Addis Ababa University

College of Law and Governance Studies

School of Law

LL.M Program in Business Law

Involving Constituent States in Negotiating Tax Treaties in Ethiopia

By: Serkalem Eniyew Amare

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Declaration

I, Serkalem Eniyew, hereby declare to the Addis Ababa University thesis approval committee that the contents of this thesis are my own original works except those which are duly cited and quoted. I also declare that it has not been previously or concurrently submitted for any degree in any other institution or university.

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Abstract

This paper scrutinizes whether there is a constitutional background for the regional states of Ethiopia to participate in the negotiation of tax treaties and /or be consulted before the tax treaties of Ethiopia are signed or ratified. It also assesses the practical scenario of the involvement of the regional states in negotiating tax treaties and /or being consulted in relation to the tax treaties.

The paper argues that regional states have constitutional right to participate in the negotiation of tax treaties and also the right to be consulted before the tax treaties of Ethiopia are signed or ratified. The researcher discovered that regional states are not involved in the negotiation of tax treaties and also are not consulted by the federal government before the tax treaties are signed or ratified.

Finally, the writer recommends that an administrative mechanism has to be implemented so that regional states can actively participate in the negotiation of tax treaties and also be consulted on the tax treaties before the tax treaties are signed/ ratified. Also, the provisions of the FDRE Constitution must clearly stipulate that regional states should be involved in the negotiation and also be consulted on international treaties, especially on matters affecting their special interest.

List of Acronyms

Art. -Article

E.C.- Ethiopian Calendar

ed. - Edition

e.g. - Example gratia= for example

ERCA- Ethiopian Revenue and Customs Authority

FDRE- Federal Democratic Republic of Ethiopia

FDI-Foreign Direct Investment

HPR- House of Peoples Representative

HoF- House of Federation

IBFD- International Bureau of Fiscal Documentation

IMF- International Monitory Fund

MoFEC- Ministry of Finance and Economic Cooperation

Neg. Gaz- Negarit Gazette

No. –Number

OECD- Organization for Economic Cooperation and Development

P.- Page

pp.- Pages

UN-United Nation

USA- United States of America

VAT- Value Added Tax

Vol. -Volume

List of Annexes

- Annex 1- Letter written from the HoF to MoFEC and ERCA on 25/09/97 E.C letter no. ባ-3/ሀ1/አ.21/9/1
- Annex 2- Letter written from the HoF to MoFEC and ERCA on 23/09/97 E.C letter no.ባ-3/ሀ1/አ.21/12/1
- Annex 3- Letter written from the Federal Inland Revenue Authority to the revenue bureaus on 21/12/95 E.C letter no ዋሥአ/ን/ 2032/95
- Annex 4- Explanatory note written from MoFEC to the Council of Ministers explaining about the tax treaties signed between the Government of Ethiopia and Saudi Arabia, Netherlands, Portugal, North Korea and Ireland, No. ገ/ኢ/1/2/72, Dated 16/10/2007 E.C.

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Chapter One
Introduction

1.1 Background of the study

Bilateral tax treaties are international agreements in which their creation and consequences are determined according to the rules contained in the Vienna Convention on the Law of Treaties of May 23, 1969.[1] Bilateral tax treaties are concluded between two sovereign countries to eliminate double taxation of an income and avoid barriers for international trade and investment. The reason for double taxation of an income emanates from tax laws of countries in which both apply source–source or residence-residence or source-residence rule.[2] The scope of application of a tax treaty is on income tax and sometimes on capital[3] imposed by contracting states of the bilateral tax treaty.

The Constitution of the Federal Democratic Republic of Ethiopia (FDRE Constitution hereafter) expressly provides the tax powers of the federal, regional state and the concurrent powers of the two levels of government under Articles 96, 97 and 98 respectively. Also the FDRE Constitution under Article 99 provides how powers of taxation which have not been specifically provided under the Constitution are to be determined. These constitutional provisions show that the FDRE Constitution has recognized the notion of tax autonomy of each level of governments since tax autonomy is described be own revenue sources, shared tax or tax sharing (Revenue sharing).[4] Thus to decide on matters that fall under their jurisdiction is up to the two levels of government in which one should not interfere in the jurisdiction of the other.

Ethiopia has concluded more than 25 bilateral tax treaties with other countries. The tax treaties encompass different provisions on income like employment, agricultural activity, dividend, royalty and interest. Some of the income types subject to tax treaties are in the exclusive

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[1] Klaus Vogel, "Double Tax Treaties and their Interpretation," **Berkeley Journal of International Law**, vol. 4,1986, p.15

[2] Ariane Pickering, Why negotiate tax treaties, **Papers on Selected Topics in Negotiation of Tax Treaties for Developing Countries,** UN,USA, 2014, p.9

[3] OECD, **OECD Model Tax Convention on Income and on Capital,** 2014, p.77

[4] Ghebrehiwet Tesfai Baraki, The Practice of Fiscal Federalism in Ethiopia: A Critical Assessment 1991-2012 an Institutional Approach, University of Fribourg, Faculty of Economics and Social Science,(unpublished), 2015, p.209

jurisdiction of the regional state and some fall under the concurrent taxation power of the two levels of government. Thus to decide on the taxation power of the regional state is the constitutional right of the regional state as per the provisions of the FDRE Constitution.

Therefore, the writer of this paper has assessed whether regional states exercise their taxation power during the negotiation and conclusion of tax treaties. For convenience, the writer used the word 'constituent state', 'regional state', 'federal units' and 'states' interchangeably. Also, the words "central" is used similar to the word "federal".

1.2. Statement of the Problem

The tax treaties of Ethiopia are applied on income taxes imposed on behalf of the contracting state and its political subdivision or local authority.[5] Thus taxes imposed by the regional government are also included in the tax treaties of Ethiopia. Specifically, the provisions of the tax treaties consist of income types that are in the exclusive taxing powers of the regional state like employment income from employees of the regional states and private enterprises and agricultural income tax. Also, income types that fall under the concurrent power of taxation like business profit of a company and dividend are also included in the tax treaties of Ethiopia.

The FDRE Constitution recognizes tax autonomy of regional state under Articles 97, 98 and 99. On the exclusive power of taxation, the regional state has constitutional right to impose and collect the income taxes. Also on the concurrent taxing powers, the regional states have an equal power with the federal government when decision is made regarding these taxation power.

Article 51(8) of the FDRE Constitution gives the negotiation and ratification power of international treaty to the federal government. Thus it is the mandate of the federal government to negotiate treaties. However it is not clearly stipulated under the FDRE Constitution whether the federal government can negotiate on matters that fall under the mandate of the regional states without the involvement of the regional state or not.

Generally, the limited provision of the FDRE Constitution in addressing the involvement of regional states in the negotiation of treaties that they have interest and/or consultation to be

[5] Model of Ethiopian Tax Treaty, version of 2014/15, Art.2

made with regional states may have its own effect on the constitutionally protected division of power of taxation. As a result this paper focuses on the problem that may arise because of the nature of bilateral tax treaties in limiting the constitutionally protected taxation power of the regional states.

1.3 Objectives

General objective

The main objective of this study is to assess whether regional states have constitutional right to participate in the negotiation of tax treaties and be consulted in tax treaties.

Specific objectives

- To assess the legal framework on the involvement of regional states of Ethiopia in the negotiation and/or consultation of tax treaties.
- To analyze the existing practice of the participation of the regional states in the process of negotiation and/or consultation of tax treaties.
- To propose possible administrative and legal remedies that will enhance the involvement of regional states in the negotiation process and to be consulted of the tax treaties.

1.4. Research Questions

- Is there any legal framework that requires or allows the regional states to participate in the negotiation of tax treaties of Ethiopia and/or to be consulted of the tax treaties?
- What is the practical scenario on the involvement of regional states in the negotiation of tax treaties and whether tax treaty consultation is made with the regional state or not?
- What are the possible administrative and legal framework solutions that would enhance the involvement of regional states in the negotiation of tax treaties and for the consultation of regional states on tax treaties before they are ratified by the parliament?

1.5 Significance of the study

The involvement of regional states of Ethiopia in the negotiation and/or consulted of tax treaties is not adequately studied. Accordingly this paper is designed to contribute knowledge on the legal frame-work and practical involvement of regional states in the negotiation and/or consultation of tax treaties. Thus, the study is intended to bring a positive effect on the constitutionally protected taxation power of the regional state in their involvement in the negotiation and or consultation of tax treaties during ratification.

1.6 Methodology

A qualitative approach is used in assessing the legal framework of the involvement of regional states in the negotiation and/or consultation of tax treaties. The practical scenario is also analyzed taking the practice of the three regional states of Ethiopia relating to negotiation and/or consultation of tax treaties. To this effect, data is collected using mixed (primary and secondary) data collection methods. Primary information is collected from the FDRE constitution, different legislations and other legal documents. Also, interviews are undertaken with different key authoritative persons including the Director of the Legal Affairs Directorate at the Ministry of Finance and Economic Cooperation, the Director of Regional support and coordinate Directorate at the Ethiopian Revenue and Customs Authority, the Chief negotiator of the Ethiopian Tax Treaty, a member of the Ethiopian tax treaty negotiation team, and different officials of the three regional states. Also secondary information is gathered from books, journals, thesis, and internet sources on related topics.

The three regional states are selected to conduct this study since these regional states have quite a number of large investments and this leads to the possibility of application of the tax treaties. The regional state of Oromia, Amhara and Southern Nation, Nationality and People Region are selected to conduct the study. Hence a study conducted on these regional states may significantly show the participation of regional states of Ethiopia in the negotiation and / or consultation of tax treaties.

Also a comparative approach is used to analyze the involvement of regional states in the negotiation of tax treaties and/ or consultation with regional states before the tax treaties

are signed/ ratified. Germany, Switzerland, Australia and India are used for comparative analysis since these countries have well developed federal structures and dealt the involvement of the federal units in the negotiation and/or consultation of international treaties with different approach.

1.7 Limitation of the study

The research has come across a number of limitations. The first limitation is that most of the international books dealing with this topic are e-books so that it is hard to access them. In Ethiopia too, it is very hard to get materials written on the tax treaties of Ethiopia. It was very hard for the writer to see the practice of the nine regional states because of time and financial constraints. However maximum effort were made to address the involvement of regional states in the negotiation of tax treaties from collected documents and interviews made.

1.8. Organization of the study

The study consists of four chapters and each chapter is divided into sub topics. The first chapter deals with the proposal of the study. The second chapter is literature review: on the general overview of division of power, international juridical double taxation and bilateral tax treaties. The third chapter deals with the Ethiopian perspective on the division of power of taxation, Ethiopian tax treaties, and the legal framework on the involvement of the regional states in the negotiation and/or consultation of tax treaties of Ethiopia and finally the consistency of the practice with the legal framework. Finally the fourth chapter focuses on conclusion and suggests some recommendations.

Chapter Two
General Overview

2.1 Division of Power of taxation in a Federal Set up

2.1.1 Nature of Federal System of Government

A growing number of countries have adopted a federal system of government that serves as a catalyst of dividing powers between two (or more) tiers of a government and it is deployed through the supreme law of the land i.e. Constitution of the countries. Thus, broadly in a federal state, there are two levels of governments i.e. central (federal) and federal units (constituent states), ruling on the same land and people.[6] The federal and the constituent units exercise self- rule power as well as shared power within the domain of the federal system.[7] Thus, the self-rule has to be exercised independently within the power limit as enshrined in the constitution of a country, in which the federal government should not interfere in the jurisdiction of the constituent states and vice versa.

A federal system has some salient features. Hence, different writers explain the common features of the system. Some of the common features include: a formal constitutional distribution of legislative, executive and judiciary power as well as allocation of revenue resources between the two orders of government in ensuring some areas of genuine autonomy for each other[8], provision for the designated representation of distinct regional views within the federal policy- making institutions, usually provided by the particular form of the second chamber,[9] a supreme constitution not unilaterally amendable and requiring the consent of a significant proportion of the constituent units,[10] and an umpire (in the form of courts or provision for referendum) to rule on disputes between governments.[11]

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[6] Gosaye Birhanu, Vertical Distribution of Powers in Ethiopia: a Comparative study with Canada and Germany, Central European University,(unpublished), 2009, p.6

[7] Ibid

[8] Ronald L.Watts, **Comparing Federal Systems in the 1990's**,(3rd ed), McGill-Queen's University Press, Canada, 1999, p.7

[9] Ibid

[10] Ibid

[11] Ibid

A federal system is particularly important for regional states that differ in terms of territorial size, ethnic composition and economic and social circumstances.[12] Thus this system of government tries to minimize these differences and enable constituent states to concentrate on their similarity.

In general, the very essence of federation is that federal government cannot unilaterally change the status and territorial autonomy of the constituent units since the constitution gives guarantee to the legal personality of the constituent units and also at the same time backs the autonomy of the constituent units.[13] Thus, a constitution creates the constituent states and at the same time it gives protection to them so that the constituent states will not be eliminated by the willing of people on power.

Thus, for the constituent states to ensure and independently exercise their powers and functions as bestowed by the constitution, they need to have the power pertaining to fiscal issues. These fiscal issues help determine the leverage of autonomous constituent units and are mostly linked with power of taxation. The following section elucidates the bases for taxation power and the nature of this power in relation to the federal government and constituent states role in handling this issue.

2.1.2 Bases for Taxation power in a Federal system of Government

The power of taxation in a federal system of government lies in the federal government or constituent state or concurrently on both levels of the government. However the taxation power or the tax assignment of a federal system of government can be described in different forms. Independent legislation and administration by sub national governments and tax sharing are alternative techniques of tax assignment.[14] These techniques differ in the level of fiscal independence they provide to sub national governments, their ease of compliance and administration, the fairness and neutrality they are likely to produce, and the degree of inter jurisdictional redistribution they can provide.[15] For instance Germany is characterized by

[12] Zemelak Ayitenew, "The Politics of Sub-national Constitutions and Local Governments in Ethiopia," **Perspective of Federalism**, Vol.6, 2014, p.90
[13] Gosaye Birhanu, cited above at note 6, p.13
[14] Tesfaye Mergia, Tax Assignment to Sub-national Governments in a Decentralized Fiscal System of Ethiopia, Addis Ababa University, School of Graduate Studies,(unpublished), 2005, p.17
[15] Ibid

legislative centralization but decentralized administration.[16] This means the law that regulates a particular type of tax, including rate, is legislated by the federal government, whereas the administration of the tax is done by both the federal and the constituent state.

Thus constituent states tax autonomy is characterized by allocation of taxation power in the form of own revenue sources, shared tax and shared revenue (revenue sharing). The own revenue source implies when specific type of revenue is allocated to constituent states. On shared tax, both the federal and the constituent states fix their own tax rate, administer and collect such tax. In this case, the type of tax imposed is the same for both levels of government, but both levels of government have distinct jurisdiction. On shared revenue, the administration of the tax is done by one of the two levels of government and the revenue will be shared between the two levels.

