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ADDIS ABABA UNIVERSITY

COLLEGE OF LAW AND GOVERNANCE STUDIES

BUSINESS LAW/ MASTER OF LAWS (LL.M) PROGRAM

CAPITAL GAINS AND VALUE-ADDED TAXES ON ACQUIRING IMMOVABLE COLLATERAL AND RESALE OF THE ACQUIRED PROPERTY BY BANKS: THE LAW AND THE PRACTICE

BY

SIMBO GEMECHU AMANU

A THESIS SUBMITTED TO THE COLLEGE OF LAW AND GOVERNANCE STUDIES OF ADDIS ABABA UNIVERSITY IN PARTIAL FULFILLMENT OF THE REQUIREMENTS OF THE DEGREE OF MASTERS IN BUSINESS LAW (LLM)

ADVISOR: Dr. TADDESE LENCHO (PHD)

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Examiner 2 Signature Date

Declaration

I, the undersigned, declare that this thesis is my original work, and has not been presented for a degree in any other University, and that all sources of materials used for the thesis have been fully acknowledged.

Simbo Gemechu Amanu

Signature:

Date:

Acknowledgment

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Simbo Gemechu Amanu

Acronyms

CGT- Capital Gains Tax

VAT-Value Added Tax

DGB- Debub Global Bank S.C.

WB- Wegagen Bank S.C.

AB- Awash Bank S.C.

NIB- Nib International Bank S.C.

CBE- Commercial Bank of Ethiopia

FDRE- Federal Democratic Republic of Ethiopia

CEO- Chief Executive Officer

Abstract

When banks lend money to customers, they need collateral as a guarantee that the debt will be paid, and if the borrower defaults, the Property Mortgaged or Pledged with Banks Proclamation No. 97/1998 allows the creditor banks to foreclose the collateral through a public auction and use the proceeds to pay off the borrower's debt. Furthermore, if no buyer shows up at the second auction, Property Mortgaged or Pledged with Banks (Amendment) Proclamation No. 216/2000 permits the creditor banks to acquire the collateral property at the floor price set for the second auction and transfer ownership of the property into their names.

However, banks sometimes might not transfer the legal ownership of the property from the name of the mortgagor to the bank after acquiring the collateral until they resale it, which leads to the question of how taxes, particularly CGT and VAT, are being treated during the process of acquisition and resale of the acquired property by the banks. To appropriately address the issues, qualitative and doctrinal methods of conducting research have been used. As a result, the research's findings show that the five banks used as a sample do not transfer ownership of the property they acquire; instead, they sell it later while the title deed is still in the name of the mortgagor. This practice of the banks results in the non-payment of CGT and VAT both during the acquisition and resale of the acquired property, which causes the government to lose a sizable amount of revenue. The finding also reveals that the government agencies in charge of tax collection and payment are unaware of this activity on the part of the banks.

This research examines how CGT and VAT are handled when banks acquire collateral property and later resell the acquired property.

Key words:

Banks, Acquisition, Collateral, Mortgagor, Commercial Immovable Property, CGT, VAT, Resale,

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CHAPTER ONE

Introduction

1.1. Background of the Study

The banking industry plays a vital role in the Ethiopian economy. Beyond providing a range of important financial services, the banking industry is a major contributor to the gross domestic product(GDP), employment and information technology (IT) investment. Additionally, the banking industry supports the Ethiopian Economy by paying millions of birr in tax and millions of birr dividend each year.[1]

Over the years, the number of banks operating in Ethiopia has grown from 18 to 30, of which 28 are privately owned commercial banks and the other two are government-owned.[2] Commercial banks provide a range of financial services, with loan services being the most important.

The Banking Business Proclamation No. 592/2008 authorizes Ethiopian banks to receive funds from the public in a manner approved by the National Bank of Ethiopia and to use the funds for loans and investments at their own risk. [3] Hence, it is up to the lending banks to manage or avoid the potential risks that might occur as a result of defaulting borrowers. The banks typically safeguard their loans against collateral in order to reduce the risks associated with the failure of the borrowers to pay their debt. So, banks accept both movable and immovable assets as collateral, and where the borrower defaults, the banks will liquidate the collateral asset to collect their loan[4]. Thus, Collateral for loans is

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[1] Abiyot Alemu and Abebe G, ' Contribution of the Banking Sector for Economic Growth, Case of Ethiopian Banks', 2015, < https://www.researchsquare.com/article/rs-923248/v1 > accessed 15 October 2022

[2] National Bank of Ethiopia, ' Banks in Ethiopia Continue to Grow Despite Challenges' (NBE News 2022) <https://nbe.gov.et/banks-in-ethiopia-continue-to-grow-despite-challenges/ > accessed 17 October 2022

[3] Banking Business Proclamation, 2008, Proc. No.592, Fed. Neg. Gaz., year 20, no. 82 (Banking business proclamation) article 2 (2) (a), (b)

[4] Property Mortgaged or Pledged with Banks Proclamation, 1998, Proc No. 97, Fed. Neg. Gaz, year 4, no 16 (Property mortgage or pledged with banks proclamation) article 3

meant to be an asset held by the banks as a fallback in case of default or to mitigate the presumed credit risk.

The Property Mortgaged or Pledged with Banks Proclamation No. 97/1998, which regulates the banks' security rights over immovable property, was issued to help banks swiftly collect their debts by enabling them to sell the collateral on their own through an auction rather than having to go through the formal litigation process, which would otherwise take too long.[5] Accordingly, Proclamation No. 97/1998 and its amendment, Proclamation No. 216/2000, respectively, authorize the creditor banks to have the debtor agree in a contract for the banks to sell the collateral by auction upon giving the debtor a prior notice of at least 30 days[6], or if no buyer appears at the second auction, to take over the property at the floor price set for the first auction and have the ownership of the property transferred to it.[7] Consequently, where no bidder appears and the banks take over the property as satisfaction of their loan, the law requires them to transfer the ownership of the collateral into their name.

Here, the fact that the mortgagor property transfers ownership to the creditor banks raises the question of whether CGT and VAT should be paid in connection with the acquisition of the collateral and sale of the acquired property thereafter by the banks.

CGT is a tax levied on gains upon disposal of capital assets like shares, bonds, and buildings held for a commercial purpose[8]. Since a person is required to pay an income tax if the amount gained exceeds the cost of disposal, in principle, CGT should be paid when banks acquire a commercial building (collateral) if there is a gain. In the case of foreclosure sale ,however, CGT is required to be paid on the amount left over after covering the debt.[9]

However, the practice in the banking industry shows that no transfer of ownership occurs from the debtor to the bank, where banks acquire the collateral. Rather, the banks simply hold the title deed and take the physical possession of the building until they sell it thereafter. Thus, as there is no actual

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[5] Property Mortgaged or Pledged with Banks Proclamation (n4), see the Preamble of the proclamation

[6] Ibid, article 3.

[7] Property Mortgaged or Pledged with Banks (Amendment) Proclamation, 2000, Proc No. 216, Fed. Neg. Gaz, year 6, no 46 (Property mortgage or pledged with banks (Amendment) proclamation) article 2(9).

[8] Income Tax Proclamation, 2016, Proc No. 979, Fed. Neg. Gaz,year 22, no 104, (Income Tax Proclamation) article59.

[9] Capital Gains Tax Implementation Directive No. 8/2011 E.C, article 12

transfer of ownership, the CGT that would have been paid had the debtor actually transferred ownership to the bank might not be paid. And this might further affect the payment of CGT later on when the banks sell the property they acquired.

When it comes to VAT, as stated earlier, since no actual transaction takes place and no transfer of ownership occurs from the debtor to the acquiring banks, the banks essentially might escape the payment of VAT when they take over the collateral as a payment of their loan and where the banks sell the acquired property later on as well.

The researcher of this study tries to address how CGT and VAT are handled when banks acquire collateral property and determine if they truly pay CGT and VAT when they later resale the acquired property.

It is against this background that the researcher embarks on this study.

1.2. Statement of the Problem

Proclamation No. 216/2000, A Proclamation which partially Amended the Property Mortgaged or Pledged with Banks Proclamation No. 97/1998, authorized creditor banks if no buyer appear at the second auction to take over the property at the floor price set for the first auction and have the ownership of the property transferred to them.[10] Based on this authority, where no bidder appears at the second auction and the creditor bank takes over the collateral as a payment of the debt, a transfer of property (ownership) takes place between the debtor and the bank. According to articles 59(1), (2), and (7) a of the Federal Income Tax Proclamation No. 979/2016, a person who derives a gain on the disposal of an immovable asset is required to pay 15% of their income tax on the gain. Accordingly, where a transfer of the collateral property takes place between the debtor and the bank, the debtor (transferor) is required to pay CGT if he/she/it derives a gain on the transfer. However, contrary to the law, where the banks acquire the collateral because actual transfer of ownership between the debtor and the bank did not occur, there is a high risk of non-payment of CGT during acquisition and later, when the banks eventually sell the property they acquired.

[10] Property Mortgaged or Pledged with Banks (Amendment) Proclamation (n. 7), article 2

The same is true for VAT. Value Added Tax Proclamation No.285/2002 requires every taxable transaction to be charged 15% VAT.[11] As a result, where creditor banks acquire collateral property and then sell it, VAT should be charged on the transfers or sales because the transaction falls under taxable transactions. However, since transfer of ownership does not take place during acquisition and ownership of the property remains in the name of the debtor, VAT might not be paid when the banks acquire the collateral and sell the acquired property later on.

Therefore, this study addresses how CGT and VAT are being treated where Ethiopian banks acquire collateral property as a payment of their debt and sell such property later on through negation, auction or other methods. And, it tries to assess whether the banks are actually paying CGT and VAT upon acquiring collateral property and when they sell the acquired property thereafter.

1.3. Research Objective

The main objective of this study is to examine whether CGT and VAT should be paid when banks acquire immovable collateral and later sell that same property.

Under the umbrella of the aforementioned general objective, the study also has the following specific objectives:

- To assess the legal obligation concerning the payment of CGT and VAT during the acquisition and resale of the acquired immovable collateral by banks.
- To evaluate the practice of Ethiopian banks regarding the payment of CGT and VAT upon acquiring immovable collateral and when they resell it later on.

1.4. Research Questions

The study mainly focuses on answering the following major research questions:

1. Should banks pay VAT when they acquire immovable collateral?
2. Should banks pay CGT when they resell the acquired collateral?

[11] Value Added Tax Proclamation, 2002, Proc No. 285, Fed. Neg. Gaz, year 8, no 33 (Value Added Tax Proclamation) article 7(3).

3. Is the mortgagor legally required to pay CGT when the creditor banks acquire the collateral?
4. Are the acquiring banks legally required to collect VAT when they resell an acquired property?
5. Do banks, in practice, pay VAT and CGT during the acquisition and resale of the acquired property, respectively? Are they practically collecting VAT while they resell the acquired property?

1.5. Significance of the Study

As the study focuses on identifying whether CGT and VAT should be paid by the banks under the Ethiopian Tax Laws and assessing the practice of Ethiopian banks, it helps the concerned tax authority, legal practitioners, academicians, and professionals know how CGT and VAT should be treated when banks acquire immovable collateral property and resell it later on. In addition, it provides individuals working in the field with a better understanding of CGT and VAT in relation to the acquisition of collateral and the resale of the property by the banks. It also helps the lawmaker make the necessary amendments to avoid the loopholes within the law that lead to the non-payment of CGT and VAT by the tax payers. It can also serve as a basis for further study in the field.

1.6. Scope of the Study

Even though Ethiopian banks are allowed to acquire special movables they hold as collateral as well, this research is limited to identifying whether Ethiopian banks are required to pay CGT and VAT when they acquire commercial immovable collateral and when they resell it later on, and if so, whether they are practically paying the tax.

1.7. Literature Review

To the knowledge of the researcher, there is no domestically written literature on the subject. But there are different domestically written articles and research that address various issues in relation to CGT and VAT.

