 legal framework in Ethiopia. The problem with such kind of practice was that it was solely uncoordinated in the sense that different tax authorities didn’t correspond to each other. So, it was usual to find numerous divergent letters on the same subject written by different institutions. Consequently, depending how a specific letter characterized the contract, the same kind of income become subject to different tax rates. The responses were as many as the departments within the tax authorities.

This was mainly because of the absence of concrete framework. Under the 2016 proclamation (proclamation no. 983), regulating which layer of government that has a mandate to issue advance rulings and under what conditions and terms, including when they become valid. Article 6 (3) of the proclamation provides about capital gain income tax. Capital gain income tax is an income tax on the transfer of selected capital assets including shares, bonds and immovable properties held for business. Capital gain income tax is calculated as: it is equal to sales price minus cost of capital asset. When it is the transfer of shares, the tax rate is 30 percent; when it is building or immovable or immovable property, the tax rate is 15 percent.

Sometimes, in international cross-border transactions, a company, let's say, Mop is set up in let's again say in Dubai. This company is an investment company which is commonly owned by Mop Ethiopia. When Mop Ethiopia transfers its shares, there are capital gains. But, let's say Mop Ethiopia does not transfer the shares, but Mop Dubai is sold. The question is then, if they sell the company in Dubai, or in other countries, does that constitute the sale of interest in Mop Ethiopia and does that attract the capital gain tax? Obviously, there is no dispute. They have not yet sold; but, they have already negotiated contract to sell Mop Dubai to a third company which means Mop Dubai will be acquired by a third party and Mop Ethiopia will force automatically the transfer to the buyer. The problem is, however, the buyer will demand for assurance that there will be no any capital gain in his tax. Because, he/she wants to avoid any consequences of the tax authorities coming after the sale of company occurred in Dubai.

Therefore, Mop Ethiopia, on behalf of Mop Dubai, or even Mop Dubai itself can ask for clarification of consequences setting out the facts that it wants to sell to a third party in a transaction which could be concluded outside Ethiopia. The answer of tax administration may be either no or yes or as a third option, it may say up on some conditions. In this regard, if the tax authority says that it leads to capital gains tax, they may adjust the price. The unique merit of the advance rulings is that they are binding only up on the tax authority. An advance ruling applies to third parties, or even to the party, only with respect to the set of facts disclosed therein. Remember; it is called advance ruling because it is applied in advance of contemplated transaction. It can also be properly called because it is more advanced than a rule.

By virtue of article 72 of the proclamation, the tax authority can reject the request of the parties submitted to it by private individuals. It does not have a duty to respond to all requests; it responds only to those requests which properly submitted and met the conditions laid down in the tax administration proclamation. Art. 72 of proclamation no. 983 reads:

Refusing an Application for a Private Ruling

1/ The Ministry may refuse an application by a taxpayer for a private ruling if any of the following applies:

a) the Authority or the Ministry, as the case maybe, has already decided the question that is the subject of the application in the following:

(1) a notice of a tax assessment served on the taxpayer;

(2) a public ruling made under Article 69 of this Proclamation that is in force;

(3) A private ruling published under Article 75 of this Proclamation that is in force.

b) the application relates to a question that is the subject of a tax audit in relation to the taxpayer, an objection filed by the taxpayer, or an application by the taxpayer under Article 29 of this Proclamation for an amendment to a self-assessment;

c) the application is frivolous or vexatious;

d) the transaction to which the application relates has not been carried out and there are reasonable grounds to believe that the transaction will not be carried out;

e) the tax payer has not provided the Ministry with sufficient information to make a private ruling;

f) in the opinion of the Ministry, it would be unreasonable to comply with the application, having regard to the resources needed to comply with the application and any other matters the Ministry considers relevant;

g) The making of the ruling involves the application of a tax avoidance provision.

A person cannot apply for a private ruling to litigate a tax assessment notice. If he/she has already received a tax assessment notice, the only option is to follow the normal dispute settlement procedure which is applying to the review department, and then to tax appeal commission up to the cassation bench. The other thing is that we cannot apply for an advance ruling with respect to a question that is subject to a tax audit. If we are being audited, for example, we cannot go to the ministry of finance and appeal for ruling on the process. The tax audit follows its own distinct procedure. The result of tax auditing is tax assessment notice. So, it is not possible to subvert the tax auditing process on the basis of advance ruling system.

“If the application is frivolous or vexations/”... there should be seriousness to the question that we ask. Example: “I’m an investor from France and I was visiting Lalibela. I loved this country and I want to invest in Ethiopia. Please, tell me how much the Vat rate is”. Sometimes,

international investors ask some general jurisdictional questions like what the corporate tax rate? What is the base? What types of expenses are reductible Etc. this is another ground for the authority to reject response. Because, those things are provided in the laws.

Once they are properly issued, private rulings can be used by third parties. There was a case between one of the powerful companies in Ethiopia and the tax assessment authorities. This powerful company had had a tax assessment. The tax assessment was based on the rejection of the expense that this company incurred for its football club. The company went to the authorities and the ministry of finance and got mabrariya (the clarification) which made the football club necessary. When the company was back to the auditors, the auditors were angry at the disclosure of the rulings asked how the company did have ascertained the ruling that they thought to be confidential. Taxation is a public tool. Therefore, any service should be available for all concerned and entitled parties. The other kind of rule that we find in the Ethiopian tax system is the so-called 'administrative manuals'. Administrative manuals or guides are documents important sources of information about a tax administration. But, they are also source of legal practice. We can identify three categories of administrative manuals.

1. Internal manuals. These are manuals that are prepared for officers of tax administration and regulate how the officers' conduct tax administration. So, tax assessment procedures, auditing manuals, customs procedures Etc. some of them. It is undesirable to underestimate the role of internal manuals in the tax administration. Because, they are set of rules that regulate the relationship between the tax administration and the tax payers. For example, we don't find auditing rules in the major laws we have already stated. Thus, some vital questions like what sort of procedures that the auditors should follow? What kind of informations should an auditor request? what are the obligations of the tax payers when they are being audited? Do the tax payers have the right to ask questions at the end of the investigation? Etc.

Auditing is one of the areas where the rights of the tax payers are violated. Because, it is not properly regulated and it is governed by such internal manuals which are not available to the tax payers. For example, in the course of an audit process, the auditor is required to hold what is called an exit conference. Exit conference is a meeting between investigative auditors and the tax payers regarding the findings of the auditor. The problem is, however, we don't find such rights in the major laws. That is why [I] regard them as "internal manuals". Now, the question is,

whether we can cite these internal manuals against an auditor who has not afforded us the right for an exit conference. Sometimes, the auditors may conduct an exit conference without giving the opportunity for the tax payer to be heard.

The second type of administrative manuals is the so-called external manuals. These are tax payer guides. They are characterized as 'external' because they are used by tax payers. They are prepared for the instruction, education and the literacy of the tax payers. The principal tax legislations may be complex for the ordinary tax payers. Therefore, in order to have effective and efficient tax administration, it is imperative to inculcate the tax payers in a way they can simply follow complex procedures like Vat which is new and alien to our system. It is also a mistake to despise such documents; because, they contain some statements which are really statements of law. However, it is puzzling to what extent can the tax payers rely upon external manuals during compliance. When these manuals are carefully prepared, there is a disclaimer at the beginning. The disclaimer says: "this manual is only for information purposes. Please, do not rely upon it. In case of doubt, consult your lawyer or accountant".

The third kind of manual which is somehow similar to the second category is the so-called instructional manuals. Instructional manuals are issued on ad hoc basis for training purposes. It is prepared by the tax authorities to instruct their workers. But, these are also important sources of law. So, these are additional source or law which not visible to the tax law by simply reading the major legislations. The other source of law is notices (mastawekiyawoch). Notices are obligatory notifications. The other one is a tax form. There are so many tax forms that we have to fill particularly if we are subject to assessment. Forms could be employment income tax, corporate tax, customs, or it may be Vat. These forms are necessary for they help the tax payer arrive at the amount of tax that he/she has to pay. The problem with these forms is that they are prepared haphazardly or generated internally. For some tax payers, the form is the only piece of tax legislation that they ever get to read. The form may not be consistent with the law and may not include all informations that necessary for the tax payer to make proper computation of the ta.

Lecture 9-october20, 2019.

Today, I want to discuss the tax administration in a nutshell. We will be observing a skeleton of proclamation no. 983. We have already referred to some issues in this proclamation; so, we will

not delve deep in to each specific crux of the proclamation. As we have observed in our previous sessions, this proclamation is a tax administration law of Ethiopia. It is procedural law specific to tax administration law. As far as the scope is concerned, this tax administration law applies to all federal laws except customs. So, this is like "Ethiopian tax procedure law". Somebody said that as far as the country like Ethiopia is concerned, tax administration is tax policy. This is very imperative suggestion. Because, all principles of taxation that we have been discussing so far were reduced in to this single administration law (proclamation no. 983/2016).

Without such comprehensive tax administration law, all thoughtful ideals that we have talked about economic policy, general theories in taxation Etc. are of academic interest and metaphysical until it is reduced in such an important area of law. All types of domestic taxes have been subsumed in to this law so that it became a common tax administration law for all. But, note must be taken that this does not mean that all tax administration laws are here; there are separate tax administration laws in each area of law. Tax administration laws which are specific to income tax, for example, are found in this law. The same is true with excise duties, and other types of taxes. But, the common tax administration issues are covered in this law.

The proclamation contains about 139 articles divided in to 16 parts. For easier method of reading, it is important to classify it in two major parts. One is temporal organization of tax administration. By "temporal organization", [I'm] referring to rules of administration and procedure that regulate taxation from the beginning to the end in a temporal sense. Under this procedural organization in terms of time, we have identification of tax payers, books and records, returns, assessments, enforcement, collection of recovery, credit refund, waiver (release from tax liability),.

Rules of identification is primarily about initial procedures of the tax payers like tax identification number, vat registration number and that sort of things. This is where taxation starts. Once identified as tax payers, tax payers keep books and records with themselves which can be business tax, corporate tax, employment income tax, Vat Etc.; books of records may include receipts, vouchers, contracts and other similar sort of things. The next procedure after identification process is return or declaration. The tax payers declare to the authorities their income, their sales, expenses Etc. depending on the type of the tax. After returns come assessments. There are different types of assessments; [I] will focus some of them because they

require special attention. Assessment is calculation or computation of tax. The types of assessment include self-assessment, estimated assessment, jeopardy assessment Etc.

Collection, recovery and enforcement are the next procedures. Mostly, tax payers pay voluntarily; but there are also involuntary systems against none-compliant tax payers. Then, we have credit; for example, in the cases of Vat, there may be situations where the tax payer pays more than what they ought to pay. So, the tax administration need to have a procedure for a refund and waiver whereby in some circumstances, even though they owe a government a debt in the form of tax, interests and payments, the tax payers can ask for release from tax liability.

The second part of the proclamation contains common provisions. This includes the following:

1. Definitions.

2. Rules about rules and tax administration.

3. Communications (forms, notices Etc.

4. Rules about collection of informations.

5. Rulings

6. Tax dispute ssettlement.

7. Licensing of tax agents.

8. Administrative as well as criminal penalties and rewards.

9. Tax offences.

10. Miscellaneous provisions.

So, under the temporal organization of this proclamation, the procedures are given in the following sequential order. Tax identification registration in articles9 -16, books and records-arts. 17-20, returns-arts. 21-24, assessments-arts. 25-29, enforcement, collection and recovery-arts. 30-48, credit refund-arts. 49-51. this is if and only if taxation is properly administered and fully complied with. Remember: the requirements of books and records may vary from one tax law to another. The books and records that we keep for Vat may differ from those we keep for corporate income tax purposes. Even within corporate income taxes, there are variations among different categories of tax payers.

At the beginning, definitions are common in every proclamation. Arts. 2-4 of this proclamation contain rules about tax administration laws. In addition, communications (forms and notices) are found in arts. 77-85, information collection-arts. 61-67, advance rulings-arts. 68-76, dispute settlement provisions arts. 52-60 and arts. 86-94, licensing of tax agents-arts. 95-99, administrative as well as criminal penalties and rewards-arts. 100-115, tax offences-arts. 116-133, miscellaneous provisions-arts. 136-139. there is also separate chapter dealing with rewards for verifiable informations of tax evasion –arts. 134-135.

The other thing is this tax administration does not actually regulate the institutions that are involved in tax administration. So, we need to make reference to other laws. For example, there was a proclamation issued back in 2008; it is also instructive to look at the proclamations that provide the powers of the executive organs. The tax administration widely deals with the involvement of institutions including the tax appeal commission and the powers of ministry of revenues are not necessarily found in such tax administration law. It is also equally important to note that there are some other rules outside the tax administration law. One very good example is auditing. Although it appears to be one major area that affecting the tax administration, auditing is not included in this proclamation.

Assessments.

Before assessment, there are other things like investigation and auditing that come first. Assessment is the conclusion of identification, books and records and returns. It is a determination of the amount of tax that we have to pay. The major tax assessment form that Ethiopia is supposed to follow is the system of 'self-assessment'. According to this system, whoever prepares returns and keeps books and records also assesses his tax by himself. The tax administration usually accepts such assessment at face value. This is considered desirable because the tax authority cannot assess taxes at individual basis. Throughout the developed world, the policy of self-assessment is widely implemented with the assistance of significant technological mechanisms. In such countries, the role of the tax administration is to correct some errors that may come from individual tax payers.

This applies to most taxes including corporate income taxes, Dividend tax, withholding tax, payroll tax, Vat, Excise tax Etc. However, it doesn't apply to customs. With respect to customs, official assessment prevails; it is determined by the tax administration. Custom tax is separately treated for administrative purposes. Now, the question is: why is custom is treated differently? Custom is different in the sense that it is based on control of movement of goods. So, the procedures, valuation methods, the clearance forms, the examination of the goods and so on are peculiar in their nature. Thus, custom tax is governed by separate law called customs proclamation. That is why the tax administration law says: "this proclamation applies to all taxes except customs". Self-assessment is not a final assessment; it only means that a tax payer bears a burden of assessment. If a tax payer makes a mistake, he is responsible to correct them according to tax administration law. If he overpays, he has nobody to blame other than himself. But, if he underpays, the tax authority has enough time to come after him. The period of limitation in this case is usually 5 years. The main advantage of self-assessment is that it shortens the period of limitation from forever to 5 years.

. If the tax payer fails to declare his self-assessment on time, the tax authority has unlimited period of time to come after him. In this way, the individual tax payer would be in a state of permanent anxiety. But, beware: even after a tax payer has self-assessed, if the tax authority has reason to believe that a tax payer has committed fraud or concealed his income, it can still trigger that unlimited period of time against him. The other form of assessment is 'estimated

assessment'. Art. 26 (1) of the tax administration proclamation, proclamation no. 983 reads: "When a taxpayer has failed to file a tax declaration for a tax period as required under a tax law, the Authority may, based on such evidence as may be available and at any time, make an assessment (referred to as a "estimated assessment")".

This is so much abused subject of the tax system; because, it says, "when the tax payer has failed to make self-assessment". It doesn't indicate any other condition. Hence, the tax authorities use self-assessment whenever they are suspicious about the tax payer. Basically, this 'estimated assessment' has changed in to an abusive instrument to apply presumptive assessment. So, this is a subject which is commonly litigated within the dispute settlement courts. It is controversial that what constitutes estimated assessment and in what circumstance is it legitimate for the tax authority to resort to it. For example, in case of customs valuation, when goods pass through the customs offices, the importer declares the value of those goods. But, the customs authority automatically rejects it because they believed that it is "under-invoiced". 'under-invoice' means, the value that is declared on the customs commercial invoice is not actual value of that good.

For instance, the suspicion of the authorities is that the importer may declare a value of a car to be 100,000 Birr where the actual amount is 200,000 Birr. The problem is, the importer might have sold the car for 150,000 Birr. In this case, the importer will suffer a severe loss since he paid greater than the profit of his sale. There are suppliers having long standing customers. Companies like Coca kola, Pepsi Etc. have some customers that provide with them corks, bottles and other materials. In such cases, they operate with predetermined price for 5 years which cannot be varied. It is not economically feasible for such suppliers to operate with the market price since the buyers can prefer other suitable suppliers. So, in order to lock the price, they usually supply certain inputs at a fixed price. The amount of a fixed price for which they supply in the supermarket differs from temporarily negotiable prices; because, the supermarket is their regular customer. They negotiate with lowest price to avoid the circumstance where the tax auditor may vary it by considering the presumptive market price.

The third form of assessment is 'amended assessment'. Both the tax payer and the tax authority have the right to amend a self-assessment return. If there is anything that the tax payer has discovered subsequent to the submission of his self-assessment return, he has the right to amend it. An estimated tax assessment should be limited to those who have not filed their return though

the practice is to the contrary. It must be noted that it is called “estimated” because there is no return or information submitted or filed by the tax payer to the authority. Where there is information, it should fall under amended assessment. The kind of assessment is ‘jeopardy assessment’. Jeopardy assessment is a preemptive assessment where the tax authority can determines, for one reason or another that the tax payers are unlikely to comply with their tax obligation. This is the case when some individuals may escape to avoid taxation. There are legitimate circumstances when jeopardy assessment can be conducted by the authority.

There are other forms of assessments that can be implied from the tax administration law. Reduced and increased assessments: reduced assessment is made when the tax payer appeals to deduce his tax liability and the increased assessment is part of amended assessment. The other form is ‘agreed assessment’. There are situation in which the tax authority and the tax payer can agree that the amount of the tax payer owes is much. The agreement does not only include the amount of tax owed, but also the penalty that is sought to be reduced, the installment payment scheme (the extension of due date of payment) Etc. The tax authority has also the right to withdraw assessment. As we can observe from our proceeding discussion on forms of assessment, there is one important thing that has not been properly stated; which is the tax auditing procedure.

Lecture 10-october 23, 2019.

Last time, we were discussing about tax auditing. The area of auditing is the area of the tax administration where we need more official transparent laws. Auditing is subsumed in the so-called administrative manuals that we have discussed in earlier sessions while discussing the Ethiopian tax system. There are so many kinds of auditing that are only found in such internal administrative documents. They are available only with the tax authorities being far from official publicity, which is the initial requirement for any document to have a binding effect upon the citizens. Now, we will observe some of these forms of tax audit.

In practice, we find different types of auditing which are subsumed under the process of assessment including comprehensive auditing, issue auditing, desk auditing, advisory visit audit, special audit, refund audit, investigation, and De-registration audit. Comprehensive audit is an auditing which is supposed to involve all kinds of taxes; that is why it is called “comprehensive”.

Comprehensive audit is typically conducted against the tax payers every 5 years. Thus, it is a 5 tax years. For example, if a company has been audited in 2014, the next auditing year would obviously be this year (2019). The tax authority scrupulously investigates the whole documents of 5 years regarding the tax assessment of the company. In case it finds any assessment that has not been declared by the company, it will automatically launch an amended assessment. So, two main elements contribute to its comprehensive nature, first, it involves multiple tax years; and, it involves multiple taxes.

Remember: it is not every company that goes through the auditing process; because, the tax authority has its own internal risk-assessment on the basis which it decides to conduct any audit against the company. Issue audit, as the name itself indicates, is related to a specific issue. For example, it can be the issue about whether the capital gains tax is due or, it can be about a loss that a company has reported. In practice, whenever companies report losses, they are generally suspects. Because, it is assumed that they tend to exaggerate their losses so that they fall under such suspicion which typically means that the authority conducts an issue audit. Both forms of auditing require visits to the tax payers' premises in order to do the investigation. Otherwise, the tax payer may be ordered to surrender all relevant financial documents to the tax authority. As a result, it might take a time. Particularly, comprehensive auditing may require about 6 months. But, the issue audit is very small form of audit so that it doesn't take that long.

Desk audit is an audit whereby the tax authority may not necessarily need to go to the tax payer's premise. Instead, it simply analyzes all financial informations that the tax payer submits. For example, let's say, a company has made a taxable income of 1000,000 Birr in which it pays 300,000 Birr in corporate income tax. The company has failed to pay dividend tax which is 10 percent. Now, there are certain circumstances under which the dividend tax is due even when the company has chosen not to distribute profits. Based simply on the desktop assessment of the returns of this company, the tax authority may conclude that the Dividend tax is due.

But, it must be borne in mind that the tax authorities may commit mistakes when they merely rely upon such desktop informations. Because, they don't inquire as to why certain company has not withheld dividend tax. There was a company which failed to declare dividends. The tax authority erroneously assumed that the company failed to declare due to its reluctance. But, the actual fact was that the company could have declared dividend under the commercial code.

There is one provision which dictates that companies which have losses may not distribute dividends until they replenish their losses. Advisory audit is triggered by the tax payer. Let's say company called ABC is being considered for a takeover by another company called DEf. Accordingly, company DEF needs to get assurance before taking over company ABC whether company ABC owes a tax or not.

So, company ABC might ask the tax authority for an advisory audit in order to give assurance to third acquirer that company ABC has clean tax slate. However, this does not mean that the authority has to conduct an advisory audit whenever it might be asked. The other form of audit is special audit projects. Special audit is conducted in the event when the tax authority gets any credible information against specific category of tax payers or specific sector. This is what is termed in Amharic as "ye zemecha odit". Refund audit typically arises usually in Vat. When a company requests for a huge vat refund, it triggers an audit against the company. There is a directive which provides if the Vat refund request exceeds a determined amount, an audit should be conducted.

Investigation audit is, on the other hand, a criminal auditing process when there is a credible information about criminal activities like money laundering, concealment of income, tax evasion Etc. The result may be both amended assessment and criminal prosecution that may entail punishment. The other kind of audit is de-registration audit. This type of audit is conducted when a business person or organization exits the business in order to get tax clearance and hence be de-registered. Lawyers are not involved in the auditing process until the assessment notice is received. Auditing is the area where many issues arise. These various forms of audit are not articulated in the official laws. The internal manuals in which they are found are not available to the tax payers so that they are not well-protected in the conduct of any of these auditing processes.

For instance, the tax payers may be required to submit all relevant and original documents. But, the problem is that such documents may be lost. It is questionable that how much right do the tax payers have for an explanation of how the process works. So, the process of auditing may result in different between the tax payers and the tax authority. For example, when the tax payers are interrogated or interviewed by the authority, they have no ample information as to what is the proper thing they have to say before the interrogators.

Tax dispute settlement.

Dispute settlement is one major area where the tax administration law has made significant changes. Auditing is part of dispute. Tax dispute is often referred to as post-audit process. But, it is wrong expression as auditing itself is part of dispute settlement. Unlike many lawyers tend to think, dispute starts at the time of formation of a contract or every negotiations between parties which occurs before a court proceeding. Thus, tax disputes arise when the tax payer is registered. For example, there is another type of audit that we didn't discuss earlier which is called compliance audit before dispute settlement. Compliance audit is an audit which conducted by the tax payer before the main audit to be made by the authority. But, compliance audit does not eliminate all kinds of disputes; but it minimizes it the chances of receiving an amended assessment.

If we observe arts. 52-60 of proclamation no. 983, dispute is considered as the right to object. This objection is to be the review committee or the department after receiving tax assessment notice. The members of the review committee are internally organized because its members are entirely comprised of the tax administration office. Although it is not independent organ, it gives the tax payers opportunity to have their assessment reviewed by a separate unit of the tax administration. The tax payer have the right to submit any question of law or question of facts regard the tax auditing process. The review committee works pretty much like a regular court. After the review committee, the tax payer may take his/her case to the tax appeal commission. The power of tax appeal commission is regulated under arts. 86-94 of the proclamation. The commission has existed for a long time in the Ethiopian tax administration history. But, in 2016, the independence and impartiality of the commission has been somehow enhanced.

It became an administrative tribunal which is separate from the tax administration office. It is organized under the supervision of the prime minister's office and the members are appointed by the prime minister. They are independent in the sense that they cannot be recruited from the tax administration itself. So, any person who has served in the tax administration office for the last two years cannot serve as a member of the tax appeal commission. The rationale behind this prohibition is to maintain the impartiality of the commission. If the individuals who have been serving in the administrative for last two years are allowed to take part in the adjudication of the

commission, they may face pending dispute that they have adjudicated while they were in the tax administration.

The tax appeal commission is a high breed tribunal. Because, the members should comprise accountants and lawyers. The job of the commission does also include the question of accounting. So, familiarity with accounting and auditing principles is as important as familiarity with the tax law. As stated earlier, in the tax administration law, the tax appeal commission is accountable to the prime minister. Under the proclamation that regulates the powers and responsibilities of the executive organs, there is a provision which states that the commission is accountable to the office of attorney general. Prior to 2016, the commission was under the supervision of the attorney general. Consequently, the drafters of the proclamation thought that the commission was still part of the office. This is a typical example where a conventional principle that dictates later laws prevail over the general laws is unhelpful. One of the defects of the prior law was this provision which makes the commission part of the executive organ.

The other contentious point prior to 2016 was the issue of condition to appeal to the commission. There was a rule that unlike a review committee, a tax payer who wishes to appeal to the tax appeal commission must post 50 percent of the tax assessed. Now, in case of review committee, this rule has been removed so that anyone can appeal without any prior payment. The payment prior to 2016 met tax+ interest+ payment. However, under the 2016 tax administration law, this 50 percent only applies to the tax not to interest and payment. But, this is also not without problem. Some people complain that this amount of payment can still prevent many tax payers from appealing to the commission particularly in cases of huge and unanticipated taxes. Previously, the right of appeal hinges on assessment. But, this right of appeal hinges on what is known as ‘tax decision’. Tax decision is much broader than tax assessment.

