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THE LAW OF CORPORATE TAXATION IN ETHIOPIA

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Abstract

The taxation of business organizations generally falls into two basic models-“Corporate” taxation and “Partnership” taxation. Corporate taxation typically imposes a tax on the income of certain types of business organizations and also taxes the profits distributed to the holders of the ownership interests. The partnership taxation model, on the other hand, taxes the income derived by the organization directly to the owners whether or not distributed. This Paper assesses the treatment of corporate taxation in the Ethiopian tax law and argues that the corporate tax issues are not properly addressed in a manner that attracts corporate business investment.

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Abbreviation

Art	article
Arts	articles
Bus.	Business
CIV.C	Civil Code
COM.C	Commercial Code
Corp.	Corporation
e.g.	example gratia= for example
EC	Ethiopian Calendar
ed	editor/edition
eds	editors/editions
et al	et alii= for example
Eth	Ethiop
FDRE	Federal Democratic Republic of Ethiopia
ff	and the following pages
HARV	Harvard
Id	idem = the same
Inc.	Incorporated
L.REV	Law Review
No	Number
P.	page
Plc	Private Limited Company
Pp	pages
PR	Peoples' Representative
Proc.	Proclamation
Prtg	Printing
S.V	Sub Verbo= under the word
UNCITRAL	United Nations Commission on International Trade
VAT	Value Added Tax
Vs.	Versus

Chapter 1: Introduction¹

1.A Background of the Problem

Ethiopia is an ancient² and the oldest continuously sovereign nation in the world³ with a recorded history of three thousand years.⁴ Similar is true with its tax system. Ethiopian tax system dates back to ancient times.⁵ In the Axumite Kingdom, for example, there was a practice of traditional taxation that was levied on crops, livestock and livestock products, hunting and on handcrafts.⁶ According to Bahru Zewde, Aksum was above all sustained by trade, both inland and maritime.⁷ From this statement, it will not be inappropriate to infer that the Axumite Kingdom's tax system included trade related taxes.

According to A.B. Levy, however, the ancient world did not recognize business associations with corporate personality.⁸ In other words, business life remained individualistic. In this regard, Ethiopia will not be unique. Accordingly, one can infer that the ancient Ethiopian taxes were of individual nature-devoid of corporate tax. The same was true with the Zagwe dynasty, which followed the Axumite Kingdom in the chronology of the Ethiopian History.⁹ In the Empire that followed the Zagwe dynasty that was built by Yekanno-Amlak and his successors Amda-Tseyon and Zar'a-Yaegob, there was again no significant change in the tax

¹ Note that in this paper, the format, style, and citation (that is, the text typeface, citation form, and all other aspects of cites in the body and footnotes) conform, as nearly as possible, to the citation rules of the 17th edition of The Blue Book: A, Uniform System of Citation. And the Bibliography follow the humanities style described in paragraphs 16.71-16.89 of The Chicago Manual of Style. The pattern of citation and bibliography is based on the American Association of Law Libraries Law Library Journal Author's Guide available online at <<http://heinonline.org/HOL/PDFsearchable?handle=heinjournals/eej100&collection=journals&id=614&print=3§ioncount=1&ext.pdf>> (accessed on FR Sep 4 06:00PM 2009). Also see generally THE BLUEBOOK: A UNIFORM SYSTEM OF CITATION (Columbia Law Review Ass'n et al. eds., 17th ed. 7th prtg. 2003) (A copy of this edition is available in the Ethiopian Civil Service College Law Library).

² See BEHARU ZEWEDE, A HISTORY OF MODERN ETHIOPIA: 1855-1991, 1 (2nd ed. Addis Ababa: Addis Ababa University Press, 2002).

³ See KINFÉ ABRAHAM, ETHIOPIA FROM EMPIRE TO FEDERALISM, Milestone of Ethiopian Civilization (2001).

⁴ Id. at 63.

⁵ See GEBRIE WORKU MENGESHA, TAX ACCOUNTING IN ETHIOPIAN CONTEXT, 4 (2nd ed. 2008).

⁶ Id.

⁷ See BAHURN, *supra* note 2, at 8.