Dr. Taddese Lencho, in his article captioned “To Tax or Not To Tax: Is that Really the Question? VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia” has argued that, “whenever the creditor banks take over the collaterals in payment of the loan (debt), a supply occurs from debtors to banks, and the taxation of this supply depends on whether the debtor is a taxpayer under VAT”. He further argued that “if the bank sells the collateral in a public auction, the

supply will now become a supply by the bank to a third party. This sale in a public auction, or for that matter, any type of sale, is a taxable supply."[12] However, Dr. Taddese's article is limited to how VAT is treated when banks conduct a foreclosure sale.

Getu Amsalu, in his LLM thesis, has written on Legal and Practical Issues Relating to CGT. The author argues in his paper that there are many disparities between the law and practice of CGT, and that these disparities disadvantage both taxpayers and governments. [13] The researcher further argues that "the practice of collecting CGT by the Addis Ababa City Land Administration Office, which has the authority to collect CGT, is not in compliance with the tax proclamations, and even the practice is not uniform, which leads to non-payment of CGT under certain circumstances." But his thesis is limited to assessing the constitutionality of imposing and collecting CGT and the legal and practical problems concerning CGT in Addis Ababa City Administration.

Serkalem Eshete argues in his thesis that, "…. apart from the constitutional issues related to CGT, there are also legal and practical problems in the actual administration of CGT in Ethiopia, which affects both the revenue of the government and the CGT payers." She further argues that, "The flaws regarding the collection of the tax and the lack of awareness about the CGT system by the tax authorities, taxpayers, and other relevant bodies are also mentioned as a major problem related to the administration of CGT in Ethiopia. "[14] However, the scope of his thesis is limited to evaluating administrative issues and practices related to CGT in Bahirdar city.

Although the aforementioned literature has addressed some of CGT and VAT-related problems, none of them has attempted to address the core subjects of this research, which are CGT and VAT-related issues when banks acquire collateral property and subsequently resale the acquired property.

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[12] Taddese Lencho, ' To Tax or Not To Tax: Is that Really the Question? VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia' [2011] MIZAN LAW REVIEW 294, p. 45

[13] Getu Amsalu, 'Legal and Practical Issues Relating to Capital Gains Tax: the Case of Addis Ababa City administration' (LLM Thesis Addis Ababa University 2021), <file:///C:/Users/Branch/Desktop/CAPITAL%20GAIN/Getu%20Amsalu.pdf > accessed 20 October 2022

[14] Serkalem Eshete, 'Constitutional and Administrative issues and Relations to Capital gain Tax in Ethiopia: The Case of Bahirdar City Administration', (LLM Thesis Bahir Dar University 2016) <file:///C:/Users/Branch/Downloads/LAW27-1.pdf> accessed 20 October 2022

1.8. Research Methodology

In the course of the study, the researcher has used both qualitative and doctrinal methods of conducting research. To address the research questions, the practice of how banks acquire and resell the acquired collateral and its process, with reference to the banks internal procedures and manuals, have been used. Additionally, the legal provisions of codes, proclamations, regulations, and directives have been examined properly.

Other published and unpublished literature in the area, like books, journals, official letters, and internal memos, has also been reviewed.

1.8.1. Source of Data

To address the key research objectives, the researcher collected data items relevant to this particular study from primary as well as secondary data sources. Thus, the data that is employed is an interplay of both primary and secondary data. Accordingly, the primary data is collected from interviews with foreclosure and acquired property administration managers and officers of five (5) selected commercial banks, interviews with Addis Ababa city land administration offices, and acquired property administration manuals or procedures of the banks. On the other hand, the researcher used secondary data collected from different books, journals, and other publications written in relation to this study area. Further, codes, proclamations, regulations, directives, letters, and internal memos of different banks written in relation with acquired properties have been consulted as a secondary source of data.

Finally, systematic analysis of statutory provisions and legal principles based on data collected from primary and secondary sources is conducted, presented, and interpreted by using a qualitative analysis strategy.

1.8.2. Limitation of the Study

Domestic scholars and researchers pay little attention to the topic. As a result, there are no adequate publications on this particular subject in Ethiopia. In addition to this, as the research is carried out concurrently with my regular job, there would be time constraints.

1.8.3. Organization of the Study

This paper is divided into four chapters.

The first chapter deals with the general background of the study, the statement of the problem, the research questions, the research objective, and the scope of the research.

Chapter two provides a review of the literature on the general concepts of CGT and VAT and their applicability to the transfer of immovable property. Moreover, the acquisition of immovable property in general and the acquisition of collateral property by banks in particular are examined from a legal point of view.

Chapter three deals with the practice regarding the treatment of CGT and VAT by Ethiopian banks during the acquisition of immovable collateral and the resale by the banks of the acquired immovable property thereafter.

Chapter Four sets out the conclusion and possible recommendations.

CHAPTER TWO

General Concept of CGT, VAT and Acquisition of Immovable Property

2.1. Introduction

This chapter discusses the general concepts of CGT, VAT, and the acquisition of immovable property. So, it starts with the definition and nature of CGT before thoroughly examining both the applicability of CGT to transfers of immovable property in general and CGT under Ethiopian tax law in particular. In a similar vein, the definition, nature, and applicability of VAT on the transfer of immovable property in general and its applicability under Ethiopian Tax Law will be discussed as well. The general concepts of the acquisition of immovable property and the acquisition of mortgaged property by Ethiopian banks are covered in the remaining section of this chapter.

2.2. Definition, Nature and Tax Treatment of CGT

2.2.1. Definition of CGT

In order to comprehend CGT and determine what is subject to this tax, we must first identify capital gains. Black's Law Dictionary defines "capital gains" as gains from the sale of capital assets in excess of their appraisal values or costs.[15] Capital assets are assets of a permanent or fixed nature employed in carrying on business or trade.[16] But this definition of CGT and capital assets by Black's Law is neither complete nor clear, as it limits capital gains and capital assets to the sale of capital assets and the fixed assets used to carry trade, respectively. However, looking at different literature, the concept of CGT and capital assets is very broad. Capital gains are gains from the sale or exchange of a capital asset.[17] Capital gains in the ordinary sense are the profits that one makes from selling any of one's assets that are not offered for sale in the usual way of doing business.[18]

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[15] Henry Campbell Black, M. A, Black's law Dictionary, Definitions of the Terms and Phrases of American and English Jurisprudence, Ancient and Modern, Revised Fourth Edition, St Paul, Minn. West Publishing Co. (1968) 263

[16] Ibid

[17] Leandra Lederman, 'Understanding Corporate Taxation', 2002, p.14

[18] Ambirajan Srinivasa, ' The Taxation of Corporate Income in India', 1965, p. 38, <https://archive.org/details/in.ernet.dli.2015.149612/page/n53/mode/2up> accessed 28 October 2022

The main sources of such gains are those capital assets that are owned mainly to generate income rather than for consumption purposes. Such assets include corporation securities, real estate, government bonds, and interests in partnerships, leases, and contracts.[19] Capital gains represent a real increment in one's economic position when there is an absolute change of value.[20] In general, "capital gain" is the difference between the money earned from disposing of the asset and all deductions and costs incurred for the capital asset.

CGT is imposed on the increase in cash value of certain kinds of property when that increase is "realized" by means of a sale, exchange, or other disposition that terminates the owner's interest in the property and marks the success or failure of his investment.[21] Whatever the cause of an increase in capital gains, as long as there is an increment, there will be CGT. So, in calculating CGT, the whole amount of money received from the disposal of a capital asset is not subject to tax; rather, it is the gain that is subject to tax. [22]

Thus, For the purpose of calculating the tax, all that matters is how much the asset has appreciated in value minus some deductible expenses. Finally, it is important to understand that not all countries impose a CGT and that the types of capital assets that are subject to CGT as well as the rate of taxation vary from one country to another.

2.2.2. Nature and Tax Treatment of CGT

Due to the differences in tax treatment between regular income and capital gains, establishing the character and nature of the CGT has always been complex and subject to debate. With respect to capital gains, the tax treatment varies to a large extent among countries, i.e., from taxing none to taxing some or even all gains. If taxable, such gains may either fall within the scope of general taxes on income or be levied in the form of a separate tax.[23] Income from capital has presented income tax

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[19] Ibid, p.38

[20] Ibid, 38-39

[21]Roland L. Hjorth, ' An Introduction to Capital Gain and Losses ' [1996] Wash. L. Rev. p. 2, 764, <https://core.ac.uk/download/pdf/267975408.pdf > accessed 16 November 2022

[22] Getu Amsalu (n 13) p.9

[23]Jan de Goede, 'Taxation of Investment Income and Capital Gains' , 2013, Paper No. 7-A, P. 6, <file:///C:/Users/Branch/Desktop/CAPITAL%20GAIN/cgt%20vs%20income%20tax.pdf> accessed 16 November 2023

systems with a special set of problems, forcing some countries to exempt income from capital altogether and others to concede special treatment in the taxation of income from capital.[24] In some countries, capital gains are subject to a distinct CGT (whether comprehensive or more specific), and in others, the capital gain will be taxed under the general income tax provisions rather than as a separate tax on capital items only. [25] Furthermore, within a single nation, different taxpayers may receive different treatment for capital gains. Countries like Belgium and Denmark exempt capital gains from personal income taxation, while Germany taxes them fully.[26]

Tax systems vary in their treatment of capital gains. But, whatever approach nations use to the taxation of capital gains, academics continue to disagree on whether capital gains should be regarded as ordinary income for tax purposes. Concerning the tax treatment of capital gains, John R. King argues that "in comparing different country's tax systems it is not sufficient to examine the particular provisions that they contain relating to capital gains, but It is also necessary to determine how, in practice, they draw the line between capital gains and ordinary income."[27] Barry Bracewell-Milnes argues that, "income and capital gains are as distinct as day and night, even though there are short periods of ambiguity at dawn and dusk." If it were right to tax capital gains as income, indexation would merely remove the additional burden imposed by price rises. "But I believe that it is not right to tax capital gains as income." [28] Furthermore, Ambirajan also argues that, "If a strictly economic

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[24] Taddese Lencho, ' The Ethiopian Income Tax System: Policy, Design and Practice', a Dissertation Submitted in partial fulfillment of the requirements for the degree of Doctor of Philosophy in the Department of Interdisciplinary Studies, TUSCALOOSA, ALABAMA, (2014) p.195

[25] United nations Attachment to Coordinator Paper: (2) ' Note on Capital Gains Taxation and Taxation of Indirect Asset Transfers', 2015, P.5, <https://www.un.org/esa/ffd/wp-content/uploads/2015/10/11STM_Attachment2_Cgt.pdf > accessed 16 November 2023

[26]Joeri Gorter and Ruud de Mooij, 'Capital income taxation in Europe' (Econopapers 2001) <https://www.cpb.nl/sites/default/files/publicaties/download/capital-income-taxation-europe-trends-and-trade-offs.pdf> accessed 2 January 2023

[27] John R. King, ' Taxation of Capital Gains-Tax Policy Handbook ' , (Parthesarathi Shome ed., 1995), P. 156,

<file:///C:/Users/Branch/Desktop/CAPITAL%20GAIN/John%20king.pdf, > accessed 2 November 2022

[28] Barry Bracewell-Milnes, ' Capital gains taxation in Britain: The merits of indexing and tapering' , 1978, p.116, <file:///C:/Users/Branch/Desktop/CAPITAL%20GAIN/IntlEvidenceNoCapitalGainsTaxSec3A.pdf>

interpretation is sought, then capital gains cannot be considered as income. From the standpoint of general economic theory, the essential element in a capital gain or loss is its unexpected character." [29]

On the other hand, those who favor the treatment of capital gains as ordinary income argue that these are not different from ordinary income, for these capital gains also increase the economic power of the individual, and hence there is every reason to add them to ordinary income. Ambirajan argues that, "Schanz-Haig-Simons' comprehensive measure of income during a given period would include, on par with other types of income, the change in value of all the capital assets and liabilities of an individual or business during that period."[30] Under the proposal by Simons, realized capital gains would be taxed at the same rates as other personal income. Now a day's many countries impose income tax upon capital gains, but the peculiarities of capital gains (e.g., their irregular nature and higher than normal susceptibility to inflation) have forced a number of concessions from actual income tax systems so as to separate the treatment of capital gains from other sources of income. [31] Furthermore, whether capital gains should be taxed on an accrual basis or upon realization is also a subject of debate among scholars. However, despite all these various arguments regarding the nature and tax treatment of capital gains, tax systems around the world continue to apply widely varying tax structures for capital gains under their respective tax regimes.