For example, if a tax payer has requested a refund, there will be no assessment against him. With regard to the posting requirement to be heard before the tax appeal commission, it is better for the tax payers if they pay 75 percent of what they have paid for three years or 100 percent of what they paid last year. In most cases, the review committee remands the cases to the administration. For example, if the tax payer claims that any document to be investigated, the review committee will simply remand it with order to reinvestigate the alleged document. So, after the review committee, the tax payer may face another tax assessment notice. This creates

another problem; because, it opens up to corruption. The remand process puts the tax payers back at the mercy of the auditor who was already responsible to their problem.

Lecture 11-october 25, 2019.

Last time, we were discussing about dispute settlement procedure. We have said that one dangerous procedure of the tax appeal commission is remanding. First of all, when we remand the case, there should be a system of reporting back. Remember: taxation is public money. So, we should not allow private parties to negotiate between them with this public money. For example, nobody is going to check if the tax administration decides as: "instead of 50000,000, we have decided that the tax payer owes only 5 million." There is no scrutiny as to how did the authority reduce 50 million tax to 5 million birr. The remand should have some kind of checking mechanism so that the tax appeal commission will reassess what the parties have decided.

In fact, the auditors know this gap and manipulate it for to negotiate over the public money. This happens even more frequently within the review committee. The tax administration law says that the decisions of the committee are not actual decisions but recommendations. When we say the tax payer should pay 50 percent of the tax to appeal to the tax commission, we are talking about the 50 percent of the disputed tax. If the tax payer admits that the other tax is properly assessed, he/she has to pay 100 percent. Thus, the tax payer needs to identify what he/she is disputing whether the whole or part of the tax assessed. In some instances, the tax payer may better be advised to pay 100 percent of the tax assessed to stop the flowing interest. Particularly, this is very crucial strategy in case the chance of winning is at stake. If the commission confirms the decision, the tax payer will be obliged to pay 100 percent including the interest; because, the interest does not stop while the tax payer is appealing.

Remember, the interest rate is extremely high. Currently, the law says, 50 percent above the highest prevailing bank rate. So, if the highest prevailing bank rate is 70 percent, for example, the interest can run up to 20 percent. So, even if the minimum requirement is up to 50 percent, sometimes, it is economically better to pay for the tax payer and still dispute it. This is called "an appeal on protest". In case the tax payer has a good relationship with the bank, he/she may raise the loan up to 16 percent and save the remaining 4 percent of the interest rate.

The interest and the penalty may be three times the tax. Prudential judgment is required in such circumstances to save the bleeding economy of the tax payer. So, the lawyers are expected to give a proper advice to their clients. Note must be taken that the spent interest will not be refunded back. The other important point is the behavior of the institutions. The decisions of the tax appeal commission are not binding. However, it is crucial to read them in order to understand how the commission makes decisions. These decisions have some regular and uniform pattern which is professionally worth studying. "Sometimes, when wrongness is repeated enough times, it becomes law". The lawyers should tell such "repeated wrongness" to their clients even if they disagree.

Income tax.

"In Ethiopia, we don't have income tax; what we have is 'income taxes'". Before we talk about the nature of the Ethiopian income tax system, it is imperative to discuss about design of income taxation. If you remember, in our general discussion about taxes, we have said that the preference for some taxes than others is based on the tax policy. Not all taxes are equal; but some other taxes are equal than others. Because, some taxes are preferable than others. If a given country has to choose its taxes, it prioritizes its fundamental tax policy principles like equity and revenue. In respect of equity, over the 20-first century, many writers agree that income tax is preferable than other taxes. Income tax became most preferable over the 20-first century largely because of its economic and moral justifications. Income was initially defined by the American economist Henry Simons as "algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of property rights between the beginning and end of the period in question".

In the most ideal world which has never existed, income tax can only be assessed after death. The tax payer's ability to pay cannot be gaged until his/her death. So, we can only have the life income tax assessment. A period for the tax purpose is either a month or a year. Otherwise, if we follow the definition of Simons to its logical conclusion, it means that the government has to wait until a person dies to assess an income tax against him. If the government is authorized to do so, it will kill individuals when it is desperate for money. So, in a pragmatic world, when we talk about income taxation, we are referring to very small chunk of time which is a year or sometimes less than a year. There are few cases in which actual tax systems look at an

accounting period longer than a year. In some countries, such accounting period is for only those who are high income earning professionals whose shelf life on income generation is very short.

For example, athletes, actors, modalists Etc. Basically, every economic gain made by individual is considered as income. For instance, if a person grows vegetables in his backyard for his own consumption, it is regarded as an income. Besides, we are a lawyer so that in many instances, we don't seek the advice of another lawyer on legal matters. Thus, we enter in to contracts and other juridical acts having legal consequences without any assistance of a third party. This self-produced service is considered as income. Any durable good that we own generates income. If a person has a house, the rental value of that house is an income. This is called 'imputed income'.

When we own a house, we save the rental cost that we would have paid hadn't it been our own. This is a very good definition for achieving ideals of the ability to pay. Because, the person's ability to pay shouldn't be judged simply how much cash they have generated from their work, but also how much self-service they provide to themselves. However, if this is to be reduced in to a practice, it becomes challenging. Thus, conceptually, the idea of income is broad. In taxation, it is not simple task to ensure equality in the best possible. If we buy a house, it appreciates in value. Even if it is not sold, this appreciation is income. This is what is indicated in the forgoing definition as "change in value of the property".

There are two values in the house which can be considered as income. First, there is rental (imputed) income. Second, there is also a hidden income which is the appreciation of the house. Metaphorically, the tree grows and bears a fruits. The growth of the tree by itself is income. Further, the gain from the fruits is an imputed income. The tax system is so deficient in its tools of valuation of certain kinds of income that it cannot possibly reach some types of income including in kind benefits, imputed incomes, self-produced goods Etc. the actual income tax is based on one fundamental premise which is the concept of 'realization'. For example, if a person holds a house for an indefinite period of time, it is difficult to assess tax against that person as long as he holds on to that house. In this case, taxation starts when the house is sold. The question is: why are tax systems ambivalent about achieving this?

With a view to overcoming this real problem of valuation, we have proxy in kind payment valuation system. For instance, if a person has a house, that is how much the house means in

terms of income. But, in many instances, the income tax completely disregards that we have gained income. Even though it is known in the market that the house in which we live appreciates in value every year, no tax system actually assesses tax on the basis of such imputed appreciation of the house in the market. Some types of income are realized recurrently; for example, wages, business income, rental income Etc. some other types of income are irregular; for example, if we sell our capital asset like house, it will be subject to capital gains tax which is a species of income taxation.

We have four income tax models: comprehensive income tax model (which is based on the definition of Henry Simon's), scheduler income tax, flat income tax and expenditure income tax. Comprehensive income tax model is also called 'global income tax model'. It tries to aggregate the income of the individual regardless of the differences in the origin of that income. All of income is aggregated and a person is assessed one tax.

Lecture 12-November4, 2019.

Last time, we have started to discuss about income tax models. Scheduler income tax system can be divided in to two; dual and semi-structured income tax system. Global or comprehensive income tax model is followed by Australia, United States of America, and Canada Etc. On the other hand, Scandinavian countries subscribe to dual scheduler income tax model. Germany, Japan and Ethiopia fall in to the category of semi-structured scheduler income tax model. Flat income tax model is favored by east European whereas no country follows the expenditure income tax model.

According to comprehensive income tax model, the proper unit of tax should be individual citizen; not the source of income. This assertion is based on the notion that the income tax should be able to measure or to gage the ability of a person to pay. A person may get income from employment, business activities, professional activities, rental of property, writing of books, owning share in company Etc.; all of that income should aggregate together and an individual is supposed to pay one tax. In the United States, with some exceptions, the income tax is individual in the sense that a person is expected to report his all sources of income. So, the tax liability of the individual is based on aggregate income. The sources are important for administrative withholding purposes. The concept of ability that we talked at the beginning of this course makes

sense philosophically only if we take individual in to account; sources of our income do not have ability. Concepts like “consumption”, “saving” Etc. are human concepts.

No other being actually feels the concept of income. For example, what will happen if we give money to a cow or other animal? What will be its reaction? Just as we have a fiction called corporation, we also have a fiction in tax called corporate income tax. The fictitious nature of corporation (their legal personality) led to fictitious income tax. There is a consensus in the ambit of constitutional law that corporations do not vote. Of course, the corporations don’t go to the ballot stations; however, they can vote with money. Corporate income tax constitute very huge amount of taxation in many countries. However, to measure the ability of the tax payers to pay, the only way is from the individual perspective. There is no such thing called “the ability of a corporation to pay tax”. Because, it does not have pain and pleasure in the utilitarian sense. So, in comprehensive income tax model, individual is the only unit.

Countries following comprehensive income tax model may have some scheduler elements. But, they have gone as far as they can in designing income taxes on the basis of the individual. The individual may be a family member, single, married Etc.; all this factors are taken in to account where the individual is made the central unit of taxation. In countries like the United States, when an individual files an income tax return, the above factors are duly considered. So there are joint filing structures. If a person is married, for example, it is assumed that they (the spouses) share costs in our tax system; the tax payer is asked whether he/she is employed, a property owner, business person Etc as a matter of administrative feasibility.

Nevertheless, this is a theoretical experiment; in real practice, in a country like Ethiopia, it makes things extremely difficult since it requires high administrative efficiency. Comprehensive income tax model is appropriate only for the most developed and sophisticated income tax systems in the world. In countries like France, there is a family income. There are certain families whose siblings earn income. In such jurisdictions, those individuals are also contained in the same pot. Economists suggest that comprehensive income tax model is not achievable at all. The most wide spread income tax model is scheduler. Scheduler income tax systems are based on segregation of different sources of income. Income may be generated from employment, business, rental of property, investment, interest, royalties, dividends Etc. when the income tax

system administration is structured along these different sources of income, it is called ‘scheduler system’.

As mentioned earlier, there are two models of schedulers. One is dual scheduler which is followed by the Scandinavian countries. These countries have divided the sources of income in to two. One is ‘active income’ and the other is ‘passive income’ (the investment income). Active income consists of income generated from work like employment, business or any other income generated by ‘doing something’. “When income is generated from income, it is passive income”. For example, interest is passive income; because, it is generated from another income. Dividend is another example of passive income. Essentially, dual scheduler is based on the idea that the income should be divided in to two parts. The active income is usually subject to progressive income tax; whereas, the passive income is subject to a flat proportionate income tax rate. It is very often experienced in the north European countries.

Semi-structured scheduler income tax model is ‘semi-structured’ in the sense that it can consist as many source of income as income tax can segregate different sources of income. So, it can have 7 schedules, 4 or 5 schedules depending on the sources of income. This is where Ethiopia belongs. Ever since Ethiopia introduced the modern income tax, it had always scheduler income tax model. Therefore, when we speak of the Ethiopian income tax system, we must remember that we are basically referring to “income taxes”. “Our income tax administration is based on sources; the individual is rarely taken in to account although we pretend as If the individual matters”. So, there are multiple sources of income taxes; for example, employment income tax (schedule A), business income tax (schedule B), property income tax (schedule C), miscellaneous income tax (schedule D) Etc. “the Ethiopian tax system is more preoccupied with administration than with equity.”. In the case of employment income tax, for example, we employ withholding income taxation. Employees rarely report tax to the tax authority. It is justified; because, we cannot afford to look at each individual. Imagine; if every individual is required to submit income tax return every year, it would be completely overlapping to the tax system. The tax administration would not be able to handle this kind of massive tax file by every individual.

Most of the taxes in Ethiopia are collected by intermediaries or through withholding schemes like employers instead of employees. Due to limited administrative resource, it is only traders

who directly submit their tax reports to the authority. In Ethiopia, even in employment income tax, the only thing that is taken in to consideration is the salary of individuals. It is immaterial whether a person has 20 kids or 10 kids; married or not married. The same is true with the other kinds of taxes. The flat tax model is the east European income model. It was developed in the US by the American academics; but of course, the American academics were not able to influence the US tax system to introduce a flat tax model. So, they went to countries where these kinds of theoretical models are easily implemented; which is east European country. The east European countries including Russia followed this model. In flat income tax model, all sources of income are subject to the same tax rate. There is no progressivity in the tax system whether it is employment tax, dividend Etc.; for example, if the tax rate is 20, every kind of tax is subject to the same rate.

This is important partly because it makes the tax administration extremely easy to execute. In flat income tax model, there is no worry about the source. All we do is we apply 5 percent on the source. When we say 'source', there might be some variation on the expenses that we incur. In some cases, the rate falls on the gross income; it may fall on the net in other cases. Expenditure model: expenditure is explained as consumption is income minus saving. So, it is a variation of the income tax except that the tax burden falls only on consumption, not on saving. No country has ever employed the expenditure tax in its direct form. We have indirect expenditure taxes like Vat. But, it is very popular model among some economists who believe that the income tax has efficiency cost on saving and investment. They suggest that we apply income tax not only on consumption; but also for saving. When we have saving, saving itself generates another income so that it is subject to tax. So, whenever we save, according to their argument, there should not be tax; tax must not fall until we consume since our ability is expressed only in consumption.

The Ethiopian income tax system.

As mentioned earlier, the Ethiopian tax system consists of several income tax systems. It follows the scheduler income tax model. Currently, we have 5 schedules: employment tax (schedule A), rental of buildings (B), business and professional activities (schedule C), miscellaneous income taxes (schedule D) and, the exempt tax (schedule E) which has been added in the recent income tax proclamation, proclamation no. 979/2016. We have other income taxes. Agricultural income tax: it is income taxes imposed on farmers under the regional states' domain. Prior to 2016, there

were separate income taxes; for example, mining, petroleum and gas income tax (which are now part of schedule C). There are also municipality income taxes. In Ethiopia, when tax laws are issued, they are issued as if the country is a unitary country. “We have a common law system which is not really common law in common sense. When the federal government issues the federal tax laws, it issues on all sources”. Under the Ethiopian constitution, all of these sources are federal, regional or concurrent taxes except agricultural income taxes. Agricultural income tax on farmers is the only income tax which is the exclusive domain of the regions.

In most cases, the regions replicate the laws of the federal government. If we look at the regional income taxes, the same kind of source is mentioned which is sometimes very embarrassing to mention. “Some of the regions might even repeat the signature of the president and the end”. For example, if you look at the preambles of the regional income taxes, it say: “whereas, the economic policy of the federal democratic republic—“they don’t bother to customize their own laws. In terms of legislations, we have very interesting jurisprudence which is that “the federal government proposes, the federal government disposes and the regions also dispose”. The regions have no legislative trend to reinvent their own law based on the constitution. Anyway, the Ethiopian income tax system, (at least the federal one), consists of 5 schedules. But, it is essentially 4; because, the 5th schedule is about the different exempt income for organizational purpose.

In terms of sources, however, we can go up to 17-18 schedules. The fourth schedule (schedule D) is very misleading. It consists of miscellaneous income. Under this miscellaneous income, we have several sources of income which are separately administered. For example, dividends, interests, royalties; even among dividends we have repatriated dividends, undistributed dividends, insurance premium, income from entertainment, income from airline activities Etc. so, when we talk about Ethiopian tax system, we are referring to a collection of these different income taxes. Each of them has separate rules of administration. Agricultural income tax is the area where the regions relatively exercise their power. There are variations among the regions; because, there is no federal agricultural income tax law from which the regions can take so that they could not copy and pest which means it encourages some kind of innovation. The other type of income tax is municipality. This is an area where the urban tax terrain is not sufficiently explored. Municipalities have their own autonomous systems of taxation.

rrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrrgygygygygygygygygygygygygygygygygygygygyWhether we call it taxation or system of fees or not is another question altogether; but they have their own business and professional taxes which are proxies for income taxation.

So, it is important to remember that municipalities have particularly the major municipalities (like Addis Ababa) have their own independent income taxes in addition to the federal income tax. Legal double taxation is different from economic double taxation; the former arises only when the law explicitly provides that there is double taxation. For example, there is corporate income tax and dividend tax which is paid additionally. Several economists argue that dividend is double taxation. With respect to municipality taxes, the municipalities argue that their tax is separate in the sense that it is not the federal tax laws that require paying professional and business taxes; it is the municipality laws.

The existence of multiple sources of taxation usually creates the problem of overlap of basis. The basic premise of a scheduler income tax system is the principle of 'mutual exclusivity of bases'. Mutual exclusivity means, it should be determined as to when income falls under A or B or C and D. because, there may be frequent conflict between different categories. The problem is, there is no rule in the income tax laws which say double taxation is illegal. But, we can infer from the given structure that only one of the schedules should apply to a certain source of income. The reason why the income tax law segregates income in to separate bases is that it assumes all kinds of income in the world to fall under one and not the other income tax basis. Thus, once we have determined the income falls under schedule A, it means that we cannot impose schedule C up on same income or vice versa.

However, because of the real differences in assessment, tax rates or time, the practice is different from this theoretical construct. For example, in our case, what is the difference between Schedule a (income from employment) and schedule C (income from business and professional activities)? How do we determine whether an income is from employment or from business and professional activities? When do we say, for example, a person is self-employee or an independent contractor (whose income falls under schedule C) or employee (whose income falls under schedule A) under our income tax law? The basic distinction between an independent contractor and employee is that employee provides services under direct control or supervision. Art. 2 (7) of income tax proclamation, proclamation no. 979/2016 reads,

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

On the other hand, art. 2 (15) of the same proclamation defines an independent contractor as; ““Independent contractor” means an individual engaged to perform services under an agreement by which the individual retains substantial authority to direct and control the manner in which the services are to be performed”. So, the question is, when do we assume that there is direct control to categorize it under employment income? In another example, if a person writes a module and gets paid, is that employment or independent contract? As [I] have concluded in [my] article entitled “in the eyes of the withholder”, we do not have uniform application of categorization. In some places, the withholders categorize a particular source of income under income from business and professional services and with hold 2 percent. In some other cases, the same service may attract 35 or even 5 percent as a royalty.

Such differences in the tax rates arise largely because of how the boundaries of each schedule are defined. So, the principle of mutual exclusivity is defeated precisely because of the overlap between the different boundaries of schedules. Hence, different individuals who provide the same kinds of services may be subjected to various tax rates simply because of the characterization. The real problem in the application of the mutual exclusivity of bases arises because of the application of different tax rates on the same type of income. For example, there are letters which rule that in case where a module is prepared by lecturers employed in universities, the tax rate is 35 percent and 2 percent for those modules written by other parties who are not employee of the universities. The universities hire the outsiders in order to reduce the tax rate.

Let’s consider these 3 cases. 1. Commercial bank of Ethiopia generates side income from rental of building. 2. Ayat real estate company is engaged in both rental and sell. 3. Wabi shebale hotel rents rooms (albergo). Now, all of these have rental to them. How do we know which falls under schedule B or C? In practice, the real estate company reports rental of buildings separately from sell of building although it is established for both. Schedule B is source of income for the regions

and schedule C is joint income tax. There are companies which provide a higher purchase of green houses.

Higher purchase is a provision of goods and financial service which can also be called 'financial lease'. These companies report all of its income to the federal government. Considering greenhouses as buildings, the regions claim tax payment from such companies pursuing to article 97 of the constitution which provides that the rental of buildings belongs to the regions. The companies on their part argue that it is income from business and they should pay to the federal government. Some of the regions say to the companies, "find the federal land for your greenhouses".

Lecture 13-november6, 2019.

Last time, we were discussing about the schedules of the Ethiopian income tax. The current Ethiopian income tax proclamation (proclamation no. 979/2016) is the consolidation of multiple income taxes. Each source of income has its own self-contained set of rules with respect to number of issues; one is rates and brackets. Rules of exemptions, exclusions and deductions, assessment, methods, accounting methods and periods Etc. are also separate. For each schedule, there is separate rate structure. Accordingly, art. 11 provides the rate structure for schedule A while arts. 14 and 19 for B and C respectively. In case of schedule D, the rate is separate for each source of income as it is miscellaneous schedule.

Bracket is an income tax base which expresses the range of income. Bracket is important because, at least superficially, our income tax law is progressive. For schedules A, B and C, the income tax rates are progressive; the lowest rate0 and the highest rate is 35 percent. But, this is the combination of the application of the rate with the income bracket. Schedule A is categorized as: 0-600 birr (0 percent), 601-1650 (10 percent), 1651-3200 (15 percent), and, over 10900 (35 percent). This rate structure is progressive in the sense that these rates apply on each of these brackets. It must be noted that we are not talking about the individual; for example, if a person gets 1100 monthly income of gross salary, all of these rates apply to this person. A person with a Flore income (below 600 birr) is not subject to tax. The different between art. 11 and 14 arises

from timing; the accounting unit for schedule A is a month whereas it is a year with respect to schedule B and C.

But, if we closely read article 11, although the rates are the same, the income brackets for employment is different from business and rental of property. Because, if we multiply 600 by 12, we get 7200 which is the income bracket for schedule B and C. This is because; the law has to maintain some modicum of uniformity. The other essential question is that why does the law repeat the rates and brackets in the three articles? By the way, this rule completely breaks down with schedule D; schedule D is a collection of several income taxes. These sources of income are ruled by different rates; some of them being 15 percent, 5 percent and other rates.

The accounting period makes difference. Although the rates and brackets are uniform, there are times when schedule tax payers with same income of amount are subject to variable tax burdens precisely because of the accounting period. When it is monthly income, it does not aggregate in to income in the year. For example, if a person loses his job in the middle year, it is assumed that your 6 months income is uniformly and steadily applied. A monthly accounting system is that have retained for jobs.

The other major difference that arises in the schedules is the rules about exemptions, deduction; one exemption does not apply across the board. Exemptions are schedule-specific Exclusions; the word ‘exclusion’ could be used interchangeably with exemption. Exclusion means, a person is subject to a tax, but only specific source of income exempted from taxation. For example, transportation amounts or hardship allowance is excluded from the tax payers. Deductions apply to expenses that people incur in order to generate income. Deduction rules are separate for schedule. For some schedules, there is no deduction. For example, under schedule A, there is no deduction; which means, the tax year apply on the gross income. For reason of ease of administration of taxation, certain sources of income do not enjoy the privilege of deduction. In respect to schedule, we can consider such sources of income like dividends, royalties, interest and Etc.

Most of the schedule tax payers are, in principle, subject to net salary while schedule D is gross income. Essentially, they are allowed to deduct their cost and expenses. Assessment methods are also separate for each schedule. Employees are assessed by withholding with considerable

variation. As to accounting period, schedule A is subject to monthly accounting while schedule B and C are subject to a year. However, schedule D is not subject to single accounting period as it contains multiple sources of income. Accounting method means the time when do we record the income. Basically, there are two kinds of recording.

These are accrual and cash-basis accounting. Under accrual system of accounting, the tax payer is required to record income long before he/she actually receives the income in cash. The tax payer records the income when the income accrues in his/her favor in the same manner with the expenses. In a cash-basis accounting, we record the tax when we receive it. This implies that certain tax payers are subject to cash accounting; for example, employees are generally subject to such accounting because of the withholding taxation. On the other hand, business persons may be subject to both depending on the nature of their entity. The other essential question is: why do we have progressive income tax for individuals and flat income tax for companies? This is because of tax equity; as we have said last time, the tax equity is anthropocentric and it applies only to human beings.

There are various opponents of corporate income tax. However, the governments are impatient to listen to such debates; because, corporations generate a huge amount of revenue. So, the basic reason why the countries continue to have corporate income tax is because of the revenue potential. In fact, many countries generate most of their tax from corporate tax. The idea is that since the corporate entities are fictitious entities and do not have ability, it is not reasonable to apply the progressive income tax on them. The ability to pay is the philosophy rooted in the theory of income, consumption and saving which is anthropocentric. It usually creates anomaly; the government considers it as “part of income tax but not of income tax”. Nonetheless, we cannot actually transplant the principle of the ability to pay to corporations; that is why we have a flat tax rate on companies.

The governments even impose an additional dividend tax on the shareholders. So, in the classical corporate income tax model (which Ethiopia follows), a corporation pays tax on its net corporate income. Then, when the corporation distributes dividend to the shareholders, the shareholders also pay another tax which is part of their individual income tax. In Ethiopia, it is not really an income tax; in other countries, dividend is included in portfolio of income.

Art. 2 (14) of the income tax proclamation defines income as “"Income" means every form of economic benefit, including non-recurring gains, in cash or kind from whatever source derived and in whatever form paid, credited, or received”. As we can observe, this definition is aspirational in the sense that it seeks to capture all forms of income. Remember: income is economic benefit; it is not any other kind of benefit including intellectual or psychological benefit. According to this definition, the scope of income is not constrained by the form of the economic benefit. It is immaterial whether the source is regular or irregular, recurrent or none-recurrent legal or illegal (though it is not the case in practice). So, even drug money, money from sex work Etc. can constitute since the above definition says “from whatever source...”

This definition basically imitates the Henry Simons definition of income which is consumption and saving. Despite the language may be different, the Ethiopian income tax system has adopted the meaning of income which is closest to the comprehensive income tax model. It is questionable whether we really need the definition of income under Ethiopian income tax law which follows the scheduler system. In scheduler tax system, unless the source is mentioned, it is virtually none-taxable. For example, where do we categorize drug money? Of course, in such cases, taxation does not come first. Rather, the government will confiscate such properties. In other countries, illegal money from drug, gambling Etc. is considered as income. Moreover, countries like Netherlands consider money from prostitution as an income.