Theory of Taxation power

Tax assignment/taxing power as one expression of fiscal decentralization, explains which level of government should tax what (the tax base), how and which type of taxes have to be the concern of the federal government or the regional government.[17] Federal states have a centralized or decentralized tax assignment depending on their choice and ability to administer the tax. There is no one and the same path of division of taxing power among countries in the world and hence different countries adopt different ways of assigning taxing power depending on the actual socio- economic, political and historical realities of a country.[18] Macroeconomic stability, interpersonal equity, mobility of tax base, tax exportation and tax externality are centralization forces whereas, tax assignment criteria such as fiscal independence/tax autonomy, visibility to taxpayer and accountability and tax flexibility justify the decentralization of taxation powers.[19] However, having a proper assignment of tax to a right level of government has the merit of enhancing accountability of government and overcoming misallocations of resources; reducing the sense of dependency mentality of sub national

[16] Gosaye Birhanu, cited above at note 6, p. 27
[17] Tesfaye Mergia, cited above at note 14, p.11
[18] Alene Agegnehu and Ayele Behaylu, "Tax Assignment: Theory Nexus Practice in Australia, Canada, Germany, Ethiopia and Switzerland: Review," **Research Journal of Finance and Accounting**, Vol.6, 2015, p.123
[19] Ghebrehiwet Tesfai Baraki, cited above at note 4, p.188

governments on the centre, and minimizing the mismatch between expenditure needs and revenue sources of sub national governments.[20]

First Generation Theory of Fiscal Federalism (FGTFF)

This theory attempts to have a right tax assignment to a right level of government and hence it envisages general principles based on economic criteria.[21] According to the FGTFF prescription: (i) tax bases with cyclical nature should be assigned to the centre, (ii) mobile tax bases having highly progressive rate for redistributive purpose should be assigned only to the central government, to avoid labour mobility, capital flight for tax reasons, and wasteful competition among states and to reduce compliance costs; whereas, sub national governments' taxation power should be limited to immobile taxes, user charge fees and excise taxes.[22] Thus, taxes that have an uneven base and distribution among constitute units of the state and that bear complex administration of resource, like Value Added Tax (VAT hereafter) and customs duty should be assigned to the central government.[23] In addition, income taxes applied to individuals (or households) and taxes on personal wealth and on wealth transfers (e.g., estate taxes) should be given for the federal government.[24] On the other hand, taxes which are completely immobile like property (land, house etc) are easy to be administered and collected without much wastage of resource and energy by the sub-national governments, should be assigned to the constituent states.[25]

Second Generation Theory of Fiscal Federalism (SGTFF)

The SGTFF considers non-economic variables like tax autonomy, accountability, tax flexibility.[26] This theory proposes that if a sub national government wants to enjoy tax autonomy, in addition to user charges and immobile real property taxes, it must have access to

[20] Wallace E. Oates, " Towards a Second Generation Theory of Fiscal Federalism ", **International Tax and Public Finance**, Vol.12, 2005 as cited in Alene Agegnehu and Ayele Behaylu, cited above at note 18, p.123
[21] Ibid
[22] Ghebrehiwet Tesfai Baraki, cited above at note 4, p.181
[23] Wallace E. Oates, " Towards a Second Generation Theory of Fiscal Federalism ", **International Tax and Public Finance**, Vol.12, 2005, as cited in Alene Agegnehu and Ayele Behaylu, cited above at note 18, p.123
[24] Robin Boadway, Sandra Roberts and Anwar Shah, Fiscal Federalism of Tax Reform in Developing Countries, Policy Research working paper, World Bank,1994, p.9
[25] Wallace E. Oates, " Towards a Second Generation Theory of Fiscal Federalism ", **International Tax and Public Finance**, Vol.12, 2005, as cited in Alene Agegnehu and Ayele Behaylu, cited above at note 18 , p.123
[26] Ghebrehiwet Tesfai Baraki, cited above at note 4, p.181

various revenue sources including mobile tax bases, at least marginally.[27] From this, one can easily grasp that second generation theory could not reject the criteria proposed by first generation theory; instead, it gives emphasis on the role of politicians and officials in the tax assignment process.[28] Generally, this theory proposes non-economic variables should also be taken into consideration, in dealing with tax assignment.

From the experience of countries that have a federal setup, some go in line with the FGTFF, but not with SGTFF. These countries seem to follow a centralized tax assignment in which most of the sources of taxes are under the jurisdiction of the central government. So taxes those have macroeconomic stabilization and redistribution impact like custom duty and VAT fall under the jurisdiction of the central government.[29] The best example for this is Germany in which its tax law is the most uniform and centralized one so that Landers (regional states of Germany) lack discretion over determining tax bases and rates.[30] Whereas country like Canada go in line with SGTFF in which some resource tax that bring accountability and develop a sense of ownership in the taxpayer are handled by the sub national governments. To that end Personal Income Tax, Corporate Income Tax, and VAT are granted to the province.[31] Especially for VAT, Quebec, one of the provinces of Canada, collects VAT as long as the transaction is conducted in its own jurisdiction.[32]

In general taxes that have stability, redistribution, mobility character and taxes that have the character of avoiding tax exportation should be the jurisdiction of the central government.[33] Whereas, taxes that achieve the benefit received principle and taxes that brings visibility, accountability and administrative feasibility have to be within the jurisdiction of the constituent state.[34] However for the reason that natural resources are unevenly distributed, it is recommended that they fall under the shared jurisdiction.[35] Thus, progressive redistributive

[27] Ibid
[28] Wallace E. Oates, " Towards a Second Generation Theory of Fiscal Federalism ", **International Tax and Public Finance**, Vol.12, 2005, as cited in Alene Agegnehu and Ayele Behaylu, cited above at note 18, p.123
[29] Ibid
[30] Id., p.125
[31] Ibid
[32] Id., p.124
[33] Ghebrehiwet Tesfai Baraki, cited above at note 4, p.197
[34] Ibid
[35] Ibid

taxes, stabilization instrument taxes and resource rent taxes would be suitable for assignment to the federal government; while immobile taxes are suitably assigned to state governments.[36]

2.2 International Juridical Double Taxation

International juridical double taxation is an excessive taxation for the taxpayer and an obstacle to capital movements, in the process of increasing cooperation between countries and increasing the economic and financial relations between them.[37] International juridical double taxation occurs when two or more states impose income taxes on the same taxpayer for the same subject matter.[38] Most commonly, double taxation arises because states impose tax not only on domestic assets and transactions but also on assets and transactions in other states which benefit resident taxpayers, resulting in the overlap of the states' tax claims.[39] This is a juridical or legal double taxation in which it is different from economic double taxation. Economic double taxation phenomenon consists of the submission of certain taxable raw at two or more taxes in the favour of the same authorities or different public authorities, at the same financial year.[40] The concern of this study is on international juridical double taxation in which the writer uses "double taxation" to refer international juridical double taxation.

The phenomenon of double taxation occurs not because of the different structures of the tax systems but because of the different concepts (criteria) underlying the imposition of tax.[41] It can generally be defined as the imposition of comparable taxes in two (or more) states on the same taxpayer in respect of the same subject matter and for identical period's.[42] International juridical double taxation is manifested in different ways for example where two states requires total income from the wealth of the one and same person, i.e. if a resident person in one of the state obtain revenue or possesses wealth in the other contracting state and where both states taxed the income or wealth. [43]Also, where each state taxed the same person in which he/she is

[36] Robin Boadway, Sandra Roberts and Anwar Shah, cited above at note 24, p. 8
[37]Nicoleta Barbutu Misu and Florin Tudor, "The International Double Taxation- Causes and Avoidance," **OECONOMICA,**Vol.5, 2009, p.147
[38] Klaus Vogel, cited above at note 1, p.4
[39] Ibid
[40] Nicoleta Barbutu Misu and Florin Tudor, cited above at note 37, p.151
[41] Id., p.152
[42] Klaus Vogel, cited above at note 1, p.6
[43] Nicoleta Barbutu Misu and Florin Tudor, cited above at note 37, p.152

not resident of the contracting states, but for the revenue or for wealth that he/she owns there.[44] For the two states to claim based on source of the income is when a non-resident person has a permanent office or a fixed base through whom/which it generates revenue or possesses wealth in the other contracting state.[45] However, customary international law does not forbid double taxation.[46] Double taxation, resulting from the interaction of the domestic laws of two (or more) states, will be consistent with international law so long as each individual law is consistent with international law.[47]

2.2.1 Causes

As stated above, the phenomenon of double taxation occurs because of the different concepts (criteria) underlying the imposition, and not because of the different structures of tax systems.[48] This means the structure of the tax system of countries may be the same but because of the principle that the country's tax system follows, international double taxation may occur. The relation of a person to the state can be manifested by political or social or economic dependency.[49] Political dependence is characterized through nationality; whereas social dependence is manifested through the individual stay in the country of his residence or domicile and economic dependence can result from individual participation in the activity of production, circulation or consumption of goods in that State. [50]

Income tax is typically levied by a country on the domestic and foreign income of its residents and the domestic income of nonresidents.[51] Thus a particular state imposes tax on its resident on the income they generate in the state which is a domestic income and on an income sourced in other states. Where as if the taxpayer is a non resident, the state imposes tax only on the income generated in that particular state. As an international trend, countries impose tax based on source principle, resident principle or sometimes on the basis of the nationality principle. When states apply these principles separately or jointly, double taxation will occur. Hence,

[44] Ibid
[45] Ibid
[46] Klaus Vogel, cited above at note 1, p. 8
[47] Ibid
[48] Nicoleta Barbutu Misu and Florin Tudor, cited above at note 37, p.152
[49] Id., p. 149
[50] Ibid
[51] Richard J. Vann, "International Aspects of Income Tax," **Tax Law Design and Drafting**, Vol. 2 ,1998, p.4

juridical double taxation occurs when one state applies its own domestic tax laws freely without considering the tax laws of the other states since there is no international tax law unlike international law, so that states don't have an international obligation to regard other states tax laws when imposing their own domestic taxes. Since no state unilaterally waives its right to tax transactions or assets of residents and non-residents within its own territory based on the principle of source, the tax claims of different states necessarily over-lap.[52] As a rule, a state may impose tax when its resident generates an income from worldwide income generating activity or when a non resident generates an income in the source country. So, most countries want to tax both the resident and nonresident with some exceptional countries like Hong Kong that imposes tax only on source base. Hong Kong imposes tax on both its residents and non residents only when the source of income is only from Hong Kong. [53] But the fact that Hong Kong imposes tax on source base will not eliminate the possibility of double taxation. Therefore, a country's measure to impose tax only on one of the bases of taxation i.e. resident, source or nationality, may not avoid the occurrence of double taxation.

In general, causes for international juridical double taxation are source-source conflict, residence- residence conflict and source -residence conflict.

i. Source-Source conflict

This is one cause of international juridical double taxation where two states or more states claim the jurisdiction to levy tax since the states consider the source of the income as emanating from them. It occurs when source rules overlap because two (or more) states find the same economic transaction or asset to be within their territory. One country may regard income from certain services as being sourced in their territory if the activities are performed in that country, while another country may treat the same income as sourced in their territory if the services are paid for by a resident of that country. [54] Also, one of the countries may claim to have jurisdiction over the income since the transaction is conducted in its jurisdiction, whereas the other state bases its claim on where the manufacturing of the products takes place. Hence, if the countries impose tax on source base for non-residents, the

[52] Klaus Vogel, cited above at note 1, p.6

[53] Richard J. Vann , cited above at note 51, p. 38

[54] Ariane Pickering, cited above at note 2, p.9

tax payer is liable to pay income tax in the two different countries giving rise to the occurrence of juridical double taxation. In source- source cause of double taxation, the states that exercise taxing jurisdiction do not raise the issue of residence, but always claim that the source of income is from their jurisdiction.

ii. Residence- Residence conflict

Double taxation may also arise when a person is deemed to be a resident simultaneously by two or more states. Residence-residence conflict occur where a person is taxed on worldwide income or capital in more than one country on the basis that the person is regarded as a resident for tax purposes in each of those countries.[55] A person may be considered as a resident of two states for the same period so that the person will be taken as a tax payer in the two different states. This occurs because of the definition given by the states of 'resident'. For example, for legal person, some country may define "resident" based on the place of incorporation, whereas the other country on the basis of the place of effective management. In such instances, juridical double taxation may occur because of the reason that the countries apply residence principle.

iii. Residence - Source conflict

This is the other cause of juridical double taxation. It occurs when one state claims tax based on the residency of the taxpayer and another state claims tax on the basis of the source of the income. The country which imposes tax based on source is imposing tax on non-residents whereas the other levies tax on the worldwide income of its residents. Thus, the person being treated as taxpayer of the two states has to pay tax on the same income to the two states. Similarly, double taxation may arise where states tax the worldwide income of their citizens even when they are residents of another state, as is the case with the USA and Mexico.[56]

2.2.2 Consequence

Double taxation is likely to cause a barrier to international transactions, and the nations of the world have generally agreed on the desirability of removing such barriers as a means of

[55] Id., p. 8
[56] Klaus Vogel, cited above at note 1, p.8

increasing global welfare.[57] The occurrence of juridical double taxation has its own adverse effect in the relations between countries. First residents/nationals of a state will not be willing to invest in the other state if both states impose tax on them. This has impact on the investment relations of the two states because it discourages the flow of capital and people. Thus, the phenomenon of double taxation occurs frequently representing a difficult poison for the foreign trade activity, especially hindering investments abroad, technology transfer or proliferation of income generating activity outside of the state of the companies' branches.[58] Thus, from investment point of view, the impact of imposing tax by the host country discourage investors not to invest in a host state, which automatically have a negative effect on technology transfer that benefit the host state. Developing countries wish to attract foreign direct investment, some by providing tax incentives and/or reducing tax rates on various conditions.[59] However, granting tax holiday for such investors will not achieve the need of the developing countries if the investors are taxed in their home state (of residence). [60]Thus, most of the time there is a need to conclude tax treaties between the home and host state to avoid such circumstances, providing for the possibility of tax sparing.[61] This notion considers the tax relieved by the host state as a paid one and relieves the tax payer from paying tax in his home state.[62] In such scenario, the host states achieve the aim of granting a tax holiday.

2.2.3 Remedy

Countries provide different remedies for the problem of double taxation; as the measure could be unilateral, bilateral or regional measure which has binding effect on the states concerned. Let us discuss the remedies as follows briefly.