2.2.3. Scope of CGT

Even though literatures simply state that CGT applies in case of transfer of capital assets, what constitute capital asset is something which is determined by domestic laws and it varies among countries. CGT exists in various forms and is levied at various rates in numerous countries. [32] In order to understand the scope of applicability of CGT or to identify which property or transaction attracts CGT, it is important to look into the various tax systems. In determining the scope of CGT, different countries follow one of the two approaches. The first approach is to simply stipulate or list out those

[29] Ambirajan Srinivasa (n 18) p. 40

[30] Ibid, p.155

[31] Taddese Lencho (n 24) p. 196

[32] Guglielmo Maisto and Jacques Malherbe, ' Trends in the Taxation of Capital Gains on Shares under Domestic Law', 2013, p. 2, <file:///C:/Users/Branch/Desktop/CAPITAL%20GAIN/Taxation-of-Companies-on-Capital-Gains-sample.pdf>

assets whose transfer is subject to CGT. Countries like Australia, Ghana, Nigeria, and Ethiopia follow this approach, and their laws list out those capital assets, the transfer of which attracts CGT.[33] The second approach to determining the scope of CGT is to specify those assets that are not capital assets so that their transfer does not attract CGT. Thus, according to this approach, if an asset is not on the list of non-capital assets, then it is subject to CGT. The USA tax system adopts the second approach, and hence, for determining CGT, a capital asset is any asset of a tax payer except those assets specifically excluded under the law.[34]

Though most of the time CGT applies when capital assets are sold, exchanged, or transferred [35], this does not mean that CGT always applies in relation to the transfer of capital assets. Thus, the scope of CGT is determined by the domestic tax laws of each country.

2.2.4. CGT on Transfer of Immovable Property

CGT is imposed upon the realization of a capital asset, i.e., when the asset is transferred by way of sale, exchange or other methods and mostly for consideration. A "realization event" is a necessary precondition for the taxation of capital gains[36], and this is true in almost every major tax system. The realization requirement is one of the most basic elements of the United States income tax. Due to this requirement, any increase in the value of a person’s property is not taxed when it occurs. Rather, the tax on asset appreciation is deferred until the occurrence of a realization event, that is, until the property is transferred in exchange for money or another consideration.[37] Under most tax systems, immovable property falls within the list of capital assets, and therefore its realization or transfer in exchange for money or other considerations attracts CGT.

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[33] Serkalem Eshete (n 14) p. 11

[34] US Internal Revenue Code of 1954, section 1221

[35] Getu Amsalu (n 13) p. 8

[36] Leandra Lederman (n 17) p.14

[37] Jeffrey L. Kwall, ' When Should Asset Appreciation Be Taxed? The Case for a Disposition Standard of Realization' [2011] INDIANA LAW JOIRNAL, p. 78 <https://www.repository.law.indiana.edu/cgi/viewcontent.cgi?article=1028&context=ilj>

The taxation of capital gains upon realization leads to varying opinions over the issue. Some scholars argue against the requirement of realization, while others favor it. Jeffrey L. Kwall argues against the realization requirement by stating that the requirement is inequitable because it causes asset appreciation to be taxed more favorably than other forms of income, thereby violating the normative goal of taxing all forms of income equally. In addition, the realization requirement adds complexity to the tax system and sacrifices potential tax revenue due to the deferral it confers.[38] On the contrary, by mentioning the practical difficulties of measuring capital gains as they accrue in each income period, John R. King argues that, "the valuation of all the assets of each individual or business at the appropriate market prices at the end of every period appears generally impracticable and In the absence of such valuations, capital gains could only be subjected to tax when they are "realized" in the disposal of the asset." [39]

Lee Burns and Richard Krever argue that "in most cases, a gain or loss is realized at the time the taxpayer ceases to own the asset and while a taxpayer will normally cease to own an asset as a result of the sale of the asset, there are other ways in which this can also occur (e.g., as a result of an in-kind exchange, a gift, or a distribution of the asset)." [40] Thus, they suggested that the concept of disposal, rather than a narrower concept like sale, be used to state the basic realization rule and in its ordinary meaning, disposal covers all situations in which the ownership of the asset changes.

The typical "realization" for tax purposes is the disposal of an asset for consideration. Other events may, however, be treated as "deemed realizations" for tax purposes—for example, transfers by way of gift or upon the death of the owner.[41] Quite clearly, a mere transfer of property is not sufficient for realization because gratuitous transfers of appreciated property are not realization events.[42] The U.S. income tax has always embraced a realization requirement, thereby deferring the taxation of asset

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[38] Ibid, p.78

[39] John R. King (n 28) p. 156

[40] Lee Burns and Richard Krever, ' Taxation of Income from Business and Investment, Tax Law Design and Drafting ' (1998) Victor Thuronyi ed., <https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch16.pdf >

[41] Ibid, p.157

[42] Jeffrey L. Kwall (n 38) p. 80

appreciation until the occurrence of a realization event (normally, a sale or exchange of the appreciated property).[43]

From the reading of the various literatures mentioned above, it is possible to say that the same rule applies to the taxation of capital gains in the event of the disposal of immovable property. Hence, not every transfer of immovable property is considered a realization for CGT purposes. For CGT to be levied on transfer of immovable property, first, the appreciated immovable property should be disposed and it should be for consideration. Second, there should be a realization event, i.e., the moment where the property is transferred through sale, exchange, etc. and the transferor acquires the actual profit or gain. And the third is that, the transfer should not be among the list of exceptions under the respective domestic tax law. Thus, the fulfillment of the above three conditions makes the transfer of immovable property subject to CGT.

2.2.5. CGT in Ethiopia

The idea of taxing gains from the transfer of capital, which took off in the rest of the world for a long time, did not reach Ethiopia until a special income tax law charging gains from the transfer of some types of capital assets was issued in 1994.[44] Proclamation No. 108/1994 was the first law in Ethiopia to specify taxing earnings from the transfer of capital assets. Shares, bonds, and urban houses were the three capital asset categories the proclamation chose as being subject to the tax upon sale.[45] The tax was to be assessed on the difference between the sales price and the original cost of these assets adjusted for inflation, which gave the 1994 tax law all the hallmarks of a CGT law.[46] The CGT applied regardless of whether the asset was held by an individual, a business, or a company. And the tax rate for all the specified assets was 30%. However, aggregate annual gains of less than birr 10,000

[43] Ibid, p.79

[44] Taddese Lencho (n 24) p.498

[45] Payment of Tax on Gains from Capital Proclamation No. 108/1994 (Payment of Tax on Gains from Capital Proclamation) article 3

[46] Taddese Lencho (n 24) p. 499

realized upon sale from the increase in value of capital assets were exempted from the payment of CGT.[47]

Despite the fact that the 1994 CGT law was issued as a special tax law distinct from the then income tax law, numerous provisions of the income tax law of the time were made applicable by cross-references because the 1994 law in itself only contained a few provisions about charging the CGT.

Income Tax Proclamation No. 286/2002, which repealed Proclamation No. 108/1994, incorporated CGT into the main body of the income tax system by designating capital gains as one of the miscellaneous sources of income chargeable with tax under Schedule D.[48] The 2002 Income Tax Proclamation reduced the capital assets that were to be subject to CGT upon transfer (sale or gift) to buildings held for business purposes (factories, offices, and shares of companies). Gains from the transfer of buildings held for residence, which had previously been subject to CGT under the 1994 CGT proclamation, were exempted by the 2002 Income Tax Proclamation, and the issue of bonds was not mentioned at all. With regard to the tax rate, buildings held for business factory, and offices were subject to 15% tax, while 30% tax rate was levied on shares of Companies.[49]

Under the 1994 CGT proclamation, all urban houses irrespective of whether it was intended for dwelling, business or other purpose, was subject to CGT at a rate of 30%. But, the 2002 income tax proclamation made a major deviation from the previous CGT proclamation by excluding residential buildings from the scope of CGT and by reducing the tax rate by half, into 15%.

The Federal Income Tax Proclamation No. 979/2016, which repealed the Income Tax Proclamation No. 286/2002 and which is effective now, imposes a certain amount of tax on income from the disposal of certain investment assets. Article 59(1) of the Proclamation states that, a person who derives a gain on the disposal of immovable property, a share, or a bond (referred to as a "taxable asset") is liable to pay an income tax. Under the proclamation, a person is required to pay an income tax based on the amount of a gain on disposal. The amount of a gain on the disposal of a taxable asset by a person is the amount by which the consideration for the disposal of the asset exceeds the cost of the asset at the time of disposal.[50] Therefore, a person is only required to pay income tax if the

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[47] Payment of Tax on Gains from Capital Proclamation (n 46), article 8

[48] Income Tax Proclamation, 2002, Proc No. 286, Fed. Neg. Gaz,year 8, no 34, (Income Tax Proclamation) article 37

[49] Ibid, article 37 (1) a and b

[50] Income tax proclamation (n 8) article 59(3)

amount gained exceeds the cost of disposal. Moreover, for income tax purpose, a person disposes of an asset when the person has sold, exchanged, or otherwise transferred legal title of the asset, and includes when the asset has been cancelled, redeemed, relinquished, destroyed, lost, expired, or surrendered.[51]

For the purpose of determining CGT, there are two types of taxable assets: class "A" and class "B." Class "A" taxable assets are immovable assets, which include a mining or petroleum right or mining or petroleum information, as defined in Article 36 of the Proclamation, while class "B" taxable assets are shares and bonds.[52] This being said, the rate of CGT is 15% for a class "A" taxable asset (an immovable asset) and 30% for a class "B" taxable asset (shares and bonds).[53] The proclamation under Article 59(4) even offers an offset for a person making a loss on the disposal of a taxable asset when the cost of disposal exceeds the consideration for the disposal during a tax year. So, since disposal of an asset for CGT purpose includes transfer of a legal title from one person to another, the transfer of ownership of mortgaged property from the debtor to the creditor bank as a payment of debt is subject to CGT under Ethiopian Tax Law. In addition to the income tax proclamation, the income tax regulation No. 410/2017 provides for the regulation of CGT where the asset is disposed of as a donation in which case, the recipient of the donation is liable to pay the tax.[54]

Recently, Ethiopia's Ministry of Finance issued Directive No. 8/2011 E.C, which provides detailed rules for the taxation of capital gains on the disposal of certain capital assets. The directive contains detailed rules for the implementation of CGT. Particularly, concerning property mortgaged with banks, the directive states that, CGT will be applicable only on the amount which lefts after covering the total debt of the banks, if any. which means that when the creditor bank sells the mortgaged property for the purpose of recovering the debt, even if there is a gain for the owner, if nothing remains after satisfaction of the debt, CGT will not be paid.[55]

Generally, the existing legal framework of CGT in Ethiopia is, mainly comprised of the income tax proclamation, income tax regulation, implementation directive, and some explanatory letters or

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[51] Ibid, article 67(1)

[52] Ibid, article 7 (b) (c)

[53] Ibid, article 59(2)

[54] Council of Ministers Federal Income Tax Regulation,2017, Regulation No. 410, Fed. Neg. Gaz,year 23, no 82, (Income tax Regulation) article 53

[55] Ibid, article 12

guidance issued from time to time by the concerned government authority concerning the implementation of the tax.