In practice, however, every source of income is not subject to tax in Ethiopia. This is primarily limited by the structure of the tax system which is scheduler, practical administrative limitations and legal limitations. In terms of structure, in spite of the broadest sense of income, what constitutes income is really mentioned in each individual schedule. What is not mentioned in each individual schedule is virtually beyond the tax payer. Practically, the administrative reach of the Ethiopian tax system is so limited that only the formal economy is truly subject to taxation. In respect of legal limitation, there are a lot of exemptions in the income tax law itself, in the investment law Etc. which actually militates against the applications. One of the reforms introduced by the new law (proc. 979/2016) is the introduction of other income. This might be useful to capture all sources of income which are not expressly stipulated by name.

Lecture 14-november9, 2019.

Today, we will be discussing about jurisdiction in taxation. Every country defines its jurisdiction in its own way; but, there is almost a universal consensus on what is appropriate rule of jurisdiction. Basically, there are two ways of defining jurisdiction; global or personal jurisdiction and territorial jurisdiction. Global jurisdiction defines the authority of tax law by reference to the person's relationship with the state. The relationship of a person with the state is defined by (1) residence; and (2) nationality. Most countries that define their jurisdiction in this way use the word 'residence' instead of 'nationality'. Very few countries in the world like the United States define their jurisdiction by reference to nationality.

Due to its international economic as well as political power, the United States believes that its tax jurisdiction should follow the persons wherever they may live. So, no matter how long may a person stay abroad, he/she is subject to the US income tax jurisdiction. Because of this tax power, the US citizens tend to change their nationality. The other dimension to define jurisdiction is territorial jurisdiction. In territorial jurisdiction, individual is not important; what is important is the territory which is the source of income. Prior to 2002, the Ethiopian tax jurisdiction was territorial. The territorial jurisdiction is very easy to enforce precisely because, the government has not to follow the residence of the person.

"The Ethiopian tax system is inspirationally worldwide; but actually territorial. When we need to define our jurisdiction by person, we need to have some expectation that our citizens or residents generate substantial revenue outside Ethiopia. "Personal jurisdiction to [me] right now is not really a very important expression as far as Ethiopia is concerned. Because, taxation is a practical instrument; meaning, you only legislate only what you can actually execute". Ethiopia collects virtually very little in terms of revenue from this 'aspirational expression of jurisdiction'. Jurisdiction and international taxation can interchangeably be used. International taxation refers to domestic laws defining jurisdiction over cross-border matters. International taxation is derived largely from domestic laws and few other international rules like double taxation treaties (DTTS). A person obtaining foreign income is a cross-border matter. In terms of source, a none-resident generating income in Ethiopia is a cross-border matter. We have certain presumptive rules defining what the source means.

Most of these rules are found in the domestic legislations of Ethiopia; so, they are unilateral definitions of international taxation. There are aspects of international taxation which are identical with international tax when the rules about international taxation are derived from the double taxation. Ethiopia has signed more than 25 double taxation treaties with the number of countries in the world. About 14 of such treaties including those between Ethiopia and China, Saudi Arabia, Ireland, the Netherlands, France, India Etc. so, the Ethiopian income tax system has two sources of rules; the domestic legislations and specific agreements between Ethiopia and other countries.

Residence.

Art. 7 of the income tax proclamation provides the following in respect of the income jurisdiction of Ethiopia.

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

2/ Subject to Article 64(2) of this Proclamation, a taxpayer that derives income from different sources subject to tax under the same Schedule for a tax year shall be taxable under the Schedule on the total income for the year.

The former sub-article dictates residence while the latter is about the source of income. The income tax legislation defines residence separately for the tax purpose. Accordingly, arts. 5 of the proclamation defines it by 3 categories of residents; individual (natural) person, entities (legal person) and both governments of the federal democratic republic of Ethiopia (though not important). For our purpose, only the two categories (the natural persons and legal persons) are important to discuss. According to art. 5 (2) of the proclamation, natural person is considered as resident of Ethiopia if he/she has domicile in Ethiopia. An individual person is also considered as a resident of Ethiopia if the person is the citizen of the country who is the consular, diplomatic or similar official posted abroad.

The third element is the so-called ‘physical presence test’. If a person is present in Ethiopia continuously or intermittently for more than 183 days in any one year period, he/she becomes a resident of Ethiopia by virtue of the law. Domicile is the first marker of the residence for

individual law. However, it is defined nowhere in the income tax legislation; thus, we need to refer back to the definition of the Civil code (arts. 183 to 191). For the civil code, domicile is the place where a person has established his principal set of his business with intention of living their permanently. So, in order to determine the residence of a specific person, we need to establish, by certain evidentiary rules, that the person is permanently settled in particular area with intention to live there. A person cannot have multiple domiciles; because, normally, individual cannot have intention to live in multiple areas permanently in a manner prescribed by the law. There are presumptions of domicile in the civil code. Normal residence of a person is deemed to be a permanent residence of a person.

In most cases, it is not difficult to establish the domicile of a person in Ethiopia. Sometimes, a person may work in one place and have family or social life. In such cases, the place where a person has a family is normally taken as the person's domicile. In case of persons moving from one place to another, we can rely on their entry and departures to count the period of 183 days in a year. There are other presumptive rules provided under art. 5 (3) and the following with respect to physical presence test. The physical presence test is easy to apply in any cases. But, this does not necessarily mean it is equitable. Physical presence is only useful to establish the residence of a person whose residence is not determined by source.

Thus, it is a mechanism of exercising a global jurisdiction. The Ethiopian source income is subject to tax regardless of the residence of a person. There is confusion about the rule under art. 7 (2) of the proclamation which provides that Ethiopian income tax jurisdiction reaches the Ethiopian source income of none-residents. Some people wrongly understand this provision to mean that source is important only for none-residents. However, even if a person (foreigner) has worked for and generated income for one day half a day or an hour, that income is taxable in Ethiopia as long as it has source in Ethiopia. Residence matter only for foreign source of income. Permanent establishment is the key terminology that defines Ethiopian source of business income.

In taxation, there is characterization of countries as 'capital exporting countries' and 'net capital importing countries'. Capital exporting countries are generally developed countries. Their citizens do capital by generating income from their countries. The countries in which the income is generated are source countries; the countries from which the capital is exported are residence

countries. The other thing worth considering in line with jurisdiction is tax equity; residence jurisdiction is equitable. It ensures that there is tax justice as between all residents. The primary aim of double taxation treaties is avoidance of double taxation. It tries to avoid double taxation by allocating tax jurisdiction between the resident and source country. For example, the double taxation treaty between Ethiopia and the Netherlands allocates jurisdiction between the two. Double taxation can be avoided by actually defining what is considered to have its source in Ethiopia. If it has its source in Ethiopia, the Netherlands will have no right to tax it.

The other way of overcoming double taxation is by having relief of double taxation treaties. The treaties may provide as to what each country should do to prevent double taxation. This relief may include foreign tax credit, deduction Etc. The other point is the residence of legal persons. Art. 5 (5) of the federal income tax proclamation provides that a legal person (corporation) is considered to be a resident of Ethiopia: (1) if it is incorporated or formed in Ethiopia; and (2) if it has its place of effective management in Ethiopia. Unlike the past laws, the current income tax law does not require the registration of legal entities to be residents of Ethiopia; the only standard is incorporation. What is incorporation? When can we say a company is incorporated?

Basically, if the company is a plc. it is incorporated in Ethiopia because the shareholders sign the memorandum or articles of association in Ethiopia. There are many foreign companies which establish branches for project offices in Ethiopia; but, branches are not considered as residents. So, for tax purposes, it is a subsidiary limited liability company which qualifies as incorporation. Foreign companies do business in many ways; for example, they may simply export goods, have contracts for provision of certain goods and services, setup a branch or subsidiary Etc.

Worldwide income of a specific branch of a company is not subject to taxation. Rather, the branch is only subject to the Ethiopian source income. The other element for a residence of legal persons is effective management. How do we prove that a company is effectively managed in Ethiopia? Some people tamper to avoid tax by incorporating their company in one country and effectively managing it in other countries. For instance, there are many companies incorporated in Moricious but effectively managed in Ethiopia, Kongo, Uganda or Kenya. Facts and circumstances are very important to determine whether a company is effectively managed in one country or not. If a company incorporated elsewhere has a branch here, we immediately apply

the permanent establishment (PE) rule. But, it is possible for the branch to be considered as effectively resident of Ethiopia if it is managed from another country for artificial users.

The immediate consequence of this is double taxation. The reason why we defined worldwide residence is in order to impose tax on a foreign income. So, a resident person is not only subject to an Ethiopian source income, but also to other foreign income. But, that foreign income is either already subject to foreign tax, or is going to be subject to foreign tax. Most countries which define their jurisdiction in worldwide terms have rules for overcoming double taxation. One of such unilateral rules is foreign tax credit rule which Ethiopia follows. Ethiopia exercises over the foreign income of its residents only after the deduction of the foreign tax credit over such income. It is called 'credit' because it deducts the tax.

Note: foreign tax credit rule applies only for the three active sources of income; Schedule A, Schedule B and Schedule C. so, although it is not expressly provided in the law, effectively, if an Ethiopian resident generates investment income like royalties interests or dividend, it is not subject to the Ethiopian jurisdiction. "I infer this from the absence of foreign tax credit for the schedule D type of income". It must also be noted that such rules are unilateral rules which are provided in the domestic legislations. For instance, art. 46 of income tax proclamation lays down the rules for the application of the foreign tax credit rule. For investment income, Ethiopia employs exemption. If an Ethiopian resident derives dividend income from shareholding in a foreign company, the income need not be reported in Ethiopia. So, the foreign income does not include 'passive' type's of income and therefore it is an exemption.

The difference between exemption and ~~credit~~ Is that in the case of credit, no tax is due in Ethiopia; on the other hand, in the case of credit, the tax is due if the Ethiopian tax is higher than the foreign tax. For example, let's assume an Ethiopian professor works in South Africa and generates an employment income where the tax rate is 45 percent. In this case, he pays 0 percent; because, the South African income tax is higher than that of Ethiopia. But let's reverse the scenario and assume that south Africa impose only 20 percent. In this scenario, 20 percent of the Ethiopian tax rate is deducted and the professor will only be required to pay up to 15 percent out of 35 percent. so, essentially, the foreign tax credit rule dictates that Ethiopia credits the foreign tax for tax lesser than what the person owes in Ethiopia. So, as far as worldwide taxation is concerned, two things should be borne in mind; first, the foreign tax is calculated separately from

Ethiopian source of income. Second, only up to the tax that a person (resident) owes in Ethiopia Is creditable. Therefore, if the foreign tax is higher than the Ethiopian tax, the Ethiopian resident pays nothing; but, Ethiopia does not give that person any kind of credit more than what he/she owes to Ethiopia.

Lecture 15-november14, 2019.

Last time, we have discussed that the obvious consequence of the exercise of worldwide jurisdiction is residence source conflict. Basically, when Ethiopia exercises a worldwide tax jurisdiction, there may be double taxation. Because, the resident is subject to the Ethiopian taxation power and at the same time, the resident may also be subject to the source country. For example, let's hypothetically assume that there is an Ethiopian resident obtaining the foreign income of the UK. The worldwide jurisdiction implies that this resident is subject to Ethiopian tax for his foreign income; but this resident is also subject to the UK income tax as it is the source of his income.

So, in this hypothetical case, there are two jurisdictions which are in conflict. This is not a conflict of jurisdiction; but it is the problem of double taxation. There are multiple ways of solving such problem which include exemption, deduction and a credit method which is called foreign credit tax (FTC). Foreign tax credit (FTC) is a unilateral solution for residence –source conflict. Double taxation is not equitable. Besides, it becomes a barrier to movement of capital and labor across jurisdictions. As we mentioned in our previous session, foreign tax credits are gifts or grants for the tax payer to the foreign jurisdiction (to UK in our hypothetical example). This is provided under arts. 45 and 46 of income tax proclamation and arts. 20 and 25 of the income tax regulations. It must be noted that residence-source conflict is one phenomenon of jurisdictional conflicts. There might be so many kinds of other situations; for example, source-source conflict, residence-residence conflict and Etc. because, each country designs its income tax jurisdiction in terms of its own tax policy.

"There are times when a person may not be considered the resident of any country". The other problem is the problem of "no taxation". Taxes like Google tax, apple tax, and Facebook tax Etc which are designed by many countries were intended to this phenomenon. Previously countries have been trying to eliminate double taxation. However, multinational companies usually

exploited differences of taxation across different jurisdictions. Ethiopia is following foreign tax credit for active income. For passive income (royalties, dividends, interests Etc), there is no foreign tax credit; the assumption seems that there is no worldwide taxation on this types of income. For passive income, Ethiopia follows the exemption method.

One of the principles regarding the foreign credit tax is the principle of 'quarantine'. The principle of quarantine basically requires that the foreign income of a resident should be kept separate from the domestic income. This necessarily means that the tax on foreign income should be calculated and be subject to special rules. The other important point is that the FTC Is available only up to the notional tax that is due in Ethiopia. So, the credit does not affect the local tax liability on the domestic income. This is an extension of a quarantine principle. For instance, in the preceding example, if UK tax on the foreign tax is higher than Ethiopian tax, the resident pays 0; if it is equal, again the resident does pay nothing and hence gets full credit in Ethiopia. But, if the UK tax is less than the Ethiopian tax, the Ethiopian resident pays on the difference. so, any excess foreign tax cannot be carried forward.

The other thing is calculation of foreign tax. Foreign tax is the application of the average tax rate on the net foreign income. The average tax rate in individual taxation is the average of 0 to 35 percent. In case of Ethiopian tax system where the tax rate is progressive, for example, if a person earns a foreign business income of 50,000 birr, we have to apply the average tax rate and the income bracket together. So, the average tax rate is the combination of income bracket as well as the tax rate. Remember: this is the statutory tax rate. The statutory tax rate is not the average tax rate. Rather, the average tax rate is the amount of tax that we will find by combining the statutory tax rate with income bracket.

So, it is calculated as: the amount of tax a person pays divided by his income. The result may vary; the lower the income, the lower the tax rate; the higher the income, the higher the tax rate. The problem is, however, not the computation; it is the assumption that Ethiopian tax scheduler arrangement of tax is imitated elsewhere. The big question to the Ethiopian tax jurisdiction is how to create correspondence between Ethiopian income tax and the foreign income tax. It is assuming that the UK has a similar tax arrangement that a person obtains income in the UK is paying employment income, for example, separately from business income. Art. 46 of the income proclamation provides that the tax should be paid within two years after the end of the

year in which the foreign income has been derived by the tax payer. Further, the tax payer must produce a receipt for the tax from the foreign tax authority.

The other condition is foreign losses. Foreign losses are subject to certain limitations in obtaining foreign tax credit. The first limitation is that foreign losses can only be deducted against future foreign income. If a person incurs a loss in foreign jurisdiction in carrying a business activity, he/she cannot bring it over in Ethiopia and deduct it from their domestic income. So, the domestic income tax remains unaffected by anything that happens outside Ethiopia. In his life time, a person can only obtain a loss carry forward twice. So, a person cannot carry forward for more than 5 consecutive years from the date of the loss and, second, h/she cannot enjoy a foreign loss carry forward for more than twice in his/her life time. This extremely rare situation to Ethiopia.

The unilateral relief that we have discussed so far does not provide complete relief for all kinds of jurisdictional conflict. For example, the residence-residence conflict cannot be resolved through the FTC rule. Because, it is solution only for residence-source conflict. Other kinds of jurisdictional conflicts like source-source, residence-residence Etc are solved through bi-lateral and multilateral relieves. One of the reasons why many countries enter in to double taxation treaties is because they realize that their domestic or unilateral approaches to overcome double taxation do not always resolve other kinds of conflicts. Because double taxation treaties usually involve two countries, they must be ratified by both countries pursuing to some formal exchange of ratification instruments. Whenever a person is considered to be a resident of both by virtue of the domestic legislation of a country, there are ‘tie breakers rules’ that give priority to one of the countries. Double taxation treaties are also used to fight against the problem of international tax avoidence.

In the past, double treaties are mainly concerned about double taxation. But, nowadays, the countries came to realize that residents of multinational companies using the loopholes in the domestic legislation to avoid taxes. Double taxation treaties are also useful to attract foreign investment. Investors may not be confident about domestic legislations; they tend to observe the double taxation treaties between Ethiopia and various countries. The new international order is more focused on fighting tax avoidance; because, many countries are realizing that some companies like Google, Facebook and apple are not paying tax in source countries due to the

digitalization of the world economy it is becoming extremely difficult to enforce their domestic legislations on such companies.

When the world economy is digitalized, countries may need to change their traditional rules of tax collection. The traditional rules of jurisdiction are based on physical presence. They usually consider the physical staffs like the leased offices of companies, raft of employees and other operational arrangements. But, these days, such physical mechanisms cannot withstand the recent shift of tax avoidance techniques by various personalities. Companies like Google and apple do not have to show up in any other country to generate huge revenue. A couple of years ago, multilateral instrument were signed by about 85 countries. Prior to this multilateral agreement, for last 100 or so years, the international tax law was dominated by domestic tax legislation and bilateral treaties. There were no multilateral instruments like world trade organization (WTO). Because, countries could not reach a consensus; every country was fighting for its piece of cake in the international tax.

Because of this enormous threat from the digitalized economy, many countries have now come together and signed multilateral treaties called MLI (multilateral instrument). It is called 'multilateral' because, it is not a substantive treaty; rather it is the coordination of double taxation treaties that each country has. There is also the OECD project which is called base erosion and profit shifting (BEPS). The BEPS mechanism is eroding the tax base of tax in a country where the tax rate is high with a view to shifting it to another country with a low tax jurisdiction like Moricious. Many multinational companies want to have their own special purpose vehicles (SPVs) in countries like Netherlands, Ireland or moricious is to apply these base erosion tools and shift profits. In this manner, the amount of tax that the multinational companies pay is much lower or sometimes 0... This is called 'international tax avoidance'. For example, let's say a company from US which has SPV in moricious comes to Ethiopia which has no tax or offshore. Under Moricious law, offshore companies are companies which do not have any domestic operation in the country. The sole reason for these companies to be in Moricious is to establish intermediary companies.

The multinational companies which come to Moricious with low or no tax jurisdiction establish this company so that the profits of this company are strict. So, the tax that they pay in other country is either low or 0. Thus, a lot of income is recognized in Moricious and the expense is in

Ethiopia. In this way they retain the profit they generate in Moricious since they do not pay tax there. BEPS is a project against international tax under the umbrella of OECD. The second principle that is layed down under art. 48 of the income tax proclamation is the principle of priority of treaties over the domestic legislations in times of conflict. But, there is exception to this rule under sub-article 3 of the same provisions. Accordingly, the treaty over rides principle applies in situations of limitation of benefit. Basically, treaties prevail over the domestic legislations in times of conflicts. However, this provision is deviating from this international principle. Art. 48 (3) of the proclamation provides the following.

Subject to sub-article (4) of this Article, when a tax treaty provides that Ethiopian source income is exempt or excluded from tax, or the application of the tax treaty results in a reduction in the rate of Ethiopian tax, the benefit of that exemption, exclusion, or reduction is not available to a body that, for the purposes of the tax treaty, is a resident of the other contracting state when fifty percent or more of the underlying ownership or control of that body is held by an individual or individuals who are not residents of that other contracting state for the purposes of the tax treaty..

The aim of this provision is to combat 'international tax avoidance'. If the US national establishes SPV in moricious, the SPV may be considered as the resident of Moricious. This means, the SPV would enjoy the privileges of the residence of a Moricious as a contracting state to the double taxation treaties with Ethiopia. However, according to the rule of limitation of benefit which is given under art. 48 (3), if 50 percent of the shareholders of the SPV are not the resident of Ethiopia, a company does not enjoy the privileges. This is the phenomenon of treaty shopping; essentially, it is very easy to establish companies in contracting states. So, a company which is established in Moricious must show not only is that company is the resident of Moricious, its underlying owners should also be residents of Ethiopia. The other important and more practical marker of jurisdiction is the source principle. Source is more important than residence; because, it is much easier to apply. The source rules for almost all types of income are provided under art. 6 of the proclamation. Let's begin with employment.

Art. 6 (1) of the income proclamation provides: employment derived by an employee shall be considered "employment exercised". An Ethiopian source income; (a) to the extent that it is derived in respect of employment exercised in Ethiopia, wherever paid//. The critical phrase in this sub-article is "employment exercised". When do we say that employment is exercised in

Ethiopia? When the person performs the work in Ethiopia? When the employer is in Ethiopia? What is the marker of 'exercise of employment'? Let's assume that an American professor is connected to Skype and teaches the AAU students through video conference. Can we say that employment is exercised in this hypothetical case? It is not easy to determine as to the appropriate time when we can presume employment is exercised. Particularly, in modern age where it is quite possible technologically to provide services anywhere in the world. In most cases, foreign companies minimize any kind of physical contact with individual tax jurisdictions.

Lecture 16-november 15, 2019.

Last time, we were talking about a very important concept of source. When we talk about source, what we have in mind is none-residents. With respect to resident, the presumption is that every income the resident has obtained in Ethiopia is considered to be an Ethiopian source income unless the resident shows that the income is derived from sources outside Ethiopia. According to art. 7 (2), Ethiopia has an absolute jurisdiction over the Ethiopian source income of none-residents. The fixing rule for employment income is the employment exercised in Ethiopia. Sometimes, foreign companies establish parent company. For example, let's say there is a parent construction company in China as PE (permanent establishment). There are people who provide services from the remote location like designing, accounting, financing Etc.

The question is; should the PE withhold employment income tax on the salaries of that the parent pays these employees? These employees are working for Ethiopian project. Remember: employment income tax is administered through its withholding. We have to respond this question for the PE, not for the employees. In addition to the withholding income tax, interests, dividends Etc are assessed against the PE. Sometimes, some people wrongly take 183 days as a condition for taxation in Ethiopia. However, for source, stay is immaterial. In case of source, the important factor is that the employment is exercised In Ethiopia (whatever that means). So, a person who stays for one day and exercise employment in Ethiopia will be subject to Ethiopian taxation.

Ethiopian income tax is somewhat complicated because of so many withholding taxes on none-residents. We have technical or management service fees tax which is 15 percent. The term 'technical' or 'management' is broadly defined so that it may include all kinds of services by

none-residents. So, the line between the employment and the technical services fees income tax is not clear. It is puzzling whether we should consider the none-resident as an employee of the company in Ethiopia or we should consider the none-resident as a technical services provider of the resident company.

In some circumstances, the contract itself makes it clear. But, sometimes, an individual person provides consultancies. The Reason why we grapple with this controversy is the difference of tax rate among these two kinds of sources. For instance, in the above case, if we consider the person as an employee, we apply progressive income tax rate from 0-35 percent. If we consider him as a none-resident technical service provider, however, we apply only 15 percent. Sub-articles 2 and 3 of article 6 of the income tax proclamation fix how business profits income are attributed to Ethiopia. Art. 6 (2) reads as: "Business income derived by a resident of Ethiopia shall be Ethiopian source income except to the extent that it is attributable to a business conducted by the resident through a permanent establishment outside Ethiopia". The normal presumption is that the income that a resident entity has derived is considered to be an Ethiopian source income. Otherwise, it is an income derived from the operations of the PE (permanent establishment) outside Ethiopia.

If it is derived from the operations of a PE in Ethiopia, it is a foreign income. Under Ethiopian law, residence of entity cannot be ascertained by branches except a foreign company has effectively its management in Ethiopia even though it operates only through a branch. If a company is established in Moricious but all its operations and managements are conducted inside Ethiopia, even though it is not incorporated in Ethiopia, it is considered to be a resident of Ethiopia. The second rule is laid down under art 6 (3). It provides as: Business income derived by a non-resident shall be Ethiopian source income to the extent that it is attributable to:

a) A business conducted by the non-resident through a permanent establishment in Ethiopia; this is the direct business operation. Business is defined under art. 2 of the proclamation. The second attribution rule is (b) disposals in Ethiopia by the non-resident of goods or merchandise of the same or similar kind as those disposed by the non-resident through a permanent establishment in Ethiopia; or third, (c) any other business activity conducted by the nonresident in Ethiopia of the same or similar kind as that conducted by the non-resident through a permanent establishment in Ethiopia. This is called 'limited attraction rule'. With respect to attribution of business profits,

there are basically two principles in international taxation. The first rule is separate and distinct rule which is espoused by western countries. The separate and distinct rule essentially dictates that the permanent establishment is considered to be separate and distinct from the parent or affiliate company.

The second rule which is espoused by most developing countries is the limited attraction rule which basically states that a part of the income of the parent company must be attracted in to the PE

By virtue of art. 6/4 (b), if the rental income is derived from the lease of immovable asset located in Ethiopia, it is considered to have its source in Ethiopia. On the other hand, if the rental income is derived from movables located in Ethiopia, it is subject to casual rental tax under art. 58 of this proclamation. Like technical services fees tax, casual rental tax is subject to 15 percent. There are companies which never set foot in Ethiopia, but rent heavy machineries from outside. The companies have no other establishment like an office, employee Etc; because, the machinery is so specialized that it does not have any other purpose other than accomplishing specific task. The other very common practice is with the airline industries; for example, the Plaines of the Ethiopian airlines are leased. In such circumstances, the none-resident companies wonder whether they are subject to Ethiopian tax because of their assets in Ethiopia. The other important concept is capital gains. Capital gains is one type of income tax which is applied on irregular income derived from transfer of selected capital gains assets.