⁸ See A.B. LEVY, PRIVATE CORPORATIONS AND THEIR CONTROL 7 (London: 1950).

⁹ The Aksumite Kingdom flourished from the first to the seventh century AD. From the middle of the seventh century, it entered into a process of decline. The rise of Islam and the subsequent disruption of the Red Sea trade sapped Aksum's source of life. Aksum was folded by the Zagwe Kingdom, which lasted from 1150 to 1270. See BAHRU, *supra* note 2, at 8.

structure-business life was still individualistic and so was the tax structure.¹⁰ In short, until 1905 business continued to be carried out by individuals. In 1905, the bank of Abyssinia was established with a starting capital of £ 100,000 the founding committee of which were three British members, three Italian members and one German member.¹¹ The shares were simultaneously offered in Addis Ababa, Cairo and a number of European capitals, as well as in New York.¹² From this, one can infer that corporate business began to play a role in the Ethiopian economy under Menilek II and continued to develop during the reign of His Imperial Majesty Haileselassie I.¹³ There was, for example, a law of companies of 1933. In addition, the Stamp Duty Proclamation of 1943 defined “banker” to include a person whether *incorporated* or not who carry on the business of banking.¹⁴ Moreover, the Personal and Business Tax Proclamation of 1944 defined a “business” to include *any company incorporated* or registered under any law in force in Ethiopia or elsewhere.¹⁵ The same is true with the subsequent proclamations, decrees and regulations on tax,¹⁶ i.e., the corporate entity was included in the definition parts of these laws.

Apart from including in the definition part, Decree No. 19/1956 provided a *separate tax rate for corporate* bodies. This decree provided 15% of the taxable income for *incorporated* bodies and separate rate for unincorporated ones. Proclamation Nos.173/1961, 255/1967, and 155/78 also pursued this pattern of separate tax rate for corporations, which were 16%, 20% and 50% of the taxable income respectively. Similar pattern continued until to date. The current Income Tax Proclamation, for example, provides for a 30% tax rate of the corporate taxable income.¹⁷

According to Robert R. Pennington, taxation of companies is a complex subject.¹⁸ This complex subject gets its birth with the origin of the corporate form of organization the traces of

¹⁰ See GEBRIE, *supra* note 5, at 4. It was, however, during Zer’a-Yaegob’s time that the first tax system introduced for those people engaged in livestock production. *Id.*

¹¹ See BEHARU, *supra* note 2, at 102.

¹² *Id.*

¹³ See GOLDBERG F EVERETT, *THE COMMERCIAL CODE OF ETHIOPIA: SELECTED TOPICS* 3 (1972).

¹⁴ See ART. 2 of PROCLAMATION NO. 41/1943.

¹⁵ See ART. 2 of PROCLAMATION NO. 60/1944.

¹⁶ See for example, PROCLAMATION NO. 107/1949; DECREE NO 17/1956; DECREE NO 19/1956, PROCLAMATION NO 205/1963 PROCLAMATION NO 23/1975, etc. All these included the corporate entity in their definition parts.

¹⁷ See ART. 15(a), 19(1) of the INCOME TAX PROCLAMATION, PROCLAMATION NO. 286/2002.

¹⁸ See PENNINGTON R ROBERT, *COMPANY LAW* 38 (London: Butterworth’s, 1990).

which according to A.B. Levy, goes far back to the Code of Hammurabi (2075-2025B.C.).¹⁹ As can be seen from the above paragraphs, this complex subject was introduced in the ancient and the oldest continuously sovereign nation Ethiopia in the twentieth century AD with the introduction of the corporate form of doing business. Today corporations (or companies) constitute, in addition to other categories, a category of taxpayers known by the common name “Body” and according to Prime Minister Meles Zenawi’s Tikemt 6, 2001E.C. statement to the House of Peoples Representative:

«ግብር የማይከፍለው ትልልቅ ግብር ከፋይ ነው። ከጠቅላላ የኢትዮጵያ ህዝብ ወደ 13 ሺህ የሚሆኑት ትልልቅ ግብር ከፋዮች ተገቢው እና ትክክለኛውን ግብር ቢከፍሉ የመንግስት የበጀት ጉድለት ማስቆም፣ መቀነስ እና መቀየር ይችላል ...።»²⁰

Which roughly means:

“From the overall Ethiopian population there are about 13,000 ‘large taxpayers’²¹ (bodies). These are the ones that are not paying tax. If these large taxpayers are made to pay their respective due taxes appropriately and effectively, it is possible to stop, reduce and change the budget deficit of the government.”