2.3. Definition and Nature of VAT

VAT (known in some countries as "Goods and Services Tax") is an indirect tax levied on the value added by producers, suppliers, and service providers at each point in a supply chain, and its cost is usually passed on to the consumer.[56] Despite its name, the VAT is not generally intended to be a tax on value added as such; rather, it is usually intended as a tax on consumption. Its essence is that it is charged at all stages of production, but with the provision of some mechanism enabling firms to offset the tax they have paid on their own purchases of goods and services against the tax they charge on their sales of goods and services.[57] Thus, if the ultimate consumer is a business that collects and pays to the government the VAT on its products or services, it can reclaim the tax paid. In the case of VAT, the person who ultimately bears the burden of the tax is not necessarily the same person as the one who pays the tax to the tax authorities. Accordingly, the financial burden of the tax falls in principle on the final consumer—the person at the end of the chain of transactions running from production to the retail stage.

VAT arises whenever a taxable person makes a supply of goods or services in the course of business operations. Although the tax is intended to be borne by the consumer, the consumer is not taxed directly. Instead, "taxable persons" are all producers and distributors who manufacture and trade in taxable goods and services, and each taxable person has to remit that part of the total tax collected by the retailer from the final consumer that equals the tax rate times the value added by that taxable person.

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[56] Action Aid International, ' Value-Added Tax (VAT): Progressive taxation policy brief ' , (2018), p.1,

< https://actionaid.org/sites/default/files/publications/value_added_tax.pdf > accessed 5 January 2023

[57] Liam P. Erbill ,Michael Keen and Victoria J Perry, 'The Nature, Importance, and Spread of the VAT', (2010), p.1, https://www.elibrary.imf.org/display/book/9781589060265/ch01.xml

In essence, VAT is imposed upon "taxable events," that is, the delivery of taxable goods and services. However, there are two approaches to determining what constitutes a taxable event for VAT, i.e., the economic and legal approaches. From an economic point of view, the VAT should tax all consumption activities, including self-produced items of consumption, because this would ensure equal treatment with other products bought in the marketplace.[58] Under the legal approach to VAT, however, it is emphasized that even in principle, the VAT is not intended to tax non-market consumption activities. The tax is on consumption expenditures rather than consumption activities.[59] Accordingly, the definition of a taxable event in the majority of VAT statutes emphasizes that only goods and services bought in the marketplace (or business context) are taxable.

VAT is a tax on consumption expenditures. Even if it is said that VAT is a consumption tax, every consumptions does not attract VAT. Rather, it is the expenditure on consumption which is taxed under VAT. Ultimately, the VAT is a tax on consumption expenditures as they are incurred.

Currently, the majority of tax systems worldwide, including those of the vast majority of developing countries, levy VAT. Some suggest that "a VAT is the most effective instrument for generating government revenue" and that "the marginal cost of raising funds for public purposes through a VAT is generally lower than it would be if other taxes were employed."[60]

With regard to the methods of calculating the VAT base, there are three basic methods. Some use the invoice-credit method, under which tax paid on inputs is offset by a credit against tax due on output, the tax paid being recorded in invoices issued by the seller to the buyer.[61] There is also sales-subtractive VAT method. Under the sales-subtractive method, VAT is imposed on the difference between sales receipts and allowable deductions for purchases from other firms.[62] The third is the Addition method of VAT. In this kind of VAT, the taxable business totals its payments for factors of

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[58]Sijbren Cnossen, 'VAT Treatment of Immovable Property', p.2, <file:///C:/Users/Branch/Downloads/9781557755872-ch07.pdf >

[59] Ibid, p.3

[60] Alain Charlet and Jeffrey Owens, ' An International Perspective on VAT' [2010] tax notes international p.944

[61] Liam P. Erbill ,Michael Keen and Victoria J Perry (n 58) p.2

[62] Alan Schenk, *VALUE ADDED TAX A Model Statute and Commentary*, A Report of the Committee on Value Added Tax of the American Bar Association, (1989), 2

production—compensation, rent and interest, expense, and profit.[63] Among the three calculation methods, the invoice-credit method is the most dominant in the world, and this is due to its capacity to prevent tax evasion.

In terms of their essential characteristics, VAT systems are defined in substance by two fundamental features that they share. First, the VAT constitutes a broad-based tax on final consumption, which means the VAT is charged on a wide range of supplies of goods and services. Second, the VAT is collected through a staged collection process. Under the staged collection process that characterizes the operation of a VAT, each business in the supply chain participates in the process of collecting the tax, and the tax is collected on the "value added" at each stage of production and distribution.[64]

In general, despite variations in tax rates and calculation techniques VAT remains widely implemented by different tax systems.

2.3.1. VAT on Transfer of Immovable Property

VAT is intended to apply generally to supplies of goods and services. It is not a sectoral tax applied only to particular goods or services, and it is not a tax that is applied to persons. Mostly, "goods" and "services" are defined broadly so that the tax applies as widely as possible to economic activities involving supplies of value from one person to another for reward.[65] Thus, the supply of goods and services is subject to VAT unless clearly exempted. Here, to become acquainted with the VAT treatment of the transfer of immovable property, we need to identify the place of immovable property within the meaning of the supply of goods and services.

According to literatures, the normal approach is that, to impose VAT, the following general requirements need to be fulfilled: First, there should be a supply of goods and services. Second, those supplies should be "taxable" and not exempt from VAT. Third, those taxable supplies need to be made by a "taxable person," that is, a person within the scope of the charge to VAT. Fourth, the

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[63] Ibid, p.2

[64] OECD, 'Mechanisms for the Effective Collection of VAT/GST When the Supplier Is Not Located In the Jurisdiction of Taxation' , 2017, p.11, < https://www.oecd.org/tax/tax-policy/mechanisms-for-the-effective-collection-of-VAT-GST.pdf

[65] KPE Lasok QC, ' Nature and Origins of Value Added Tax' (Elgaronline 2020)

< https://www.elgaronline.com/display/9781784718008/09_chapter1.xhtml> accessed 7 January 2023

taxable person makes those supplies as part of the person's business activities and not as part of a non-commercial activity.[66]

Since the focus of this research is on the transfer of immovable property, only the definition of the term "supply of goods" and "taxable transaction" from a VAT perspective will be discussed here.

Transactions are usually stated to be within the scope of VAT if they are supplies of goods or services, and VAT laws usually contain a definition of a supply of goods or services. David Williams states that "the definition needs to avoid being too closely related to any definition of a similar concept in the commercial or consumer law of the state, because the scope of the VAT rule will usually be wider than the scope of the commercial law." He further suggests that, "In particular, the terms need to cover transactions dealing with land or other immovable property and with intellectual property rights."[67]

In the EU legislation, "taxable transactions" are, strictly speaking, transactions that fall within the scope of VAT and that, accordingly, are capable of being subject to a charge of tax.[68] Accordingly, the EU VAT Directive defines "supply of goods" as the transfer of the right to dispose of tangible property as an owner, and it further allows member states to consider the handing over of certain works of construction as a supply of goods.[69] The Directive provides Electricity, gas, heat, refrigeration as tangible properties. And further, the directive allows member states to consider certain interests over immovable properties and shares as tangible properties.[70]

The US Model Statute on VAT defines a taxable transaction as "the sale of property or services in the United States by a taxable person in connection with a business."[71] Under the model statute, "property" is defined as a tangible asset (excluding money and other intangible properties like securities), and the transfer of ownership of the property from a seller to a buyer for consideration is

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[66] David Williams, ' Value-Added Tax, Tax Law Design and Drafting-International Monetary Fund ' Victor Thuronyi, ed. (1996), p.10, < https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch6.pdf >

[67] Ibid, p.21

[68] Ibid, p.19

[69] COUNCIL DIRECTIVE (EC) 112/2006 on the common system of value added tax [2006] article 14 (1), (3), < https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32006L0112&from=EN >

[70] Ibid, article 15

[71] Alan Schenk (Model statute and commentary) (n 63) sec 4003 (1)

considered a "sale of property."[72] Thus, under the Model Statute, any business-connected sale of property or service that is made by a taxable person is considered a taxable transaction so that it attracts VAT.

Similarly, the Value Added Tax Act of Kenya defines supply of goods as a sale, exchange, or transfer of the right to dispose of the goods as owner or the provision of electrical or thermal energy, gas, or water. And under the Act goods are defined as tangible, movable, and immovable property.[73]

As the word "supply of goods" is defined in terms of tangible property, we must first establish what constitutes immovable within the meaning of tangible property in order to determine how to treat immovable property for VAT purposes. Most of the time, the definition of what constitutes immovable property for VAT purposes is provided under the domestic tax laws of the country. Mostly, Immovable property includes land, building and permanent construction or their part.

In the European Union, the definition of immovable property for VAT purposes is provided under Council Implementing Regulation (EU) No. 282/2011. Accordingly, immovable property mainly includes land, buildings, and constructions fixed to or in the ground.[74] Thus, the cumulative reading of the EU VAT Directive and its implementing regulation shows that the supply of immovable property attracts VAT within the EU. However, in respect of the supply of immovable property, domestic laws of member states have drawn distinctions between the supply of "newly constructed" buildings, the supply of "old" buildings, the supply of building land, and the supply of land other than building land. Further, in some member states, the supply of immovable property is totally exempt from VAT.[75] For example, in Finland and Germany, the main rule is that the supply of immovable property is exempt from VAT.

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[72] Ibid, p.20

[73] Value Added Tax Act, Kenya Gazette Supplement No.88 (National Assembly Bills No.9) National assembly Bill 2013, part I,2 <http://kenyalaw.org/kl/fileadmin/pdfdownloads/bills/2013/THEVALUEADDEDTAXBILL2013.pdf>

[74] Council Implementing Regulation (EU) (EC) No.282/2011 on VAT implementation [2011] article 13b < https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32011R0282&from=EN >

[75] Arthur Andersen, ' Study on the application of Value Added Tax to the property sector, Executive summary and Country overviews', (2016) p.9 <https://taxation-customs.ec.europa.eu/system/files/2016-09/report_vat_immovable_property.pdf > accessed February 10 2023

The US Model Value Added Tax Act under Sec. 4006 (2) states that for VAT purposes, the sale of real property shall be treated as occurring where the real property is located. This statement shows that under the Model Act, the sale or transfer of immovable property is subject to VAT.

Thus, when it comes to the issue of the VAT treatment of immovable property, since VAT is a tax on transactions designed in such a way that, ultimately, only consumption expenditures are taxed, immovable property should be taxed if and when it is transferred from the production or business circuit to the consumption or consumer circuit. Thus, newly constructed buildings, both residential and commercial, should be taxed at the time they are completed.[76] Typically, countries do not simply impose VAT on every transfer of immovable property, particularly buildings. Rather, the use that may be made of the buildings and the fact that it is a newly constructed building are taken into account, thereby, under certain circumstances, exempting the transfer of non-commercial or residential buildings and newly constructed buildings from the scope of VAT. For example, in most of the EU and OECD member countries, residential buildings are exempt from VAT.

Alan Schenk suggested that, when immovable property is transferred from the debtor (owner) to the creditor (banks) as a payment of debt, the transfer is regarded as a sale of the asset by the debtor to the creditor. In such a case, if the debtor is a taxable person within the context of VAT, then the transaction will be taxable and the debtor will be liable to pay the tax.[77] However, the person actually making the sale (it could be the creditor) may also be liable for the tax if that person has control over the remittance of proceeds to the debtor.[78]

Generally, since VAT is a tax levied on consumption expenditures made in the context of a taxable transaction, the transfer or supply of immovable property, particularly a building, that is transferred or sold in a business-connected transaction involving a taxable person is subject to VAT unless clearly exempted by the law.

2.3.2. VAT on Transfer of Immovable Property as per Ethiopian Tax law

Ethiopia introduced VAT in 2003 as a replacement for the then-sales tax. The introduction of the VAT along with the Turnover Tax was touted for their superior revenue generation potentials over the previous sales tax regime in Ethiopia, the operation of which was limited to manufacturers and

[76] Sijbren Cnossen (n 59), p.5

[77] Alan Schenk (Model statute and commentary) (n 63) sec 4039

[78] Ibid

producers.[79] Ethiopia introduced VAT to minimize the damage caused by attempts to avoid and trade the tax and ascertain the profit obtained by tax payables, to enhance economic growth and imports, to enhance the relationship between domestic production and government revenue, and to increase saving and investment as it is essentially a consumption tax and does not tax capital.[80] Currently, VAT is one of the most important sources of revenue for the Ethiopian government. In terms of design, VAT is imposed on the supply of goods and services other than exempted supplies.[81] VAT is based on the invoice credit method, in which taxpayers are given credit for the VAT paid on inputs when it is supported by the relevant documents. The tax is also based on the destination principle, in that imports are taxed but not exports.[82] VAT is chargeable at a standard rate of 15% on all taxable supplies of goods and services other than those that are zero-rated.