Capital gains assets are basically of two types; the first category is class an immovable held for business. The second is class B (transfer of shares and bonds). These are the only assets whose transfer attracts capital gains tax. Art. 6/4 [c] is intended to fix when capital gains tax should be paid in Ethiopia; because, the gain is considered to have its source in Ethiopia. Accordingly, there are some presumptive rules. The first presumptive rule is immovable assets located in Ethiopia. The second is what is known as indirect transfer rule. Art. 6/4/c (2) provides that a membership interest in a body, if more than 50% of the value of the interest is derived, directly or indirectly through one or more interposed bodies, from immovable asset located in Ethiopia. For example, let’s assume a Moricious SPV named Ethio-invest which has a subsidiary company in Ethiopia called ABC. This company has its shareholders. Accordingly, a UK company owns 30 percent while the British virgin Island (BVI) 50 percent and Netherland company 20 percent

respectively. Now, in this hypothetical case, we do have two entities; the Ethio-invest Company and ABC Company. Normally, Ethiopian law applies if ABC Company transfers its all or part of its shares to DEF Company in Ethiopia. So, this is an onshore transfer.

But, let's take a different scenario; if these three shareholders sell their share to another company established in Moricious, the indirect transfer rule becomes relevant. Indirect transfer rule is premised on immovable assets. If 50 percent of the value of any of the shareholders is derived from immovable property located in Ethiopia, it is presumed that its source in Ethiopia. This means, even though the transfer is offshore, the capital gains should be paid in Ethiopia. This is an anti-tax avoidance rule. Because, these shareholders know the Ethiopian tax law. They know that if they conduct onshore transfers, it results in capital gains tax at the rate of 30 percent. Therefore, if they don't have indirect transfer, they engage in offshore transaction. The other essential question is: when do we say that the offshore transfer derives 50 percent or plus of its value from an immovable property located in Ethiopia?

There is another rule, the threshold of which is even lower for mining, petroleum and gas. In such cases, interest and indirect transfer is lowered to 10 percent. According to art. 44 of federal income tax proclamation, with respect to mining, petroleum and gas, and indirect transfer rule starts applying if the indirect interest constitutes more than 10 percent. Why the rules are more stringent for mining, petroleum and gas? The rationale is that they are natural resources. It is exploitation of none-renewable natural resources. So, they should be given a higher value than the rest properties subject to taxation. As far as tax is concerned, there are so many loopholes that these mining, petroleum or gas companies can exploit.

For instance, they can simply obtain a license for their discovery of certain minerals at certain area from the relevant authority. Then, they can sell it to foreign countries without extracting by themselves. So, pursuing to art. 44, whenever the company which has the mining interest in Ethiopia conducts some kind of transfer outside Ethiopia, and if it constitutes more than 10 percent of the control of the company, it should be reported and attract capital gains tax in Ethiopia. This is called 'change of control rule'. In this regard, the very obvious immovable asset is the real estate. If there is a real estate company which owns immovable in Ethiopia, even if the real estate's shares or interests is not directly transferred, by virtue of art. 6/4/c, the income has

its source in Ethiopia when the shares and interests are indirectly transferred offshore remote from Ethiopian location.

The real estate company seems very easy to apply; but let's say the company is agricultural company. Foods and vegetables producers depend upon land; however, land is not what they own. Such company owns the fruits of the land only. Thus, it is questionable whether we can say the company derives its value from an immovable property located in Ethiopia. The other essential question is that how do the governments know about the offshore transfers conducted by companies outside their territory where the companies evade it? It is all about the possibility of being discovered; the governments are simply hopfull of compliance of the companies to declare themselves. The governments assume that they declare themselves that the companies worry that there might be some whistle blower.

The other way is double taxation treaties. One of the purposes of double taxation treaties is exchange of informations. In such treaties, every country is obligated to exchange informations about its respective residents. There is a possibility for each country to request for informations about certain companies. For instance, if the Ethiopian government has signed a double taxation treaty with the government of Netherland, the Ethiopian government has the right to ask informations with respect to transactions of subsidiary companies in Netherland. The other important development that we have today is multilateral instruments (MLI). The central action plans of BEPS, for example, is distribution of informations. Dividend and interest are considered to have its source if it is paid by a resident body. Sometimes, a parent company may have a permanent establishment (subsidiary company) in Ethiopia. The relationship with the parent is such that the parent company may borrow from international sources and pay interest.

But, it borrows for the operation of the subsidiary company in Ethiopia. If that is the case, the interest is considered to have its source in Ethiopia even though the payment is made by the parent company. Despite the subsidiary company is not directly paying the interest, a foreign financiers like banks which lend money to the parent company in order to buy goods or machinery for the subsidiary company, the banks have no interaction with the subsidiary company. Here, the relationship of the parent company with Ethiopia is that the parent company borrows for the benefit of the subsidiary. So, sometimes, the whole transactions may not occur in

Ethiopia. But, the tenuous relationship between the parent and the subsidiary companies should be examined thoroughly.

Permanent establishment: PE is separately defined under article 4 of the proclamation. There are multiple markers of permanent establishment. The first marker is fixed place of business. Art. 4 (1) reads, "Subject to the provisions of sub-articles (2), (3), (4) and (5) of this Article, a permanent establishment is a fixed place of business through which the business of a person is wholly or partly conducted".

A concept of permanence dictates that a business operation must be such that it has some level of permanence to it. So, irregular or short term businesses do not constitute permanent establishment. The purpose of permanent establishment is to employ business profit tax. However, it does not necessarily mean that a business organization which has no PE in Ethiopia doesn't owe tax; for example, it may still owe a withholding taxes technical service tax. Therefore, PE serves to apply the net business profit tax of schedule C. Although there are a lot of controversies as to the meaning of 'fixed place of business', it means that if it has a branch or an office from which it operates in Ethiopia, it is considered to have PE in Ethiopia due to its physical attribution. But, note must be taken that such physical characteristics is being defeated by technological revolution since the companies are becoming to set their business operation without fixing any physical establishment.

There are presumptions of PE under art.4/2. Thus, the following are specifically treated as PE.

A) 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;

B) A mine site, oil or gas well, quarry, or other place of exploration for, or extraction of, natural resources;

c) the furnishing of services, including consultancy services, by a person, including through employees or other personnel engaged by the person for such purpose, but only when activities of that nature continue for the same or a connected project for a period or periods aggregating more than one hundred eighty three days in any one-year period.

Art. 4/2/c is about service PE; some companies send their employees to render services without any arrangement of place of management or office. Because, in terms of mining and quarry, there is no need of offices and other PE factors. There is another confusion as to the application of 183 days. For example, let's assume that a foreign consultancy company sends 30 employees to work for commercial bank of Ethiopia for 60 days. If we calculate their stay in Ethiopia by aggregate, it does not exceed 183 days; however, if we multiply 60 days by the number of the employees (30), it exceeds the 183 days.

The other type of PE is called the construction PE. Art. 4 (3) provides that a building site, or a construction, assembly, or installation project, or supervisory activities connected with such site or project shall be a permanent establishment only when the site, project, or activities continue for more than one hundred eighty three days. This comes particularly in respect of the EPC contractors.

Lecture 17-november 18, 2019.

Last time, we have said that PE is a useful concept for capturing the business income of foreign business organizations that operate in source countries without setting up basic formal establishment. So, PE is not useful where a subsidiary is established. But, multinational companies use to operate inside the country for specific purposes; for example, an international construction company (EPC contracter) may choose to operate in Ethiopia by opening a branch in Ethiopia. The whole purpose of this branch is to execute contract. In this scenario, this international EPC contracter exercises very limited duration of operation. In such cases, The EPC contracter may not have to establish a business organization. Even if it wants to, there are certain regulatory restrictions that prevent the EPC contracter from opening a subsidiary company.

Therefore, the EPC contracter wins the contract through international competitive bidding and registers a contract office with the ministry of trade. This contract office is different from regular business organization in that first, it is not PLC; it is a branch or office. Sometimes, it may even not need an office; for example, if the contract is a contract of road construction, its office may be a working place. Second, such contract office is temporary; once a contract is over, the contracter dismantle all structure and they move on to another place. The concept of PE exists to

capture such irregular forms of doing business. The definition of PE wants to capture; (1) the place of operation like an office Etc. and (2) the service providers. Particularly, in the service industry and consultancy, office is not necessary for operation.

Service providers are not required to have registered business place. They enter in to a service contract with Ethiopian resident company or government institution and provide services. In such circumstances, it is easy to avoid taxation. The other important question is that how do we count the period of consultancy. In the definition of permanent establishment, the important element is stay of a person. We can find whether a person stayed in Ethiopia for 183 days from his immigration records; so, the tax authorities need to coordinate with the immigration authorities and airport authorities to ascertain how long has a person stayed in Ethiopia. It is illegal to come to Ethiopia and work without getting a necessary work visa. Usually, when foreigners apply for visa, the first question that they are asked is why they are in the country.

There was a Chinese national who came to Ethiopia on tourist visa. He wanted to renew his visa as it has expired. He went to the immigration offices with his working uniform cloths. When he was asked what he was doing there, he replied that he was to renew his visa in his broken English. Finally, he was jailed. So, the practicality of such kind of laws depends on other laws. Furthermore, there are necessary information's that are gathered from foreign hotel customers about their nationality and the activities they are conducting in Ethiopia. As far as service is concerned, the business organization is presumed to have a permanent establishment through its employees or its consultants which doesn't necessarily require specific place of work.

So far, we have been talking about 183 days. In double taxation treaties, however, the rule is different. One difference that we notice in double taxation treaties is that the period of stay with some of the countries that signed such treaties with Ethiopia may be longer in order to attach PE. In international taxation, there are two influential templets upon which countries choose to negotiate the double taxation treaties. One is the OECD model which basically favors the residence or the developed countries. The other is the UN model which tend to favor the source or developing countries. OECD is a model convention; we just pick from the shelf or download from the internet and use it to negotiating; because, typically, a free double taxation treaty has about 31 articles.

Both models are more or less similar in content except for some notable differences. One of this differences is the concept of PE. The UN model has expansive definition of a permanent establishment. It intends to favor the source countries for which a concept of PE is very much important. On the other hand, one major difference in the OECD model is that the period of stay must be 9 months. In the UN model, however, if employee stay in a country for 6 months, it is sufficient to attach a PE to a foreign business organization. The 6-month rule apply mainly for none-double taxation treaties. Because, it is a domestic tax law which applies to all tax payers. So, it is important to look at the definition of the concept of PE and business profits particularly in articles 5 and 7 of the double taxation treaties.

As we have mentioned in our previous session, in our case, art. 48 of the income tax proclamation states that whenever there is a conflict between a domestic law and the double taxation treaty, the treaty prevails with certain exceptions. With regard to foreign business organizations, we have two types of rules; first, if the country in which the business organization is situated has double taxation treaties with Ethiopia, the provisions of the double taxation treaties in respect of period of stay apply. Otherwise, the second alternative is the application of service PE provided under article 4 of the federal income tax proclamation.

The other type of attachment of PE is agency PE. International tax law generally divides agency in to two; dependent and independent. This is particularly important in the distribution of goods. In cross-border transactions, most business organizations rarely show up in countries to do business. Most of the goods that we find in the market are supplied by foreign business organizations that do not have any contact with Ethiopia except that there is an importer who acts on their behalf. For example, Toyota car manufacturing company does not have distributors for its product (cars) through dealers or importers who import the cars in to Ethiopia from the company itself, from its intermediaries or from other dealers. However, the question in some cases arises whether the distributor or the agent acts independently or is dependent upon the foreign business organization. Article 4 of the income tax proclamation says that if the Ethiopian importer or distributor or an agent is a dependent agent, the agent or the distributor is considered as a permanent establishment of foreign business organization.

The dependent agent is virtually considered as an employee of a business organization. Thus, it might be considered as an extension of a service PE. Such agents are operationally or

economically dependent on a business organization. Furthermore, they act upon the instruction, control and direction of the foreign manufacturers. The consequence of such situation is that the foreign business organization must report its income in Ethiopia. It is required to report not the income of its distributors, but the income of the organization. More importantly, when a foreign business organization realizes that there is a PE, it must register properly in Ethiopia because, doing business without having the requisite license entails criminal liability. Art. 4 (4) of the proclamation provides the following:

Despite sub-articles (1) and (2) of this Article, when a person, other than an agent of independent status acting in the ordinary course of business, acts on behalf of another person (referred to as the "principal"), the first-mentioned person shall be a permanent establishment of the principal if the person:

(a) regularly negotiates contracts on behalf of the principal; or

(b) maintains a stock of goods from which the person regularly delivers goods on behalf of the principal.

The real issue here is that how much control does the foreign business organization exercises upon the activities and operations of the agent. If the agent has flexible independence to negotiate contracts independently, the agent would not be considered as a dependent agent. But, if the whole supply chain to the customers is controlled by the foreign business organization, and the agent is reduced to somebody who simply negotiates adhesive contracts, the agent qualifies as dependent agent and hence the PE rules shall apply. The same is true with the maintained stalk of goods in the company. The immediate consequence of such relationship between the agent and the foreign business organization is that the organization must register in Ethiopia and declare its corporate income to the tax authority. In order to declare its corporate income, a business organization needs to set up an office, maintain books and records Etc which prompt the organization not to act on its agent. However, as stated earlier, for the tax purpose, the minimum a foreign business organization is required is to declare its income.

It must also be noted that there some administrative regulatory tax consequences flowing from the attachment of the PE. So, the concept of PE is not limited to simple calculation of corporate business income. Even if the foreign business organization is not subject to the attachment of PE,

still it is subject to the withholding tax. In such circumstance, it is not the obligation of the foreign business organization; rather, it is the obligation of its counterparts. The rules that we have laid out are the traditional rules. Because, they simply apply the physical presence test; like existence of employee, consultant Etc. in Ethiopia. One of the areas where we find challenges to these rules is electronic commerce. For foreign business organizations, exit is more difficult and expensive than entry. There are many stringent formalities like tax clearance

As long as we can enforce a technical service fees tax, many scholars (including our instructor) do question why the foreign business organizations are required to have working shop in Ethiopia. Because, they believe that it discourages the right kinds of businesses. They further argue that the aforementioned stringent formalities to establish PE, which have physical nature, prevent the highly qualified companies to expand their business in Ethiopia. Other countries highly focus on the issue of PE because they don't have the service withholding tax; which means, if a foreign business organization operates in such countries for less than 183 days, the income is 0. In Ethiopia, however, the income is 15 percent. For example, if there are two contracts which take 180 days and 184 days respectively, the latter contract is required to be registered. The digitalized economy poses a greatest danger to such traditional physical nature of PE. Unfortunately, the Ethiopian tax PE scope does not apply to the electronic commerce. Article 4 of the income tax proclamation expressly excludes the digitalized economy. These are remote location services like services rendered using computer servers.

With respect of PE, there are two very important concepts. One of these concepts is the attribution of profits to the PE. Article 6 (3) of the federal income tax proclamation gives extensive understanding of PE. A PE in Ethiopia is required to report the income directly generated by its parent company along with the income directly generated by itself. In 'force of attraction rule', the PE has far wider consequences upon the none-resident company than just the income directly generated by the parent company.

For example, let's imagine a scenario where the Adama to Hawasa speed way is constructed. In such engineering procurement construction (EPC) there are three parts; one is the engineering part. The parent company does the engineering and the design outside Ethiopia. The second part of the contract is procurement. Some of the procurements can be done in Ethiopia if the goods and materials are available in Ethiopia. Procurement is also done by the contractor including the

heavy vehicles and machineries. The third part is the construction part. Construction is considered as onshore service; because, it is conducted where the construction is meant. The former two parts of the EPC contracts are offshore in the sense that they are wholly supplied from abroad. So, the construction part is the only aspect of the contract that is fully handled in Ethiopia. In this scenario, the question arises whether the project office should report its income only from the construction.

Remember: the PE is not established until the contract is fully complete. The foreign company sets up its office in Ethiopia after the contract is signed. So, the PE is a post-contract organization. The rule of attribution of profits enshrined under article 6 (3) dictates that the project office in Ethiopia is required to report not only the income from the contract, but also from the engineering and procurement. Sometimes, the parent company may continue to supply goods even after or during the performance of the first contract to other parties. This is a different engagement from the EPC contract for which the company has not to set up a permanent establishment since it doesn't require service. The question is: should the parent company report this independent income from separate contract to the Ethiopian authorities simply because it happens to have the PE?.

This is one of the greatest risks of article 6 (3) (b) of the income tax proclamation. Because, it states, "disposals in Ethiopia by the non-resident of goods or merchandise of the same or similar kind as those disposed by the non-resident through a permanent establishment in Ethiopia". One of the benefits of having double taxation treaties is to overcome such problems. Many of the double taxation treaties apply the rule of separate and distinct rule for such challenges. The flip side of this is expenses. The logical and fair application of the attribution of profits means that the recognition of profits should be as expensive as the recognition of profit. The PE should have the right to report all the expenses of the machineries, tools and so on whether those expenses are incurred inside or outside Ethiopia.

otherwise, the tax authority may not be able to force the PE to report its total income. For example, in the forgoing example of the Adama Hawasa speed way, all machineries should be recorded here. Any construction task requires many kinds of equipment's. In such situations, the question arises whether it should be recorded by PE or not. Remember: the PE is just a branch of a company whose parent may situate in china or India. It is questionable how does it report. Even

worse, it is quite challenging to prevent double reporting. The company may exaggerate its expense. For instance, if the value of a heavy machinery is 5 million, the PE may report the sale of the machinery to be the same price which in turn produce no income.

Employment income tax.

So far, we have been discussing general rules of taxation which applies to the Ethiopian tax jurisdiction. We have also dealt with the background and interpretation of these rules. Hereafter, we shall discuss each schedule separately. Accordingly, we start with schedule A, employment income.

Employment income tax is one of those main schedules of income taxes in Ethiopia. It has been imposed since the inception of the Ethiopian modern income tax. In Ethiopia, one characteristics of employment income tax is that it is reported separately and almost exclusively administered through withholding. The withholding obligation falls on the employers. Most employers are passive but active in the sense that they cannot escape taxation. Employment is the most effective tax; because, the employees are usually captive tax payers though Employment is not substantial source of revenue for the government. Under Ethiopian tax law, employment itself is not defined; however, it is indirectly defined through employee. So, we need to begin by asking who an employee is.

Article 2 (7) of the income tax proclamation gives a classic definition of employee which hinges on the concepts of direction and control. It provides: ""Employee" means an individual engaged, whether on a permanent or temporary basis, to perform services under the direction and control of another person, other than as an independent contractor, and includes a director or other holder of an office in the management of a body, and government appointees and elected persons holding public offices".

The negative definition of employee is an independent contractor, who provides services under his own authority. But, the above definition of employee is expansive so that includes director. This is one of the controversies plaguing the tax disputes prior to 2016.

So at least now, we have clear provision that states a director, who is a member of board of directors; or any person holding an office in the management of a body, as well as government

appointees like ministers, high government officials including the prime minister; and elected persons like parliament offices are considered as employees despite such relationship is regulated by other special laws. Tax law defines an employee from a specific perspective of income. For labor law, government officials, managers are not employees. There is one confusion with respect to directors even now. There are many companies, as a result of their articles of associations, pay directors about 10 percent of their annual profit in addition to they are payed for their board duties. The question is: how should we characterize this payment. Such payment is not based on services the directors provide, it is based on the profitability of the company. It is like a thankyou payment.

Lecture 18-november 25, 2019.

Last time, we have started to discuss about employment income tax, schedule A. Today, we will discuss about the scope, some of the peculiar features of this schedule and particular source of applicability of this schedule. As far as the scope of this schedule is concerned, we need to examine articles 2 (7) and article 2 (15). Before we apply schedule A, we must establish two cumulative factual elements. First, we must show that there is employer-employee relationship. Second, we need to establish that the income is from employment. In our previous session, we have looked at the very definition of employee, which is a good insight to understand the idea of employer. Employer is defined under article 2 (8) as "An employer is a person who engages or remunerates an employee".

The definition accorded to 'employee' under article 2 (7) is intended to distinguish the concept of employee from an independent contractor, who provides similar kinds of services. The basic difference between employee and independent contractor is that employee provides services under the direction and control of another person called employer; whereas, pursuing to article 2 (15) of the income tax proclamation, independent contractor is an individual who engaged to perform services under an agreement by which an individual retains substantial authority to direct and control. Obviously, this conclusion provokes a question as to what facts and circumstances constitute control and direction. In taxation terms, if it is established that there is employer-employee relationship, the income falls under schedule A; otherwise, if an individual

is engaged to perform services by retaining a substantial authority to direct and control, it falls under schedule C.

There are notable differences between the two schedules (schedule A and schedule C). First, the tax rates are different. Second, an independent contractor (schedule C) is subject to self-assessment. So, schedule A is subject the withoulding tax; schedule C may be subject to withholding tax, but for different kind of tax. For example, if an employee gets 30,000 birr, 35 percent of tax on this 30,000 birr is withheld by the employer; if an independent contractor gets 30,000, however, only 2 percent is withheld by the client. The employees are passive tax payer; because, they don't even know how much is deducted from their regular salary for tax purpose and other payments like pension. In the case of independent contractor, it is assumed that they pay taxes by themselves. The 2 percent tax withheld by their client is an advance tax, the difference tax which they have to pay at the end of the year.

The other important difference between the two schedules is that employment income tax is a gross income tax; whereas, income tax imposed on an independent contractor is a net income tax. The law is negligent about the expenses that the employee may incur in pursuance of employment services when it denies any right of deduction. Article 10 (3) of the proclamation reads: "An employee shall not be allowed a deduction for any expenditure incurred in deriving employment income". In contrast, independent contractors may submit list of their expenses incurred in connection with provisions of independent contract and will get reduction as long as the expenses are deductible under Ethiopian law. All of these cumulatively lead to an inescapable conclusion that there is difference between the two schedules not only in its administration, but also in the amount of tax imposed. If we compare an employee with any independent contractor, it turns out to be the independent contractors pay much less than employees due to three main factors; the application of monthly withholding taxation, the application of gross withholding taxation and the denial of the deduction.

In practice, the elements of control and direction have been ignored persistently because of the tendency of the tax authorities to apply elements which are not actually in the law like the distinction between part-time and full time teaching services in the universities. There are instances when employers apply different rates and schedules against the same kind of income and the same kind of work. In another example, legal practitioners who teach in the universities

by part time contract are often treated not as employees, but as independent contractors. The status of the service providers should be immaterial. The only relevant element that we need to observe is a circumstance under which a persons provides services.

In respect of the application of employment income, this instructor suggests a standard reduction whereby the employees get some lawful reduction for the expenses that they incur while providing employment services without submission of receipts of their expenditures like the business persons. Standard reduction Is a situation where the legislator assumes a fixed amount of income tax to be expense. For instance, 20 percent of the employees' income tax may be wholly considered as expense which dictates legal deduction. In this manner, the employment income tax is imposed on only the rest 80 percent.

Income from employment: the other vital element that we should observe in the application of schedule A is that the income must be derived from employment. It must be noted that the mere fact that there is employer-employee relationship does not necessarily mean that schedule A applies. Put differently, not every payment by the employer is income from employment. There may be many circumstances where a payment from the employer may not be considered as income from employment. For example, employers sometimes lend money to their employees. The employers may renounce this money that their employees owe to them. This kind of income may be characterized as a sympathy income. 30 years ago, there was a real case of Share Ethiopia. Share Ethiopia was a fuel station which was taken over by Total Ethiopia. The employees of this company were organized in to trade unions. In their collective agreement, they had what they call 'provident fund'. Provident fund is like a private fund; the employees had a deduction from their monthly salary and Share Ethiopia has also contributed to this fund. Later on, Share Ethiopia decided to use this saved money and pay for its interest. The company was paying 7 percent interest. At that time, the tax authorities said that it was income from employment.

In this case, the element of employer-employee relationship existed. The controversial issue was, however, whether the provident fund which is established for the benefit of the employees could be considered as income from employment or not. Income is said to be from employment only when there is a causal relationship between the services of the employee and the payment. In the laws of 2016 and 2017, it is clearly provided that both cash and none-cash benefits are

considered to be employment income. Article 12(1) (a) of the federal income tax proclamation, proclamation no. 979/2016 lists what are included in the employment income. Accordingly, salary, wages, an allowance, bonus, commission, gratuity, or other remuneration received by an employee in respect of a past, current, or future employment are involved under this sub-article.

The different kinds of payments that footballers get can be one example of future employment income. Such payments are usually paid to distinguished peoples to entice them in to one's company. On the other hand, past income is a type of income which is paid to employees when they leave. An elaboration of sub-article A is given under sub-article C of the same provision as: "an amount received by an employee on termination of employment, whether paid voluntarily, under an agreement, or as a result of legal proceedings, including any compensation for redundancy or loss of employment, or a golden handshake payment". There is a mistake with this provision; a golden handshake is for future, not for the past. Income from employment also includes none-cash benefits which are called 'employment fringe benefits'.

It must be noted that there are also cash employment fringe benefits like transportation allowance, hardship allowance, or Par dime allowance (ye wulo abel). In kind benefits pose great challenges to the tax administration precisely because they are benefits paid in kind. For example, the Ethiopian Airlines provides a free air ticket to its employees. The question is: how the value of this free air ticket is quantified? Prior to 2016, all in kind benefits were virtually untaxable as there was no valuation. But, currently, the regulations of 2017 have come with detailed rules about the valuation of each type of employment fringe benefits. Valuation is important because of the fact that in kind benefits do not have their own value. The moment the employer provides certain in kind benefits for free, the value of such benefits becomes subjective.

Sometimes, laws presume that if employers chose to provide in kind benefits, they should also bear the tax burden. In this regard, employment fringe benefits become an employer 'fringe benefits tax'. But, the problem with this is that most likely, the government will not comply with such rule. So, ultimately, only private employees will bear such tax burden. In another scenario, let's assume that a particular employee earns a monthly salary of 30,000 birr. Let's also assume that the rental payment of this person is about 20,000 birr. The tax imposed on 30,000 may be 10 percent. In this scenario, the employee is left with nothing. Therefore, the employer would bear

the cost of rental payment by providing a residence house to the his/her employees. If the employment fringe benefit tax creates an equivalence between market value and the subjective value, it turns out to be a tax on the employer. So, in Ethiopia, we have a mixture tax on employers and employees.