2.2.3.1 Unilateral Remedy

Double taxation can be avoided unilaterally by one state on withdrawal of its tax claim. The limitation by a contracting state of its domestic tax law may consist of the waiver of its tax

[57] Id., P. 3
[58] Nicoleta Barbutu Misu and Florin Tudor, cited above at note 37,p.147
[59] Interview with Ato Birhanu Tadesse, MoFEC, Senior Legal Expert and member of the Ethiopian tax treaty negotiation team, December 7,2016
[60] Ibid
[61] Ibid
[62] Definition of " tax sparing" available at: www.investorwords.com/18981/**tax_sparing**.html, (last visited on October 2, 2016)

claim in favor of the other state (exemption method) or of the grant of a credit against its tax for taxes paid in the other state (credit method) and even sometimes deduction.[63]

Exemption is a method in which most developing countries grant double taxation relief to their domestic corporations in which the very aim of giving such exemption is to assist their domestic companies and make them competitive at the international market.[64] Developed countries apply the exemption method to avoid double taxation: Switzerland exempts income from permanent establishments and real property located abroad; the Netherlands and Australia exempt foreign source income generally if the income is taxed in the source country.[65]

On the other hand, foreign tax credit is the unilateral move whereby the state of residence, to the extent it is not simultaneously the source state, allows a credit for the tax levied in the source state up to an amount equal to its own tax charge.[66] Thus the resident state will give a tax credit on the tax paid in the source when calculating the tax to be paid by the taxpayer in the resident state because of its worldwide income. In such instance, the taxpayer is required to pay tax in the resident state, only on the difference between the tax imposed by the resident state and tax imposed by the source state.

Deduction is the other unilateral method, even if it is not used by most countries. In deduction, the country of resident allows its taxpayer to ask for deduction of taxes, which have been paid to a foreign government in respect of foreign source income.[67] Thus this method considers the tax paid in the source country as an expense for the tax that will be paid to the resident state.

In general unilateral remedies are taken unilaterally by states according to their domestic income tax legislation. Thus, unilateral remedy encompass either the exemption method: whereby the foreign income is exempted from tax in the residence country, or the foreign tax

[63] Klaus Vogel, cited above at note 1, p. 23
[64] Brian J. Arnold and Michael J. McIntyre, **International Tax Premier** (2nd ed), Kluwer Law International, Netherland ,2002, p.99
[65] Klaus Vogel, cited above at note 1, p. 9
[66] Ibid
[67] Azzimudin Law Associates, How Tax Treaties Allow Benefits from Double Taxation, available on *https://www.hg.org/article.asp?id=30908* (last visited on October 2, 2016)

credit method: whereby the tax of the residence country on the foreign income is reduced by the amount of source country tax on the income.[68] The distinction between these methods is that the exemption method refers to the income, crediting method refers to tax,[69] whereas deduction method refers to the amount of tax paid.

2.2.3.2 Bilateral Remedy

As the name indicates the mechanism forwarded through this scheme is based on the co-operation/ willingness of two states. This means the measure is taken by two states making an agreement to decide which state should impose tax on a particular income so as to avoid double taxation. Unlike the rules of private international law, tax treaty rules assume that both contracting states tax according to their own laws; therefore, treaty rules do not lead to the application of foreign law.[70] In bilateral remedy, parties to the treaty conclude the application of one of their domestic tax laws, i.e. rules of double taxation are "rules of limitation of law".[71] Thus in tax treaties, states are limiting their taxing power over an income and choose to apply the laws of other contracting state.

Tax treaties are the well known remedies for the avoidance of double taxation, but there are some arguments why they are bilateral, rather than multilateral. The usual explanation is that tax treaties depend too much on the specific investment flows between countries, and therefore cannot be multilateral.[72] The investment relationship of states is a mutual relationship in which it has its own particular feature on the interest that needs to be protected by the parties involved in the investment relationship. Also, the fact that tax treaties are bilateral is mostly due to the fact that the models were developed before World War II, when bilateral treaties were the norm, and when differences between the tax laws of different countries were larger than they are today.[73] Thus, tax treaties were highly developed since in the then time tax laws of countries consists different notion which was so hard to make such laws in one package in which countries which have an interest to protect their taxing right found it served their

[68] Richard J. Vann, cited above at note 51, p.4
[69] Nicoleta Barbutu Misu and Florin Tudor, cited above at note 37, p.154
[70] Klaus Vogel, cited above at note 1 , p.14
[71] Ibid
[72] Reuven S. Avi-Yonah, Double Tax-Treaties: An Introduction, University of Michigan, (unpublished), 2007, p.11
[73] Ibid

interests better to conclude a bilateral treaty.[74] However, the first preposition can be alleged in relation to developing countries since, at this time, most developing countries conclude tax treaties without taking into consideration their investment flow with their developed country treaty counterparty.

The main feature of a bilateral tax treaty is that it neither creates a tax claim that does not otherwise exist under domestic law nor expands the scope or alters the character of an existing claim.[75] Like unilateral remedy, exemption and tax credit methods are applied within the treaty. Thus to the extent an exemption is chosen, its effect is in principle independent of both whether the other contracting state imposes a tax in the situation to which the exemption applies, and of whether that state actually levies the tax.[76] Hence as a rule, in an exemption method, the contracting state that grant exemption from income tax, is not required to check whether the other contracting state has levied a tax in its domestic tax law or the tax is actually levied by the other contracting state according to the domestic law. It is only in exceptional cases, and only when expressly agreed to by the parties that the exemption in one contracting state dependent upon whether the income or property is taxable in the other contracting state, or upon whether it is actually taxed there.[77]

Also, tax credit as one method of bilateral remedy is encompassed under bilateral tax treaties. The tax treaty may specify that the resident country may grant a tax credit to the taxes that will be paid in the source state. Thus, the resident taxpayer will pay tax in its resident state on the difference between the tax paid in the source state and the tax that will be paid in the resident state. There are circumstances in which the tax paid in the source state may be greater than the tax that will be paid in the resident state. In that case, the resident state will not impose tax on the foreign income that will be taxed in the resident state because of the world wide income principle. Sometimes the treaty of the provision that is stipulated by the phrase 'shall be' will be applied to avoid double taxation not by exemption but by tax credit like dividend and interest.[78] Thus according to this meaning if the tax rate that will apply to interest is

[74] Ibid
[75] Klaus Vogel, cited above at note 1, p.23
[76] Ibid
[77] Ibid
[78] OECD, cited above at note 3, 2014, Art 23 B

negotiated at, for example 5%, then the source state will apply the 5% tax rate and the resident state can apply the tax rate on its resident taxpayer only if it has a tax rate above 5% in its domestic law.

2.2.3.3 Regional Remedy

Regional remedies emphasized, in the multilateral treaties which back their enforcement, are focused most of the time, on geographical location. This remedy like the bilateral treaty is an obligatory one such that members of the multilateral treaty can claim a right against member state of the treaty. As an example, the CARICOM agreement is a multilateral agreement which is solely a source based multilateral tax treaty.[79] It is entered into by 11 of the 14 member countries of the Caribbean community viz Antigua and Bermuda, Belize, Dominica, Grenada, Guyana, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, and Trinidad and Tobago.[80] The unique feature of this multilateral tax treaty is that it is premised on the exclusivity of the source states right to tax and prohibition against the tax payer state of residence levying tax on a worldwide income basis (at least in respect of income derived from other treaty partner states).[81] Thus according to this agreement, the source state is the one empowered to levy tax. Such an agreement is beneficial to the parties where there is a balance of investment, whether passive or active, between the members of the multilateral treaty.[82]

The Nordic convention is also another multilateral agreement albeit its focus is on tax administration.[83] The Nordic convention is a multilateral double taxation avoidance agreement between Nordic countries (1996), i.e. between Denmark, the Faroe Islands, Finland, Iceland, Norway and Sweden.[84] It contains particular provisions concerning the presence of a permanent establishment (PE) in a contracting state, and a unique article governing activities in connection with surveying, exploration for and exploitation of

[79] Kevin Holmes, **International Tax Policy and Double Tax Treaties**(2nd Rev. ed),IBFD, Netherland,2014, p.68
[80] Ibid
[81] Ibid
[82] Ibid
[83] The Nordic convention,1996
[84] Ibid

hydrocarbon deposit because of the economic importance of extractive natural resources to those states.[85]

Even international documents allow for the creation of some multilateral treaties. Article 220 of the treaty of Rome (1957) which created the European Economic Community (now the European Union) allows for the conclusion of a multilateral tax treaty among the member states of the European Union.[86] In addition, the OECD and the Council of Europe have sponsored a multinational Convention on Mutual Administrative Assistance on Tax Matters which provides for extensive cooperation on collection of assessed taxes.[87]

The Income Tax Convention (1957) between Chad, Gabon, Middle Congo, Ubangi- Shari and French Equatorial Africa, the Arab Economic Union Council Income and Capital Tax Treaty (1973), and the West African Economic and Monetary Union Income, Capital and Inheritance tax treaties (2008) are also some of the multilateral tax treaties.[88] In addition, the General Agreement regarding Fiscal Cooperation of January 29, 1971 of the Organisation Commune Africaine, Malgache et Mauricienne(OCAM), and the two agreements within the purview of the Council for Mutual Economic Assistance (COMECON) of May 19, 1978, can also be mentioned as Multilateral Tax Treaty.[89]

2.3 Overview of Bilateral Tax Treaties

2.3.1 Nature and Characteristics of Tax Treaties

Tax treaties are bilateral agreements concluded between countries in order to set out rules on how to eliminate double taxation of their residents, with respect to incomes received in the other country.[90] Tax treaties confer rights and impose obligations with regard to tax on the contracting states. Tax treaties, unlike conflict rules of private international law, do not choose between applicable domestic and foreign law.[91] Instead, they recognize that each contracting

[85] Kevin Holmes, cited above at note 79, p. 68
[86] Ibid
[87] Brian J. Arnold and Michael J. McIntyre, cited above at note 64, p. 93
[88] Kevin Holmes, cited above at note 79, p. 69
[89] Klaus Vogel, cited above at note 1, p.13
[90] Zelalem Eshetu, "Decentralizing Treaty Making Power of the Federal Government under the Ethiopian Federal System: in search of Better Safeguarding Mechanisms," **The International Journal of Ethiopia Legal Studies**, Vol.1, 2015, p.11
[91] Klaus Vogel, cited above at note 1, p. 22

state applies its own law, and then limit the contracting states' application of that law.[92] Thus in tax treaties, the law that will be applied to avoid the double taxation is one of the two laws of the contracting states as enshrined under the tax treaty.

Though states have original jurisdiction to tax, by concluding tax treaties they agree to restrict their substantive tax law to be applied in their jurisdiction. Tax treaties do not impose tax since tax is imposed under domestic laws of the contracting states.[93] This means tax treaties do not give right to tax a contracting state which is not provided under the domestic laws of the contracting states. However, France and several African countries following the French practice are notable exceptions in this regard because taxes may be imposed pursuant to treaty provisions even though not imposed under domestic law.[94] Also, in situations when an overlapping of substantive tax law is expected to occur, states which are parties to tax treaties decide which of them shall be bound to withdraw their tax claim.[95] Hence when their tax laws are in a position not to go in line with each other, the tax law will provide a solution to give priority to the domestic tax law of the state or the tax treaty concluded.[96]

Tax treaties have the effect of shifting tax power from source countries to residence countries, because under the generally accepted rules, the source country is allowed to impose the first tax on any revenue deriving from sources within it.[97] In the absence of a tax treaty, source countries can impose tax on active and passive income within the country and are not bound by a permanent establishment or double tax treaty sourcing rule defining what income originates within the country.[98] So the very purpose of a double tax treaty is to shift the taxing power from the source state and gives it to the resident state especially on active income like business income and providing reduced withholding tax rate for passive incomes. In some jurisdictions, a tax treaty will not have effect on how a resident of that state is taxed. For example, the USA will not negotiate on how to tax its residents because the United States argues that double tax

[92] Ibid
[93] Lee Burns, Double Tax Agreements , MoFEC, (unpublished),2016
[94] Brian J. Arnold and Michael J. McIntyre, cited above at note 64, p. 95
[95] Klaus Vogel, cited above at note 1, p.22
[96] Federal Income Tax, 2016, Art. 48, Proclamation No. 979, **Federal Neg.Gaz.**, Year 22, No 104
[97] Reuven S. Avi-Yonah, cited above at note 72, p.3
[98] Ibid

treaties are not designed to protect Americans from American tax.[99] Hence states that conclude tax treaty with the USA do so to give protection to that states' residents so that they are not taxed in USA even if the source of income is in USA. But the contracting state will not get the jurisdiction to tax residents of USA even if the residents of USA earned an income from the contracting state.

2.3.2 Scope and Importance of Bilateral Tax Treaties

2.3.2.1 Scope of Tax Treaties

Most tax treaties are concluded with the aim to avoid double taxation in which double taxation arises when a particular taxpayer is subject to taxation of different jurisdiction.[100] The country which imposes tax may apply the source rule, where as the other country may apply the residence rule or both countries may apply the source rule or the resident rule but both claim the right to tax on that particular income.[101] So in order to avoid such a situation, countries conclude a tax treaty with each other.

There are different types of tax treaties in which some are on income, capital (wealth and land), inheritance & gift and also shipping and air transport.[102] However, most tax treaties are concluded to avoid taxes on income and this sometimes includes capital. [103]The income tax may be business income, employment income, rental income or some other income like dividends, royalty or interest. [104]So the main concern for tax treaties is income tax only. Indirect taxes are not covered under tax treaties.[105]

On the scope of tax treaties, the other very essential question raised is whether the tax treaty is binding on the constituent states of a federation, or for dependent territories of a contracting

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[99] Id., P.5
[100] Interview with Ato Birhanu Tadesse, cited above at note 59
[101] Ibid
[102] Kevin Holmes, cited above at note 79, p.59
[103] Interview with Ato Birhanu Tadesse , cited at note 59
[104]The tax treaties between the Federal Democratic Republic of Ethiopia and the Republic of Ireland & the Government of the Federal Democratic Republic of Ethiopia and the government of United Arab Emirates (UAE) are selected in dealing the Ethiopian tax treaties. The first treaty ratification instrument is exchanged between the two countries, while the second one is ratified by the Ethiopian side.
[105] Interview with Ato Birhanu Tadesse, cited above at note 59

state.[106] In general, tax treaties apply to all income taxes imposed by the contracting states, including taxes imposed by provincial (state), local and other sub national governments.[107] However, in some federal states central government is constrained by constitutional mandate or established tradition, from entering in to tax treaties that limit the taxing powers of their sub national governments.[108] This is the situation in Canada and USA in which, a sub national government may impose taxes in a manner that would not be permitted to its central government.[109] Accordingly, the tax treaties of such federal states apply only to federal taxes.