For the purpose of determining the scope of application of the VAT, some basic terms like "supply of goods" and "rendition of services," "goods," "services," "taxable transactions," and "taxable activity" are defined under VAT Proclamation No. 285/2002.

Accordingly, article 4(1) a of the VAT Proclamation defines "supply of goods" as a sale of goods, a grant of the use or right to use goods, and a transfer or provision of thermal or electrical energy, gas, or water. Further, under article 2(7) of the proclamation, "goods" are defined as all kinds of corporeal movable or immovable property, thermal or electrical energy, heat, gas, refrigeration, air conditioning, and water, but it does not include money. An activity that is carried on in Ethiopia, or partly in Ethiopia, that involves or is intended to involve, in whole or in part, the supply of goods or services to another person for consideration, whether or not for a pecuniary profit, is a taxable activity that attracts VAT under the VAT Proclamation.[83] As a result, the supply of goods or the rendition of a service in Ethiopia in the course or furtherance of a taxable activity is a taxable transaction as per the VAT Proclamation.

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[79] Taddese Lencho (n 24) p. 114

[80] Dasalegn Mosissa Jalata, ' The Value Added Tax and Sales Tax in Ethiopia: A Comparative Overview ' [2014] European Journal of Business and Management p. 248 <https://citeseerx.ist.psu.edu/document?repid=rep1&type=pdf&doi=092c608d2d8112798d8275af746c5e61d20a25bc>

[81] Value Added Tax Proclamation (n 11) article 7(3)

[82] Ibid, article 7(2) a

[83] Ibid, article 6

Since the supply of goods is the main subject of VAT and goods are defined to include immovable property, the sale or transfer of immovable property is the subject of VAT under the Ethiopian VAT Proclamation. However, the VAT Proclamation does not contain a definition of immovable property for tax purposes. So, for the meaning of the term "immovable property," one should refer to the civil code. Accordingly, under article 1130 of the civil code, "lands and buildings" are provided as immovable property.[84] But, since land is not subject to sale or to other means of exchange in Ethiopia,[85] the reference to immovable property for tax purposes here is only related to a building.

Based on the cumulative reading of articles 4(1) a and 2(7) of the VAT Proclamation and article 1130 of the civil code, it is possible to conclude that the supply or transfer of immovable property, particularly buildings, is subject to VAT under Ethiopian law. However, the presumption that buildings are subject to VAT under Ethiopian VAT law is not absolute since the law provides exceptional rules and exempts certain buildings from the scope of applicability of VAT based on the use that may be made of the buildings. Accordingly, the sale or transfer of any building used predominantly as a place of residence is exempted from VAT under Ethiopian law.[86]

2.4. Acquisition of Immovable Property

Acquisition of Property refers to the process of gaining ownership right over a property. The rules of acquisition of any given property may vary from country to country; however, usually they follow a standard process. From a legal point of view, there are various methods for acquiring ownership of property. So, ownership of property can be obtained through possession, prescription, agreement, inheritance, gift, etc. However, depending on the domestic laws of countries, some of the acquisition methods applies only for movable property while others apply for both movable and immovable property.

In civil law jurisdictions, a distinction is made between original and derivative acquisitions. Derivative acquisition refers to the mode of acquisition of right of ownership through transfer from one person to another. It is a mode of acquisition in which the right of the transferee is dependent on

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[84] Civil Code of the Empire of Ethiopia Proclamation, 1960, Proc No. 165, Neg. Gaz, Extraordinary, 19th Year No.2, (1960) article 1130

[85] Constitution of the Federal Democratic Republic of Ethiopia Proclamation, 1995, Proc No.1, Fed, Neg,Gaz, Year 1, No. 1, (FDRE Constitution) article 40(3)

[86] Value Added Tax Proclamation (n 11) article 8(2) a

the right of the transferor. Hence, the governing principle here is that "no one can transfer a better title or right than he has," and where the transferor is not an owner or if his right is defective, the transferee will not acquire the right to ownership or will acquire a defective right. Original acquisition, on the other hand involves the creation of new property rights, which are independent of any preexisting rights over the same thing.[87]

When it comes to the acquisition of ownership of immovable property, depending on the laws of the country, ownership can be acquired either through prescription, possession, agreement, or inheritance. However, because ownership of immovable property is mostly proved by a title deed, it can be said that ownership of an immovable property is said to be acquired when the title deed of the ownership is transferred from the owner (transferor) to the transferee (the buyer).

2.4.1. Acquisition of Mortgaged Property by Banks in Ethiopia

Ethiopian banks continue to be the primary sources of finance for investors and traders looking to start a new business or grow an existing one, and even for personal consumptions. Yet, the types of loan facilities and the requirements to be met by potential borrowers may vary depending on the internal procedures or manuals of the banks. When the banks provide a loan, they mostly require collateral for the loan in order to minimize or avoid the potential risks associated with the borrower defaulting on his/her payment of the debt. Customarily, the Ethiopian banks used to accept immovable property and special movables as collateral, and as a result, property mortgaged or pledged with banks Proclamation No. 97/1998 was enacted in order to enforce the security rights of banks over their immovable and special movable collaterals. However, with the coming into effect of the Movable Property Security Right Proclamation No. 1147/2019, which governs security rights over movable properties, there is a huge opportunity for the Ethiopian banks to accept various types of movables listed under the proclamation as collateral for loans.[88] Thus, Proclamation No. 1147/2019 governs the creditors' (including banks') security interests over movable property, while

[87] Hemant More, Modes of Acquisition of Ownership, (2020) https://thefactfactor.com/facts/law/legal_concepts/jurisprudence/modes-of-acquisition-of-ownership/8900/ accessed June 25/2023

[88] Movable Property Security Right Proclamation, 2019, Proc No. 1167, Fed. Neg. Gaz,year 25, no 76, (Movable Property Security Right Proclamation) article 2 (27)

Proclamation No. 97/1998 with its amendment Proclamation No. 216/2000 regulates the banks' security rights over immovable property. But, whatever the type of collateral is, its purpose is the same: to serve as a security in case of default by the borrower.

Where the borrower defaults, Proclamation No. 97/1998 allows banks to sell the collateral property by auction and offset the loan.[89] But if no buyer appears at the second auction, Proclamation No. 216/2000 authorizes the creditor banks to take over the property at the floor price set for the first auction and have the ownership of the property transferred to them.[90] Thus, the law authorizes banks to acquire the ownership of a collateral immovable property in the event where the borrower fails to pay his/her debt and no buyer appears at the second auction.

However, since it is an immovable property, in order to say the banks have acquired ownership, there are certain requirements that need to be fulfilled in accordance with the law. Accordingly, article 1195 of the civil code states that the issue by administrative authorities of a title deed to the effect that a given immovable belongs to a given person shall raise a presumption that such a person is the owner of such an immovable. Thus, as ownership of immovable property is proved by a title deed or certificate of ownership, to say the bank has acquired the ownership of mortgaged property, there should be a transfer of ownership from the debtor to the bank, which is established by the issuance of a title deed in the name of the bank after paying the necessary taxes associated with the transfer.

Generally, Ethiopian banks acquire ownership over immovable collateral in the event the borrower defaults on his debt and no buyer appears during the second auction. And legally speaking, the banks acquire ownership of the immovable collateral when the concerned government authority issues a title deed in the name of the bank in accordance with the law.

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[89] Property mortgage or pledged with banks proclamation (n 4) article 3

[90] Property mortgage or pledged with banks (Amendment) proclamation (n 7) article 2(9)

CHAPTER THREE

CGT and VAT During the Acquisition and Resale of Immovable Collateral by Banks in Ethiopia

This chapter is the main part of the thesis, as it deals with CGT and VAT during the acquisition of immovable collateral and resale of the acquired property by the banks in Ethiopia. The first section of the chapter deals with the general idea of the right of banks to acquire immovable collateral, the acquisition process, and the resale of the acquired property. The legal obligation to pay CGT and VAT as well as the practice of the five selected banks (NIB, DGB, AB, WB and CBE) regarding payment of CGT and VAT during the acquisition of immovable collateral and resale of the acquired property by the banks are covered in the following section of this chapter.

3.1. Acquisition of Immovable Collateral by Banks in Ethiopia

3.1.1. The right of banks to acquire collateral

As has been mentioned in Chapter two, the main purpose of obtaining a security interest over a debtor's property is to enable a creditor bank to recover its claims against its borrower in the event of the borrower's failure to fully or partially discharge its repayment obligation towards its creditor. Where the debtor fails to pay its debt, creditors take different legal measures in order to collect their claims from their defaulting debtors. In other words, they enforced their rights (legal, contractual, or judicial) against the property on which they had obtained security interests.[91] Various legal systems recognize different means of enforcement, such as private sale or foreclosure of the collateral by the

[91] Bereket Alemayehu Hagos, 'The Scope of Banks' Power in The Enforcement of Security Interests Under Ethiopian Law: Lessons From The US and the OHADA Laws ' , LL.M. Short Thesis, Central European University, Budapest, (2018) P.10

creditor, direct taking of the collateral by a creditor for the purpose of satisfying a debt of the debtor, enforcement through a court order, etc.

Accordingly, the first enforcement tool the law gave Ethiopian banks to recover their claim from a non-paying debtor is a foreclosure sale. [92] Hence, when an agreement to this effect is made between the debtor and the creditor bank, the law authorizes Ethiopian banks to foreclose on the collateral property and transfer ownership to the buyer in the event that the debtor fails to pay its debt in accordance with the terms of the loan contract. The acquisition of the collateral as a means of satisfying the debt, which is also the major focus of this thesis, is the second enforcement mechanism the law provided to Ethiopian banks to recover their claim.

Property Mortgaged or Pledged with Banks (Amendment) Proclamation No. 216/2000 authorizes the creditor banks to take over the property at the floor price set for the first auction and have the ownership of the property transferred to them if no bidder shows up at the second auction. Thus, acquisition after the second auction is a right given to the banks, and it is not compulsory. In other words, if no bidder shows up at the second auction, the creditor bank is not obliged to acquire the collateral property immediately; instead, depending on its internal procedures, it can hold another auction or acquire it by using the legal option or right provided by the law. In general, what needs to be noted is that acquiring collateral as a payment of debt is a right provided to Ethiopian banks in the event the debtor fails to pay its debt.

3.1.2. The Acquisition Process in Banks

Commercial banks are supposed to establish internal procedures that set out guidelines for how they should obtain collateral and maintain that collateral once they have it. Accordingly, the acquisition process is discussed below with reference to the internal procedures and manuals of the five selected banks.

I. The Legal Service Procedure of WB under Article 44 provides that where a property fails to be sold at the second auction, the bank shall acquire it and requires the case to be transferred from the Legal Service Directorate, which conducts the auction, to the Material Resources and Facilities Management Directorate in order to enable the latter to manage the acquisition

[92] Property mortgage or pledged with banks proclamation (n 4)

process and to administer the acquired property.[93] Accordingly, once acquisition decision is made by the foreclosure committee and the decision gets the approval of CEO of the bank, Article 4.10.1 of the Material Resource and Facilities Management procedure requires the Procurement and Property Administration Unit of the bank to collect documents that are essential for the acquisition process, which includes the loan contract, title deeds, security contracts evidencing registration of the collateral, property estimation forms, approvals in which acquisition decisions are made, minutes of each auction conducted to sell the properties, and other relevant documents.[94] Additionally, the procedure requires the unit to maintain a register book for acquired properties on the date of taking over and to ensure relevant ownership documents are possessed by the bank.[95] Apart from stating that land fees, municipality fees, and other obligations to the government in relation to the property shall be settled as long as the property acquired remains under the acquisition of the bank,[96] the procedure nowhere mentions the transfer of ownership of the acquired property from the mortgagor to the acquiring bank during acquisition.