Article 8 of the regulations no. 410/2017 lists down the kinds of employment fringe benefits. Debt waiver fringe benefits, household fringe benefits: employers may agree to provide a household person to their employees. This is particularly for experts who work and operate from gust house. C. A housing fringe benefit. D. Discount on loan interest fringe benefits: banks may provide loan in interest to their employees with a view to enabling them to buy a residence house. The employees may pay them in mortgage within 20 or 30 years

Currently, banks give loans to none-employees on 16-18 percent loan interest rate with collateral. But, if a borrower is an employee, the interest rate may be 8-9 and the house they buy will serve as a collateral. E. Mere or refreshment fringe benefits. F. A private expenditure fringe benefits: this is very specialized kind of fringe benefit for high income earners which includes payments for gym, spa, massage Etc. G. A property or service fringe benefits: this is the acquisition of the property of the employing company freely or to purchase it for low price. H. Employee share scheme fringe benefit: this gives a right to buy the share of the company. I. Vehicle fringe benefit and J. The residual fringe benefit: anything which is not categorized under the previous lists.

Article 8 (2) of the regulations provides an exception to the fringe benefits. It provides that a benefit is not a fringe benefit to the extent that if the employee acquires the benefit the expenditure incurred by the employee in acquiring the benefit would have been incurred in deriving employment income. This means, any instrument that employee deploys to perform his/her employment service is not a part of fringe benefit. For example, the employer may provide a laptop or desktop computers for the purpose of service provision. According to the above provision, such equipment's are excluded from lists of fringe benefits. There are exemptions in article 8 (4) of the regulations. There are fringe benefits which are not considered for taxation purpose. One is any benefit exempted under Schedule E of the income tax proclamation like transportation allowance, hardship allowance Etc.

The second exemption is the so-called deminimies: this are type of benefits which are not sizable. Article 8 (4) (b) of the regulations provides that a benefit, the value of which after taking in to account the frequency with which the employee provides similar benefits is so small as to make accounting for it unreasonable or administratively impracticable in accordance with the directive to be issued by the ministry is not part of fringe benefit. The third exemption is subsidy to a meal or refreshment provided in a canteen, cafeteria, or dining room operated by, or on behalf of, an employer solely for the benefit of employees and that is available to all non-casual employees on equal terms.

The fourth exemption is what is called 'employment condition benefit'; the provision of accommodation or housing to a non-managerial employee in a remote area if: (1) the employee's' usual place of employment is in the remote area; and (2) it is necessary for the employer to provide the accommodation or housing to the employee in the remote area because the nature of the employers' business is such that the employee is likely to move frequently from one residential location to another or there is insufficient suitable residential accommodation available in the remote. This situation particularly applies to the cases like employees performing a mining work. In addition, health insurances expenditures, provision of mobile phone, payment that employee incurs for mobile phone calls, tuition fees for employees paid by employer for attendance of courses offered in universities, provision of a security guard to an employee Etc. are also excluded from the list.

Lecture19-november 27, 2019.

Last time, we were talking about employment fringe benefits taxation. There is a difference between the market value of the fringe benefits and the subjective value which is quite difficult to quantify for the tax administration. Therefore, throughout the world, the presumptive rules are applied to deal with the challenge. Such rules set the value of the fringe benefits for the purpose of taxation. The public value does not accord with the private value. That is why different tax administrations adopt the principle known as 'fair market value' (FLV) or cost to employment and other system of valuation. This is also injected in article 8 and the following provisions of the 2017 of income tax regulations. In our previous session, we have observed the principle of fringe benefits under article 8 of the regulations. Now, we shall discuss separately each fringe benefits in detail provided in the following provisions of the regulations.

Debt waiver (article 9): whenever employer grants loans to the employee and the debt is waived to some stage, the waiver constitutes an employment fringe benefit. The value of the debt waived is the amount waived. This is not a common form of employer-provided benefit. Further, it requires a detailed regulation; because, it has to be determined when the debt is considered to be waived. So, the due date should be considered; until the due time, there is no debt waiver.

Household personnel fringe benefit (article 10): this type of fringe benefit is given to managerial employees; mainly for experts who come from elsewhere. Article10 provides that The value of a household personnel fringe benefit for a month shall be the total employment income paid to the household personnel in that month for services rendered to the employee reduced by any payment made by the employee for such services.

Housing or accommodation fringe benefit (article 11): house fringe benefit is the very common type of benefit that employer provides to the employee. Like other benefits, the question arises as to the value of the house when the employer provides housing fringe benefit. Article 11 (1) states: "The value of a housing fringe benefit provided by an employer to an employee for a month when the employer owns the accommodation or housing shall be the fair market rent of the accommodation or housing for the month reduced by any payment made by the employee for the accommodation or housing".

When the employer does not provide the house by itself and the house is rented from third party, article 11 (3) says it is the amount of rent paid by the employer to the third party. This looks a very easy rule at face value; however, what is the fair market rent? How do we find it? The critical problem is that the rental value has no objective value; it is not public value. Hence, it is the broker (Dalala) who knows the fair market of something. The trouble with this rule is that it exposes the employers to set of uncertainties. Because, employers have no viable means to ensure the fair market rent. However, if the employer rents the house from another person, it becomes easy. In such circumstance, the actual amount paid by the employer is considered.

Discounted interest loan fringe benefit (article 12): article 12 (1) of the regulations provides: "A loan provided by an employer to an employee is a discounted interest loan fringe benefit if the interest rate under the loan is less than the market lending rate". This is very essential rule to regulate companies which do provide loan to their employees at affordable interest rate. For

example, commercial bank of Ethiopia (CBE) may provide a long term loan to the employee to buy a house which is used as a collateral of security at the rate of 9 percent. From this scenario, what we need to assess is whether the above rate of interest is lower than the market rate as envisaged in the regulations. Obviously, the rate in the forgoing example is not a market rate. Again, we face the same controversy in respect of the standard of market rate.

It is important to consider that a market rate may vary from one loan to another. For instance, housing mortgage loan is different from trading loan. There is also difference in the length of a loan. For example, short term loan, medium term loan and long term loan have their own distinct interest rate. A loan payable within 20 years Is not equal to a loan payable within 6 months. Typically, employees seek loans to acquire some other benefit like vehicle, houses Etc. The other vital thing that should be considered is the difference among banks. The interest rate that each bank charges may vary from the rest. If the employer is the bank, it is not difficult to fix the rate; but, if the employer is not a bank, the question arises as to with which bank should we compare. For example, CBE may charge 15 percent, Awash bank 14 percent, and Birhan Bank 14 percent.

The variation in rate may entail not only legal obligation, it also has risk of auditory challenge.

Because, during the comprehensive audit, for example, the auditor may simply reject alleging that the rate is not the fair market rent. So, it is risky particularly for private employers. Further, sub article 2 of the same provision states: “The value of a discounted interest loan fringe benefit for a month shall be the difference between the interest paid by the employee on the loan for the month, if any, and the interest that would have been paid by the employee on the loan for the month if the loan had been made at the market lending rate for that month”. Why should we take the average market lending rate? For example, why don’t we take the lowest rate? Let’s ad another simple scenario to proceeding example. Let’s assume that Inat Bank provided 12 percent interest rate. What if, for example, the employee demands to take this rate? Sometimes, the interest rate is factor of so many things; for example, the aforementioned 12 percent should be calculated in light of the income of the person.

Meal or Refreshment Fringe Benefit (article 13): article 13 reads: “The value of a meal or refreshment fringe benefit shall be the total cost to the employer of providing the meal or refreshment reduced by any amount paid by the employee for the meal or refreshment”. This

requirement of cost removes the confusion of fair market rent. Because, the employer can simply show the amount of cost he incurred. However, it must be noted that although this could be relief for most employers, it cannot apply to a hotel or hospitality industry. Because, it is difficult to assess such free services in hotel industry as they usually provide it in excess. There is no receipt which is issued to record such expenses.

Vehicle fringe benefit (article 14): under this provision, we have formula for valuation of vehicle as a fringe benefit. The formula is: A times 5 percent divided by 12. A stands for the cost of the acquisition of the vehicle. In income tax depreciation, vehicle normally depreciates in 5 years. The other important consideration is that the value cost of vehicle is extremely high which highly affects the employers. Because, there are various tax burdens of tariffs. To mention some of them, 16 percent excise tax, 35 percent customs duties, 15 percent value added tax, and 10 percent sur tax.

Let's say the value of the car is 1.5 million birr. The monthly fair market value is 6250 birr. The calculation of the tax can also be problematic; if we calculate it separately, the amount of tax that should be withheld for this is 997 birr. If we consider the car in progressive tax terms and apply 35 percent (flat), the amount of tax is 2187 birr. But, such extremely high value of car is unreasonable price in the sense that it is obvious that it has artificially inflated by the disproportionate amount of duties that the people have to pay. If the car Is imported on duty free, it does not show the actual cost of the car. So, the cost of the car, in our scenario, 1.5 million Plus the duties and taxes which would have been paid for acquisition of the car had the car been acquired without duty free.

Article 14 (2) of the regulations provides that: "Subject to sub-articles (3) and (4) of this Article, the value of a vehicle fringe benefit for a month shall be the amount calculated in accordance with the following formula: (A x 5%) 12 Where: A is the cost to the employer of acquiring the vehicle or, if the vehicle is leased by the employer, the fair market value of the vehicle at the commencement of the lease. However, in case of a vehicle imported free of duty and taxes, the value of the vehicles' fringe benefit shall include the duty and taxes that would otherwise have been paid on the vehicle". The provision refers to leasing car; but, what happens when the employers pay for leasing companies? The concern is about service cars, which are available for

large number of employees. When the employer provides such service cars, are they taxable or exempted?

Article 14 (3) of the regulations talks about value of the vehicle fringe benefit and the deductions that should be made. Article 14 (3): From the value of a vehicle fringe benefit calculated under sub-article (2) of this Article the following shall be reduced:

a) any payment made by the employee for the use of the vehicle or for maintenance and running costs;

b) the proportion of the use of the vehicle (if any) by the employee in the conduct of employment;

c) the proportion of the month (if any) that the vehicle was not provided to the employee for private use.

The rule under article 14 (3) (b) warrants the classification of vehicle use in to private use and employment or business use of a car. The use of the car for employment is not taxable. Now, the question is: how do we know how much time, from the total use of the car, is being used for business? It is important to have a detailed directive on application of this rule. For example, the directive may prescribe in terms of mileage. So, if it is about 30 Kms from employee's home to the work place, the length of such travel is multiplied by numbers of the days in a week and then in 4 months. Therefore, the directive may prescribe that the difference between the total mileage and the private use of a car is a business use. However, this is extremely difficult to administer. The 10 percent rule is very appropriate for employers to overcome such regulatory challenge. The 10 percent rule is a rule whereby the employers can simply pay 10 percent of the salary of their employees.

Private expenditure fringe benefit: the only worth noting point in respect of this type of fringe benefit is that it is more or less like a residual fringe benefit. Property or services fringe benefit: (article 16); under this article, there is a presumptive rule which states:

Subject to sub-article (3) of this Article, the value of a property or services fringe benefit shall be:

a) if the employer supplies the property or services to customers in the ordinary course of business, 75% of the normal selling price of the property or services; or

b) in any other case, the cost to the employer of acquiring the property or services (art. 16/2 of the regulations).

The other worth mentioning provision Is sub-article 4 of the forgoing provision which provides: "For the purposes of sub-article (2)(a) of this Article, if the property or services fringe benefit is the provision of free or subsidized air travel by an employer that is an airline operator, the normal selling price is the standard economy fare for the flight provided by the employer".

This is a very huge burden for the Ethiopian airlines; because, airlines do not provide a free air ticket not for the purpose of fringe benefit. Rather, because they know that it has no cost to them. But, even though the airline is providing the tickets at no cost, for tax purposes, it is assumed that 75 percent of the fair market of the value of the free ticket would be subject to taxation. So, the ultimate tax liability would go to the airline.

Employee share scheme fringe benefit: this benefit is called 'share option' or 'stalk option'. For example, if a person is an employee of a share company, he may agree with his employer, in stalk option contract, that in the future he will be able to buy the stalk (share) which is of 50,000 birr from the company. But, the employee exercises this benefit only if he fulfills certain criteria. It is a sort of additional incentive for employee to work very hard, rich certain performance standards Etc. This basically means that the 50,000 birr is considered as employment fringe benefit. The employees will be shareholders after acquisition of share. They can also transfer the share since the share is, by virtue of the law, a property. Article 17 (2) (b) provides that in such cases, employees will pay the capital gains tax in accordance with article 59 of the income tax proclamation.

If the employee transfers the share for 70,000 Birr, for example, how much is the capital gain tax? The other kind of employment fringe benefit is residual fringe benefit which is provided under article 18 of the regulations. Residual fringe benefit is any benefit which is not specified by name in this regulations the valuation of which shall be in a manner prescribed under article 18 of the same law. On the other hand, article 19 of the regulations is vital provision to overcome

all the administration complexities arising from the application of the employment fringe benefit. Because, it puts a limitation on the amount of a fringe benefit that should be applied.

Article 19. Limitation of Tax Liability on Fringe Benefits

1/ Notwithstanding the provisions of this sub-section, the aggregate tax liability on fringe benefits shall under any circumstance not exceed 10% of the salary income of the employee.

2/ For the purpose of this Article "salary" doesn't include other employment related benefits. This implies that employment fringe benefit is calculated separately. The tax liability on employment fringe benefit, according to this law, is imposed on the total value of the provided benefits.

Lecture 20-december 2, 2019.

Last time, we have finalized our discussion on the employment fringe benefits. The next issue that we will observe is exemptions for Schedule A in respect of fringe benefit as provided under the proclamation and the subordinate legislations (the regulations and the directive) in particular reference to the current directive issued by the ministry of finance in this year (2019). The provisions of article 65 (1) (a, b, c, and d) are the provisions which set forth the exemptions in respect of schedule A. even though these excluded are considered as income, they are exempted by the grace of the legislator. There are several reasons for such exemptions. First, they are employment-related expenses. As we have discussed in our previous sessions, one of the characteristics of schedule A is that it is a tax imposed on gross income without any deduction of expenses. Therefore, the law is trying to compensate such disadvantage to the tax payers through some kind of proxy.

It is not administratively feasible to allow every employee and employer to submit all of their lists of expenses as it becomes onerous for the tax administration. For example, transportation allowance is granted to the employees to cover the cost of transportation from their home to the work place and vice versa. So, to find some kind of equitable solution to the problem of denial of deduction, the law invented a kind of proxy which is exemption or exclusion. The second reason is the need to adopt varieties of economic, administrative and social policies. Though they may not necessarily be related to the employment related expenses, they highly advance the policies

of the government in power. This can be drawn from the nature and scope of the exemptions. These exemptions are not open-ended; there are some prescribed conditions that need to be met for the application of these exemptions.

One of the exemptions is medical allowance-article 65 (1) (a) (1). Medical allowance is an amount paid by employer to cover the actual cost of medical treatment of an employee. This provision provokes a number of questions. For example, what does the law mean when it says "actual cost of medical treatment of an employee"? for example, if an employer purchases a medical insurance for the employee, does it amount to the 'actual cost of medical treatment'? the other question Is who is an employee? What if, for example, an employer purchases a medical insurance for the employee's family, does it fall under the umbrella of this provision? The third question is what is a 'medical treatment'?can it be a payment for spa, gym Etc in the sense that they help to prevent disease? Should the employee necessarily go to the hospital?

These days, there are different kinds of therapies like music therapy, poetry therapy, working therapy Etc as an alternative medicine. So, it begs a question how to identify medical treatments from the none-medical treatments. These all questions can be answered in the income tax exemptions directive, directive no. 1/2019 which is available at the website of ministry of finance. The second type of exemption is transportation allowance. According to article 65 (1) (a) (2), transportation allowance is an allowance in lieu of means of transportation granted under a contract of employment. If an employee provides with service, it is virtually exempted as there is no value for it. if an employer pays a transportation allowance on monthly basis in the form of cash, it is governed by the rule of article 65 of the proclamation since there is no valuation problem. But, what if an employer monthly pays for transportation service providers on behalf of an employee?

The easy form of transportation allowance is that which an employer monthly pays an employee a specified amount of money for transportation cost. In such circumstance, nobody checks whether an employee is using the money for transportation or the means of transportation he/she uses. According to article 3 (b) of directive no. 1/2019, a transportation allowance is an amount of payment made to the employee in accordance of the employment contract between an employer and an employee to cover the cost that an employee incurs while traveling from his/her home to the work place and from work place to his/her home. This provision encompasses two

types of transportation allowances; one is commuting (from home to work place and back) and the other is a real transportation allowance which is required by the nature of the work.

Prior to this directive, commuting was not exempted. However, it must be expressly stated in the contract. Article 5 (1 and 2) of the directive put a limitation on this exemption. The exemption should not be in exxess of 1-4th of the employee's salary. However, in case 1-4th of the employee's salary is beyond 2220, it shall not exede 2220 birr. For example, if the employee's salary is 20,000 Birr, 5000 Birr will be 1-4th value. So, according to the above provisions, the maximum limit of its exemption for the purpose of transportation is 2220. However, if the salary of the employee is 5000 Birr, it shall not exceed 1250 Birr. If the transportation is for commuting, sub-3 of the same provision prescribes that whether a transportation service is provided or not, up to 600 Birr of the employee's salary is exempted for the purpose of transportation allowance. So, the limitation of 2220 only applies to the work-related transportation allowance.

Hardship allowance-article 65 (1)a) (3):previously, hardship allowance was known as " ye bereha abel", "ye ayer nibret abel" Etc. in Kidus Pawlos hospital, there were doctors who claimed for special allowance for they operate a mortuary in the hospital, where the dead bodies are kept before an autopsy is conducted. The doctors complained that they suffer from different kinds of hardships like the pressures of compressed chemicals, bad smell out of the dead bodies and other psychological and biological pressures while they operate the mortuary. Finally, the authorities replied that they wouldn't pay a hardship allowance for mortuary; because, a hardship allowance only intends to remunerate the hardship in desert areas. They inferred this conclusion from the Amharic version of the name of 'hardship allowance' which is translated as "ye bereha abel".

Such allowances are paid for better nutrition of the employees in order for them to accomplish their tasks dilligently. For example, employees who spray chemicals are paid such allowances. It is a form of compensation for the risks they take at the work place. The current directive has come with solution to resolve this controversy by setting two standards of measuring hardships. The first type of hardship is the working condition hardship. Thus, pursuing to article 3 (d) of the directive, hardship includes difficulties that have a negative consequences on the health of the employees. So, when the nature of the work exposes an employee to effects of chemical

compressions, lack of fresh air, adverse weather condition, disease Etc, a hardship allowance may be paid. The second standard is the working place hardship. A hardship allowance is paid where the working place is remote from urban areas, unsuitable for living or when it has any other adverse condition for the employee in accordance with the directive issued by the civil service commission. There are identified places the weather of which appears to be hot by the commission. So, this rule follows those standards while setting hardship allowances. When the hardship Is caused due to the working place, the standards of the civil service commission will be applicable. On the other hand, if it comes from the working condition, an employer may require a verification from the ministry of revenue to pay a hardship allowance.

When the civil service commission designates the places, it also determines the amount of the hardship allowances. Thus, the employer will be bound to follow such limit. The other exemption is transportation expenses and per dime payment to an employee traveling on a tour of duty. This is a transportation expense covered by an employer when an employee is required to travel away from the normal place of work. According to article 5 (5) of the directive, such expense may not exceed the working tariff price or the total amount of the expenses that an employee paid for all means of transportations services. So, the exemption is based on actual cost incurred by an employee which is to be proved. With respect to per dime, article 6 of the ~~proclamation~~ provides that a per dime payment to an employee is exempted from tax up to 500 bir or or 4 percent of the employees salary or less than the greater value of both of them. Although this is quite improvement, it still creates a problem. Because, according to the forgoing provision,an employee who earns 100,000 birr will acquire 25,000 birr in the form of per dime.

Traveling expenses paid to an employee recruited from a place other than the place of employment is another type of exemption. This includes the case where the travel expenses have been paid pursuant to specific provisions of the employee's contract of employment (article 65/1/a/4 of the proclamation). Remember:there is difference between transportation expense and traveling expense. Transportation expense is paid for transportation costs. On the other hand, traveling expense is paid not only for transportation, but also for accommodation. So, it also may include food. The private employees may travel many times in a year. For instance, an expert that works In Ethiopia may travel to the country and back to his/her home 4 times in a year. All these travel expenses are covered by an employer. In most cases, however, the tax authorities

tend to limit such travels to twice a year. In such cases, the employee may demand for exemptions of travels that he/she takes to visit his family whose residence is outside Ethiopia more the prescribed limit. So, this Is very controversial issue that usually occur between the tax authorities and the employees.

Mode of payment.

According to article 88 of the income tax proclamation, the primary mode of payment of employment income tax is withholding. So, the employer bears a legal responsibility and liability for withholding of taxation. Employees are utmost passive in the payment of employment tax. The Ethiopian law adopts this rule for the purpose of administrative simplicity of the withholding taxation. Article 88 (1) reads, "Subject to sub-article (2) of this Article, an employer paying employment income to an employee who is subject to employment income tax under Article 10 of this Proclamation shall withhold tax from the gross amount of each payment of employment income made to the employee at the rate or rates applicable to the employee as specified in Article 11 of this Proclamation".

However, in case an employee works for several employers, and the employer is aware of such fact, an employer should agrigate the total gross income of the employee. It is the duty of the employee to inform the second employer that he/she is working for another employer. Otherwise, the employee will be liable for the difference that has not been deducted (art. 88/2 of the proclamation). The other situation is where an employee works for an exempt organization. Article 93 of the proclamation states that workers who works for exempt organization are subject to 'self-withholding' which is very controversial feature of the Ethiopian taxation. Exempt organizations are organizations that enjoy immunity from withholding. These are like embassies, consulars, international organizations Etc. A self-withholding obligation is an obligation on the part of the employee to withhold the tax and pay themselves which should technically be called self-assessment. However, if the exempt organization withholds the tax voluntarily, It is not necessary for the employee to self declare. Article 93 (2) of the proclamation states that Sub-article (1) of this Article shall apply only when the international organization or foreign government does not withhold tax as required under Article 88 of this proclamation. This is not

properly enforced in Ethiopia partly because, if the employer chooses not to comply, it shall be inapplicable.

Schedule b: income from rental of buildings.

If it is rental of any other property than building, it will go to the territory of different schedule. For example, rental of business assets is subject to schedule C. On the other hand, if it is casual rental of property, it will fall in to schedule D. it may also result in higher purchase or financial lease when it is rent plus finance but, normally, when rent is combined with finance, it is considered as the form of sell which takes it to the boundary of schedule C. as far as tax law is concerned, schedule C is preoccupied with rental of building for a short term. Even in cases of long term, it does not, in any way, involve a transfer of the property. In our federal structure, it creates jurisdictional conflicts. Because, according to the constitution, rental of buildings is the income of regional governments. But, sale of building by a sole proprietor will be the regional income tax; if it is by companies, however, it is joint income.

Article 13 of the proclamation provides that Rental income tax shall be imposed for each tax year at the rate or rates specified in Article 14 of this Proclamation on a person renting out a building or buildings who has taxable rental income for the year".

Rental income tax is specified in article 15. art. 15 (2): Subject to sub-articles (3) and (4) of this Article, the gross amount of income derived by a taxpayer from the rental of a building for a tax year shall include the following:

a) all amounts derived by the taxpayer during the year under the lease agreement, including any lease premium or similar amount;

b) all payments made by the lessee during the year on behalf of the less or according to the lease agreement;

c) the amount of any bond, security, or similar amount that, during the year, the taxpayer is entitled to retain as a result of damage to the building and that has not been used by the taxpayer in repairing the damage to the building;

d) the value of any renovation or improvement made under the lease agreement to the building when the cost was borne by the lessee in addition to the rent payable to the taxpayer.

Lecture21-december 4, 2019.

Last time, we have started to discuss Schedule B. As we shall see in detail in due course, unlike schedule A and schedule D, Schedule B and schedule C share many things in common. The major difference between the two schedules is source of income. The source of income for schedule C is business profits. Whereas, for schedule B, one type of property is subject to source of income which is rental of [building] including furniture if it is necessary. However, we must be careful while drawing such distinction; because, there are times when rental of building may not be subject of schedule C like the case of hotel or hospitality services. The other one is casual rental. Casual rental is the most unusual and anomalous kind of rental property which is subject to schedule D. The scope of casual rental is still not clear.

Article 58 (1) of the income tax proclamation reads, "A person who derives income from the casual rental of asset in Ethiopia (including any land, building, or movable asset) shall be liable for income tax on the annual gross rental income at the rate of 15% of the gross amount of the rental income". "This is one of the most enigmatic type of income in Ethiopian taxation. It is not always clear what casual is, how casual should it be ". Real estate companies are subject to tax under schedule B. But, remember: a real estate company does not necessarily have to rent; it can also sell. The second scenario is another type of business, a bank, let's say Hibret Bank, having rental of offices. The third scenario will be a house owner who conduct rental of residential houses. In the case of a real estate company, the sale is reported under schedule C. The rental offices of Hibret bank is reported under B and the rental of residential houses falls under B. As mentioned earlier, a hotel business is reported under schedule c despite the fact that it rents offices.