2.3.2.2 Importance of Tax Treaties

States conclude tax treaties so as to avoid double taxation that emanate from tax rules of contracting state of tax treaties. The very aim of concluding double taxation treaty is to benefit taxpayers of a contracting state since both of the contracting state claim the right to impose tax based on the connecting factor of residence of the taxpayer and source of the income. Tax treaties provide a solution for the tax claims of the two countries on a particular source of income either by assigning the whole claim to one of the governments or by prescribing the base on which the tax claim is to be shared between them.[110] Thus, the agreement helps to allocate the taxing jurisdiction among the contracting parties with regard to the different heads of income which are the subject matters of the treaty.[111] By their nature, double tax treaties do not create a right to tax which does not exist under the domestic tax law of the contracting state.[112] Rather they decide the party who exercises jurisdiction to tax on income in which they limit the taxes otherwise imposed by the contracting parties.[113] Hence the very objective of tax treaty is to avoid double taxation which would otherwise arise from an international transaction or where each country imposed its own tax on the same income or capital.[114]

Tax treaties also prevent the evasion of taxation on those international transactions or events by allocating the taxing rights between the contracting states and by information sharing or

[106] Klaus Vogel, cited above at note 1, p. 25
[107] Brian J. Arnold & Michael J. McIntyre, cited above at note 64, p. 94
[108] Ibid
[109] Ibid
[110] Zelalem Eshetu, cited above at note 90, p.11
[111] Ibid
[112] Brian J. Arnold & Michael J. McIntyre, cited above at note 64, p. 95
[113] Ibid
[114] Kevin Holmes, cited above at note 79, p. 58

cooperation provisions of the tax treaties.[115] In addition, tax treaties put mechanism for the resolution of conflicts and uncertainties, by clarifying taxing right of each state and by the dispute resolution provisions of the treaty. [116]

The other importance of tax treaties is determination of revenue between contracting states. The application of the treaty's distributive rules will determine how much revenue each state will receive from the taxation of the particular transaction or event. [117] In one of the two contracting states, the substantive tax law will remain unaffected; the tax claim will at most be limited in amount ("primary taxation") whereas, in the other contracting state, relief from double taxation will be provided by the allowance of either an exemption or a credit for the tax paid in the first state ("secondary taxation").[118] The other positive role of a tax treaty is that, it puts standardized taxable income definitions, and identifies the jurisdiction of the taxation authorities among the treaty countries.[119] In particular, tax treaties are useful in clarifying actual income taxability and reducing related ambiguities. [120]

In general, tax treaties remove impediments to cross border trade in goods and services and the movement of capital and people between countries, eliminates double taxation , prevent fiscal evasion, eliminate discrimination against foreign nationals and non residents, facilitates exchange of information, and it provide the mechanism for resolving disputes arising from the interaction of tax systems.[121] Thus tax treaties by removing impediments to cross border trade relation indirectly facilitate trans-boundary trade and investment and encourage residents of one state to invest in another state. Also tax treaties pave a way for the exchange of financial and tax information between treaty countries, helps the countries gain international economic recognition.[122]

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[115] Ibid
[116] Roy Saunders, "Understanding Double Tax Treaties," **Journal of International Trust and Corporate Planning**, Vol.9, 2002, p.32
[117] Klaus Vogel, cited above at note 1, p.26
[118] Ibid
[119] Bavik R. Parikh, Pankaj Jain and Ronald W. spahr, The Impact of Double Taxation Treaties on Cross Boarder Equity Flows, Valuation and Cost of Capital (University of Memphis, (unpublished), 2011, p.7
[120] Ibid
[121] Kevin Holmes, cited above at note 79 , p. 57
[122] Bavik R. Parikh, Pankaj Jain and Ronald W. spahr, cited above at note 119, p.112

With respect of the importance of tax treaties for developing countries, tax treaties between developing countries and developed countries, benefit the developing countries despite the absence of tax sparing because tax treaties ensure developed country investors a certain level of institutional stability in the developing country.[123] Studies of tax treaties between developing and developed countries show that the existence of a tax treaty has a significant positive effect on the flows of foreign direct investment into the developing country.[124] These studies lend support to the argument that tax treaties increase investor confidence in the stability of investing in developing countries, and therefore, although the developing country might forego some tax revenue from the conclusion of the tax treaty, it probably benefits in the long run from the increased foreign direct investment.[125] Also, nowadays since developing and transition countries desire to encourage capital importation from capital-exporting countries, tax treaties may facilitate this process in a number of ways. In a very general sense, entering into tax treaties acts as a signal to a country that it is willing to adopt the international norms.[126] Using a coordinated portfolio investment survey (CPIS) dataset from the IMF, it is noted that after the conclusion of tax treaties, bilateral portfolio investment flows between the treaty countries tend to increase by 48.53%.[127]

In contrast, empirical economic studies show that the existence of tax treaty between two developed countries does not materially affect foreign direct investment, suggesting that tax treaties between developed countries mostly affect the distribution of revenue between the governments of the two countries.[128]

2.3.3 The Process of Making Tax Treaties

The conclusion of tax treaties between countries has its own process like any kind of treaty making procedure i.e. initiation, negotiation, and ratification process. The conclusion of a treaty is preceded by negotiations. Thus, in order to initiate the negotiation process, the party that seeks to negotiate must have the legal capacity to take part in the negotiation. This

[123] Reuven S. Avi-Yonah, cited above at note 72 ,p.14
[124] Ibid
[125] Ibid
[126] Richard J. Vann, cited above at note 51, p.8
[127] Bavik R. Parikh, Pankaj Jain and Ronald W. spahr, cited above at note 119, p.5
[128] Reuven S. Avi-Yonah, supra note 72, at 14

capacity most of the time is manifested in the constitution of the country. In federal states, allocation of treaty making power is either centralized or decentralized.[129] As a general trend, states follow a centralized treaty making power in which the federal government is the one entitled to take part in treaty making without the involvement of the constituent states.[130] USA and India are the best example for centralized treaty making power whereas, countries like Germany and Switzerland turn aside from the general trend and decentralize their treaty making power because their constitution allows constituent units to have an active role in treaty making.[131]

Also on the legal capacity to participate in a negotiation, a special organ of the federal/ constituent state has to be identified to conduct the tax treaty negotiation. For example, in Germany, tax treaties are typically negotiated by the Minister of Finance, represented by a chief negotiator.[132] Representatives of the Foreign Ministry and other Federal Ministries participate in the negotiations to the extent necessary, and in certain cases representatives of one or more of the individual German States (Landers) may take part.[133] As it has been stated above, the process of concluding a tax treaty is commenced with negotiation. The focus of negotiation between parties to the treaty is usually on the points that are not initially agreed or which are not established by international practice.[134] During negotiations a treaty text is drafted, initially only in one language so that both of the contracting state can understand the document.[135] Then parties will begin to discuss the prepared document especially on the issues that have been framed as of specific concern or interest. These issues are the ones on which the parties involved take a different position. Most of the time, such issues are principles focusing on treaty shopping, tax sparing, limitation of benefit, force of attraction rules and sometimes rates of withholding taxes of passive incomes. In general, only points of difference will be the

[129] Cantons of Switzerland and Landers of Germany are good examples for the decentralization of treaty making. The cantons responsibility is just to inform the federal government when they are on the way to ratify the treaty (Article 56 of the 1999 o f the Switzerland constitution). While the Landers have to get approval from the federal government but approval by the federal government cannot be withheld without good reason. (Article 32(3) of the 1949 Constitution of Germany).
[130] Zelalem Eshetu, cited above at note 90, p. 7
[131] Ibid
[132] Klaus Vogel, cited above at 1, p.16
[133] Ibid
[134] Ibid
[135] Ibid

focus of negotiation so as to allow the contracting parties to reach a common point of agreement.

After the parties finalize their negotiation, the text of the finalized treaty will be initiated by the head of the negotiators of the contracting states. However this document will not come in to force automatically. The contracting parties have to make such treaty as part of their domestic law through the process of ratification. Each contracting state has its own internal procedures for ratifying treaties that must be satisfied. For example many countries provide that a treaty negotiated by the government must receive legislative approval or domestic legislation to be effective and to make the agreement part of the national laws of the contracting state and to publicize the agreement.[136] Once these internal procedures have been satisfied, the contracting states will exchange instruments of ratification and the tax treaty will become effective.[137]

Generally, the main processes to conclude a tax treaty are negotiation and ratification. The negotiation stage is started with the exchange of text of the first draft, then the negotiations take place, both face-to-face and by correspondence.[138]

[136] Brian J. Arnold & Michael J. McIntyre, cited above at note 64, p.107
[137] Ibid
[138] David L. Raish and N. Susan Stone, "Issues paper on the Tax Treaty Making Process," **Tax Lawyer**, vol. 46, 1993, p.478

Chapter Three

Involving Constituent States in Negotiating Tax Treaties in Ethiopia

3.1 Division of Power of Taxation in Ethiopia

The notion of fiscal federalism addresses issues related to fiscal decision-making, assignment of responsibilities and functions between the federal government and the regional governments, in relation to taxation power and the design of inter-governmental transfer (subsidy) of fiscal resources coupled with provisions about the borrowing windows to sub-national governments.[139] Assignment of taxation power, as one feature of fiscal federalism, focuses on the power of the federal government, the constituent states of the federation or to both levels of government to levy and collect taxes and other duties.

As Ethiopia has established a federal system of government, the power of government i.e. legislative, executive or judicial power has been divided between the federal and state governments. The FDRE Constitution provides for the establishment of two orders of government structured at federal and state level.[140] The Federal Government and the States shall have legislative, executive and judicial powers.[141] Both levels of government exercise their respective functions as provided under the Constitution. The legislative, executive and judicial powers of the federal and state governments are briefly provided under the Constitution.[142] Being legislative and executive powers are core and decisive powers, the federal government has been conferred a wide range of powers and functions such as power to formulate and execute the country's financial, monetary and foreign investment policies and strategies, formulate and implement foreign policy, negotiate and ratify international agreements, enact a law on inter-State commerce and foreign trade; approve general policies

[139] Yohannes Mesfin and Sisay Bogale, Introduction to Fiscal Federalism and Division of Revenues under the Ethiopian Constitution , available at www.abyssinialaw.com/study-on-line/item/1067-**division-of-revenues**, last visited on December 5,2016

[140] Zemelak Ayitenew, cited above at note 12, p.92

[141] The Constitution of the Federal Democratic Republic of Ethiopia, 1995, Art.50(2), Proclamation No.1, **Federal Neg. Gaz**., Year 1, No.1

[142] Id., Art. 51 , 52 ,55, 77, 79 and 80

and strategies of economic, social and development, and levy taxes and duties on revenue sources reserved to the federal government.[143]

On the other hand, the state governments have also their own powers and functions which are explicitly provided under the FDRE Constitution. The states are empowered to formulate and execute economic, social and development policies, strategies and plans of the State, to levy and collect taxes and duties on revenue sources reserved to the States and to draw up and administer the State budget; and administer land and other natural resources in accordance with Federal laws.[144]

In addition, the FDRE Constitution provides a residual clause on matters that are not expressly provided under the Constitution. The Constitution stipulates that all powers not given expressly to the Federal Government alone, or concurrently to the Federal Government and the States, are reserved to the States.[145]

In dealing with the power of taxation of the two orders of government, the notion of tax assignment will be raised. As tax assignment refers to a decision of determining which tier of government should be empowered to levy and collect which kinds of taxes[146], this decision is backed by different theories as proposed by different scholars. Thus, in analyzing the Ethiopian tax assignment with the theory, corporate income tax is a concurrent tax, whereas personal income tax becomes decentralized even if the First Generation Theory of Fiscal Federalism (FGTFF) recommends centralizing both corporate and personal income tax.[147] However assigning the taxing power of property and land use fee to the regional states makes the tax assignment compatible with the theory of Second Generation Theory of Fiscal Federalism (SGTFF).[148]

The division of taxation power in Ethiopia is mainly structured according to the categories of taxpayers or particular things as a source of revenue.[149] The exclusive domain of each government is not the tax base rather the source of the taxable income. Therefore the tax

[143] Id., Art. 51, 55 and 96
[144] Id., Art. 52
[145] Ibid
[146] Alene Agegnehu and Ayele Behaylu, cited above at note 18, p.123
[147] Id., p.126
[148] Ibid
[149] Alefe Abeje, "System of Division of Revenue in Ethiopia," **European Scientific Journal,** Vol.2,2014, p.96

system of Ethiopia does not result in taxing the same income, transaction or thing by both levels of government.[150] Hence juridical double taxation is not a problem on incomes generated within the country even if source of income is from the federal and the tax payer resides in one of the constituent states. As a result, there is no limit to levy taxes for the federal government with the intention that sub national governments can raise enough money.[151] Therefore, the federal government collects tax revenue that is within its constitutional competence.

In division of power of taxation, the FDRE Constitution follows a different approach than the way it has provided on the power and responsibility of the two levels of government. The Constitution put the exhaustive list of types of revenues belongs to the federal and the regional states and to both levels of government as concurrent powers of taxation. The Constitution also recognized the notion of undesignated power of taxation. This is a power of taxation that is not specifically provided under the FDRE constitution.[152] Hence the House of the Federation(HoF hereafter) and the House of Peoples Representatives (HPR hereafter) shall, in a joint session, determine by a two thirds majority vote on the exercise of powers of taxation which have not been specifically provided for in the FDRE Constitution.[153] Thus the FDRE constitution does not recognize residual taxation power of regional states unlike the other powers. [154]

Like in most federal countries, in Ethiopia too, the federal government has, relatively speaking, wide sources of revenues.[155] It can be argued that the reason for having relatively wider source of income for the federal government is justifiable since the federal government has stabilization and redistribution functions, it needs more revenues than the federating units. Taxation powers of the federal government are income tax from the employees of the federal government and its public enterprises and international organizations; custom duties, taxes and other charges in imports and exports; income, profit, VAT[156]and excise taxes on enterprise owned by the federal government; income from winnings of national lotteries and other games

[150] Ibid
[151] Ibid
[152] See the FDRE constitution, Art. 99
[153] Ibid
[154] Id., Art. 52(1) and Art. 99
[155] Alefe Abeje, cited above at note 149, p.95

[156] VAT is introduced in Ethiopia through Proclamation no 285/2002. It replaced sales taxes imposed on transactions of goods and services.

of chance; income on air, rail and sea transport services; rental income from houses and properties owned by the federal government; fees and charges relating to licenses issued and services rendered by organs of the federal government; federal stamp duties and taxes on monopolies.[157]

The FDRE Constitution clearly provides the taxing jurisdiction of regional states. The very reason that taxation power is given to regional states is with the objectives of enabling the regions to carry out the responsibilities assigned to them, encouraging regional initiatives, narrowing the development gap between regions, and promoting activities that are of common interest to regions.[158] Thus, taxation power of the regional states within their jurisdiction include: employment income tax from employees of the state government; agricultural tax from farmers, tax on individual traders, houses and other property owned by private persons or regional government; employment, and excise tax from public enterprises owned by the state government; forest products, royalties and land lease fees from small mining undertakings.[159] Especially regional states exercise their exclusive power on agricultural income in which they have independent legislative and administration power on agricultural income tax and rural land use fee.[160]

The other power of taxation is the one which is exercised by both the Federal and State government i.e. concurrent power of taxation, which are: profit, VAT, excise, and personal taxes on enterprises they jointly establish; taxes on the profits of companies and dividend due to shareholders; taxes on the incomes derived from large-scale mining and all petroleum and gas operations, and royalties on such operations.[161] Currently, the federal government levy and collects taxes on those listed under concurrent powers of taxation, and the incomes are shared with the regional states, based on the decisions of the HoF, the upper chamber of the federal legislature.[162] In the apportionment of the revenue collected, the HoF as empowered by the Constitution provides a ratio.[163] At present the ratio of shared taxes is for profit income tax and