II. The Foreclosure Implementation Procedure Manual of AB states that, after a two-time auction, the foreclosure committee may decide whether the acquisition of property is beneficial to the bank or if there are other options.[97] Accordingly, if the committee recommends the acquisition, then it will submit its recommendation to the CEO of the bank for approval, and if the recommendations get approval, the case will be transferred to the Buildings and Acquired Properties Administration Division of the bank so that it can handle the acquisition process.[98] Upon acquisition, the division is required to maintain an up-to-date record of all acquired properties showing the type of property, name of borrower or the mortgagor, ownership title, acquisition date, and acquisition value.[99] With regard to the transfer of ownership from the owner to the bank during acquisition, the Fixed Assets and

[93] Legal Service Procedure(Revised) of Wegagen Bank S.C, (2022) article 44 (i), (ii

[94] Material Resource and Facilities Management Procedure of Wegagen Bank S.C.(2015) article 4.10.1

[95] Ibid, article 4.10.2 (ii)

[96] Ibid, article 4.10.3 (xiii)

[97] Foreclosure Implementation Procedure Manual of Awash Bank S.C. (2021) article 3.3.15

[98] Ibid, article 3.3.16 and 3.3.17

[99] Fixed Assets and Material Management Procedure Manual of Awash bank S.C. (2021) article 4.1.4

Material Management Procedure Manual of the bank provides that every effort should be made to sale the acquired properties before changing the ownership title from the mortgagor to the bank, and the only situation where ownership could be transferred is where the bank wants the acquired property for its own use. [100] In such a case, the manual requires the title of the property to be transferred to the bank and the property to be transferred from the acquired property category into the fixed assets category.[101]

III. The Legal Service Procedure of DGB under Article 72 provides that where no bidders show up or an adequate number of bidders fail to appear at the second auction and the Legal Service Department believes that acquisition of the property is in the best interest of the bank, it refers the case to the CEO for approval.[102] Where the CEO approves the acquisition of the property, the case, together with the relevant documents, such as the title deed, copy of the collateral registration confirmation letter or document, minutes of the auction, etc., will be forwarded to the Property Administration and Facility Management department of the bank to enable the department to handle and administer the acquired property.[103] The Legal Service procedure further states that the physical possession of the acquired property shall be affected within a month from the date of the approval of acquisition by the foreclosure committee. [104] Except for stating that the bank will take physical possession of the acquired property, the procedure says nothing about the transfer of ownership title to the bank where the bank acquires the property. However, The Acquired Asset Administration Manual of the bank, which contains detailed guidelines about the administration of properties acquired by the bank, clearly states that after the property is acquired, it must be disposed of by way of auction sale without transferring the ownership title into the bank's name, as this helps the bank avoid the transfer cost, including taxes. [105] It further states that, if keeping acquired properties without transferring ownership does not entail any risk, the transfer of ownership title to the bank shall

[100] Ibid, article 3.16

[101] Ibid, article 3.15

[102] Legal Service Procedure (Revised) of Debub Global Bank S.C. (2023) article 72

[103] Ibid, article 72 (2), (3), and (4)

[104] Ibid, article 72 (6)

[105] Acquired Asset Administration Manual (Revised) of Debub Global Bank S.C. (2023) article 2.3

not take place until the bank disposes of the property.[106] The only situation where the manual implicates the transfer of a title deed to the bank is whenever the need arises to transfer an acquired property for the bank's use. [107]

IV. The Foreclosure Right Implementation Manual of NIB under Article 8 provides that where a property fails to be sold at the second auction, the Legal Service Directorate, which conducted the auction, shall propose to the CEO of the bank in order to acquire the property, and if the president approves the proposal, the case will be transferred to the Facilities and Property Administration Directorate of the bank in order to enable the directorate to handle the acquisition process.[108] Here, except mentioning the transfer of the case and the loan balance of the borrower to be credited to the extent of the floor estimation price of the property on the date of acquisition,[109] the procedure says nothing about the transfer of ownership of the acquired property into the name of the bank during acquisition. Similarly, if the property acquired is an immovable property, the Disposal of Acquired Property Manual of the bank requires the Facilities and Property Administration Directorate of the bank to ensure that the bank takes the physical possession and the document of the legal title of the property.[110] The manual nowhere mentions about transferring the ownership of the acquired property into the name of the bank except where the "Disposal Committee" of the bank decides the acquired property to be a fixed asset of the bank, and this decision of the committee is authorized by the CEO of the bank.[111]

V. The Legal and Loan Recovery Procedure of CBE under article 57 reads that where no bidder appears at least on the second auction and the bank needs to acquire the property, it requires the attorney of the bank that conducted the auction to forward the case with relevant documents to the lending branch or acquired asset administration and to facilitate the handing over of the acquired property.[112] The procedure further requires the physical possession of the

[106] Ibid

[107] Ibid, article 5.2(b)

[108] Foreclosure right implementation procedure of Nib International Bank S.C. (2012) article 7 (1)

[109] Ibid, article 8(2)

[110] Acquired Property Disposal Manual of Nib International Bank S.C. (2008 E.C.) article 2.1

[111] Ibid, article 15 (1), (2) and (3)

[112] Legal and Loan Recovery Procedure of Commercial Bank of Ethiopia (2014) article 57(1) and (3)

acquired property to be effected within a month from the date of the second auction, and the loan balance of the borrower to be credited to the extent of the floor estimation price of the property on the date of possession.[113] Furthermore, the Acquired Asset Administration Procedure of the bank under Article 3.2 (iii) states that the acquisition process shall be finalized by the taking over of a property of the defaulter and the transfer of ownership certificate to the bank.[114] In addition, article 3.3 of the procedure clearly places the transfer of ownership in the name of the bank during acquisition as a mandatory requirement that should take place immediately upon acquisition.[115] In order to facilitate the transfer of ownership, the procedure requires the bank to notify the municipality, land administration, or concerned city about the acquisition of the property by the bank and the bank's willingness to pay CGT and other taxes related to the transfer if there is an extra amount after the settlement of the loan.[116]

Overall, as stated above, with the exception of CBE, the procedures and manuals of the four banks mentioned above show that during acquisition, none of them require the banks to transfer the legal title of the acquired property unless the banks need the property for their own use. But the procedure of the CBE makes it mandatory to transfer ownership of acquired property into the name of the bank.

3.1.3. Resale of Acquired Property by Banks

Banks want their acquired properties to be sold as soon as possible since they acquire the property not because they want to acquire it but rather due to legal requirements in the event that no buyer shows up at the second auction. But sometimes it takes long time to resale the acquired property. So, apart from the cost of administration and maintenance, banks want to sale the acquired property so that they will not face a liquidity problem. As a result, each of the five banks mentioned above have internal committee called "Acquired Property Disposal Committee or Panel" that is in charge of selling or disposing of acquired properties. The composition and number of members of the committee vary depending on the internal procedures of the respective bank. The process of reselling the acquired property with reference to the procedures and manuals of the five banks is summarized here.

[113] Ibid, article 57 (5) and (6)

[114] Acquired Asset Administration Procedure of Commercial Bank of Ethiopia (2019) article 3.2 (iii)

[115] Ibid, article 3.3

[116] Ibid, article 3.3(a), (b)

I. The Material Resource and Facilities Management Procedure of WB, requires the management of the bank to form a "disposal panel" accountable to the CEO to dispose of acquired properties by way of sale, donation, etc. [117] The panel is authorized to dispose of acquired property by sale if the amount is within its limit; otherwise, it is required to present the sale proposal with an estimated cost and book value to the CEO for approval. [118] During the sale of the acquired property, the panel shall apply the relevant bid procedure stated in the bid purchase, and after the property is sold through a bid, the title deed transfer and handover of the property will take place.[119] However, if the property is unable to be disposed of either through a bid or negotiated sale or when retaining the property is believed to be more economical than disposing of it, the procedure provides for the bank to own the property after getting the approval of the CEO,[120] and it requires the Procurement and Property Administration department of the bank to transfer ownership into the name of the bank.[121] Additionally, nowhere in the procedure is it stated that ownership or legal title will be transferred directly from the bank to the buyer during a resale or disposal of the property.

II. The Fixed Assets and Material Management Procedure Manual of AB provides that the sale of acquired property will be handled by the "Acquired Property Disposal Committee" of the bank.[122] The committee shall dispose of the acquired properties through auction, negotiation, or other means. The procedure requires the acquired property to be auctioned at least three times before considering selling it through negotiation. The committee's deliberations are recorded in a minute and submitted to the office of the CEO.[123] Where the property is sold, the procedure states that a sale agreement will be signed between the buyer and the bank, and the property administration division of the bank will write a letter to the concerned government

[117] Material Resource and Facilities Management Procedure (n 95), article 4.10.4

[118] Ibid, article 4.10.4 (ii) f

[119] Ibid, article 4.10.4 (ii) g, and i

[120] Ibid, article 4.10.4 (iv)

[121] Ibid, article 4.10.4 (iv) c

[122] Fixed Assets and Material Management Procedure Manual of Awash Bank S.C (n 100) article 4.4.1

[123] Ibid, article 3.2,3.3, 3.4 and 3.6

office to transfer ownership title to the buyer. [124] However, the procedure says nothing about whether the bank will transfer the legal title of the acquired property directly from the name of the bank to the buyer upon resale.

III. The Acquired Asset Administration Manual of DGB S.C. clearly requires the disposal of acquired properties in the shortest possible time through the concerted efforts of all concerned organs, prudently and efficiently.[125] The manual provides that the property can be disposed through sale, transfer for own use, giving away, or discarding, as the case may be.[126] Consequently, once the property is acquired, the manual requires the sale by auction of the acquired property as soon as possible, unless the bank needs it. In addition, the manual clearly requires the sale by auction of the property acquired before transferring ownership to the bank.

IV. The Acquired Property Disposal Manual of NIB provides that, unless there is a sufficient reason to do so, the bank should dispose of the property it acquired through an auction sale [127], and the "Disposal Committee" of the bank is the one in charge of conducting the auction. Apart from sale through auction, the manual provides various methods of disposing of the acquired property, which include sale through negotiation and sale by extending a loan to the buyer. Where the property is sold through auction, the manual clearly requires the legal title and physical possession of the property to be transferred to the winner (buyer).[128] However, the manual says nothing about the overall process of how the legal title to the property will be transferred or whether it will be transferred from the name of the bank (the seller) to the buyer.

V. The Acquired Asset Administration Procedure of the CBE provides that the bank may dispose of the property it acquired through sale, transfer for its own use, donation, discarding, selling at scrap, etc.[129] According to the procedure, the sale can take place either through auction, negotiation, or partial financing by the bank. Where the bank sells the acquired property, the

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[124] Ibid, article 5.2.1.10

[125] Acquired Asset Administration Manual of Debub Global Bank S.C. (n 106), article 1.2 (b)i

[126] Ibid, article 1.2(c)

[127] Acquired Property Disposal Manual of Nib International Bank S.C (n 111) article 5

[128] Ibid, article 11

[129] Acquired Asset Administration Procedure of Commercial Bank of Ethiopia, (n 115)

procedure requires the bank to conclude a sales contract with the buyer and to effect the transfer of title deed or ownership title in the name of the buyer upon full payment of the sale price by the latter.[130]

Generally, the resale process and its requirements of the banks cited above are almost similar, with the exception of CBE, which clearly requires the bank to transfer ownership of the property from the name of the bank to the buyer during the resale of the property.