The question is: is there any logic to this income tax allocation? Even more, in FDRE constitution, schedule B is mainly regional tax. But, in case of schedule C, if it is the company, it can create a jurisdictional conflict; because, the regions want to maximize their revenue and may demand a company to report separately the rental of offices even if it is hotel. "One of the recommendations [I] make, but of course it requires a constitutional amendment, is to merge

schedule B with schedule C, as long as the income is generated in the context of a business. Even though it is a separate income, [I] would, from administrative point of view, argue that rental income, in many ways, should be part of schedule C except for the rental of house owners who are doing on an irregular basis".

For example, there is no valid reason to require a real estate company to report its rental of offices under schedule B and its sale of buildings under schedule C. There is also no stronger reason to require bank to report its rental of offices separately from its banking business. Because, such splitting of reports will increase the compliance cost of the companies. Anyway, there is a huge constitutional barrier to merge these two schedule. Under the current income tax arrangement, one real estate company is thus required to have two separate accounts; one is for the sale and the other for the rental. This can also create complexity in terms of reporting expenses. We have said that schedule B is a net income like schedule; meaning, deductions incurred for the generation of income are allowed. So, the taxable is the difference between gross income minus deductions. If it is an entity, the tax rate is flat; if it is an individual, it is progressive under schedule B.

Article 15 (5) of the income tax proclamation divides schedule tax payers in to two; those tax payers who maintain books and whose expenses are deductible in accordance with the expenses recorded in the books and those who do not maintain books and records. Article 3 of the proclamation stipulates categories of schedule B and schedule C tax payers. Therefore, under this provision, tax payers are divided in to three categories for the purpose of maintaining books and records as schedule A, schedule B and Schedule C. We distinguish them mainly on the basis of their annual turnover and the type of organization. Category A tax payers are all entities or business organizations and any other person having annual gross income of birr 1000,000 or more. Regardless of its annual gross income, any business organization is a category A tax payer; thus, there is no category B or category C business organization. Category B tax payers are tax payers being a person, other than bodies, having an annual gross income of birr more than 500,000, but less than birr 1000,000. On the other hand, category C tax payers are tax payers being persons, other than bodies having the annual gross income of birr less than 500,000.

So, when article 15 (5) of the proclamation refers to "who do not maintain books and records", it mainly refers to category C tax payers. Because, under the law, it is only category C tax payers

who are not required to maintain books and records. They are assessed tax through presumptive rules of taxation and referred to in Amharic as ye kurt gibir kefayoch. Then, the next question will be how the expenses of category C tax payers is deducted under schedule B? Article 15 (5) provides:

In computing the taxable rental income for a tax year of a taxpayer who does not maintain books of account, a deduction shall be allowed for the following amounts:

any fees and charges, but not tax, levied by a State or City Administration in respect of the land or building leased and paid by the taxpayer during the year;

an amount equal to fifty percent (50%) of the gross rental income derived by the taxpayer for the year as an allowance for the repair, maintenance, and depreciation of the building, furniture, and equipment.

Let's assume A is a rental of a building whose annual gross rental is 400,000 birr. So, 200,000 birr is deducted. Fees and charges are separately treated; because, the individual can simply acquire the receipt for his/her lease price as long as it is paid to the government and demand for deduction by producing the receipt. So, the deduction encompasses all depreciations that the person incurred while constructing the houses. However, the provision says "fees and charges payable to the city administration"; it does not speak of the deduction of tax. The question follows: why the taxes are not deductible? Obviously, one tax which is not deductible is the forgoing tax itself; because, the reason why we apply deductions is to determine the amount of tax that should be due. But, the question still lingers; why other corollary taxes like property tax Etc are not deducted?

Normally, it should be referring to the same tax (rental of building) though it can lead to a dispute. Whenever we talk about tax, it should be related to the property; for example, with respect to rental of buildings, there couldn't be a valid claim for deduction due to the employment income. Because, the two are completely different types of taxes. For example, there might be stamp duty; "if a person pays stamp duty to the authority, [I] believe it should be deductible". We should actually limit the taxes to the tax itself. A tax which is due under schedule B could not be deductible. This is a simple rule which relieves the tax payers under this

category from complex task of maintaining books and records. So, there is no need of receipt for a person who leases a residential house and discharges an electricity fees by him/herself.

Now, the question follows; what if this tax payer submits the receipts of his expenses for electricity fees demanding deduction? Is that deductible separately from the 50 percent rule? How much is payable to the city administration? Obviously, electricity is not a charge or fee levied by the city administration; irrespective of the land or building, it is for the use of the electricity. It is paid for the rental of building and hence should be included in the 50 percent. On the other hand, article 15 (7) of the proclamation gives a lists of deductions which is applicable to category A and B which are required to maintain books and records. Article 15 (7) provides: In computing the taxable rental income for a tax year of a taxpayer who maintains books of account, a deduction shall be allowed for any expenditures to the extent necessarily incurred by the taxpayer in deriving rental income and paid during the year including:

a) the cost of the lease of land on which the building is situated;

b) repairs and maintenance;

c) depreciation of the building, furniture and equipment;

d) interest and insurance premiums; and

e) fees and charges, but not tax, levied by a State or City Administration in respect of the land or building leased.

This provision also evokes hosts of controversies. For example, let's assume someone does not maintain books and records. But, let's say he has built his house by taking a loan. So, he pays interest to the bank. Can this person present this interest as a separate bill if he doesn't maintain books and records? In the case of category, A and B, it is possible to deduct the interest. But, where the books and records are not maintained, the only expenses which are deductible on actual receipt of the cost are the fees and charges payable to the city administration. Schedule A is exempted from tax up to 7200 Birr in a year which could also be applicable to schedule B. So, it is better to rent a building than to work for another. A person who rents building and earns 400,000 Birr of gross income in a year will acquire 33,000 Birr of monthly salary. From this 33,000 birr, 35 percent is subject to tax. Almost certainly, the schedule B tax payer pays much

lower than the schedule tax payer because of the rule of net income taxation. Thus, the tax rate is not uniform though it seems uniform.

Assume that unless exceptionally provided by law, the rules under schedule C pertaining to rules about losses, depreciation Etc apply to schedule B. So, it is quite important to understand the rules of schedule C to perceive Schedule B. Sometimes, individuals may sub-lease part of the building they possess by rent to a third parties for offices or residence. In respect of such sub-leasing, article 16 (1) of the proclamation provides that The taxable rental income of a sub-lesser of a building for a tax year shall be the difference between the total rental income received by the sub-lesser during the year and the total rental income paid to the lesser of the building plus other expenses to the extent necessarily incurred by the sub lesser to generate the income. This is a situation where the payment that is paid to the lessor by sub-lessor is considered as an expense in time of taxation. But remember: in accordance with sub-article 2 of the above provision, the primary responsibility for taxation of a sub-lessee rests on the lessor in case the lessee fails to pay the tax.

Schedule C.

Schedule C consists of income from business. So, as usual, we have to define the scope of the schedule before our considerations about the detailed rules and ideas. Therefore, we need to define the concept of 'business' on which the schedule C hinges. What is business? Business is defined under article 2 (2) (a) of the income tax proclamation as "any industrial, commercial, professional, or vocational activity conducted for profit and whether conducted continuously or short-term, but does not include the rendering of services as an employee or the rental of buildings". In this all-encompassing definition, there are two tests; the activity test and the intention test. The list of activities in the definition is almost endless so that it involves all industrial, commercial, professional or vocational activities. So, it is possible to conclude that any activity that is done for profit is a business. Even if someone makes money out of praying for somebody, that is business.

As far as taxation is concerned, the formality of registration, license or form of operation doesn't matter; what matters is what do we do and why do we do. The only thing that schedule C excludes from its ambit is the rendering of services as an employee. However, an independent

contractor is subject to this schedule. The two subsequent sub-articles (B and C) of the same provision even expand the range of schedule C by including any activity that is considered as a trade under the commercial code and any activity other than rental of buildings of a share company or private limited company regardless of its object.

Lecture 22-december6, 2019.

Last time, we have commenced to discuss about the scope of schedule C. Today, we would further explore this schedule. As we did in our previous session, the first question that needs to be addressed in schedule C is the question of its scope vis-à-Vis Schedules A, B and D as it shares boundaries with all of these schedules. For example, one of some parallel features between schedule A and schedule C is that income from independent contract is categorized under Schedule C while income from employment falls under schedule A. Some types of income relating to rental are considered as under schedule C rather than schedule B. For example, rental of business assets is chargeable under schedule C; whereas, rental of buildings is taxable under schedule B.

But, it must be noted that use of building is the subject matter of schedule C. Schedule C also shares boundaries with schedule D; because, casual rental of property is schedule D. On the other hand, sometimes, as we will discuss in due course, capital gains tax under article 59 of the proclamation also shares boundary with schedule C. The sale of buildings results in schedule D income; but, part of it also results in schedule C. So, it is essential to consider that in what situation is that a certain income considered to be under schedule C rather than the rest three schedules or vice versa. However, this does not necessarily mean that the boundaries are always clear; because of the imprecision of the tax rules, it may not be clear, so to speak, where one boundary ends and the other starts.

As we indicated last time, business is any human activity intended to profit and conducted professionally and regularly. So, what excludes an activity from the ambit of schedule B is the fact that it is covered under other schedules. For example, if a person buys a share in a share company, as a shareholder, he/she acquires a dividend. So, there is still the intention of gain though the type is somehow different. But, because dividend is covered under schedule D, it is not the subject matter of schedule B. By the same token, someone who lends money in exchange

of payment of interest collects the profit of interest. However, schedule B does not consider it as it is encompassed under schedule D. In effect, all activities that are not covered under other schedules are covered under schedule C.

Remember: there is the issue of priority; which means, when certain activity can be categorized under schedule A, B, C or D, it should be properly determined as to where should it fit. For instance, the rental of building cannot fall under C. It is quite possible for a given company to be subject to multiple taxes under Ethiopian law. Let's consider this hypothetical case. ABC company is engaged in rental of building, export and import, invests in other companies, has a publishing unit, it lends money to a subsidiary companies and rents some of its tracks occasionally which it holds for business operation and sold one of its building. According to this scenario, rental of building will fall under schedule Import export under Schedule C, investment in other companies under schedule D. With respect to publishing unit, however, we need to think twice and resolve some controversies. If it regularly publishes, we have to ask what type of income does the company get. If it sells, it goes to schedule C; if it gets royalties, it falls in to schedule D.

Further, the loan of money to a subsidiary company falls under schedule D, the sale of building under schedule C plus D, sell of tracks under schedule C, an occasional rental of tracks under C (if we consider it as business) or schedule D (if it is considered as casual rental of property). As we can understand from this scenario, this company has engaged in multiple activities which resulted in multiple taxes. This implies that in Ethiopian tax system, source is more important than anything. "Don't ask who is paying the income; ask what is the source of the income". In our scenario, ABC doesn't withhold the dividend as it is the bearer of the burden. Dividend is withheld by the payer company. So, the dividend should be a separate income account of ABC; it should not be included in the corporate income of ABC. Because, it will lead to double or triple taxation.

With respect to capital gains tax, part of the income is considered as capital gains income and part of it is considered as corporate income. Article 21 of the proclamation provides the content of business income of a tax payer. Art. 21 (1) provides: Subject to other provisions of this Proclamation, the business income of a taxpayer for a tax year shall include the following:

a) the gross amounts derived by the taxpayer during the year from the conduct of a business, including the gross proceeds from the disposal of trading stock and the gross fees for the provision of services (other than employment income); in the forgoing example, regular publishing, lending when it is by financial institutions, the regular sell of the tracks are considered to be business.

b) a gain on disposal of a business asset (other than trading stock) made by the taxpayer during the tax year; for example, the tracks are business assets the sale of which is business.

c) any other amount included in business income of the taxpayer for the tax year under this Proclamation; this rule is very vague. For example, there are business organizations who rent their hall for meeting or for wedding. Such institutions don't report it separately as a casual rental of property; because, it increases burden upon them. Therefore, this provision serves them as a legislative support. It should be allocated between the amount that should be included under business and the amount that should be involved under capital gains tax. Article 21 (4) provides:

If a business asset is a taxable asset under Article 59 of this Proclamation:

a) the gain on disposal of the asset included in business income under sub-article (1)(b) of this Article is the amount (if any) by which the cost of the asset exceeds the net book value of the asset at the time of disposal; and

b) any gain above cost is taxable under Article 59.

Net book value means the current book value of the asset. So, let's assume that we bought a building for 10 million. The building was sold 30 million after 10 years of the use of the building for business. This building has depreciated by half. So, the net book value of this building is 5 million. The cost of the asset is 10 million. Hence, the difference between 10 million and 5 million will be 5 million and that is what is considered as business income. The rest 25 million is considered as capital gains tax. This is appropriately known as 'depreciation recovery'. In the preceding example, the 5 million is considered as a business income with a view to recovering the depreciation that the business has incurred over the 10 years' period.

Under Ethiopian tax law, the rate of corporate income tax is 30 percent and the capital gains tax is 15 percent. The root cause of all these acrobatics is because of this difference. A reduction

obtained under business profit tax should be taxable under business profit tax when the asset held for the business, (building in our example) is sold. Building depreciates in 20 years; so, if a person held it for 10 years, he/she would recover the half of the cost out of the cost of the building (5 million out of the 10 million in the forgoing example). In this regard, if the tax payer is allowed to deduct the original cost, he/she will make tax saving of 5 million. This problem has been resolved in the recent legislations.

Deductions of expenses under schedule C.

Unlike schedule A, but like schedule B, schedule C is a net income tax which means that certain expenses are deductible. The rules of deduction are schedule-specific; only expenses which are incurred on schedule income are deductible. To put it differently, there must be a relationship between the expense and the income. For heuristic reason, we ought to divide deductions in to two categories; above the line deductions and below the line deductions. Above the line deductions are properly known as 'business expenses'. Below the line deductions are none-business expenses. The most examples of below the line expenses are donations and charitable contributions. These are not business expenses, but they are deductible for some policy considerations.

The next point that we shall address is the concept and meaning of business expenses. The general rule for business expenses is laid down under article 22 of the income tax proclamation. Particularly, article 22 (1) (a) reads, "any expenditure to the extent necessarily incurred by the taxpayer during the year in deriving, securing, and maintaining amounts included in business Income". In this provision, there are two important elements to be examined carefully while determining a deductible expenditure. First, there must be a direct causal relationship between the expenses incurred and the business income. Second, the expenses must be incurred for necessary conditions. The next jurisprudencial question is that what is 'necessary business expense'? Who decides what is necessary?

There are two predominant schools of thought regarding this jurisprudential contest. The first school of thought is the business judgement rule. According to this school of thought, the business person knows best. So, what is necessary is to be decided by the business person. On the other hand, the other school of thought holds that what is necessary is determined upon

subjective assessment of the tax authority. So, for this school, the tax authority may, at any time, through its auditors, decide that the expense is not necessary. On the other side, there is another group of intelligentsia that falls in between the above two propositions. According to this block, there are certain necessary expenses that are adjudged by law. Unfortunately, however, the Ethiopian tax law does not just define the general principle; it simply lays down some specific examples of cases in which it sought to resolve the issue of what Is necessary expense. This is called 'positive limb deduction rule'. These positive limb deduction rules are specific mentions of deductible expenditures; for example, one of the rules may state that interest, trading stalk or inventory is deductible.

The flipside of this is a 'negative limb deduction rule'. This rule provides for the expenses which are not, by the operation of the law, deductible. For example, although they are necessarily incurred in the operation of a business, penalties are, by virtue of the law, not deductible., Perhaps, one of the common features of the positive limb deduction rule is that in addition to prescribing what is deductible, it also gives in what conditions that such deductions should be made. So, in the typology of the deduction rules under Ethiopian income tax law, there is the general rule, positive limb deduction rule and negative limb deduction rule. The general rule Is helpful as a feature that imbues the specific deduction. The general rules dictate that it must be necessarily incurred and it should be for the purpose of deriving, securing and maintaining the business income. But, we usually start with the negative deduction rule.

However, it may cause a number of controversies. For example, if a given company is to be punished for its failure of renewing its business license, it is obvious that the penalty will not be deducted. But, a question arises whether the interest is penalty. Because, the company also pays interest separately from the penalty. In another example, let's assume that someone has a court case. In this court case, a person has to incur some costs including litigation cost for lawyers, papers, or even court fees. Let's again assume that this person lost the case and he would pay compensation. Is the compensation penalty?

The difference between the positive limb deduction rule and the negative deduction rule is that in the case of the former, the issue is not whether it is deductible or not; the issue is some kind of limitation. For example, it might say "the representation allowance can only be deductible up to 10 percent of the individual's salary". However, in the case of negative limb deduction, the law

is very clear; it only emphasizes on what is not deductible. So, penalties are not deductible for obvious reasons that the law does not want to incentivize companies to commit crimes and take advantage of it in taxation. Sometimes, the negative limb deduction rules may state the general rule; it might provide that personal expenses are not deductible. In fact, personal expenses are income if we stick to the Simon's definition of income which says income is consumption plus savings. Consumption is this personal expense. Nevertheless, personal expenses are not incurred for the purpose of generating income. But, there are still confusions with this assumption; for example, what if a person pays himself a monthly salary? Would it constitute a personal expense?

The positive limb deduction rule is declared under article 21 (1) (b), which states that a gain on disposal of a business asset (other than trading stock) made by the taxpayer during the tax year is deductible according to the international financial reporting standards. The concept of trading stalks is relevant for companies that are engaged in the sale of goods. For example, it does not apply to service companies or consultancy companies; because, they don't have trading stalks in proper sense of the term. One of the international financial reporting standards (IFRS) conventions is the method of accounting of LIFO (last in first out) and FIFO (first in and first out). For example, let's say that the Ethiopian fiscal year rans from July1 2018 to July 8, 2019 (in European terms). If the cost of goods in July 2018 was 100 birr and increased in to 150 birr in this year (in 2019), by Lifo Method, the last cost of 2019 is taken in to account; whereas, the Fifo Method considers the first cost of 2018 in the hypothetical example. Now, the question is why do we follow such conventional rule rather than following the actual cost of trading stalks?

The basic rationale behind this convention is the logical flow of goods. For example, let's hypothetically imagine two different shops, the one having no the front door and the other having only front door. In this scenario, the direction from where the goods are deposited in to the interior part of the shop creates a difference on the quality of the stalks. Because, a good which is added to the stalks for last time will be of better quality than those goods that have been previously deposited before it. The prior goods that precede may be affected in the passage of time. Thus, a typical customer who acquires the final last good will enjoy more qualified product than the subsequent customers. However, this only applies to none-fungible goods. It does not apply to perishable goods like fruits. For such goods, the Fifo method shall apply since the goods

must be sold quickly before they perish. So, these methods are helpful to create correspondence between the fiscal years. The final cost of good in one year will transfer to the next year. This in turn maintain constant and uniform market transaction.

As a matter of the law, trading stalk is deductible as it fulfills the elements enumerated under the general rules. It is necessarily incurred for the purpose of deriving, securing and maintaining the business income. In Ethiopia, we have financial reports standards proclamation after 2016, proclamation no. 847/2014. Trading stalk is a stalk which is an input or which is being processed or ready for sell. However, it must be noted that anything used for processing, manufacturing or transporting the goods to be sold is not part of trading stalk. Trading stalk is something which is used as input or raw material and semi-finished good or the finished good. Every business that engages in the sale of goods, whether as a trading business or manufacturing business, has three types of goods. One is the trading stalk that we have dealt with earlier. The second type of good is capital asset. Capital assets are assets which have a useful life of more than one year. The third kind of assets are assets which have a useful life of less than one year. These are not subject to the trading stalk rule; they are simply deductible for a specific fiscal year. For example, pens and soft papers are neither trading stalks nor capital assets.

For the trading stalks, the rule that we have considered above apply. The rules of depreciation shall apply to the capital assets. When we think about depreciable goods, we need to examine two things; one is the cost and the other is time. Depreciable assets like car, furniture's, building used for business activities Etc are deductible in the year in which they are incurred. Articles 22 (1) (b-e) give examples of positive limb deduction rules.

The other issue is interest expenditure. Article 23 (1) provides:

"Subject to sub-article (2) of this Article and Article 47 of this Proclamation, in determining the taxable income of a taxpayer for a tax year, the taxpayer shall be allowed a deduction for any interest incurred by the taxpayer in a tax year to the extent that the taxpayer has used the proceeds or benefit of the debt or other instrument or agreement that gives rise to the interest to derive business income".

Thus, interest is deductible as long as the loan is used for the purpose of deriving business income. For instance, let's say Mr. A, who is a controlling shareholder of ABC PLC, borrows 5

million from commercial bank of Ethiopia. ABC provides a security for a loan paid by CBE. If ABC pays the interest along with the loan, article 23 clearly provides that this is not deductible; because, the loan was not taken by the company for its business purpose. In addition, article 28 of the income tax regulations, regulations no. 410/2017 puts another requirement for foreign lenders. According to the provision, the interest paid on a loan to a foreign lender is deductible only if the loan is approved by the national bank of Ethiopia.

The other condition which is known as the excess interest rule is given under article 23 (2) which says:

No deduction shall be allowed for the following:

interest paid or payable by a taxpayer in excess of the rate used between the National Bank of Ethiopia and commercial banks increased by 2 percentage points; unless the interest is paid or payable to: 2/ No deduction shall be allowed for the following: a) interest paid or payable by a taxpayer in excess of the rate used between the National Bank of Ethiopia and commercial banks increased by 2 percentage points; unless the interest is paid or payable to: 1) a financial institution recognized by the National Bank of Ethiopia; or

(2) a foreign bank permitted to lend to persons in Ethiopia;

b) interest paid or payable by a taxpayer to a related person who is a resident of Ethiopia except when the interest is included in the schedule 'D' of the related person.

Let's say that the interest rate at which the commercial banks in Ethiopia can borrow is 12 percent. Accordingly, the maximum interest rate that can be deducted is 14 percent for any level except the banks themselves. Under sub-B of the above provision, there is a special condition of interest paid to a related person. For example, a shareholder is a related person by relationship of shares, votes and control. So, if a shareholder lends to the company, it is deductible only if interest is included under schedule D. Under schedule D, a company should withhold 10 percent. For deduction purpose, the company gets 30 percent. Because, the interest is deductible as long as the 10 percent is withheld. So, a shareholder loan is commercially viable because company saves about 20 percent as the interest is deductible under the rule of 30 percent.

So, the interest of the shareholder is suspicious because it can be used to deplete the dividend. If the shareholder gives loan and gets interest free from tax, he would prefer lending to equity contribution. With respect to deductions, there is a directive issued by the ministry of finance, directive no. 5/2011. EC. It is available on the ministry's official website.

There are further examples of positive limb deduction rules in the proclamation. Representation expense (art. 27 of the regulations), medical expenses for employees (art. 29), foods and beverages, expenses of hospitality business are additionally deductible. But, there is a limitation under article 30 of the regulations which dictates that they are deducted up to 20 percent of the salary expenses incurred by the employee. Pursuing to article 7 (1) of the aforementioned directive, for mining, manufacturing and agricultural companies, it is 30 percent. Business promotion expenses are, according to article 31 of the regulations and article 8 of the directive, deductible up to 33 percent of the gross turnover of the company.

Another specific example which is very useful for tax deduction purposes is a lease payment under lease capital agreement. Payments like higher-purchase and financial lease are considered as ordinary business expenses. In higher purchase agreement, there may be instalment payment; for example, it may be 25 years. After the last payment, the purchaser will be an owner of the property. In this case, the question arises, however, how should we deduct the lease amount? On the basis of financial reporting standard, the lessee records this as capital asset cost which is depreciation. Nonetheless, under the tax law, the lessee should report it as an ordinary expense. On the other hand, regardless of the nature of the contract, the lessor is considered to be the owner of the property. For tax purposes, the lessor is the one who records the depreciation.

This is laid down under article 34 of the regulations which states:

Deduction allowed for Business Asset held under Capital Goods Lease Agreement

1/Lease payment made for business asset held under capital goods lease agreement is deductible business expenditure from gross business income.

2/ A person realizing deduction under sub-article (1) of this Article shall not be entitled to depreciation on the asset.

Lecture 23-december10, 2019.

Last time, we have been looking at some of provisions as an example of positive limb deduction rules in the Ethiopian tax law. With regard to the question of what is necessary, there were real controversial cases between foreign owned business organizations and the Ethiopian tax authorities. Such organizations may enter in to technical consultancy agreements with permanent establishment or branch to secure, maintain or derive a business income in Ethiopia. In such circumstances, the Ethiopian tax authorities may reject this consultancy services directly connected to a business income on the ground that the business organizations can easily acquire those technical services in Ethiopia with cheaper expense without any arrangement with subsidiary companies.

In another example, a parent company may enter in to a 'political risk insurance' on behalf of its branch in Ethiopia. This insurance purchase meets the requirement of securing, maintaining and deriving business income. A political risk insurance is a type of insurance that multinational companies purchase to secure their business in highly politically insecure countries (like Ethiopia). So, in the event of destruction, protests, sabotage, riots Etc, the companies will be able to safeguard their business. However, the auditor may say that Ethiopia is politically secured country so that any business operation will not be at stake and hence no need to purchase such insurances. So, at the heart of this debate is who decides what is necessary. Even worse, the Ethiopian tax authorities persistently argued that the foreign companies should have bought such insurances from Ethiopian insurers, whom the foreign business organizations consider to be the victims of the same political risks so that they buy insurance to avoid.