[157] See the FDRE Constitution, Art. 96
[158] Tesfaye Mergia, cited above at note 14, p.49
[159] See the FDRE Constitution, Art. 97
[160] Tesfaye Mergia, cited above at note 14, p.51
[161] See the FDRE Constitution, Art. 98
[162] Alefe Abeje, cited above at note 149, p. 96
[163] The FDRE Constitution, cited above at note 141, Art. 62(7)

dividend, it is 50:50, whereas for indirect taxes like VAT 70% is for federal government and 30% for the states.[164] Whereas, royalty on mining and petroleum, the federal government share is 60% and the rest is for the regional state.[165] However, for concurrent power of taxation, the Ethiopian Constitution provides only about the power to levy and collect the taxes, not on the one who will levy and collect the taxes.[166] However, the two houses in their joint secession decided that it is the mandate of the federal government to collect and administer the concurrent taxes.[167]

Undesignated taxation power is the other taxation power which is not specifically provided under the FDRE Constitution. Hence the taxation power is jointly decided by two third majority votes of the HoF and HPR.[168] The two houses render decisions on the different tax types that are undesignated under the FDRE Constitution in which the jurisdiction to impose the tax may fall either on the federal government, regional government or concurrently to both levels of government. Among the decision of the two houses, interest on bank deposit and royalty can be mentioned. Interest on bank deposit is the jurisdiction of the federal government according to the decision rendered by the two houses.[169] On royalty, the jurisdiction to impose the royalty tax is to the regional state if the royalty is derived by physical person and if it is derived by legal person, it will be concurrent power of taxation.[170]

Regarding the exercise of taxation power, the FDRE Constitution gives explicit power to federal and regional states to exercise their legislative and administrative power of taxation. Since the HPR engages in legislating different tax laws and the executive organs in executing the laws and issue directives, it can be argued that the federal government exercises its taxing power effectively. However the exercise of legislative power of the regional state is questionable. For many years after the passing of the FDRE Constitution, the regional governments simply used the federal tax laws as source of authority to levy and collect

[164] Federal Inland Revenue Authority, letter no ዋሥአ/ን/ 2032/95, 21/12/95 E.C
[165] Ibid
[166] Tesfaye Mergia, cited above at note 14, p.35
[167] Interview with Ato Wassihun Abate, MoFEC, Director of the Legal Affair Directorate, December 12, 2016. The decision is beyond the reach of the writer.
[168] See the FDRE Constitution, Art. 99
[169] HoF, letter no. ባ-3/ሀ1/አ.21/9/1, 25/09/97 E.C
[170] HoF, letter no.ባ-3/ሀ1/አ.21/12/1, 23/09/97 E.C

regional taxes, including income taxes.[171] Regional states enact adopting legislation so that they can use the federal laws until they enact their own income tax legislation.[172] Even where, the regional states enact their own law, that law is similar to with the federal income tax law only with minor change like changing the names of the institution that implement the tax laws.[173] The reason for this can be explained by first lack of tax experts/professionals at regional level.[174] Lack of expertise in tax is common problem of the country even at federal level. This lack of expertise has meant the regional states are unable to exercise their constitutionally protected legislative power of taxation. Also, tax harmonization has to be achieved in the federal state of Ethiopia, in which this responsibility is given to the Ministry of Finance and Economic Cooperation (MoFEC hereafter) as enshrined under the Federal Financial Administration Proclamation 648/2009.[175] The main focus of tax harmonization is tax base and tax rate, as such states prefer to adopt federal government legislation to avoid replica of work.

As the main focus of this paper is on income tax like income derived from employment, business, interest, royalty and dividend, it is advisable to see how the income tax system is regulated under the Constitution. Looking to employment taxes, the Ethiopian law and the existing income tax system follows the source of the income rather than the individual taxpayer. Thus, the tax follows the employer rather than the employee. In such cases what really matters is the source of income which means that if the source is from the federal government, it is the jurisdiction of the federal government, to levy the tax. Thus, for example employment tax collected from employees of universities is the revenue of the federal government even if the employment is exercised in the regions, since their employer is the federal government.[176]

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[171] Taddese Lencho, "Income tax Assignment under the Ethiopian Constitution: Issues to worry About," **Mizan Law Review**,vol.4, 2010, p.43

[172] Interview with Yirga Handisso, Southern, Nation, Nationality and Peoples Revenue Bureau Revenue research case team leader, December 23, 2016

[173]Interview with Ato Tesfaye Mergia, ERCA, Regional Coordinator and support Directorate Director, December 20, 2016

[174] Ibid

[175] The Federal Financial Administration Proclamation, 2009, Art.64, Proclamation No.648, **Federal Neg. Gaz.,** Year 15, No.56

[176] See the FDRE Constitution, Art. 96

Royalty, as one of the source of income to the Ethiopian government, is another type of income tax. Royalty, the one related to intellectual property is not dealt under the Constitution. Thus royalty as undesignated power of taxation, the joint houses decided that if the royalty belongs to an individual, regional governments are entitled to impose the tax, whereas if the owner of the royalty is an enterprise, it will be concurrent power of taxation.[177] Also the two houses jointly decided interest on deposit to be the jurisdiction of the federal government.[178] On dividend, since dividend is a joint tax according to the FDRE Constitution Article 98(2), the administration work of the tax is done by the federal government [179]and the revenue will be shared between the two levels of government according to the ratio of sharing 50:50.[180] Also tax imposed on profit of companies according to FDRE constitution Article 98(2), is a joint power of taxation which is subject to revenue sharing.

In general on the above mentioned income types, the regional states interest is reflected since the whole income or half of the revenue collected is their revenue. As such, the increase or decrease of the revenue collected has an impact on them.

3.2 Tax Treaties in Ethiopia

Tax treaties are concluded between countries so as to protect their taxing right in a situation of double taxation.[181] Tax treaties do not create a right to tax which does not already exist under the countries domestic law. However it limits the taxes otherwise imposed by the contracting parties.[182] Thus, tax treaties will determine the state that has the jurisdiction to impose the tax.

Likewise, Ethiopia concludes a number of tax treaties with countries with the view of attracting foreign direct investment. Ethiopia also concludes tax treaties with the aim of achieving technology transfer, to increase the productivity capacity of the country and increase its participation at the international arena.[183] Concluding tax treaties with advanced countries has a

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[177] HoF, cited above at note 170
[178] HoF, cited above at note 169
[179] Interview with Ato Wasihun Abate, cited above at note 167
[180] Federal Inland Revenue Authority, cited above at note 164
[181] Please refer causes of double taxation at chapter two.
[182] Zelalem Eshetu, The Treaty Making Power under the Ethiopian Federal System: A Comparative Study, Ethiopian Civil Service University, Department of Public Law and Good Governance,(unpublished),2012, p.16
[183] MoFEC, Explanatory note about the Tax Treaties signed between the Government of Ethiopia and Saudi Arabia, Netherlands, Portugal, North Korea and Ireland, Letter No. ገ/ጵ/ነ/2/72, Dated 16/10/2007 E.C.

potential benefit to attract foreign investment even if exact data is not collected on this area.[184] At present, Ethiopia has concluded more than 25 tax treaties.[185] However, the status of the treaties differs in which some of the treaties are ratified by the two governments and ratification document is exchanged between the parties, while others are ratified by the Ethiopian government and the rest are just signed by the respective higher official of the two governments. There are only 11 tax treaties[186] which became effective after being ratified by both governments and instrument of ratification are exchanged. From legal point of view, these are the only tax treaties that are binding on Ethiopia and its counterparts.[187] The other tax treaties which are around 13 are ratified by the Ethiopian government.[188] Such treaties are not binding on Ethiopia since the Ethiopian government doesn't have any information as to the status of the treaty on the side of the other state. The rest, around 8 tax treaties are signed but not ratified.[189]

Looking at the characteristics of the Ethiopia's tax treaties, the tax treaties apply only to taxes on income, unlike the OECD Model which recommends the treaty to apply also to capital taxes like wealth and gift.[190] This is inferred from the title of tax treaties of Ethiopia which provides as "Convention Between ___ and the Federal Democratic Republic of Ethiopia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income".[191] Since Ethiopia doesn't impose taxes on capital, the tax treaties do not contain provisions on capital tax.

[184] Interview with Ato Bochu Sintayehu, MoFEC, Senior legal expert and Chief negotiator of the Ethiopian tax treaties, December 8, 2016

[185] Interview with Ato Birhanu Tadesse, cited above at note 59

[186] Tax treaty between the FDRE and Italy, Egypt, India, Sudan, China, French Republic, Turkey, United Kingdom of Great Britain and Northern Ireland, Kingdom of Netherlands, Kingdom of Saudi Arabia and the Republic of Ireland are the one that are in force at this time.

[187] Interview with Ato Bochu Sintayehu, cited above at note 184

[188] Tax Treaties between the FDRE government and Kuwait, Russian Federation, Yemen, Algeria, Tunisia, Romania, South Africa, Israel, Czech Republic, Seychelles, Portugal, Peoples Democratic Republic of Korea and United Arab Emirates

[189] Tax treaties between the FDRE government and Palestine, Poland, Cyprus, Qatar, South Korea, Slovakia, Morocco, and Singapore.

[190] OECD, cited above at note 3, p.77

[191] For the purposes of dealing with the nature of the Ethiopian tax treaty, the writer selects the tax treaty between the FDRE government and Republic of Ireland and United Arab Emirates because these two treaties are the recent one that Ethiopia has signed.

The structure of Ethiopia's tax treaties is more or less the same since Ethiopia has her own Tax Treaty Model that is presented to the other party when the need arises. Like the United Nation Tax Treaty model (UN Model) and Organization for Economic Cooperation and Development Tax Treaty model (OECD Model), Ethiopia's tax treaty starts with scope of the convention that includes persons and taxes covered under the treaty.[192] It is provided under the tax treaties that the agreement shall apply to taxes on income imposed on behalf of a Contracting State or of its political subdivisions or local authorities, irrespective of the manner in which they are levied.[193] The treaty documents provide that the agreement is not confined only to income taxes imposed by the federal government.[194] It is also applicable to income taxes that are under the jurisdiction of the regional states.

The treaties also set out the particular income taxes agreed by the treaty parties in particular, from the side of the Ethiopian government: tax on income and profit; and the tax on income from mining, petroleum and agricultural activities.[195] These taxes on income are either within the exclusive taxation power of the federal or regional government or are subject to a concurrent power of taxation. For example tax on the profits of companies is a concurrent power of taxation of the two orders of government.[196] Likewise the income generated from agricultural activity (in general income from immovable property)[197] is the income of the constituent states as long as it falls under the constituent states power of taxation.[198]

In addition, under the Ethiopian Federal System, mining activities are not entirely under the exclusive powers of the federal government.[199] As it has been provided under Article 97(8), small scale mining activities are under the exclusive jurisdiction of the regional governments. However, incomes from large scale mining activities and petroleum are under the concurrent powers of taxation in the sense that they are administrated by the federal government and

[192] Tax treaty between the FDRE Government and Republic of Ireland and tax treaty between the FDRE Government and United Arab Emirates (UAE), Art1, Art. 2.
[193] Id., Art. 2(1)
[194] Zelalem Eshetu, cited above at note 90, p.11
[195] Tax treaty between the FDRE Government and Republic of Ireland and tax treaty between the FDRE Government and United Arab Emirates(UAE), cited above at note 192, Art.2(3)
[196] See the FDRE Constitution, Art. 98(2)
[197] Tax treaty between the FDRE Government and Republic of Ireland and Tax treaty between the FDRE Government and United Arab Emirates(UAE), cited above at note 192, Art.6
[198] See the FDRE Constitution, Art. 97(2)
[199] Zelalem Eshetu, cited above at note 90, p.12

regional governments share the proceeds collected by the federal government.[200] All these sources of incomes are covered under the tax treaties of Ethiopia.

Tax treaties of Ethiopia also cover taxes on capital gains, tax that is imposed from the alienation of movable or immovable property. [201] This type of tax is recognized under the Ethiopian income tax law.[202]

The other feature of the treaty is on the allocation of new income taxes that are identical or are substantially similar to existing taxes covered under the treaty. Interestingly, the tax agreements provide under article 2(4) that the treaty is also applicable to new income taxes that will be imposed in the future.[203] However, the FDRE constitution under Article 99 provides a new source of tax which is not explicitly provided under the Constitution will be allocated by the joint session of the HoF and the HPR.

Dividend as one type of income tax is recognized under the treaties of Ethiopia.[204] Most tax treaties of Ethiopia impose dividend tax from 5 to 7.5 percent which is less than the tax rate provided under the Ethiopian income tax law.[205] The tax collected from such an income is through withholding in which the taxing power resides with the residence state of the beneficiary of the dividend. It is in exceptional grounds that the residence of the company may impose the dividend tax.[206] As dividend is a concurrent power of taxation under the FDRE constitution, the lower tax rate of the tax has a direct implication on the revenue of regional states.

Interest as one type of income tax is dealt with under the treaties of Ethiopia, on which the jurisdiction to impose the tax is given to the source country. Like dividend, withholding

[200] Ibid

[201] Tax treaty between the FDRE Government and Republic of Ireland and tax treaty between the FDRE Government and United Arab Emirates(UAE),cited above at note 192, Art.13, Art.14

[202] Federal Income Tax, cited above at note 96, Art.59

[203] Zelalem Eshetu, cited above at note 90, p.12

[204] Tax treaty between the FDRE Government and the Republic of Ireland and Tax treaty between the FDRE Government and United Arab Emirates (UAE), cited above at note 192, Art.10, Art. 11

[205] See the Federal income tax proclamation no 979/2016. Under Article 55, it provides that on dividend 10% of the gross amount of income is paid as an income tax.