It is against this background that the researcher wants to embark upon this study.

1.B Statement of the Problem

Tax is usually levied not only on individuals but also on legal entities. In some countries, the same tax law is applied to both, but particular provisions (concerning rates of tax, for example) distinguish between the incomes of individuals on the one hand and that of companies on the other.²² In other countries, separate tax laws are applied to individuals and companies.²³

Corporate tax is levied on the profits of companies (corporate entities). It is payable on profits irrespective of whether they are carried over, retained or distributed. The profit liable to

¹⁹ See LEVY, *supra* note 7, at 3. See also S AMBIRAJAN, *THE TAXATION OF CORPORATE INCOME IN INDIA* 4 (Bombay: Asia Publishing House, 1964).

²⁰ Taken from the Tikemt 6/2001 E.C Statement of PM Meles Zenawi to the House of PR. Also see Gebi Lelimat at 7(ገቢ ስልጣን).

²¹ “large taxpayers” in this context refers to the entities that are included in the definitions of the term “body” under the Tax Proclamations which include share companies, private limited companies, partnerships and joint ventures and is thus not limited to those large taxpayers administered by the Large Taxpayers Office (LTO).

²² See John R. King, “Issues Relating To Personal And Corporate Income Taxes: Integration of Personal and Corporate Income Taxes”, IMF, *TAX POLICY HANDBOOK* 149-155 (Parthesarathi Shome ed., 1995).

²³ Partnership of various kinds, which may be established under most countries’ legislations as an additional form of legal person, are sometimes treated for tax purposes in the same way as sole proprietorships and sometimes as the same way as companies. See Id, at 149, footnote. 72.

corporate tax is net annual profit, which is equal to the difference between a company's income and its costs as calculated according to standard accounting procedures.²⁴

According to Cheryl, D. Block, "corporate taxation has a reputation, among law students at least, one of the most difficult courses in the law school curriculum."²⁵ And according to Pennington, as mentioned earlier²⁶, taxation of companies is a complex subject. The complexity and difficulty begins in the policy debate on the issue of separate or integrate approach to the taxation of corporations and their shareholders and runs from the incorporation (or birth) of the corporation to the liquidation (or death) of the corporation. The later requires detailed knowledge of corporate (company) law in order to properly understand the incidents or points of corporate tax and corporate law itself is a subject the complexity of which is in progress.

Despite such difficulties and complexities, nearly all countries assess taxes on corporations and their shareholders. Today corporate tax has become a regular, universal and an almost indispensable feature of the tax system. It originally arose out of financial necessity on the state's part. Its justification then continues to be part of academic discussions among lawyers and economists. Such discussions have reduced to some theories that attempt to justify corporate tax. Some of such theories include the privilege or benefit theory, and the ability to pay theory. According to the privilege theory, for example, corporations should pay a price for the privilege of being allowed to exist and to function under the corporate form and its unique advantages. According to Goode, some of the unique advantages of incorporation are that the liability of the shareholders are limited, that the corporations have a lease of almost perpetual life, transfers of ownership can be effected with easy facility, the sources of financing can be very diffused, and the possibilities of incorporate affiliation are endless.²⁷

In Ethiopia, the government has recently restructured its tax authority and meticulously built its capacity to intensely extract revenue through taxation. Since the last year, tax issues have covered front pages, editorials, interviews and inside pages of the public and private press. Value Added Tax (VAT) is the core of the recently intensified move of the tax authority. VAT, according to this writer, is "external" to corporate tax. Corporate tax, in the context of this study, refers to the type of taxes that basically emanate from the features and events that happen in the

²⁴ Id, at 222.