The other essential ambiguity is regarding 'related party transactions'. Related party transactions suffer from transfer pricing. Transfer pricing is a real risky cross-border transaction simply because the parties can enter in to a contract to transfer price from entity to the other. Then the next question is: is the price at arms legs? "For [me], the business judgement rule is what should decide the case. Unless there is some transfer pricing, there is no reason why we have to suspect the business person. If we trust a business person in the generation of income, we have to also trust the business person in the incurring of the business expenses". The requirement of necessity in incurring expenses becomes problematic unless there is some personal element of it which is already excluded in the negative limb deduction.

There was a famous American case in which this phrase of 'necessary incurred' was litigated. The case involved a business person who brought a pastor to the work place to motivate the workers. The business person was arguing that he believed that a pastor's motivational speeches would improve productivity. Finally, the court decided in favor of the business person. The court ruled that although it may be extraordinary to bring in pastor for such purpose, it was necessary to motivate the workers as claimed by the business person. A business person may even install gym materials for his/her workers believing that it enhances the wellbeing of the workers thereby improving their diligence. The primary reason for having positive limb deduction rules is, therefore, to provide greater certainty in the deductibility of business expenses. It provides some of the typical expenses in a normal business operation like interest, representation allowance Etc. However, this doesn't mean that positive limb deduction rule prescribes exhaustive list of necessary business expenses. But, the purpose of positive limb deduction rule is to specify them to avoid uncertainty. The other reason is to limit the amount of deductibility.

Depreciation.

In some senses, depreciation is a solution to a problem of a negative limb deduction which dictates the none-deductibility of capital expenditures. Depreciation is a periodic allowance for the recovery of the cost of capital assets. Capital expenditures are not deductible at once; because, they generate income for more than one fiscal year. So, it is to create correspondence between the expense and the income. Capital expenditures are incurred for acquisition, improvement, maintenance or repair of the whole capital asset. This capital asset has a useful life for more than a year. So, it is not rational to deduct the cost of capital assets from one tax year. For example, a building has a life of 20 years. In other words, it generates income business for 20 years.

Thus, if it generates income for 20 years, the cost of acquiring or construction must be deducted from 20 years. Capital assets have their own rate of depreciation and method of depreciation. Depreciation has little or nothing to do with physical asset itself. The usual question in the issue of depreciation is: for how long should the tax payer be allowed to recover the cost. Different assets have their own preset rules; which are accounting conventions. For example, as mentioned earlier, buildings depreciate in 20 years. It does not matter whether they are made from bricks, tires, straw and mud Etc; they have the same depreciation rate.

Article 39 of regulations no. 410/2017 lays down the principle of rate of depreciation. According to this provision, computers, softeners and data equipment depreciate in 20 percent. Further, green house depreciates in 20 percent. Structural improvements other than greenhouse depreciate in5 percent. Any other asset depreciates in 15 percent rate. Depreciable assets used in mining and petroleum developments depreciate in 25 percent. The useful life of these assets is determined not on the basis of the reality on the ground, but on an estimation. It is a cost recovery scheme which means that it may depreciate multiple times. There is no asset, which is intrinsically capital asset. So, an asset which Is capital asset for one business may be a trading stalk for another. For a real estate company which sells buildings, a building is a trading stalk. But, for most other businesses, building is a capital asset. For a car dealer, vehicle is a trading stalk. These examples imply that the capital assets are directly linked to the nature of a business.

There are two kinds of capital assets provided under article 25 (7) of the proclamation. Article 25 (7) (a) provides an expansive account of business intangible assets. Under the second category, we have depreciable assets. Depreciable assets are tangible assets or structural improvements to movable assets that (1) have a useful life exceeding one year, (2) is likely to lose value as a result of normal wear and tear or obsolescence, and (3) is used to wholly or partly to derive business income. The third characteristics is not really important; because, every asset, in order to be allowed to enjoy depreciation allowance, must be used to derive business income partly or wholly. So, it is a repetition of the general rule which applies to all capital assets altogether. Obsolescence refers to technology. Sometimes, a technological device may be shining; but, it may be obsolete due to innovation of new advanced technologies. For example, in Ethiopia, there are some obsolete mobile phones with some users which are considered obsolete as compared to the smart phones of these days. For instance, there was a type of mobile phone product which was locally called Semahegn Belew. Thus, we have deep-rooted tradition of associating originality of technologies with names rather than their technical value. This made foreigners to regard Ethiopians in various ways in respect of technologies.

Once, there was an Italian who lived in Ethiopia for a long time and came to be able to speak Amharic well. He observed such situation in light of other countries. He thought that various nations created I-phones, I-pad, apple and other highly efficient mobile products. Finally, he said to his friends that the only thing that Ethiopians have deviced is “aychalim/ayhonim” (the belief

of everything is impossible). Wear and tear refers to the deterioration of the capital asset due to physical use. In tax law, there are certain assets which do not depreciate; for example, works of art. If such type of assets are acquired by business income, they should not be subject to depreciation. So, according to this rule, they are not recovered. The resale value of this asset is much higher than the acquisition value. The other none-depreciable asset is land. The general assumption is that although the structural arrangements on land may depreciate, land does not depreciate by itself. Jewelry is another example of none-depreciable asset.

The question of rate of depreciation.

Under Ethiopian law, the rate of depreciation has always been straight; every year, the same rate is applied. For the purpose of applying the rate, article 39 of the regulations provides that there are 5 categories of assets. The first category is building which depreciate in 20 percent. Computer softwhere and data storage equipment's: these are information technology assets. They depreciate at 20 percent. Under this category, we have all gadgets connected to the computer including printers, photo-copiers, scanners Etc. These assets depreciate in a pool; meaning, the asset does not have an individual identity. Green houses depreciate at 10 percent. The status of greenhouse still remains controversial; some business entities thought that green houses are immovable assets. Thus, there were some companies that used the 5 percent of depreciation for building. The authority on its part insisted that they look like any other building and should depreciate at 20 percent. Structural improvements on immovable properties other than greenhouses: the definition of such kind of asset is given under article 25 (7) [c] of the proclamation which reads:

"structural improvement", means a building or any other addition or alteration to immovable asset that becomes part of, or is permanently affixed to, the immovable asset including a road, driveway, car park, fence, or wall.

The depreciation rate of structural improvement is thus 5 percent. Any other depreciable assets: this is a large category of depreciable assets which includes vehicles, machineries, tools and furniture's. These also depreciate in a pool at 15 percent. The cost of each independent asset may be traced; However, for the purpose of depreciation, one company maintains one pool. The 5th category is depreciable assets used in mining and petroleum development operations which are

related to the mining and petroleum development operations. They depreciate at 25 percent. This is an accelerated rate of depreciation; because, mining companies essentially recover costs in 4 years. Here, the question arises where a building owned by mining companies should depreciate at 25 percent or the rate separately fixed for depreciation of buildings. This rule of 25 percent has been replicated in the current income tax law from the old mining and petroleum law.

There are two business intangibles; preliminary business expenditures and post-business starting expenditures. For preliminary expenditures, 25 rate is allowed. Preliminary expenditure is an expenditure for intangibles incurred prior to the commencement of business operation. For post-starting business expenditures, on the other hand, the rate is 10 percent. Business intangible is defined under article 25 (7) (a) of the proclamation as:

In this Article: a) "business intangible" means any of the following when used wholly or partly to derive business income:

(1) a copyright, patent, design or model, plan, secret formula or process, trademark, or other like asset or right that has a limited useful life;

(2) a customer list, distribution channel, or unique name, symbol or picture, or other marketing intangible that has a limited useful life;

(3) contractual rights (including arising as a result of a prepayment of an expenditure) with a benefit for a limited period, but which exceeds one year;

(4) an expenditure that provides an advantage or benefit for a period of more than one year, but not including expenditure incurred to acquire any tangible movable or immovable asset.

But remember: business intangibles become subject to depreciation only if they are acquired at cost. Some of the business intangibles are acquired in the course of doing the business itself. For example, goodwill is acquired by business operation. Any pre-incorporation cost that shareholders incur for forming a company can be considered as preliminary expense. They are not necessarily related to the acquisition of an Asset. Otherwise, if they are related to acquisition of asset, they depreciate as part of the assets. In defining 'preliminary expenses', article 39 (3) of

the regulations refers to the above definition of business intangibles provided under the proclamation.

The other question is: what sort of expenditure is considered as capital expenditure? According to article 68 of the income tax proclamation, a capital expenditure comprises the cost of acquisition of the asset included in the market value of the asset at the time of acquisition and, in case the asset is constructed, the cost of construction, production or development. In addition, any incidental expense to acquire or to dispose the asset and additional expenses incurred to install, alter, renew, reconstruct or improve the asset are also part of capital expenditures. With respect to cost of repair and improvement, there must be distinction between the ordinary repair cost and the cost of improvement of a capital asset. If the cost constitutes ordinary repair under the law, it is deductible once in a year in which it is incurred. In tax law, this is called 'expensing of the cost'. If the cost incurred results in alteration or improvement of the asset, it is capitalized in to the cost of the asset. Article 41 of the regulations provides for simple way of distinguishing the ordinary repair from alteration or improvement of the capital asset. The provision provides:

Repairs and Improvements.

1/ Subject to sub-article (2) of this Article, a taxpayer shall be allowed a deduction for a tax year for the cost of a repair or improvement made to a depreciable asset during the year.

2/ The amount of the deduction allowed under sub-article (1) of this Article shall not exceed twenty percent of the net book value of the asset at the end of the tax year.

3/ If the cost of a repair or improvement made to a depreciable asset during the year exceeds twenty percent of the net book value of the asset, the whole cost of the repair or improvement shall be added to the net book value of the asset.

For example, let's assume our favorite company ABC constructed a building for 2 million birr in 2014. This year (2019), ABC incurred 1 million birr for improvement of the building X; this is an additional cost incurred 4 years later. In this scenario, the question arises whether we should allow the company to deduct 1 Million birr as a whole or should we add it to the net book value of the asset. The net book value describes the undepreciated cost of a business asset. A company gets 5 percent of 2 million; in the forgoing example, it becomes 100,000. So, in our scenario,

ABC recovered 500,000 within 5 years. Hence, the net book value of the building will be1.5 million. Obviously, it is more than 20 percent. So, the company is not entitled to deduction; this 1 million will be added to 2 million. But, it must be noted that after 2019, this company will get a depreciation for 3 million.

One may be confused when he/she asks him/herself why don't we simply add this 1 million birr to 2.5 million birr. That is because of the method of depreciation for building is a straight line method of depreciation. In straight line method of depreciation, the rate of depreciation remains constant; the building depreciates at 5 percent, at the same rate, for the same value for 20 years. Therefore, in our scenario, this 2 million value depreciates up to 2033 in the absence of improvement. There is another method of depreciation; which is called declining or diminishing method of depreciation. In this method, the rate is constant while the base changes. For example, let's see a very simple example of vehicle and building. These two assets costs 1 million. Both of them are acquired in 2014. As mentioned earlier, the building gets 5 percent (50,000) for depreciation. This doesn't change up to 2033.

On the other hand, vehicle gets 15 percent (150,000 birr) in 2013. The second year net book value of the asset is calculated as 1 million -150,000 Birr 850,000 Birr times 15 percent equals to 127,500 which is added to the prior cost of depreciation. We add this for the third year and it becomes 1 million -277,500 Birr times 15 percent which is 722,500 birr. So, as we can capture from the above mathematical zigzag, in diminishing method of depreciation, the base changes as we go along. We follow the same mathematical path until we ascertain the smallest amount of cost to be deducted upon the final year of depreciation for the asset in consideration. Remember: we should think about the international financial standards whenever we talk about all these tax rules. Capitalizing is adding the additional cost to the depreciation cost. But, expensing is deductible from such cost. For example, let's say the additional cost of improvement is 50,000 Birr. This 50,000 Is obviously less than 20 percent of 1.5 million Birr. In this case, we presume that this 50,000 is deductible as a whole.

So, if the cost is more than 20 percent of the net book value of the asset at the time of incurrence, the law simply presumes that the cost has extended the useful life of the asset. Before winding up this session, we ought to speculate on the following questions which are quite intriguing with regard to depreciation for our next session.

We have said that in a pool depreciation, individual asset does not have separate identity. But, what happens when the vehicle is destroyed? Suppose the vehicle is not insured or insured; what would be the consequence?

What happens to the depreciation when the vehicle is soled?

What happens to loss or damage of the vehicle?

As we have discussed in our earlier sessions, buildings are subject to depreciation under schedule C. But, when they are sold, they will be subject to capital gains tax (schedule D). What is the tax consequence of this condition? Although it does not give a direct answer to the lingering question, article 27 (1) (e) of the income tax proclamation provides that an expenditure or loss is not deductible to the extent that it is recovered under policy of insurance, or a contract of indemnity, guarantee, or surety. But, does the same rule apply in case there is no such guarantees? Article 71 (1) [c] of the same law also gives another clue. This provision is about situations of none-recognition of expenditure or loss and gain. It reads: "by reason of the loss or destruction, or compulsory acquisition of the asset (referred to as the "replaced asset") if the consideration for the disposal is reinvested by the recipient in an asset of a like kind (referred to as a "replacement asset") within one year of the disposal or within such further period as the Authority shall allow".

Lecture 24-december13, 2019.

Last time, we have raised some intriguing questions that we shall deal with today. The first question was: what happens if a depreciable asset which has not been insured (vehicle) is totally destroyed? For instance, let's assume that ABC company bought a vehicle in 2016 for 2 million ETB. In 2019, the track was [totally] destroyed. Let's also suppose the track is not insured. There has been depreciation between 2016 to 2019. The company has received 15 percent of 2 million (5.5 K) birr for the 2 preceding years, from the total cost of acquisition. This is because, vehicle is subject to diminishing (declining) method of depreciation. So, in this scenario, a substantial value of this cost has not been recovered. If there is insurance, the insurance will take care of it; but, what happens to the insurers? To add another layer of complexity to the scenario, suppose that the company has bought another truck.

Although it does not give a direct answer to the lingering question, article 27 (1) (e) of the income tax proclamation provides that an expenditure or loss is not deductible to the extent that it is recovered under policy of insurance, or a contract of indemnity, guarantee, or surety. But, does the same rule apply in case there is no such guarantees? Article 71 (1) [c] of the same law also gives another clue. This provision is about situations of none-recognition of expenditure or loss and gain. It reads: "by reason of the loss or destruction, or compulsory acquisition of the asset (referred to as the "replaced asset") if the consideration for the disposal is reinvested by the recipient in an asset of a like kind (referred to as a "replacement asset") within one year of the disposal or within such further period as the Authority shall allow".

This is called 'involuntary disposal'. Involuntary disposal is a situation where the tax payer is forced to replace an asset by another asset. This involuntary disposal results in none-recognition of losses or gains. For instance, let's assume ABC company has insurance of 1.8 million birr. Let's also assume ABC bought a new truck for 2.5 million birr. The insurance company paid the 1.8 million in compensation for complete total destruction of the truck. Thus, the question is: what happens to this figure in tax terms. Such losses are not recognized under article 71, but have effects on depreciation. Article 71 (1) (4) provides:

If sub-article (1)(c) or (d) of this Article applies and the cost of the replacement asset exceeds the consideration for the replaced asset, the cost of the replacement asset shall be the cost of the replaced asset at the time of disposal increased by the amount of the excess.

So, basically, this 2.5 million birr becomes a new depreciation. In the forgoing example, the remaining loss which was not covered by the insurance compensation is submerged in the depreciation base of the asset; however, there is no gain since gain is also not recognized under the above provisions. Business enterprises may have to replace their destroyed assets as it is useful for their business. Therefore, we are trying our hard to answer, though not directly, the question of the tax consequence of the replaced asset and its new tax base where there is no insurance.

The other situation is what is envisaged under article 71 (1) (d), which is disposal and replacement. The provision reads: "if the asset is a depreciable asset (referred to as the "replaced asset") and the person acquires a depreciable asset of a like kind to be wholly used to derive

amounts included in business income (referred to as the “replacement asset”) within six months after the disposal or within such further period as the Authority allows”. Let’s say the vehicle was bought for 1.5 million and sold for 1.8 million. The company bought the like kind of vehicle within 6 months for 2.5 million birr. The law says that the sale for 1.8 million is not recognized as an income. But, the other consequence is that the company spent additional cost of 700,000 Birr to replace the vehicle. So, the effect is: #1, there is none-recognition, and #2, both the depreciation base will be changed.

The other point which is beyond the reach of article 71 is the condition of sell without replacement. In our preceding example, the asset was depreciated for two years. Thus, there is a depreciation recovered. We can ascertain the net book value of the vehicle in 2019 by calculating 1.5 million minus the two years’ recovery. The difference between 1.8 million, which is the price minus the net book value is income. So, sometimes, the calculation of depreciation can result in recognition of income. However, this is the simplest scenario; in most cases, multiple types of assets including vehicle, furniture and machinery depreciate in one pool. Thus, the above 1.8 million may be absorbed when the depreciation of the rest assets is reduced. We can conclude that legally, incurring additional costs like maintenance repair increases the depreciation base. On the other hand, the sale of the depreciable assets results in the reduction of the depreciation base though it may sometimes result in income. The sale of all business assets other than a building is always entertained under schedule C and may sometimes result in income under schedule D in case where the sale value of an asset exceeds the net book value.

It must be noted that the case of building is quite different. When it is building, the maintenance and improvement is the matter of schedule C; but, when a building held for a business is sold, it results in capital gains tax. The directive issued in this year (2019) by the ministry of finance, directive no. 8/2019 has detailed regulatory rules in respect of such application. To further elaborate the variation of the rule that applies to building, let’s consider the same type of scenario that we have extended to vehicle. Let’s assume the building was acquired for 5 million. In 2019, it was sold for 10 million. When there is replacement, like in the case of vehicle, article 71 applies. When there is no replacement, there are two consequences; corporate income tax and capital gains tax. Thus, the formula is: F is equal to A Minus B +D. I this formula, F is the

amount subject to capital gains tax, A is the sale price, B is the total cost of the asset and D is the inflation adjustment. This is for capital gains purposes.

In our forgoing example, A (the sale price) is 10 million while B (total cost of the asset) is 5 million. With respect to inflation adjustment, let's suppose the inflation rate of a building is 20 percent (1 over 5). So, in our scenario, we have 3 years for assessment. Therefore, the calculation goes as: 10 -5 +3 (the number of years) = 2 million. This 2 million will be subject to capital gains tax. This is ascertained after deduction of 10 million which is the sale price (A) from the total cost (B) and adding sum amount of 20 percent of inflation adjustment for the 3 years, the total amount of which becomes 3 million and deducting this 8 million from the total sale price of the building (10 million) which finally results in 2 million.

As mentioned earlier, the company in our example (ABC) divides its income in to two parts; schedule C (corporate income tax) and capital gains tax (schedule D). For this reason, it has distinct formula which is E is equal to B minus c. E represents the amount that should be included in schedule C (business profits), B is the total cost of the asset and C is the net book value. Therefore, the total cost in the preceding scenario is 5 million. Then, the net book value is calculated along with the straight line method of depreciation for the three years. So, the formula is: 5 million times 5 percent equals to 250,000 times 3 =to 750,000. Thus, the net book value will be the amount of undepreciated cost, which is 4.25 million.

The amount of depreciation for the three consecutive years (700,000 birr) is considered as business income. The rationale for employing two states of calculation for building is to prevent the companies from taking the advantage of tax rate differentials between the two schedules. The cost that is recovered is considered as income. So, the idea is to apply 30 percent tax to the depreciation recovered from the amount of the sale price (10 million in our case). Unless, the company will be able to save 15 percent every year by depreciating under schedule C and paying tax under capital gains tax (schedule D). Tat is why the part of the cost of the asset which has enjoyed depreciation under schedule C is proportionately subject to corporate tax as a business income. There is inflation adjustment for capital gains tax purpose; because, capital gains tax is an irregular kind of tax as it is generated once in a while.

Charitable contributions are deductible not because they are business expenses, but as a matter of policy considerations. The difference between gross income and above the line deduction is adjusted gross income (AGI). The difference between below the line income gives taxable income. Above the line income includes trading stalks, salary, administrative expenses depreciation Etc. Blow this, there is charitable contribution which is below the line deduction. Charitable contributions ought to be called because they are not business expenses. Article 24 (1) of the proclamation provides:

In determining the taxable income of a taxpayer for a tax year, the taxpayer shall be allowed a deduction for the amount of a donation when the donation is made:

a) to Ethiopian Charities and Ethiopian Societies defined in sub-article (3) of this Article

b) in response to a call for development or an emergency call issued by the Government to defend the sovereignty and integrity of the country, to prevent or provide relief in relation to man-made or natural disasters or an epidemic, or for any other similar cause.

The policy considerations behind the deductibility of charitable contributions is to incentivize organizations to contribute. It is also considered as indirect public expenditures. Because, the government may use private contributors through such tax incentives to perform some of its public service duties. There is a maximum amount of 10 percent of the adjusted gross income which is deductible for this purpose as provided under directive no. 5/2009.

However, the question arises what if the adjustable gross income is loss? For example, let's suppose a ABC company contributed 1 million for charity. The adjusted gross income is 100,000 birr or let's otherwise assume the income is negative. "I happen to believe that the charitable contribution is legitimately made is less than the adjustable gross income, it should be deductible as a whole". There are three types of negative limb deductions; one is capital expenditures which we have already discussed. The second none-deductible expenses are personal expenses. Personal expenditures like entertainment expenses are none-deductible; because, they are part of income. The third is policy-motivated expenses. There are two prominent examples of such expenditures; one is penalty and fine and the other is dividend. Unlike interests, dividends are not deductible; because, Ethiopia follows the classical model of corporate taxation in which the company is subject to corporate tax and shareholders are subject to dividend tax.

Lecture 25-december 16, 2019.

Last time, we have discussed that one of none-deductible expenses is penalties and fees. Sometimes, due to the shortage of foreign currency, Ethiopians may not perform their contract on time. For example, a person may apply to a bank for forex and forex may delay while the other party is counting the interest. Now, the question is: should this constitute penalty or fine? So, there are frequent disputes between tax payers and the tax authorities. Even in cases of courts, suppose a person fired an employee and employee sued the person by unlawful termination of an employment contract. There is compensation and all litigation fees that may be incurred. Should these cost be deducted? The tax payers believe that these are deductible though the tax auditors may reject. Remember, the basic principle of deductibility is that it must be incurred for the purpose of deriving, maintaining and securing the business income. But, what if the employer is unsuccessful? Or what happens if the employer is successful in the case? What is the test of deductibility in this situation? Does success matter in the issue of deductibility? The tax authorities tend to interpret penalties and fines in a broader manner.

We have addressed the issue of loss indirectly in our previous discussions; however, we shall observe it in depth. The first kind of loss is casualty loss. Casualty loss is a loss or damage to a business asset as a result of theft, fire ETC. The second is the so-called financial loss. The third is capital loss and the fourth is the foreign currency loss. Casualty loss: this is a situation where the truck may be lost due to accident; the solution to such loss is replacement under the tax law or the insurance may be another relief. What happens to the absence of such remedies? Do we deduct the loss or depreciation? There is indirect answer in the law to this question which says that any loss which is covered by insurance is not deductible. But, what if the loss is not covered by insurance? How can we apply these losses to the general rule which prescribes loss is any expense to derive, maintain or secure the business income? A loss is an expense in the negative sense.

Tax loss: the very simple definition for tax loss is gross income minus above the line deductions plus below the lines deductions. Article 26/1 provides: “If the total amount of deductions allowed to a taxpayer for a tax year (other than a deduction allowed under this Article) exceeds the total business income of the taxpayer for the year, the amount of the excess shall be the taxpayer’s loss for the year”. There is a difference between a financial loss and tax loss.

Financial loss may exist without tax loss. The company may have a taxable income without having net profit. Penalties and fines, entertainment expenses Etc are deductible under financial loss of a company though they may not be deducted in tax law. For example, there are prescribed rates for promotional expenses, pension contributions and representation allowances. But, the companies may have their own rates. Financial statement of a company may be negative with positive taxable income. Taxation does not prescribe the expenditures of the company; it only considers what is deductible or not deductible. Tax expense is calculated out of the financial statement submitted by the company.

There are two consequences of this; first, the tax payer is not subject to schedule C; because, the amount is negative. Second, the tax is not said to be none-deductible; it is called the loss is carried forward. In Tax law, the loss carry forward rule represents the scheme whereby the tax payer is allowed to deduct the loss of one tax year from the income of subsequent years. Some countries follow loss carry backward rule; which means that they allow the tax payer to carry backward the loss incurred in the previous years. Ethiopia does not allow that kind of deduction. It only allows for a maximum of 5 subsequent tax years. If we assume that the tax year is 2016, the extension will stop in 2021. In other words, if a tax payer is unable to deduct this loss within these 5 years, he may not have the right in any other time.

This is an exception to the basic principle of income tax year which is annual tax liability accounting. It is a relief from the inequity of the annual tax year. A loss is a proxy for deductible expenses. It is an extension of a deduction. Deduction basically exists because the gross income is less than the amount of deductible of the deduction applicable to the tax payer. In long term contract accounting, special type of accounting is allowed under Ethiopian law. Long term contracts are types of contracts which require more one year for its performance. These kind of contract have special kind of accounting. It is calculated on the basis of percentage of completion method. It is a form of adjustment for a situation where the company entered in to a long term contract may incur at the last year of the time of completion of the contract. Thus, loss carry backward scheme becomes applicable in such exceptional circumstance. Article 32 of the income tax proclamation specifically deals with such condition.

It is a form of adjustment. For example, let’s assume a single construction required 5 years. Let’s suppose that on the first year, it had both an estimated and actual cost. In the first year, the

company used 30 percent of the estimated cost. The cost may be 20 percent, 30 percent in the second and third years respectively. The law considers the 30 percent from the total amount of the contract.