[206] In the tax treaties between the FDRE government and China, Israel, Kuwait, Russia and Tunisia, the rate of dividend is 5%

scheme is applied and lower tax rate is provided under the treaties.[207] The Ethiopian income tax law provides the tax rate of interest for saving deposits to be 5% and 10% for other cases than saving deposit.[208] However, the tax treaties provide for 5% for other cases other than saving deposit.[209]

On royalty, most tax treaties of Ethiopia provide for a tax rate similar to that set out in the income tax proclamation. The tax rate of royalty under the Federal income tax proclamation is 5% for both residents and non residents.[210] But for different reasons tax treaties may allow for a higher tax rate than the tax rate of the Ethiopian income tax law.[211] Where the treaty provides for a higher tax rate than the domestic tax rate, this does not mean that the resident of the other state will pay royalty at the higher tax rate on the activity conducted in Ethiopia.[212] However, when an Ethiopian resident is expected to pay royalty tax in the other state, he is only expected to pay the rate that is provided under the treaty which is lower than the tax rate of the domestic tax law of the other state.[213]

Also Income from dependent service (employment income) is other income covered by the treaties of Ethiopia. This service is rendered by the supervision of an employer on which the employer may be a federal or regional government. The jurisdiction to impose the tax may fall under the state which is the residence state of the employer or where the employment is exercised. Under the FDRE Constitution, both the constituent states and the federal government can impose income taxes on their respective employees.[214] Likewise tax that is imposed on professors and researchers is covered under the tax treaties.[215] Thus if the researchers and professors of the other state come to Ethiopia and stay for less than two years,

[207] Interview made with Ato Birhanu Tadesse , cited above at note 59
[208] Federal Income Tax, cited above at note 96, Art. 56
[209] Tax treaty between the FDRE Government and the Republic of Ireland and tax treaty between the FDRE Government and United Arab Emirates(UAE),cited above at note 192, Art.11(4), Art.12(2)
[210] Federal Income Tax, cited above at note 96, Art. 54
[211] Interview with Ato Birhanu Tadesse, cited above at note 59. Ato Birhanu give one example that the tax treaty between the FDRE government and Saudi Arabia provide 7.5% royalty tax.
[212] Interview made with Ato Birhanu Tadesse, cited above at note 59
[213] Ibid
[214] See the FDRE Constitution, Art. 96 and 97
[215] Tax treaty between the FDRE Government and Republic of Ireland and tax treaty between the FDRE Government and United Arab Emirates (UAE), cited above at note 192, Art.21, Art. 17

they are exempted from income tax.[216] The income tax that would be paid by the professors and researchers if the tax treaty had not been there, is in the jurisdiction of either the federal government or the regional state to impose depending on who is the employer.

Finally the two main concepts that are dealt with under the Ethiopian tax treaties are tax sparing and treaty shopping. The tax sparing clause stipulates that for the tax spared by the source state because of tax incentive, the resident state has to give foreign tax credit, treating the tax spared as a paid in the source state.[217] Hence, tax sparing entails the benefit of a special tax reduction or exemption, granted by the source state which accrues to the investor by the provision of a credit in the residence state for tax not actually paid in the source state, i.e. a credit for "notional tax".[218] Items covered by tax sparing clauses includes income from immovable property, profits attributed to a permanent establishment situated in the State of source, dividends, interest, capital gains and royalties.[219] Thus, the function of tax sparing provisions in tax treaties is to promote investment behavior and to promote economic development of a country by saving the tax foregone by the source state under its tax incentive measure.[220] If tax sparing clauses had not been included in the tax treaty, the resident state will impose a tax since tax is not actually paid in the source state.[221] Therefore, the rationale for including tax sparing in tax treaties is to prevent the nullification of source country tax incentives and to ensure that the tax benefit accrues to the foreign investor.[222]

As a capital importing country, it is advisable for Ethiopia to include the tax sparing clause in the tax treaty. The tax sparing clause included in the tax treaties of Ethiopia will benefit a resident of the other state so that he/she can claim a foreign tax credit in his /her resident state even if the tax is not actually paid in Ethiopia but spared because of tax incentive. Most treaties concluded by Ethiopia contain a tax sparing provision in order to grant an income tax holiday by the Ethiopian government i.e. to attract foreign direct investment.[223] The Ethiopian

[216] Ibid
[217] Ariane Pickering, cited above at note 2, p.15
[218] Kristian Reinert Haugland Nilsen, The Concept of Tax Sparing ,General Analysis, and an Analysis and Assessment of the Various Features of Tax Sparing Provisions, University of Oslo,(unpublished),2013, p.9
[219] Id., p. 31
[220] Id., p. 26
[221] Id., p. 9
[222] Id., p.8
[223] Interview with Ato Birhanu Tadesse , cited above at note 59

government has a strong stand on the inclusion of tax sparing in the Ethiopian tax treaties and also the HPR will not ratify a tax treaty that does not have a tax sparing clause.[224]

On the other hand, treaty shopping refers to a situation where a person, who is resident in one country (the home country) and who earns income from another country (the source country), is able to benefit from a tax treaty between the source country and yet another country (the third country).[225] This situation often arises where there is no tax treaty between the home country and the source country, but the source country has concluded a tax treaty with the third country.[226] The person will establish a corporation (entity) in the third country and will access the benefit of the tax treaties between the third country and the source country.[227] In such situation even if the person is not the resident of the treaty parties, he/she will benefit from the tax treaties since source of income is from the contracting state. Thus it is an act of abusing tax treaties of contracting states by a third country resident i.e. a resident of non-contracting state or resident of the home state. The third country resident indirectly and spuriously access benefits reciprocally granted by the tax treaties to residents of contracting states; i.e. by circumventing the limitations imposed on nonresidents of the concerned contracting states.[228]

As treaty shopping is an effect of existing tax treaties, there are also mechanisms used to prevent such abuse. Limitation of Benefits (LOB) provisions is one of the mechanisms which is pivotal to address the abuse. LOB provisions of the treaty limit the applicability of the treaty only to residents of the other state by giving a definition of the term "resident" in the definition part of the tax treaty. For example, a requirement could be that half of the ownership of a company established in the third country has to be owned by residents of that state.[229] Also, relating to dividend, to be beneficiary of the tax treaty, the beneficial owner of a company

[224] Interview with Ato Wassihun Abate, cited above at note 167. The tax treaty between the FDRE Government and the Kingdom of Qatar didn't have tax sparing clause. So this treaty is still not ratified by the HPR.

[225] InternationalTax Blog, Treaty shopping and anti treaty shopping, available at http://intltax.typepad.com/intltax_blog/2008/05/treaty-shopping (last visited on January 17, 2017)

[226] Ibid

[227] Ibid

[228] Reuven S. Avi-Yonah, Tax Treaties : Building Bridges between Law and Economics, IBFD, Netherland, 2010, p. 26 also available at www.repository.law.umich.edu/book_chapters/78 (last visited on December 14, 2016)

[229] Interview with Ato Birhanu Tadesse, cited above at note 59

(other than a partnership) has to hold directly at least 25 per cent of the capital of the company paying the dividends.[230]

Looking to the tax treaties of Ethiopia, anti treaty shopping provisions have not been included in the tax treaties.[231] However understanding the problem that arises with treaty shopping, Ethiopia has incorporated the Limitations of benefits provisions in its newly concluded tax treaties with the Netherlands,[232] South Korea[233] and Mozambique[234].

3.3 Legal framework on involving Constituent States in Negotiating Tax Treaties in Ethiopia

At present, most matters which are under the constitutional competence of the constituent units including social and economic matters, protection of human rights, and labour conditions, have become the subject matter of international treaties.[235] But these international treaties are concluded by the federal government even if such matters are the jurisdiction of the constituent states. One of the reasons is the constitution of the countries provides that it is the mandate of the federal government to conduct foreign relation even on the subject matters of the federating units. The proliferation of treaties in number and subject matter renders is also another reason for the federal government to conclude treaties on matters that fall under the jurisdiction of the constituent states.[236] Thus there is a need to balance the constitutional rights of the constituent states with addressing international concerns. In order to balance the above interests, it is valuable to consider the domestic laws of the countries and whether it is the jurisdiction of the federal governments of the countries to conclude international treaties where the subject matter of those treaties is within the exclusive powers of the constituent states. In addition, it is important to assess whether the constituent states have a constitutional right to participate or to

[230] OECD, cited above at note 3, Art. 10
[231] Interview with Ato Birhanu Tadesse, cited above at note 59
[232] Ibid. Ato Bihanu added that the Protocol amending the Convention between the Kingdom of Netherlands and The Federal Democratic Republic of Ethiopia signed on 18th of August 2014 and becoming effective as of January 1 2017 and the Protocol inserted a new article "Limitation of Benefits" to curb treaty shopping.
[233] Ibid. In the interview Ato Birhanu added that under Article 28 of the tax treaty between the Federal Democratic Republic of Ethiopia and the Republic of Korea signed in May 26, 2016, yet to be ratified.
[234] Ibid. In the interview Ato Birhanu, under Article 29 of the tax treaty between the Federal Democratic Republic of Ethiopia and the Republic of Mozambique agreed in July 2016 but not signed yet.
[235] Zelalem Eshetu, cited above at note 90, p. 6
[236] Id., p.4

be consulted in the treaty making process and whether the constituent states have independent treaty making power on matters that fall under their jurisdiction or not.

Countries which follow the federal system of government address the above issues depending on their historical background and the reason to adopt a federal system of government. In federal countries like India, Malaysia and South Africa, the federal government can conclude international treaties even in matters that are the exclusive power of the constituent states.[237] The constitution of these countries provides that a foreign relation is the responsibility of the Federation.[238] Thus, in performing this responsibility, the federal government can conclude international treaties on matters that fall under the jurisdiction of the constituent states.

The Indian constitution provides treaty making is centralized and there is no requirement of consultations with any external agency during negotiations.[239] There is nothing in the existing rules of the Central Government which mandates consultation with states prior to taking binding treaty action.[240] However, in practice there is promoting effective dialogue between the Central Government and the States, particularly on treaty–making issues, in which Inter-State Council was set up in 1990 as constitutional body pursuant to Article 263 of the Constitution with a mandate to investigate subjects in which the States and the Union Government have common interests and make recommendations for better policy coordination.[241] Thus in India even if there is no clear provision that stipulates involvement and consultation with sates, the practice showed that states are consulted especially on matters that they have interest.

In Australia, as a federal state, the constitution centralizes treaty making power.[242] However states of the federation are invited by the federal government to participate in treaty making especially on matters on which the states have interest.[243] Even if there is no clear provision

[237] Hans J. Michelman, Comparative Reflections on Foreign Relations in Federal Countries, 2007, p.4 available at *www.forumfed.org*, (lasted visited on December 14, 2016). In addition, please refer Art. 253 of the 2007 (amended) Constitution of India.

[238] Constitution of India, the 2007(amended), Art.73 and 246, Constitution of Malaysia,1957, Ninth Schedule and Constitution of the Republic of South Africa,1996, Art.231

[239] Sudhanshu Roy,"Reconsidering Treaty-Making in India: An argument for Reform through the Prism of International Investment Agreements", **Indian Journal of International Law**, Vol.54, 2014, p.283

[240] Id., p.284

[241] Ibid

[242] Constitution of Australia, 2012(amended), Art.51

[243] Brian R. Opeskin and Donald R. Rothwell, "The Impact of Treaties on Australian Federalism", **Case Western Reserve Journal of International Law,** Vol.27, 1995, p.15

that stipulates the constitutional right of the states to participate and be consulted in the negotiation and conclusion of international treaties, the federal government consults them periodically.[244]

Whereas, in countries like Switzerland and Germany, the constituent states have a constitutional right to be involved in international treaties on matters that fall under their jurisdiction.[245] Thus, in Switzerland and Germany, the constitutional framework allows for the Cantons (constituent states of Switzerland) and Landers (constituent states of Germany) to have an active role in treaty making.

The Basic law of Germany provides that relation with foreign countries is the responsibility of the Federation and the Federation has the exclusive power to legislate on customs duties and fiscal monopolies.[246] This means the constituent states have no tax autonomy (to determine the tax base or the rate) on concurrent powers (income tax, capital gain tax, VAT and corporation tax).[247] However, in these taxation powers, if the interest of the Landers (constituent states) is affected, the federal government must take into account the opinion of the Bundesrat (a legislative organ composed of the constituent states).[248]Also, where autonomous rights of the Länder are affected, the opinion of the Bundesrat shall prevail while keeping in mind the overall responsibility of the federal government.[249] Thus, even if the power to legislate on tax matters is the jurisdiction of the central government, the views and opinion of the Landers is vital.

Whereas in Switzerland, most of the taxation power resides in the federation and revenue sharing is held with the cantons since the cantons are the ones who assess and collect the taxes.[250] Regarding foreign relations, it is the mandate of the federal government including the

[244] Ibid

[245] Hans J. Michelman, cited above at note 237. In addition, see Article 55 of the 1999 constitution of Switzerland and Article 32(2) of the 2012(amended) Constitution of Germany. Provisions of the constitutions provide that the federal government has the obligation to inform the constituent states in a timely manner and comprehensively and also the constituent states have veto power on the matters that affect their competence.

[246] Constitution of Germany, 2012(amended), Art. 32 and 105

[247] Id., Art.106

[248] Arthur B. Gunlicks, "Articles: special issues German Federalism: Theory and Developments", **German Law Journal**, Vol.6, 2005, p.8. See also , 2012 (amended) Constitution of Germany

[249] Ibid.

[250] See Constitution of Switzerland, 1999, Art. 128, 130, 131 and 132

conclusion of international treaties.[251] But the constitution requires Cantonal participation in regard to treaties affecting their interests.[252] Thus the Cantons should be consulted and preliminary information has to be given with regard to treaties affecting their interests.[253]

While, the constituent states of Belgium, Canada, Switzerland and Germany have constitutional right to conclude international treaties on matters that fall within their jurisdiction.[254] However, the treaty making power of the constituent states has its own procedure as it is provided in their respective constitution.[255]

Under the FDRE Constitution, it is clearly provided under Article 51(8) that to negotiate and ratify international agreements is the responsibility of the federal government. From this provision, we can understand that, constituent states do not have an independent constitutional power to conclude international treaties irrespective of the nature of the treaties. Thus even if the matters fall under the constituent states jurisdiction, the constituent states of Ethiopia perform international relations with the control of the federal government.[256] However, some argue that Article 48 of the constitution seems to allow the conclusion of treaties by the constituent states.[257] But looking deeply into this provision, the constituent units are allowed to conclude treaty among themselves, not with other countries.[258] Thus, the jurisdiction of the federal government to negotiate and the restriction placed on the constituent states to independently conclude international treaties are recognized under the FDRE Constitution.

However, there is no explicit provision in the constitution that stipulates the constitutional right of constituent states to be involved in the negotiation and/ or consultation of international

[251] Id., Art. 54
[252] Id., Art. 55
[253] Id., Art. 54(2) 56(1), 56(2) and 55 and Zelalem Eshetu , cited above at note 90, p.33
[254] See the Constitution of Belgium, 2007,Art. 167, Constitution of Switzerland, 1999, Art. 56 and Constitution of Germany, 2012(amended), Art.32(3)
[255] As an example, in Belgium, the regions have the constitutional right to conclude international treaties on matters that fall under their jurisdiction without consulting the federal government since the federal government is empowered to conclude international treaties only on matters that fall under the exclusive jurisdiction of the federal government. For Switzerland, the cantons after concluding the international treaty have a constitutional obligation to inform the federal government about the treaty when the cantons are ready to ratify it. For Germany, the Landers have to get prior approval from the federal government to conclude the international treaty on matters that fall under their jurisdiction but also the federal government should not withhold the approval without good reason.
[256] Zelalem Eshetu, cited above at note 182, pp. 36-40
[257] Id., p. 35
[258] Ibid

treaties, unlike Germany and Switzerland. Constituent states have no clearly provided constitutional right to be consulted on and/ or participate on matters affecting their powers and interests.[259] On this issue, some argue that the very reason that the constitution puts a clear provision that foreign relations, negotiation and ratification of international treaties to be the mandate of the federal government; precludes constituent states to involve on such treaties.[260] On the other side, the non-inclusion of a provision that stipulates the right of the constituent states to be involved in the negotiation or to be consulted in relation to international treaties should not be interpreted as meaning that the constituent states should not be consulted in matters that affect their interest.[261] Thus the status of the constituent states in the involvement of treaty making, especially on matters that fall under their competence is arguable.