3.2. CGT during the acquisition of immovable collateral and the resale of the acquired property by banks

3.2.1. Legal obligation to pay CGT

As covered in detail in Chapter two, the Federal Income Tax Proclamation No. 979/2016 requires anyone who makes a gain on the disposal of immovable property to pay income tax on that gain. However, this requirement only applies if the gain exceeds the cost of disposing of the property. The Proclamation states that a person disposes of an asset when they sell, exchange, or otherwise transfer the legal ownership of it. This means the law requires the transferee to pay CGT when a person transfers the legal title of an immovable property through a sale or exchange and the transfer generates a gain for the transferee.

When it comes to the issue of CGT during the acquisition of immovable collateral by banks, as provided by Proclamation No. 216/2000, where the borrower defaults on paying the debt and the creditor banks acquire the immovable collateral after the second auction, this same proclamation requires the ownership of the property to be transferred to the bank. Similarly, with regard to the acquisition of an asset for tax purposes, article 66 of Proclamation No. 979/2016 provides that a person acquires an asset when legal title to the asset passes to them. So, during the acquisition of immovable collateral, a legal title to the property should be transferred from the owner to the acquiring bank, and if the transfer results in some kind of gain to the transferee/owner/, then the latter should pay CGT on the amount of the gain. Concerning CGT during the resale of the acquired property by the acquiring banks, the same rule applies. Once the creditor banks acquire the collateral and transfer ownership title into their name as provided by law, if they later resale the acquired

[130] Ibid, article 5.2.3 (m), (n), (o)

property and obtain a gain on the sale or transfer, they have the legal obligation to pay CGT on the amount of the gain.

In general, during acquisition where the transfer of a legal title from the mortgagor to the creditor bank results in a gain, the former is obliged to pay CGT on the amount of the gain. Similarly, after acquiring the property, if the bank resale it and obtain a gain from the sale then the bank has a legal obligation to pay CGT on the amount gained from the sale.

3.2.2. The Practice of Banks concerning CGT during acquisition of immovable collateral and resale of the acquired property

As discussed above, in order to say the bank has acquired the property during acquisition, the law requires the transfer of the legal title to the property to take place. However, during the interview conducted with the five banks, the researcher finds out that the banks' practices are different from what the law says. Accordingly, NIB[131], DGB[132], AB[133], WB[134], and CBE [135] all do not transfer the legal title of the acquired property into their names during acquisition unless they need the property for their own use or are unable to dispose of the property by all methods. When we see the number of immovable properties each bank has acquired during the last two years (2014 and 2015 E.C.), NIB has acquired 26 properties in the last two years and sold eight acquired properties.[136] Similarly, DGB[137], AB[138], WB[139], and CBE[140] have acquired 5, 12, 9, and 27 collaterals in the last two years and sold 1, 7, 5, and 15, respectively.

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[131] Interview with Genet Eyasu, Rent and Acquired Asset Administration Division Manager at Nib International Bank S.C., 18 April 2023

[132] Interview with Aselefech Birhanu, Property and Facility Administration Manager at Debub Global Bank S.C., 19 April 2023

[133] Interview with Tegegne Abera, Building and Acquired Property Administration Division Manager at Awash Bank S.C., 25 April 2023

[134] Interview with Adera Gebre, Property Officer I at Wegagen Bank S.C., 9 May 2023

[135] Interview with Abiy G/kiristos, Acquired Property Administration Manager at Commercial Bank of Ethiopia, 9 May 2023

[136] Interview with Kibru Amare, Acquired Property Principal Officer at Nib International Bank S.C., 18 April 2023

[137] Interview with Aselefech Birhanu, (n 133)

[138] Interview with Tegegne Abera, (n 134)

The table below shows a summary of the interview result. ("X" stands for "No" and "✓ " for "Yes".

Table I

Name of the Bank	No. of Acquired Property in 2014 and 2015 E.C.	No. of properties sold after acquisition	Banks that transfer legal title during acquisition (transfer to the name of the bank)	Payment of CGT during acquisition	Bank that pays CGT during the resale of the acquired property
NIB	26	8	x	x	x
DGB	5	1	x	x	x
AB	12	7	x	x	x
WB	9	5	x	x	x
CBE	27	15	x	x	x

When we see the above summary regarding the practice of each of the five banks regarding how they treat CGT during the acquisition of immovable collateral and the resale of the acquired property, all five banks have admitted that CGT is not paid both during the acquisition and resale of the acquired property. This is because, first, since the ownership of the acquired property did not pass to the bank during acquisition, the CGT that should have been paid had the ownership title been transferred to the bank remain unpaid. Second, as the legal title of the acquired property remains in the name of the mortgagor, when the banks sell the acquired property later on, they misrepresent the resale as a foreclosure sale conducted as per Proclamation No. 97/98, so that the concerned government authority cannot request them to pay CGT. Here, concerning the CBE, as discussed earlier above, even though the procedure of the bank clearly requires the bank to transfer ownership of the acquired property and ensure the payment of CGT, during the interview the researcher was able to find out that practically the bank does not implement the procedure and does not transfer ownership of the acquired property unless the bank needs the property for its own use.[141] As a result, by eluding the

[139] Interview with Adera Gebre, (n 135)

[140] Interview with Abiy G/kirstos, (n 136)

[141] Interview with Abiy G/kiristos, (n 136)

transfer of ownership during the acquisition of the collateral, the mortgagor and the acquiring banks avoid paying CGT during the acquisition and resale of the acquired property as well.

Generally, even if the property is said to be acquired by the banks, as shown in the above table, the legal title to the property continues in the name of the mortgagor until the banks sell it later. Thus, legally speaking, we cannot say that the banks have acquired the property. And, the failure by the five banks to transfer the legal title of the collateral during acquisition results in the non-payment of CGT during acquisition and resale of the acquired property as well. Hence, the practice of the five banks reveals that CGT is not paid both during the acquisition of immovable collateral and the resale of the acquired property by the banks.

The researcher visited the land development management offices in Addis Ketema Sub-city and Gulele Sub-city in the Addis Ababa City Administration to gain an insight into whether these government offices, which are responsible for ensuring the payment of CGT during the transfer of ownership, are aware of what the banks are actually doing to avoid paying the tax in relation to their acquired property. Hence, the practice in Addis Ketema Sub-city and Gulele Sub-city land development management offices shows that when banks ask them to transfer ownership of the property they sold to a buyer, except for accepting and verifying the letter written from the banks to the office stating that the property is sold as per Proclamation No. 97/98 in order to offset the payment of the defaulted debtor, requiring the office to cooperate and transfer ownership and apart from verifying the payment of 6% transfer tax by the buyer, the offices do not require documents to be produced that can evidence the payment of CGT by the bank's (seller), and they do not make any further examination in relation to the property the banks are selling.[142]

This practice of the land administration offices might be the result of the loopholes in the Ababa City Land Tenure Service Provision Directive No. 12/2004 E.C. Article 21 of the directive, captioned "Transfer of Ownership of Properties Foreclosed and Acquired by the Banks," lists certain documents that need to be produced in order to transfer ownership of the properties foreclosed by the banks, which are the bid document, award letter, a letter written from the bank, and an agreement.[143]

[142] Interview with Degol Belay, title deed preparation and technical verification officer at Addis Ketema Sub-city Land Development Management Office, 19 May 2023 - Yohanis Wondimu, contract documents verification officer at Gulele Sub-city Land Development Management Office, 19 May 2023

[143] Ababa City Land Tenure Service Provision Directive No. 12/2004 E.C., article 21 (1), (2), (3)

Additionally, when they foreclose on a property, the directive under article 30.3.2 requires the banks to pay CGT only when there is money left over after paying off their debts.[144] The combined reading of these two provisions of the directive conveys the wrong message that when banks foreclose on or sell acquired property, they are required to provide the three documents listed above and are only compelled to pay CGT when there is money left over after paying off their debt. So, this confusion caused by the directive might be the reason why the land administration offices in Addis Ababa city are treating every sale of property by the banks as a foreclosure sale and are not asking the banks to produce additional documents, such as proof of CGT payment, because they believe that the directive exempted the banks from paying CGT as the banks typically did not declare the existence of any money remaining after paying their debt.

There are, however, a few exceptional circumstances when the tax authority discovered the banks' acquisition of the property and required them to pay CGT when they sold it and went to transfer ownership to the buyer. For instance, in a case involving Wegagen Bank S.C. and the Gonder city tax administration office, the bank sold a property it had acquired (but had not yet transferred the legal title to the bank) to Barkuma Doka Trading PLC (the buyer) in 2013 E.C. The buyer then went to the city's land administration office to transfer ownership of the property, claiming it had purchased the property from the bank. The land administration office then asked the buyer to produce a document that could show the payment of CGT by the seller, which is the bank. Hence, the buyer sent a letter to the bank, enclosed with the tax office's assessment, and requested that the bank pay CGT in order for ownership to be transferred to the buyer.[145] In the midst of this, the bank intervened and sent a letter to the Gonder City Tax Administration office explaining that because the property was sold in a foreclosure sale, wherein Directive No. 8/2011 requires CGT be paid only if there is any money left after paying the bank's debt, and because there is currently no money left over after paying the borrower's debt, the bank is not expected to pay CGT.[146] The tax office has not yet responded to the bank's letter.

Additionally, the non-compliance by the banks with their legal obligations to transfer ownership and pay CGT during acquisition occasionally ends in a dispute with the tax authority when the authority

[144] Ibid, article 30.3.2

[145] Letter written by Barkuma doka Trading PLC, Ref. No. BDT/0141/2022, 07/11/2014 E.C.

[146] Letter written by Legal Service Directorate of Wegagen bank S.C., 20/11/2014 E.C.

asks them to pay the tax and the banks either refuse or ask for the amount to be reduced. For instance, in a case between Awash Bank and the Bishoftu city tax administration office, the bank acquired a warehouse in Bishoftu city in 2012 E.C. but did not transfer ownership to the bank. However, after holding it for three years because it was unable to find a buyer, the bank decided to transfer the legal ownership of the property and started the transfer process in 2015. During this process, the bank was asked to pay CGT based on the property's current market value, which the city's tax administration office estimates to be 44,470,824 birr.[147] However, the bank objected to the tax assessment, claiming that it was excessive because it had acquired the property in 2012 for 12,500,000.00 birr (the floor price at the first auction). The bank then filed a complaint with the tax authority, requesting that the assessment be based on the property's value at the time of acquisition.[148] Currently, the issue is pending the decision of the tax authority.

The above instances are proof that practical problems exist regarding the payment of CGT and VAT in relation to the acquisition and resale of the acquired property by the banks.

3.3. VAT during the acquisition of immovable collateral and the resale of the acquired property by banks

3.3.1. Legal obligation to pay VAT

According to VAT Proclamation No. 285/2002, an activity that involves the supply of goods or services to another person for consideration is a taxable activity that attracts VAT. As the supply of goods is the main subject of the proclamation and goods are defined to include immovable property, the sale or transfer of immovable property, i.e., commercial buildings, is the subject of VAT under the proclamation. As discussed under Chapter two, only commercial buildings are subject to VAT since the sale or transfer of residential buildings is exempt from VAT.

Regarding the situation where creditor banks acquire immovable collateral, the transaction shall be viewed as a supply of goods by the mortgagor to the creditor banks (acquiring banks), which is a taxable activity under the terms of the VAT proclamation and subject to VAT. In other words, the transfer of the immovable collateral is a supply of goods by the debtor to the creditor banks, and the amount by which the property is used to offset the borrower's debt can be considered the consideration received by the debtor from this particular transaction. So, where the creditor banks

[147] Letter written by Bishofu City Tax Administration Office, Ref. No. lakk/WGBMB/4394/2015, 25/02/2015 E.C.

[148] Letter written by Awash bank S.C., Ref. No. AB/BAP/135/15, 2/09/2015 E.C.

acquire the immovable collateral, i.e., a commercial building, as payment for the debt of the defaulted borrower, the transfer falls within the meaning of a taxable transaction under the VAT Proclamation, which obliges the supplier (mortgagor) to add VAT to the property's price at the time of the banks' acquisition. In fact, since the creditor banks are in charge of the auction and acquisition processes, they have a duty to assist the supplier (mortgagor) in collecting the VAT during acquisition.