There are some conditions that need to be fulfilled for the application of this rule. The first condition is that it may not exceed 5 years (article 26/3). Second, it is allowed in life time only for two years. For instance, let's assume the loss in 2016 was fully deducted from 2017. There was also a second loss in 2018. This was again fully deducted from 2019. Thus, if there is a loss in 2020, the tax payer is not, according to this rule, entitled to deduct it from 2021 since he has already utilized his opportunity twice. Every tax payer has two loss carry forward opportunities (article 26/4). A tax payer may report a loss; that does not mean that it is acceptable. The law says that the tax authority has the right to conduct an audit within one year. Or, the tax authority may accept is as long as it is verified by the external auditors. So, when the tax payer submits a declaration of losses, it is a conditional upon the acceptance of the authority. In case of doubt, the tax payer must not deduct in his/her declaration of losses as it may be reversed by the authority and expose him/her to the re-assessment. One of the reasons why the tax payers tend to rely on the external auditors is that they believe the external auditors know better about what is deductible or not deductible. It is the best interest of the tax payer to insulate one year from the other while deducting. The two years' opportunities are calculated separately.

Capital loss is a loss resulting from the investment assets subject to capital gains tax. Such assets include buildings and shares and bonds. Mathematically, capital loss is the sale price minus cost. If the sale price is less than the capital, it is considered that there is a loss. Capital losses are not deductible from the business income. Second, they cannot be deducted from future business income. Third, they can be carry forward indefinitely. There are two types of assets; class A assets and class be assets. Shares and bonds are categorized under class A asset; whereas, class B consists of immovable held for business as a business loss. As mentioned above, capital losses can be carried forward indefinitely, but can only be deducted from capital gains tax. There is also an investment loss which should be treated separately.

The forex losses: foreign currency losses and gains are reported separately. They arise because of the difference in the reporting of income and expenses in the actual cashing of foreign currency. For example, suppose that a given company has a foreign obligation (an obligation to make

payment in foreign currency). The interest on this payment is reported in 2016 as an expense based on the exchange rate between Birr and the foreign currency (the US dollar). This is a notional amount. When the actual payment is made in 2019, the value of Birr against the foreign currency has obviously been devalued. This results in a loss. The question is: what do we do with the loss? It can also be gain. The company provided goods and services and reported the income according to the prevailing exchange rate in 2016. When it received the foreign currency in 2019, the value of Birr might have depreciated by 40 percent. This 40 percent depreciation is gain which is to be reported.

Lecture 26-december18, 2019.

Last time, we were talking about treatment of losses. The major conclusion that we can make out of the analysis of the Ethiopian tax law is that proper characterization is the first thing that we need to engage in. Article 34 and 35 have some points. One is change of control. If a change of control results in a loss, the loss is not recognized. The Change of control is defined as change of the control of more than 50 percent of the underlying ownership of the body in the loss year the carry forward year or the intervening tax years. If a company undergone 50 percent change of ownership, there will be change of control. It can occur for number of reasons; transfer of share, takeover of one company by another company Etc. If the takeover results in 50 percent of change of ownership, the tax law automatically presumes that the loss is suspicious and therefore it cannot be carried forward.

The question is: why is the law suspicious? Let's assume that company A is acquired by Company B. Sometimes, it may be share transfer in which company A buys the shares of company B. So, in this scenario let's again assume the owners of company B have sold their shares to company A. It can also happen that the assets of company B are transferred completely to the buyer company (company A). So, company B is liquidated in the sense that it will be de-registered.

If a company is acquired by another company in form of transfer of shares, or transfer of asset where it must be liquidated, the law suspect that the loss at the time of this takeover is a result of the takeover. A loss is a business. If the loss is due to total asset in such transfer, it is unusual result which is not trading stalk or inventory; but, transfer of the company (take over). It is not,

in such circumstances, legitimate for loss carry forward. So, article 26 does not apply in such case. However, there are some exceptions to the above none-recognition of loss during the takeover of a company. According to article 34 (2), if company A, that took over company B continues to conduct the same business, this rule does not apply. In other words, if company A, after take over, conduct the business that company B used to do, the law becomes suspicious. Second, if the purpose of takeover is proved to be corporate reorganization for commercial purposes as prescribed by the law, the none-recognition rule does not apply. But, if it is suspected to be for tax avoidance, it will not be legal for loss carry forward benefit.

Remember: the subject of such sale may be a goodwill with lose reputation. In the second exception, the buyer of the company has to prove that he/she is engaging in commercial activity. The flip side of this is the corporate re-organizations-article 35.

When there are two organizations who are residents of Ethiopia and merge together in share swap, one of the companies may survive where the other may transfer and the rest may not. Share swap is a condition where companies, (A and B), for example, decide to merge in to company AB or company A. In such situations, the tax consequence is that income will not be recognized (art. 35/1). This rule exists to incentivize the re-organization. It has a policy reason of removing the taxation barrier to corporate re-organization. If a loss is due to a transfer of an asset to party-related transactions, the loss carry forward is possible.

Foreign currency is exceptionally treated due to fluctuation. For example, let's take the coffee exporter who exports on credit. In 2017, the exporter has an income denominated in1 million dollars. The exporter recorded the 1 million dollars in 2017 by taking the prevailing exchange rate, which was 27 Ethiopian birr. So, 27 million was the income recognized in 2017. Let's suppose that the exporter received the actual payment in 2019. In 2019, the exchange rate grew to 30 ETB. So, within two years, the exporter has gained 3 million birr due to the rise of the exchange rate in the year of actual payment. This 3 million is thus recognized as foreign currency gain under schedule C. Remember: this is not income from business. But, it is an incidental income that results from foreign currency exchange rate fluctuations. The loss usually results from an obligation.

For example, if a company bought the exported goods for 1 million in 2017, the effect of foreign exchange rate fluctuations would have the result of loss in the same amount of the preceding gain (3 million). The previous 27 million is recorded as an expense. The loss is the same amount to be 3 million. The law says that this loss should be kept separately (article 44 of the income tax regulations). It can be deducted from the future foreign currency gain for an indefinite period. The unused amount can be carried forward indefinitely-sub-2 of the same provision. The gain is taxable under the loss. When the tax has loss, it is off set against the gain. There are two types of tax: domestic payment which is two percent and withholding tax which is 3 percent. Schedule C tax payers pay 3 percent when they import goods; it is an advance tax.

Remember: this is not an import tax; it is separate advance tax levied on supply of goods and services. This advance tax is creditable against the others. So, the hypothetical company in our previous example has list of creditable withholding taxes which are paid throughout the year. The total of the tax due minus the creditable taxes gives us the figure. The figure is: if the total tax due is more than the creditable taxes, tax is payable to the authority. However, if the creditable tax is in excess of the total tax due, the tax payer will have a 'potentially refundable tax' as provided under article 49 of the tax administration proclamation, proclamation no. 983/2016. The provision reads:

Credit for Tax Payments

1/ Where the total amount of tax credits allowed to a taxpayer for withholding tax or advance tax payments of the taxpayer for a tax year exceed the income tax liability of the taxpayer for the year, the Authority shall apply the excess in the following order:

first, in payment of any tax (other than withholding tax) owing by the taxpayer under the Federal Income Tax Proclamation;

b) then in payment of tax owing by the taxpayer under any other tax law;

c) subject to sub-article (2) of this Article and on application by the taxpayer by notice in writing, then refund the remainder, if any, to the taxpayer within 90 (Ninety) days of the date that the taxpayer filed the tax declaration for the year to which the tax credits relate.

2/ With the written agreement of the taxpayer an amount referred to in sub-article (1) (c) of this Article may be carried forward for the payment of any future tax liability of the taxpayer under any tax law.

3/ If the Authority fails to pay a refund to a taxpayer as required under sub-article (1) (c) of this Article, the taxpayer shall be entitled to interest for the period commencing from the end of the ninety period until the refund is paid.

4/ The rate of interest under sub-article (3) of this Article shall be the highest commercial lending rate that prevailed in Ethiopia during the quarter before the commencement of the period specified in sub-article (3) of this Article.

Under Ethiopian law, there are two creditable taxes; the withholding income which is subject to domestic income taxation and foreign tax credit. Foreign tax credit is not creditable against domestic income at all. This applies to big and medium tax payers. tThe detail rules of application with respect to such advance taxation are provided under arts. 85 and 92 of the tax administration proclamation (983/2016).

Income tax accounting.

Tax accounting is dealt with in arts. 28-33 of the income tax proclamation. Tax accounting has two main purposes; (1) to define the accounting period and (2) to define the method of accounting. For schedule C and schedule B tax payers, the accounting period represents the period of 12 months. According to article 2 (21) of the income tax proclamation, the tax year for an individual is the period of fiscal year or the budgetary year of the government. Accounting method is also important for recording; because, it prescribes the rules for recognition of income and expenses.

Lecture 27-december 21, 2019.

Last time, we have commenced to discuss tax accounting. Timing and methodologies are the two things to be regulated. In terms of the period, for schedule B and schedule C tax payers, the accounting period is 12 months/one year. It is counted from hamle1 to seen 30. But, entities have

the right to choose their own accounting period. But, once they chose one accounting period, they cannot simply cancel it unless they obtain the permission from the authority to change. The question is: why is the law strict on this rule? If a tax payer is allowed to shift to accounting period from the other, the tax payer may record tax expense twice in one budget year. This in turn may facilitate the tax payers to commit tax avoidance. The authority will get chance to check the manner of recording by the tax payer. There is another accounting period which is shorter than the usual accounting which mainly hinges on the time when the entities begin their business activities. When entities start business, they may do it in any time depending on their need; so, they may require a short tax year. The problem is, however, the term 'short' which is often used to characterize such period may be questionable; because, it may have consequences on their rights.

For example, let's assume that a company which has decided a Gregorian calendar as its accounting period started business on dec3, 2018. The first tax year for this company is about 28 days. Because, the calendar counts that December 31 is the end of the old year and the next day is the beginning of the new year. Let's also assume that the company incurred a loss in 2019 and 2020. If we count the 28 days of the beginning year as full tax year, it follows that the company exercises its right to carry forward The loss of only the first tax year and the second year. But, remember: the first tax year is those 28 days. The question arises whether this company should lose its right to carry forward the loss for the third tax year by simply counting the short tax year as complete tax year. So, the short period may have such effects. The question can also arise with respect to transitional tax year. Transitional tax year is also short tax year. It is not clearly resolved in the law. Practically, the authorities may count the 28 days as a full tax year; which is manifestly unjust for the tax payer. This would obviously be against the principle of equality. The accounting method is the method of income and expenses that the tax payer uses to allocate the expenses among several tax years.

Time is an imaginary perception; it does not speak. In tax law, time is a notional thing. So, for every year, if a company uses a specific accounting method, it must be consistent. There are some accounting conventions. If we use a cash accounting method, it must continue that way. In the cash method, the payment is based on the receipt. So, it is recorded when the income is actually or constructively received. Constructive income means, when someone writes negotiable

instruments in favor of another person; for example, if a person writes a check to receive a specific amount of money from bank, a person records the income at the time when the check is written in favor of him/her. On the other hand, in accrual accounting method, we don't have to receive; it is sufficient that we are entitled to receive. In accrual method, the income must be recorded long before it is received. So, what matters is entitlement. The point of time to refer is the time when some is obligated to pay to the entitled person. In cash method, however, the income is recorded when the time of payment becomes due and the payment is actually discharged.

For instance, in cash accounting method, if a person is entitled to a payment of money on 20th of Ethiopian Seen and receives the payment on Ethiopian Meskerem, he is required to record this income by the time he gets the payment. In accrual method, however, the income is to be recorded long before the actual payment. In let's consider another scenario. Let's suppose that in a contract of sales, a good has been delivered to the buyer in 2015 on credit which was paid in this year (2019). If a person is subject to cash payment, 2019 becomes the time of recording; in accrual, it is in the first year once a delivery occurred.

The same rule applies to the seller as well. The seller also records the expense when the obligation to pay is ripe. The reader is advised to go back and read the detailed explanation of these two accounting methods in the previous lectures in this note book. The accounting method in tax law helps to define when to record the income and expense; so, there is a strong relationship between the accounting year and accounting method. For Example, in our preceding scenario, if the seller who follows the accrual method records the income in 2019, the auditor may say that it should have been recorded in 2015. This is what is regulated in Ethiopia by international financial reporting standards.

A few of these IFRS rules are defined under tax law. One of them is bad debt. Bad debt is not about expense recognition; it is an adjustment of the time when the debt goes bad. Article 30 (1) of the income tax proclamation reads: In determining the taxable income of a taxpayer for a tax year, the taxpayer shall be allowed a deduction for a bad debt when the following conditions are satisfied: a) the amount of the debt has previously been included in the business income of the taxpayer; b) the debt or part of the debt is written off in the taxpayer's financial accounts for the

tax year in accordance with the financial accounting standards; c) legal action has been taken to collect the debt but the debt is irrecoverable.

It is a debt which cannot be considered as a debt. It is an accounting issue; because, it is important to understand the time of payment. For Example, in our example of contract of sale, let's otherwise assume that the payment was made prior to the agreed time in 2017. In this case, the premature payment would not produce any different effect since it has already been recorded. However, if the payment is not made on time, there must be a legal action including putting the debtor in default as provided under the above provision. When there is default, this receivable debt is paid. So, all legal actions must be taken in order to ensure that the receivable (dubei) Is paid. This may take years; in the course of this years, there is no change to the taxation since in accrual method of accounting, the income is recorded as if it is received on the assumption that it will be received. In other words, the income may not be received. In such cases, the question is: how to define when the income is not received?

That is why article 30 (1) [c] says:" the debt is irrecoverable debt". All legal actions should be taken to ensure that the debt has been paid. The first two conditions are what we need to do. Cash basis tax payers do not have bad debt. For tax purposes, they do not record what they receive. But, the accrual method followers must record their receivables entirely. It is an accounting adjustment because of the fact that an accrual method compels. Bad debt is thus an adjustment for what was included in an income as if the income is receivable. When it is recoverable, the bad debt is deductible. Financial institutions are subject to their own accounting methods (articles 45-47). In tax accounting, there is no going back except when the mistake is done and there is mischaracterization. In such exceptional cases, the tax payer may apply for an amended assessment. For example, last time, we have said that foreign currency losses are deductible from foreign currency gains.

But, sometimes, a company may deduct a foreign currency loss from their ordinary income. In such circumstances, it is possible to apply for reassessment. It may be possible to change the accounting method with application of the authorities. The companies must usually record their income in accrual method. Sometimes, it has some relationship with the extent of business. When bad debt happens, it is reversed from the recent tax expense when it is recorded prior to the existing assessment in the form of receivable. The three conditions must be fulfilled under

article 30. Even in the case of proceedings on bankruptcy, it must be established to the end of the dispute that the debt is irrecoverable due to the insolvency of the debtor; because, the partial debt may be discharged and it may create a situation of partial bad debt.

Long term accounting is a transactional accounting in the sense that it does not apply to the whole company other than transactions of long term projects. It applies to duties contracts like canals, dams, construction works including buildings, roads Etc. It is an accounting method which requires the income to be recorded in accordance with the long term contracts. For example, let's assume that ABC company has entered in to a long term contract of road construction from Adama to Hawasa for 200 million birr. According to their contract, the Ethiopian government has agreed to pay on installment basis. In such cases, it is possible to employ the method of recording which pursue the instalment basis itself. However, because it is subject to abuse, the tax law dictates such contractual relationship to be in the form of distinct method of accounting for recognition of income and expense which is called 'long term accounting method'.

This long term accounting contract requires the tax payer subject to such type of contract to record income and expense based on the percentage of the contract completed. Remember: this is convention; it is not mandatory. It must be noted that the mere fact that the contract is long term contract does not necessarily mean that it is wholly considered as long term contract for tax purposes. It is possible to have 20 years contract; that may not be a long term contract. Because, a contract can be divided in to each year. For the purpose of taxation, therefore, long term contract is a contract which requires more than 12 months for its performance. Article 32 (6) of the income tax proclamation defines longer term contract more specifically as:

In this Article, "long-term contract" means a contract for manufacture, installation or construction, or, in relation to each, the performance of related services, that is not completed within the tax year in which work under the contract commenced, other than a contract estimated to be completed within 12 months of the date on which work under the contract commenced.

For example, if it is a supply of certain goods, it does not constitute long term contract; because, it is divided in to each year. The long term projects, however, can constitute a long term contract.

Second, the “percentage of a completed contract” means a tax formula that the tax payer is required to apply as provided under article 32 (2) of the proclamation, which reads: “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”.

So, the formula is: total cost in a tax year, divided by estimated cost over the life of the project. Remember: long term contract applies only to an accrual method of accounting. Let’s assume the total cost of is 200 million while 150 million is the total estimated cost in our road construction project from Adama to Hawasa. The construction is started in 2016. So, we have 4 years if the contract is to be completed in 2019. In 2017, the company incurred the total cost of 50 million. According to the above formula, 1third of the total income (200 million) is recognized as an income in 2016. Thus, the result is calculated as: 1/3 x 200 million = 66.67 million Which means that our answer of 66.67 million is 33.33 percent of 200 million. For the first year, 66.67 million minus 50 million equals to 16 million is taxable income. In 2017, let’s suppose the company incurred 30 million. This is calculated as 30 million / 150* 200 = forty million (1-5th of200 million). Thus, this result (40 million) is the gross income recognized in 2016.

Let’s also assume that the company incurred 10, 25 and 10 million in 2017-19 years respectively. This is also calculated with the same formula as 35 million divided by 150 times 200 =46666666.6667. From this mathematical juggling, we can realize that the cost actually incurred is higher than the estimated cost. That is why the loss is likely to arise at the end of the project. The company can eliminate the variation between the estimated cost and the actual cost. According to article 32 (3) of the proclamation, a company can carry forward any loss resulting from this contract as long as it is in Ethiopia. A loss carry forward is a real tax assessment.

Simplified accounting for category B tax payers-article 33. As we have dealt with in our previous sessions, article 3 of this proclamation classifies tax payers in to three categories; category A, B and C. The basic criterion for classification is turn over. If annual turnover of a tax payer is between 500,000 and one million ETB, the tax payer is categorized under category B. The purpose of this classification is first, for defining which tax payers have book keeping obligations; second, time of payment. Category A tax payers are required income tax under

schedule C and B from 4 months from their accounting period. The flip side of it is tax compliance. It is to determine which tax payer is capable to maintain books and records.

Presumptive taxation.

Presumptive taxation is a determination of tax liability by indirect methods other than maintaining actual books and records. Presumptive taxation (yekurt gibir) is source of political and tax disputes. It is usually politicized. In most cases, peoples tend to assume that presumptive taxation applies only to category C tax payers who are not required to maintain books and records. But, in practice and under the rules of directives issued by the tax authorities, presumptive taxation is a common form of tax assessment even against category A and category B tax payers. Such indirect methods are necessary for two main reasons; first, with respect to category A and category B tax payers, their books and records may not be duly maintained or they may be rejected by the authorities on some grounds. On the other hand, category C tax payers are not required under the law to maintain books and records or they may not be accepted in case they maintain unless the books and records yield higher tax liability than what is determined under the presumptive rules.

Remember: loss is not, as it is usual encounter in business activities, possible for category tax payers. Unlike the two other categories, category C tax payers have no feasible means to show their losses and expense to carry forward. Presumptive taxation is a determination of tax liability by indirect methods other than maintaining actual books and records. This is a major limitation on presumptive taxation.

with respect to category A and B tax payers, the tax authorities simply assume that whatever is found in the account of the tax payer is income irrespective of its source. In 2017, Addis Ababa city tax administration has issued a directive in the form of letter which provides for the detailed rules of presumptive tax liability of category A and category B together with the drivers in the city. This directive introduced another special feature of presumptive taxation, which is transportation. Under this Directive, each type of business activities is presumed to have its distinct profitability rate. For instance, fruits and vegetables is 5 percent. The directives recognize more than 99 types of business activities. Standard assessment is a presumptive assessment based on type, size and location of business.

Lecture 28-december 23, 2019.

Last time, we were talking about presumptive taxation. We said that presumptive taxation mainly applies to category C tax payers. These are the tax payers on which the law imposes an indirect method of assessment which should be contrasted with self-assessment. The primary tax assessment mode for the rest categories is based on books and records. In presumptive method of assessment, we don't know how much the tax payers generate. Presumptive taxation is necessary for a number of reasons; first, it is to have simple tax compliance for simple micro enterprises. Second, it is to broaden the tax base and enhancing the comprehensiveness of the tax system. In terms of numbers, such category of tax payers is numerous in number. The other is there are certain economic groups which are hard to control which is specifically termed as underground economy. In such circumstances, presumptive taxation becomes necessity. Thus, enhancing tax equity is another reason for rationale of application of presumptive taxation. In a country like Ethiopia where the substantial part of economy is informal, presumptive tax assessment is necessary.

We had presumptive tax system for many years because of the essence of books and records. The question is: what mode of assessment do we have to adopt. Very recently, we are seeing the so-called 'standard assessment'. It is called standard because it is standard to type, size and location of a business. These three factors are important to determine annual turnover, taxable income and the amount of tax. Annual taxable turnover gives us the annual profitability rate (APR). Indirect assessment affects all of these. Annual profitability rate differs from one type of business to another. If we take serials and pulses, for example, the annual profitability rate is 5 percent. The annual profitability rate ranges from 5 to 30 percent.

So, if a person has annual turnover of 100,000, the taxable income is 5000. There are certain businesses which are based on external indicators. For example, public transport. If we consult the regulations, there are certain indicators of this sector; one is the year of manufacture of the public transport vehicle. The second is the number of seats. The year of manufacture: transport is divided in to two; if the year of the manufacture is less than 15 years, obviously, the annual turnover is higher. Therefore, a public transport of up to 5 seats and the year of manufacture is less than 15 years, the annual turnover is 94,553 and the taxable income is 18,911. Very taxi driver is subject to this fixed amount of tax; it is not subjective since it is indicator-based. This is

indicator-based. There are those business whose tax liability is based on annual rate of profit. This is fixed in the indirect method. Most business are under first category.

The question which is a source of so much pain is: how do we determine this rates? It is not virtually determined how much do these tax payers make within 1 year. It is set aside for political reason. The tax system has the crises of confidence to persuade the people that its ideology is sound. Once we determine, at least it will be good for 3 years to 10 years. The problem is not with the tax law, but with the tax system. Should the tax authorities go around and collect informations about the tax payers? Many things happen during the months of presumptive assessments. For example, The volume of trade rises presumptuously. So, the methodology is unreliable. Every time these assessments are made, there are political controversies. The presumptive taxation requires an assessment mechanism that can approximate the income of the tax payers. It is highly necessary to employ a methodology which is appropriate to the people. However, in Ethiopia, many business persons return their business license due to precipitous taxation imposed up on them through presumptive taxation.

The other thing is the presumptive tax is not to ensure that the small businesses pay taxes. In Ethiopia, nobody pays even the half of the employee. It is important to modulate the psychology of presumptive taxation in to the people. The government should tax people less than what they make. The Ethiopian tax system tends to presume that the presumptive taxation on the higher amount. There are ways of standard assessment system acceptable to the population of the tax payers. One is contractual method; it is a manner of discussing the presumptive taxation amount with the people before applying it. Through this contractual method, the authorities assess the annual turnover of the tax payers and discuss about rules of presumptive taxation with them. In this way, the tax administration can acquire a consent of the tax payers instead of taking individuals by surprise. It is also possible to have contractual method with groups of sectors to have consent of the tax payers. There is wide discrepancy between the federal tax system and the Ethiopian tax payers. First of all, this rule should have not been provided under the federal laws; because, category C payers are regional tax payers.

category C tax payers are sole proprietors, who are, under the constitution, regional tax payers. But, in practice, the constitution declares the federal state structure though the subordinate legislations are unitary in their nature. It is very unlikely for category C tax payers to be federal

tax payers. Each regional state may have its own 3 or 4 standard assessment tables. Because, location highly matters in setting the standards; for example, a barber who operates in sidist Kilo is different from another barber in Kotobe mainly due to his location. As mentioned in our previous session, presumptive taxation primarily applies to category C tax payers for the reason that they do not maintain books and records. But, there are some other types of businesses, other than category C, whose books and records are presumed to be unreliable. For instance, construction machineries are, in the Addis Ababa city directive, considered as hard to tax.

The other problem is graduation. It is shifting from one category to another category. Graduation entails increase in tax liability and the obligation of maintaining books and records. The auditor may not give an objective reason why the books and records of the tax payers is not acceptable; it is extremely subjective. This in turn disincentivizes the tax payers in maintaining books and records. There was a controversial case in which a particular company was assessed in such subjective and none-fundamental ground. The company supplies 95 percent of its trade volume to one company and the rest 5 percent to another. The 5 percent price is relatively higher than the former price of supply. Hence, the auditor held the higher price as the fixed taxable income without any other sufficient reason. One advantage of the big manufactures and businesses can easily acquire the material very cheaper. The tax administration law-article 26 have no sufficient protection. The auditor must reject the books and records only in cases he/she ascertains defects which are attributable to the intrinsic content of the books and records. The business person must not be compelled to sell and buy with price in which other traders operate; because, it defeats the primary purpose of competition.

Value added tax (VAT).

The family of VAT. Vat is a member of a large taxes which is commonly called as indirect taxes for Two reasons; (1) it is easy to administer, and (2) it is productive. It is called in direct taxes because it is imposed on goods or commodities, not on consumers. As a matter of taxonomy, such indirect taxes can be divided in to general and specific. It is also possible to divide them in to those taxes imposed on international taxes and those on domestic surplus. Under the general category, we find value added tax and customs. On the other hand, the specific category consists of Turn over tax (TOT) and excise taxes.