The core principle and provisions of the FDRE Constitution puts the onus on constituent states to claim a right to be involved in the negotiation of international treaties, specifically to tax treaties and/ or the right to be consulted in concluding the treaty.

Division of power as a core principle is recognized under the FDRE constitution. The constitution under Article 50 provides that power is divided between the federal and the regional states in which the powers of the federal government are exhaustively listed. The constituent states enjoy the residual powers and also the powers listed under Article 52 of the FDRE Constitution.[262] However, regarding the division of taxation power, the constitution follows a different approach than the normal division of power. The exclusive and the concurrent powers of taxation of the federal and constituent states are exhaustively listed.[263] The constitution empowers the two houses to give decision by 2/3 vote on taxation power that are not expressly mentioned in the constitution. Thus the federal and the state governments are expected to follow this principle whenever the two level of government exercise their taxation power. The federal government is not entitled to exercise any tax power that falls under the mandate of the constituent states.

[259] Id., p. 36
[260] Interview with Ato Wassihun Abate , cited above at note 167
[261] Interview with Ato Tesfaye Mergia, cited above at note 173
[262] See the FDRE Constitution, Art. 51, 52 and 55
[263] Id., Art. 96, 97 and 98

Also as one principle of external relation, mutual interests and equality of states is stated under the constitution.[264] This principle presupposes that the interest of the constituent states have to be taken into account in external relations, even if it is the mandate of the federal government to regulate international relations.[265] Since the positive and negative consequence of the external relations has effect on both the federal and the constituent states, it is proper to take in to consideration the interest of the constituent states. Concluding a tax treaty with another country has a positive effect on the external relations of the country. Thus, the provision of the constitution presupposes that in concluding a tax treaty, the constitutionally protected right of the constituent states including taxation power has to be taken in to account.[266]

Also Article 100 of the FDRE Constitution stipulates the principle of tax imposition in which the two levels of government shall ensure that the tax does not adversely affect the relationship of the two. The tax treaty which has the effect of limiting the taxing power of a country, should not adversely affect the relation between the federal government and the constituent states. Whenever tax is imposed or exempted, the interest of the two levels of government has to be taken in to consideration. Thus, this provision presupposes the regional states have the constitutional right to be involved in the negotiation of tax treaties and/or consulted about ~~of~~ tax treaties since the tax treaties that will be in force in Ethiopia should not adversely affect the relationship of the federal government with the regional government.

In addition, in promoting the federal system of the country, the federal government has an obligation to respect the power of the constituent states.[267] Even if the constituent states of Ethiopia do not have a constitutional right to independently conclude international treaties unlike Belgium, Switzerland and Germany, the federal government has a constitutional obligation to protect the interests of the states especially when concluding international treaties.

Involving the regional states in the negotiation of tax treaties and/ or consulting them before the tax treaties are signed / ratified is one of the mechanisms to protect the interest of the

[264] Id., Art. 86(3)

[265] Article 51(8) of the FDRE constitution provides that it is the jurisdiction of the federal government to formulate and implement foreign policy.

[266] Interview with Ato Birhanu Tadesse, cited above at note 59. Ato Birhanu added that while negotiating a tax treaty with Germany, Germany's negotiation team raised that the matters falling under the jurisdiction of the constituent states needs approval from the house that represents the states.

[267] See the FDRE Constitution, Art.50(8)

constituent states. Because, it is the early treaty making stages in which matters can be shaped before the treaties acquire legal status. Also, the tax treaties are ratified by the HPR which does not represent regional states. The house that represents the regional states at federal level, the HoF does not have legislative power so that the tax treaties will not be referred to this house and there is no any mechanism that the house can protect the interest of the regional states. Thus involving the constituent states of Ethiopia in the negotiation and/ or consult the constituent states before the tax treaty is signed/ratified has a constitutional base.[268] Thus, during negotiation, the constituent states can be represented by some organ that has sufficient knowledge of tax and can understand the effect of the tax treaty provisions.[269]

Also, the FDRE Constitution provides that international treaties concluded by the executive organ of the government should be ratified by the federal parliament.[270] Even if this provision addresses the mandate of the federal government to negotiate international treaties, it does not exclude the constituent states from being members of the negotiation team and be consulted in concluding the international treaty. Thus, even if the ratification power is the mandate of the federal government, the negotiation task can be done in inviting constituent states to be involved especially on matters that fall under their jurisdiction.[271]

Thus, from the core principle of the FDRE Constitution and from the above stated constitutional provisions, constituent states have a constitutional right to take part in the negotiation of tax treaties and have the right to be consulted in matters affecting their interests.

3.4 Consistency of the practice with the legal framework on involving constituent states in negotiating tax treaties in Ethiopia

In federal countries, the involvement or non-involvement of constituent states in tax treaties has direct relation with the tax autonomy of the states. Tax autonomy is manifested in introducing tax bases as well as setting or changing tax rates and introducing tax holidays.[272]

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[268] Interview with Ato Tesfaye Mergia, cited above at note 173
[269] Ibid
[270] See the FDRE Constitution, Art.55(12)
[271] Interview with Ato Tesfaye Mergia , cited above at note 173
[272] Zemenu Yesigat, " Sub national Fiscal Autonomy in a Developmental State: The Case of Ethiopia", **Beijing Law Review,** 2016, p.45, available at http://www.scirp.org/journal/blr, (last visited on September 20, 2016)

Thus, a tax treaty of a country should not be in a position to override the tax autonomy of constituent states, unless these states express their consent to limit their own power of taxation. The mandate of the constituent states to be involved in the negotiation of tax treaties and/ or be consulted on the tax treaties emanates from the provisions of the constitution. The FDRE constitution provides powers of taxation that are not expressly provided under the constitution as undesignated power of taxation, the designation of which will be decided by the two houses.[273] This shows the constitution gives special protection to the taxation power of federal and regional government, so that one should not interfere in the jurisdiction of the other even in concluding tax treaties.

The federal government enacts a federal income tax law which consists of a provision about the power of MoFEC to conclude tax treaties.[274] Also regional states enact a tax legislation which is more or less the same as the federal law. Relating to tax treaties, some regional states have enacted legislation allowing them to apply directly tax treaties ratified by the federal government.[275] The Tigray income tax adopting proclamation provides that the respective revenue authority will directly accept and apply the tax treaties that are ratified by the federal government.[276] The very reason that regional states directly accept and apply the tax treaties is because of a belief that the tax treaties that are concluded by the federal government will not undermine their taxing right.[277] Even if the constituent states are not involved in the negotiation of tax treaties, they take it as part of their obligation to implement the treaty and include it in their income tax laws.[278]

As the nature of tax treaty is to limit the taxing jurisdiction of contracting states, the provisions of the tax treaty have to be dealt with critically and this makes the procedure for the conclusion of tax treaties a stringent one.[279] In the process of concluding tax treaty, every country has its own model tax treaty and will present it to the other state when a need arises. The same is true

[273] Please refer section 3.1 that deals with the special feature of tax assignment under the FDRE Constitution.
[274] The Federal Income Tax, cited above at note 96, Art. 48. The provision explicitly provides that MoFEC may enter into a tax treaty with a foreign government and in case of conflict the tax treaty would prevail over the income tax proclamation except in the case of Treaty shopping and Tax avoidance.
[275] Interview with Ato Tesfaye Mergia, cited above at note 173
[276] Tigraye Income Tax (adopting legislation), 2016, Art. 4(4), Proclamation No. 281, **Tigraye Neg.Gaz.**, Year 23, No 12
[277] Interview with Ato Yirga Handisso, cited above at note 172
[278] Interview with Ato Tesfaye Mergia, cited above at note 173
[279] Ibid

for Ethiopia in which the negotiation team of Ethiopia presents its model to the other state on its own initiation or when the other country expresses its interest to conclude a tax treaty with Ethiopia.[280] The reason that Ethiopia concludes a tax treaty with the other state is to attract Foreign Direct Investment (FDI hereafter).[281] Even in bilateral investment relations, a key factor for the other state is the existence of a tax treaty between the states. FDI is the reason that most of our tax treaties include a tax sparing clause as this has positive effect on attracting FDI.[282] Then after the exchange of the treaty model, parties will express their consent to negotiate on the model tax treaties having given special focus on the provisions on which the parties take a different stand. At that point, place and date of the negotiation will be fixed for conducting the tax treaty negotiation.[283]

The Ethiopian tax negotiation team is only composed of senior legal experts and legal experts from MoFEC, which is one of the executive organs of the federal government.[284] These experts are expected to have knowledge of the tax laws of Ethiopia. The regional states are not involved in the negotiation of tax treaties. The reason for not involving regional states in the negotiation of tax treaties is that the federal government didn't believe such right is granted for the regional states under the FDRE Constitution.[285] Also the regional states believe that it is the mandate of the federal government to negotiate tax treaties.[286] The regional states base their position on Article 51(8) of the FDRE Constitution.[287]

In addition, there is no consultation to be held with regional state on the tax treaty that is going to be signed/ ratified. Though there are some consultation meeting between the federal government and the regional government on the issue of finance and tax, the issue of tax treaty

[280] Interview with Ato Bochu Sintayehu, cited above at note 184. Ato Bochu also explained that when the government is of the view that having a tax treaty will help to attract Foreign Direct investment, Ethiopia invites (by sending the model tax treaty) the other state to conclude a tax treaty and the expression of interest is done through diplomatic channels.

[281] Interview with Ato Wassihun Abate , cited above at note 167

[282] Ibid

[283] Interview with Ato Bochu Sintayehu, cited above at note 184

[284] Ibid

[285] Interview with Ato Wassihun Abate, Ato Bochu Sintayehu and Ato Tesfaye Mergia

[286] Interview with Ato Yirga Handisso, cited above at note 172, Ato Lemessa Leke, Oromia Revenue Bureau, Deputy Director, December 21, 2016, Ato Getachwe Mesfin, Amhara Revenue Bureau, Tax Assessment and Collection Senior Officer, at January 7, 2017 and Ato Engedawork Gezahege, Amhara Revenue Bureau, Tax Collection and Inspection Senior Officer, January 7, 2017

[287] Ibid

hasn't been raised.[288] The reason that the regional states are not concerned about tax treaties of Ethiopia is because the main beneficiaries of the provisions of the tax treaty are multinational companies. The tax liabilities of those multinational companies fall under the remit of the federal government.[289] In business profit, most of foreign taxpayers are multinational companies conducting their business by establishing subsidiary or opening branch in Ethiopia that these companies are federal tax payer in which the revenue collected will be apportioned with the regional state.[290] Also on employment income tax, the regional states had not faced with such question.[291] But there is one case in which an Indian employees who work on a company claims that they are entitled to employment income tax exemption according to the tax treaty between Ethiopia and India.[292] Since the regional states don't have any information about this tax treaty, the revenue bureau asks MoFEC.[293] Then the ministry wrote a letter to the revenue bureau that the employees are exempted from the employment income tax in accordance with the tax treaty.[294]

The negotiation is conducted on matters on which the two countries have a different position so as to reach to a common point. The point of difference may fall under the jurisdiction of the federal government or the constituent state. The federal government will decide on the matters that the constituent states have interest since MoFEC is the one that conducts the tax negotiation. However some officials argue that the negotiation team of Ethiopia represents and protects the interest of Ethiopia as a whole, not specifically the interest of the federal government.[295] During negotiation the focus is on the interest of the Ethiopia as a state so that the tax treaties should not undermine the taxing jurisdiction of Ethiopia and it has to be compatible with the existing tax laws of Ethiopia especially, income taxes laws of both the federal and regional state. [296]

[288] Interview with Ato Tesfaye Mergia ,cited above at note 173 and Interview with Ato Wassihun Abate, cited above at note 167
[289] Ibid
[290] Ibid
[291] Interview with Ato Lemessa, cited above at note 286 and Ato yirga Handisso, cited above at note 172
[292] Interview made with Ato Getachwe Mesfin, cited above at note 286
[293] Ibid
[294] Ibid
[295] Interview with Ato Wassihun Abate, cited above at note 167
[296] Interview with Ato Bochu Sintayehu, cited above at note 184

Income tax generated from agricultural activity may be a matter of negotiation. On this income the constituent states are constitutionally mandated to exercise an exclusive power of taxation as long as the income is derived from private farmers and cooperative societies.[297] Thus, if a foreign investor or company comes to Ethiopia and invests in agricultural activity, he/she will benefit from the tax treaty between Ethiopia and its residence country, if such treaty exists. Thus the regional states have to be the ones that decide on the contents of tax treaties too. Surprisingly, even the constituent states haven't raised such issue that their constitutional taxing power is limited by the tax treaties in "Yekilele yemekeker mederek" (consultation meeting with regional revenue and finance bureaus)[298] or as a formal question to the federal government.[299] Also, most of the regional states have not faced a foreign tax payer who wants to benefit from the tax treaty of Ethiopia and their resident states.[300]This may be a potential reason why the regional states have not sought to participate in the negotiation of tax treaties. However sometime incidental questions are raised relating to employment income tax.[301]

Tax treaty provisions on income from independent, scientific, literacy, educational or teaching activities as well as from the independent activities of physicians, lawyers, engineers, architects, dentists and accountants of a resident of a contracting country, have direct and indirect impact on the powers and interests of the Regional States in Ethiopia.[302] The above stated activity may be conducted at regional level and to impose business income tax on such income is the jurisdiction of the constituent states.[303] Even in this instance the federal government decides on the taxing jurisdiction of the regional states, without involving and/ or consulting the concerned constituent states. Similarly, tax treaty provision on income from professors, teachers and researchers of residents of contracting state restricts the powers of the constituent States. Since the employment income tax collected from such employment activity

[297] See the FDRE Constitution, Art. 97(3)
[298] As the interview made with Ato Tesfaye Mergia , "yekile yemekeker mederek" is a meeting conducted annually with the regional revenue and finance bureaus. Different issues are raised on this meeting that focus on finance and tax.
[299]There is a directorate in the Ethiopian Revenue and Customs Authority which give support to the regional states on tax matters.
[300] Interview with Ato Lemesa Liki, cited above at note 286 and Ato Yirga Handisso, cited above at note 172
[301] See Interview with Ato Getachew Mesfin, cited above at note 294, 295 and 296
[302] Zelalem Eshetu , cited above at note 182 ,p.18
[303] See the FDRE Constitution, Art. 97(4)

is the jurisdiction of the constituent states as long as the employer is the constituent States.[304] In this situation too, the federal government decide on this type of income, which is constitutionally the mandate of the regional state.