The same is true when banks eventually resale the property they have acquired. As the banks are typically expected to transfer the legal title or ownership of the acquired property and become the legal owner, they are legally required to apply VAT to the sale price and pass the collected amount to the tax authority when they sale the acquired property later on. Because, since banks are commercial organizations and VAT registered for their non-financial services, they are compelled by law to add VAT to the sale price when they sale their property including the property they have acquired.

3.3.2. The practice of banks concerning the treatment of VAT during the acquisition of immovable collateral and the resale of the acquired property

The issue of the treatment of VAT during the acquisition of immovable collateral and the resale of the acquired property by the banks is similar to and an extension of the issue of CGT, with only a little difference. During the acquisition of immovable collateral by the five banks, since the transfer of ownership does not take place between the mortgagor and the banks and there is no actual transaction that could attract VAT, the issue of VAT is never mentioned at all. During an interview, all five banks confirmed that they did not pay VAT during the acquisition of collateral, even where the property they acquired is a commercial building, and this is because, as mentioned earlier, the acquisition stage is not disclosed as a transaction to the concerned government authority. However, during the interview, the banks informed me that they collect VAT from the buyers when they sell the property they acquired if the collateral is a commercial building.

The table below shows the summary of the interview result. (“X” stands for “No” and “✓ ” for “Yes”.

Table II

Name of the Bank	No. of Acquired Property in 2014 and 2015 E.C.	No. of property sold after acquisition	Banks that transfer legal title during acquisition (transfer to the name of the bank)	Banks that pay VAT during acquisitions	Banks that collect VAT during the resale of the acquired property
NIB	26	8	x	x	✓
DGB	5	1	x	x	✓
AB	12	7	x	x	✓
WB	9	5	x	x	✓
CBE	27	15	x	x	✓

Generally, even if the law requires the banks to pay VAT during the acquisition of collateral, since the acquisition stage is not registered or reported as a transaction to the concerned government authority, the banks escape paying VAT, thereby causing the tax to remain uncollected. However, during an interview, all five banks— NIB[149], DGB[150], AB[151], WB[152], and CBE[153] — informed me that when the banks later sell the acquired property, they collect VAT from the buyers if the acquired property is a commercial building. This is because, first, even if the banks say they acquired the property, since the title deed remains in the name of the mortgagor, it is the status of the mortgagor (as a provider of the good) that will be taken into consideration when adding VAT to the sale price. Second, since the banks portray the resale after acquisition as a foreclosure sale, in which case they are considered agents of the mortgagor, it is still the status of the mortgagor that will be referred to for VAT purposes. In fact, once the banks acquire the property, it is the status of the banks (whether they are VAT registered or whether they are commercial entities) that matters when adding VAT to the sale price, as after acquisition, the property actually belongs to the banks. Yet, since the banks do

[149] Interview with Kibru Amare (n 137)

[150] Interview with Aselefech Birhanu (n 133)

[151] Interview with Tegegne Abera (n 134)

[152] Interview with Adera Gebre, (n 135)

[153] Interview with Abiye G/kirstos, (n 136)

not transfer ownership during acquisition and the legal title remains in the name of the mortgagor, when the banks later sell the property they acquired, VAT is collected from the buyers only where the mortgagor is subject to VAT or the property is a commercial building. However, if reference is made to the status of the acquiring banks for VAT purposes, since banks are commercial entities and VAT registered for their non-financial services, VAT might be collected every time the banks resale the property they acquired.

Generally, all five banks mentioned above did not pay VAT during the acquisition of collateral, but when they resale the property they acquired, they collect VAT from the buyers only if the mortgagor is VAT registered or the property is a commercial building.

CHAPTER FOUR

Conclusion and Recommendation

4.1. Conclusion

Banks are the primary sources of funding for investments in Ethiopia. The banks receive funds from the general public in various manners approved by the law and utilize the money to make loans and investments. While providing loans, in order to manage or avoid the potential risks that could arise as a result of defaulting borrowers and to ensure the repayment of their loan, banks require their borrowers to provide collateral, both movable and immovable, as a security.

In the event of a default by the borrower, the property mortgaged or pledged with Banks Proclamation No. 97/1998 authorizes the creditor bank to sell the collateral at auction after giving the debtor a notice of at least 30 days. However, if no buyer shows up at the second auction, Proclamation No. 216/2000 further permits the creditor bank to take over the property at the floor price set for the first auction and have the ownership of the property transferred to it. Here, where the bank acquires the collateral and transfers the legal title of the property as a payment for debt, the issues of CGT and VAT arise.

Gains from the sale of capital assets, including shares, bonds, and buildings, are subject to CGT, and the tax is imposed upon the realization of a capital asset, i.e., when the asset is transferred by way of sale, exchange, or other methods and mostly for consideration. Capital gain is the difference between the money received from selling the asset and the costs incurred for the capital asset. Since a gain materializes when someone sells or transfers a capital asset for more money than they originally paid for it, the gain from the sale or transfer must be taxed in the year the capital asset is transferred. Accordingly, the Federal Income Tax Proclamation No. 979/2016 requires a person who derives a gain on the disposal of immovable property, a share, or a bond to pay an income tax. The Proclamation imposes a 15% tax rate on the disposal of an immovable asset and a 30% tax on shares and bonds. Accordingly, a person who disposes of or transfers a legal title to an immovable property and obtains a gain from the transfer is required to pay 15% CGT under the Federal income tax proclamation.

In view of that, when it comes to the acquisition of immovable collateral by the creditor banks, even though the transfer is done in order to set off the debt of the borrower, since the ownership of the property transfers from the mortgagor to the acquiring bank, the transaction attracts CGT, and the transferor (owner) is required to pay CGT if there is a gain obtained by the latter. Similarly, where the acquiring bank resales the acquired property later on, if the bank obtains a gain, it is required to pay CGT.

Coming to VAT, it is an indirect tax levied on the value added by producers, suppliers, and service providers at each point in a supply chain, and it arises whenever a taxable person makes a supply of goods or services in the course of business operations. VAT is a consumption tax, i.e., the financial burden of the tax falls in principle on the final consumer. The VAT Proclamation No. 285/2002 of Ethiopia provides that an activity that is carried on in Ethiopia, or partly in Ethiopia, that involves or is intended to involve, in whole or in part, the supply of goods or services to another person for consideration, whether or not for a pecuniary profit, is a taxable activity, and the supply of goods under the proclamation includes the sale or transfer of immovable property. Thus, in principle, the supply or transfer of goods, including immovable property, particularly a building, by a registered person is subject to VAT under Ethiopian law. As a result, a registered person who transfers the ownership of a commercial building to the creditor bank as a payment of debt, or a bank who transfers or sells a property it acquires as its owner, is required to add VAT to the sale or transfer price and remit the same to the tax authority. Thus, during the acquisition of collateral by the creditor bank, if the mortgagor is VAT registered or the property is a commercial building, it should add VAT to the transfer price, and similarly, when the acquiring bank sells the acquired property, it should add VAT to the sale price.

However, the practice of the five banks addressed in the thesis is different from what the law says. First, during the acquisition of collateral, the banks do not transfer the legal title of the property into their name, and due to this, the CGT that should have been paid had the ownership title been transferred to the banks remains unpaid. Second, after acquisition, since the legal title of the property continues in the name of the mortgagor, when the banks resale the acquired property later on, they misrepresent the resale as a foreclosure sale conducted on behalf of the mortgagor as per Proclamation No. 97/98, in which case the mortgagor is only liable to pay CGT if there is any amount left after covering the bank's debt, and by doing so, the banks escape paying CGT during the sale of the property they acquired. Similarly, concerning VAT during acquisition, since no transaction (no

transfer of ownership) takes place during the acquisition of collateral by the banks, the VAT that would have been paid had a transfer of ownership of the collateral taken place between the mortgagor and the banks was left unpaid. However, during the resale of the acquired property by the banks, even if the banks are the real owners of the acquired property, since the legal title of the property remains in the name of the mortgagor, the banks collect VAT from the buyers only when the mortgagor owner is the subject of VAT or the acquired property is a commercial building. This practice of the banks paves the way for both the mortgagor and the acquiring banks to escape paying CGT and VAT during the acquisition and resale of the acquired property, which makes the government lose a large amount of tax.

4.2. Recommendations

In order to alleviate the practical problems concerning the payment of CGT and VAT during the acquisition and resale of the acquired property by the banks, the following are suggested:

- Since the exemption of payment of CGT in relation to properties sold as a result of bank debts provided under Directive No. 8/2011 E.C. is not appropriate, it is suggested that the directive be amended and the exemption in relation to the sale of the bank debt be cancelled. It is not fair to justify the non-payment of CGT by the collateral owner for the only reason that he or she is transferring the property as a payment of debt, while others who transfer their property in another situation, like sale, are required to pay CGT, and as this causes discrimination among tax payers. In addition, since the income tax proclamation does not clearly provide for exemptions in relation to CGT to be enacted by directives, it is not appropriate to put such kind of discriminatory exemption by directive. Further, as the banks are depicting the resale after acquisition as a foreclosure sale, thereby misusing Directive No. 8/2011 E.C. in order to escape paying CGT, the amendment of the directive in the way suggested above would help avoid the loophole within the law that the banks are currently using in order to avoid the payment of CGT.
- The banks are suggested to transfer the ownership of the property they acquired into the name of the bank, and this, apart from enabling the banks to fulfill their legal obligation of paying tax, could also serve the interests of the banks as well. Because if the banks did not transfer a legal title to the property during acquisition, they are not even considered the lawful owners of

the property before the eyes of the law. In addition, if the legal title to the property continues in the name of the mortgagor, different claims could be brought against the banks, either by the mortgagor or by third parties who have lawful claims against the mortgagor.

- Establishing a mechanism that helps the tax offices know the detailed list of the properties acquired by the banks would help the former identify and collect the necessary tax from the banks and the owner of the property on the transfer event. And this can be done by requiring the banks to report the list of properties they have acquired to the concerned government office.

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- Interview with Tegegne Abera, Building and Acquired Property Administration Division Manager at Awash Bank S.C., April 25, 2023.
- Interview with Adera Gebre, Property Officer I at Wegagen Bank S.C., May 9, 2023.
- Interview with Abiy G/kiristos, Acquired Property Administration Manager at Commercial Bank of Ethiopia, May 9, 2023.
- Interview with Kibru Amare, Acquired Property Principal Officer at Nib International Bank S.C., April 18,2023.

VIII. Interview Questions

- How do banks acquire properties held as collateral for loans that have defaulted? What does this process look like?
- When you put the property up for auction, do you estimate the property again? Could there be a difference between the auction estimation value and the initial estimation value? Is it possible for the floor price to be higher than the overall debt required from the debtor?
- When a bank acquires a property at the floor price, is it possible for this price to be higher than the overall debt? And in the cases in which this happens, if any, is the extra money given back to the mortgagor?

- Does the bank transfer ownership title to the property it acquires after the second auction? And how exactly is the transfer of ownership processed?
- Are the taxes related to the transfer of ownership, like CGT and VAT, paid during acquisition? Did the bank verify if such taxes were paid?
- What does the bank do with the acquired properties, and how are the properties administered?
- How does the bank later transfer title to third parties when it resells the acquired property if ownership was not transferred to the bank at the time of acquisition?
- When it resells the acquired property, does the bank truly pay CGT and collect VAT from the buyers?
- Is it accurate to say that the bank owns the property after it acquires it following the second auction but before the title is transferred?
- Do you think the bank should check to see whether any taxes need to be paid to the government throughout the acquisition and resale of the acquired property?
- Do you have any knowledge about the acquisition of collateral property by the banks in cases when the debtor defaults?
- Do you confirm if a property is an acquired property or the debtor's property when the banks request you to transfer ownership of the property they sold to the buyer? If the banks own it, do you investigate how they came to own it?
- Before transferring ownership to the buyer, do you require the banks to deliver all relevant documents related to the property they sold?
- Is there a way to identify the specifics of the properties sold by banks, including those that they have acquired?