The same is true for concurrent power of taxation that has to be exercised jointly by the two levels of government. Even if the constitution did not stipulate who will collect and administer these concurrent taxes, in 1995 E.C, the two houses decided that the federal government should exercise this power.[305] Thus the federal government is the one who administers these taxes and this will give the federal government the opportunity to treat the concurrent taxes according to the tax treaties. Thus the constituent states will not have the chance to know the tax relieved because of the tax treaty since they receive their revenue share from the federal government according to the revenue sharing formula. Questions relating to the applicability of the tax treaties of Ethiopia to specific cases are always forwarded by ERCA to MoFEC.[306] Dividend is the most frequent query as most of our tax treaties provide for a lower rate than the domestic income tax law of Ethiopia.[307] Thus the above situation creates the constituent states not to take part in on the decision given on concurrent taxes which are constitutionally protected taxing powers of the federal and the regional states.

On the tax treaty provision that deals with taxes which have similar character with the existing income tax types i.e. Article 2(4) of the Ethiopian tax treaties, two different arguments are forwarded on whether the provision violates the constitutional right of the constituent states or not. The first argument take a position that the tax treaty provision that deals with taxes which have similar character with the existed income tax types has an effect on the constitutionally protected taxing power of the constituent states.[308] These new taxes have to be decided by the two houses since the allocation of those taxes is not provided for under the FDRE constitution. Hence, if these Houses jointly decide that a new source of income tax is to be exercised by the regional States, the regional states should be the one who exercise this power of taxation to the extent of exempting that income from tax.[309] Hence, this decision making power has to be

[304] Zelalem eshetu, cited above at note 90, p.12
[305] Interview with Ato wassihun Abate , cited above at note 167
[306] Interview with Ato Bochu Sintayehu, cited above at note 184
[307] Ibid
[308] Zelalem Eshetu , cited above at note 90,p.12
[309] Ibid

extended also when tax treaties are concluded.[310] But in practice, it is the federal government who gives decision on these taxes and this is violation of the division of power of taxation.[311] Therefore, tax treaties may also affect the potential or future tax powers of the regional states under the Ethiopian federal system.[312] On the other hand, others reflect on this particular provision i.e. the tax treaty provision that stipulates about new taxes which have similar character with the existed income tax types and argue that it did not violate Article 99 of the constitution.[313] The very reason that the provision provides a tax that is identical or substantially similar taxes, does not mean that the tax is a new kind of tax that falls under the undesignated power of taxation.[314] An example of a new income tax is repatriated profit or branch profit tax.[315] This tax is the same tax that is imposed on profit income tax of a company. Thus, even if this type of income tax was not there when the tax treaties are concluded, because of the inclusion of this article in the treaty, this income tax type will be subject of the tax treaties.[316] The writer of this paper finds the second line of argument as a plausible one. The tax treaty provision has to be interpreted in a way it can go consistent with the existed division of taxation power as enshrined in the FDRE Constitution. Article 2(4) of the tax treaty provision provides the word "identical or substantially similar taxes". This means the taxes that are going to be imposed are not new types of income taxes, rather they are the one which have the same character as of the one that are provided under the income taxes of Ethiopia.

Also, tax treaties indirectly affect the interests of the constituent states by limiting the amount of total revenue collected by the federal government.[317] As constituent states are dependent on grants from the federal government, any act affecting the total revenue can easily affect the interests of the regional states.[318] Thus even if the tax collected is the revenue of the federal government, decreasing the amount of such revenue have effect on the constituent states.

[310] Ibid
[311] Ibid
[312] Ibid
[313] Interview with Wassihun Abate, cited above at note 167
[314] Ibid
[315] The Federal Income tax proclamation, cited above at note 96, Art. 62
[316] Interview with Wassihun Abate, cited above at note 167
[317] Zelalem Eshetu, cited above at note 90, p. 12
[318] Ibid

In addition, if the taxing power of the constituent states is violated by the conclusion of tax treaty, it will increase the vertical imbalance of revenue, between the federal and the constituent states. The vertical imbalance of the Ethiopian federation is partly exacerbated by the inability and/or reluctance of the regional governments to effectively raise revenues from sources assigned to them (e.g. agricultural income taxes should have been important sources of regional government revenue but they are not; the same can be said for taxes on proprietorship businesses.[319] There is strong argument as constituent states are not involved in the negotiation of tax treaties and are not consulted about the tax treaties that are going to be ratified, the vertical imbalance will be widened.

[319] Solomon Negussie, **Fiscal Federalism in Ethiopian Ethnic-based Federal System**, (2nd ed)Wolf Legal Publishers, Netherlands, 2008, p. 168

Chapter Four
Conclusion and Recommendations

4.1 Conclusion

The main research question of this paper, as has been stated in the introduction part, is assessing the involvement of regional states of Ethiopia in the negotiation of tax treaties of Ethiopia. The paper focuses both on the legal framework and the practical perspective. The paper has highlighted the concept of juridical double taxation, the division of taxation power under the FDRE Constitution and the negotiation and application of the bilateral tax treaties of Ethiopia. Countries like Switzerland and Germany have a clear constitutional provision that stipulates the constitutional right of the constituent states to be involved and be consulted on matters that affect their tax interest. Also in India and Australia, even if its constitution do not stipulate in this regard, the federal governments of both countries invite and consult the constituent states on the basis that state cooperation facilitate the implementation of international obligations, as well as ameliorate tensions in federal- state relations.

Nonetheless, the FDRE constitution does not specifically deal with whether the federal government can conclude an international treaty on matters that fall under the jurisdiction of the regional states without the involvement of the latter in the treaty negotiation or without conducting a consultation with the regional state. Provisions of the constitution are only addressing the power of the federal government to negotiate and ratify international treaties. This paper argues that the practical reality of how tax treaties are negotiated is not inline with the constitutional right of regional state to be involved in the negotiation of tax treaties and/or the right to be consulted before the tax treaties are ratified by the parliament.

The responsibility of the federal government to invite the regional states to be involved in the negotiation of treaties and to consult before the treaties are signed/ratified, especially on matters of taxation that fall under the jurisdiction of the regional states, is not specifically addressed under the FDRE constitution. However from the core principle of the FDRE constitution i.e. division of power between the federal and regional states and from specific provisions of the constitution, Articles 86(3), 50(8) 96, 97, 98, 99 and 100, it is possible to conclude that the regional states have a constitutional right to be involved in the negotiation of tax treaties on matters in which they have interest. They also have the right to be consulted before the tax treaties are signed /ratified.

The tax treaties of Ethiopia deal with income tax types that fall under the exclusive taxation power of the regional states like agricultural income tax and employment income tax. Also, joint taxes like corporate income tax and dividend are also included in the tax treaties of Ethiopia. Hence, the decision relating to the exclusive taxation powers falls on the regional state since Article 97 of the FDRE Constitution explicitly provides the regional state have the power to impose and collect the taxes that fall under their exclusive taxation power. Also on the concurrent power of taxation, a decision has to be made in consultation between the federal government and the regional states before a tax treaty is signed and ratified. Thus, the decision making power of the regional states has to be respected in the conclusion of tax treaties since treaties impose obligations on regional states.

In order to protect the constitutionally protected taxation power of regional states in tax treaties, involving the regional states in the negotiation of tax treaties and consulting them before the tax treaties are signed / ratified is suggested in this paper. The first reason is in the early treaty making stages, matters can be shaped before the treaties acquire legal status. Also, the tax treaties are ratified by HPR does not represent regional states. The house that represents the regional states at federal level, the HoF does not have legislative power so that the tax treaties will not be referred to this house and there is no any mechanism that the house can protect the interest of the regional states.

The involvement of regional states in the negotiation process of tax treaties will help the regional state to check whether its constitutional taxing power is protected under the tax treaties. This involvement will answer the question raised on the independence of regional states to make decision on their taxation power. It will also reduce administrative costs once the tax treaties are executed in Ethiopia. Also, conducting consultation with the regional states before the tax treaties are signed or ratified by the House of Peoples' Representatives will help the regional states to assess the provisions of the tax treaties in protecting their constitutionally recognized taxing rights and will give them the opportunity to forward their worries before the tax treaties are ratified.

However, in practice, the federal government has not put the mechanism to involve the regional states in the negotiation of tax treaties and also to consult about them about the tax

treaties before ratification. As such, regional states are not involved in the negotiation of tax treaties and are not consulted before the tax treaties are ratified. There is no administrative mechanism for the regional states to know the tax treaties that would be negotiated. Also, even if there is an annual meeting on finance and tax that is held between the federal government and the regional states, the consultation on tax treaty has not been an agenda. As a result the federal government is the one which decides on tax matters that fall under the jurisdiction of the regional states.

4.2 Recommendation

Administrative

In the existing constitutional framework, for the purpose of peaceful co-existence of the federal state and with the notion of the federal system of government, the federal government has to put an administrative mechsanism to involve regional states in the negotiation of tax treaties.

- At the annual meeting on finance and tax held with the regional finance and revenue bureaus "**yekilele yemekeker mederek",** tax treaties of Ethiopia should be included in the agenda of the meeting. In this consultative meeting information should be provided to the regional states on forthcoming tax treaty negotiations. This allows the regional states to identify treaties of special importance to them, to propose any comment and it will create the possibility of the inclusion of the regional states in the negotiation team of tax treaties.
- Establish a standing Committee of federal and state officials that will be charged with responsibility for overseeing the various stages of the processes. Thus, this committee will inform the regional states about the upcoming treaty negotiation before the negotiation of the treaties. At that stage, regional states can identify treaties of special importance to them; provide relevant input and be involved in the negotiation of the treaties.
- Consultation ought to be carried out with the regional states before the tax treaties are ratified by the Parliament. This will help the regional states to check if their constitutionally protected taxation power is protected under the tax treaties of Ethiopia.

- Build the capacity of regional states to exercise their constitutionally protected taxing power and arrange a Federal - State executive channel so that regional revenue bureaus can enforce the tax treaties of Ethiopia. This will make regional states to be familiar with the tax treaties of Ethiopia.

Legal framework

- Enact a treaty making procedure law. Under the FDRE Constitution, Article 51(8), the negotiation of international treaties is the mandate of the federal government. Thus the federal government can enact a legislation to execute and implement this power. This law ought to include a provision for regional states to be members of a tax treaty negotiation team and it has to carry out a consultation with regional states has to be made in the process of treaty making.
- Constitutional amendment: the constitution should be amended in a way that it can clearly stipulate that regional states should be involved in the negotiation of international treaties, especially on matters affecting their special interest. Also the amendment of the constitution should include consultation has to be made with regional states before treaties are ratified by the parliament.

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C. Thesis

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- The Constitution of South Africa, 1996
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- Letter written from the House of Federation to MoFEC and ERCA on 25/09/97 E.C letter No. ባ-3/ሀ1/አ.21/9/1
- Letter written from the House of Federation to MoFEC and ERCA on 23/09/97 E.C letter No. ባ-3/ሀ1/አ.21/12/1

E. International Agreements

- The Nordic convention , 1996
- Agreement between The FDRE and the Ireland for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income on 3rd November 2014
- Agreement between The FDRE and the United Arab Emirates for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income on12th April 2015
- Agreement between The FDRE and the Kingdom of Saudi Arabia for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income on 28th February 2013

F. Interview

Ato Wassihun Abate, Director of Legal Affair Directorate, MoFEC (Addis Ababa, December 12, 2016)

Ato Tesfaye Mergia, Regional Coordinator and support Directorate Director, ERCA (Addis Ababa, December 20, 2016)

Ato Bochu Sintayehu, Chief negotiator of the Ethiopian Tax Treaties and senior legal expert at MoFEC, (Addis Ababa, December 8, 2016)

Ato Birhanu Tadesse, Member of the Ethiopian Tax Treaty negotiation team and senior legal expert at MoFEC, (Addis Ababa, December 7, 2016)

Ato Lemessa Leke, Deputy Director of the Oromia Revenue Bureau, (Addis Ababa, December 21, 2016)

Ato Getachwe Mesfin, Tax Assessment and Collection Senior Officer at Amhara Revenue Bureau(Addis Ababa , January 7, 2017)

Ato Engedawork Gezahege, Tax Collection and Inspection Senior Officer at Amhara Revenue Bureau(Addis Ababa, January 7, 2017)

Ato Yirga Handisio, Revenue Research Case team leader at Southern, Nation, Nationality and Peoples Revenue Bureau, December 23, 2016(Phone interview, December 29, 2016)

Annex-1: Interview Guideline to Key Respondents

Addis Ababa University
Collage of Law and Governance
School of Law

The purpose of this interview is to collect first hand information about the involvement of regional states in the negotiation of tax treaties. The main purpose of this study is mainly to assess the existence of a constitution base that regional states can participate in the negotiation of tax treaties and/or be consulted before the tax treaties are signed or ratified. Also the study scrutinizes the practice whether the regional states are involved or be consulted of the tax treaties. It is believed that this study will have paramount importance to the federal government, regional states and academic discourse. Your honest response will pay a great role for this paper and you are kindly requested to make remarks to the following questions. The researcher is also need to express that responses are only to be used for academic purpose only.

To MoFEC and ERCA Officials

1. Do you believe tax treaties of Ethiopia protect the taxing interest of the country specifically regional states? How?
2. How do you see the negotiation process of Ethiopian tax treaties? Are regional states members of the negotiation team or do they participate in the negotiation process?
3. Do you believe the composition of tax negotiation team of Ethiopia protect the interest of regional state?
4. Do you believe the regional states have constitutional right to involve in the negotiation of tax treaties or the right to consult?
5. How do you evaluate the regional state taxing jurisdiction with the tax treaties of Ethiopia? Is it limited by the tax treaties or the tax treaties didn't violate the taxing jurisdiction of regional states?
6. How do you evaluate the non participation of regional state in the tax treaties of Ethiopia with the constitutionally protected of taxing right of regional states?
7. Have you encountered any question from regional states on the legality of Ethiopian tax treaties?
8. From constitutional point of view, how do you see the non participation of regional states in the negotiation of tax treaties in addition to the treaties being ratified by the HPR, the house that doesn't represent regional states unlike the HoF?

To Regional Revenue Bureaus

1. Do you believe tax treaties of Ethiopia protect the taxing interest of the country especially regional states? How?
2. How do you see the negotiation process of Ethiopian tax treaties? Are regional states members of the negotiation team or do they participate in the negotiation process?
3. Do you believe the composition of tax negotiation team of Ethiopia protect the interest of regional state?
4. Is there any mechanism that the federal government invites the regional states to participate or be consulted on the tax treaties?
5. Do you believe that the regional states have constitutional right to participate or be consulted relating to tax treaty?
6. How do you evaluate the non participation or non consultation of the regional state in the tax treaties? Does it have any effect on the taxation power of the regional state? Positive or negative effect?
7. So how do you evaluate your non involvement in the tax treaties of Ethiopia with your exclusive taxing power and concurrent power of taxation?
8. Have you encountered any question relating to the tax treaties of Ethiopia, especially if a foreigner claims to benefit from the tax treaties of Ethiopia?
9. What do you propose as a solution to participate regional states? Administrative remedy or amendment of the constitution?