²⁵ See, CHERYL D., BLOCK CORPORATE TAXATION: EXAMPLES & EXPLANATIONS xxiii (3rd Ed., Aspen Publishers, New York, 2004).

²⁶ See PENNINGTON, *supra* note 18, at 38.

²⁷ See *supra* note 19, at 9.

formation, life, and death of companies. Such events could relate with their capitals, profits, distributions such as dividends, corporate finance, liquidation, reorganization etc. Companies begin business through the investment of capital-the amount contributed by the shareholders (investors) to the company. In this regard, the Ethiopian law, under the Commercial Code of 1960, provides that a share company shall not be formed until the capital, that is to be fixed in advance and the minimum limit of which is 50,000 Eth Dollar, has been fully subscribed.²⁸ And for private limited companies, the Code provides the minimum capital to be 15,000 Eth.Dollar.²⁹ In the company's liquidation the capital serves the purpose of providing a fund for the benefit of unsecured creditors among whom the tax authority could be one. This Paper assesses the law related to corporate financing, corporate distributions and retention of dividends, capital gains, and reorganization transactions such as merger, acquisition, and division and the respective tax issues. Similar to the problems related to VAT, these are the areas of tax related problems in the Ethiopian corporate business.

According to some officials of the tax authority, such problems are so grave. In the PLC for example, the problems begin from the formation stage and runs throughout the PLC's life. In the words of Ato Mokenen Ayele, an official in the tax authority, "the whole problem begins in the formation of PLC."³⁰ He added, "The problem runs throughout the PLC's life". According to Ato Mekonen capital gains tax is the biggest uncollected tax. In his words, "it can be said that the tax authority has totally disregarded capital gains tax." Retention of dividend is other such unregulated problematic area of the corporate tax.

According to other tax authority officials³¹, some of the corporate taxpayers do not even know the type of tax they are required to pay. However, it is said that an individual with the knowledge of the tax advantages and protection provided by a corporational organization can get rich much faster than someone who is employee or a small business soleproprietor.³² Because a

²⁸ See Arts 304(1), 306(1), and 312(a) of the 1960 COMMERCIAL CODE OF ETHIOPIA.

²⁹ See Id, Art 512(1).

³⁰ Interview with Ato Mokenen Ayele, vice General Prosecutor in the Revenue and Customs Authority, in Addis Ababa (Apr. 15, 2009).

³¹ Interviews with Ato Tederos Tefera, Deputy General Operations, Ethiopian Revenue and Customs Authority; Ato Reta Alemayehu, Senior Public Prosecutor in Federal Revenue and Customs Authority; Ato Yosef Shiferaw, Customers Service Officer Ethiopian Revenue and Customs Authority; Ato Samuel Taddese, Ethiopian Revenue and Customs Authority, Lawyer in the Legal Department; and Ato Abeye Yibale, Federal Tax Appeal Commission Judge.

³² See ROBERT T KIYOSAKI, RICH DAD AND POOR DAD, 133(1998).

corporation can do so many things that an individual cannot.³³ Like pay for expenses before it pays taxes.³⁴ A corporation earns, spends everything it can, and is taxed and they try to live on what is left.³⁵ It is one of the largest tax loopholes that the rich use.³⁶ Therefore, this study will assess the law that deals with this subject of great importance to company owners, business lawyers, the tax authority and potential investors.

1.C Aim, Objective and Scope of the Study

The aim of doing this piece of work is to assess how corporate tax is treated in the Ethiopian legal system and if it is adequately treated. The concept corporate tax has been introduced in Ethiopia almost since the beginning of corporate business in the country. However, there is no distinct legislation that predominantly deals with corporate tax until to date. The existing tax legal provisions that are related with corporate tax are found scattered here and there in the tax laws especially in the Income Tax Proclamation and Regulation currently in force. So, this study makes the utmost effort in assessing these provisions from the stand point of comparative corporate tax and our company law.

The objective of this study is to assess the treatment of corporate tax in the Ethiopian tax law. This objective is to be achieved by discussing corporate formation, corporate middle life, and corporate end life events and tax issues thereof.

A corporation in the context of this study is limited to refer to the two types of companies recognized in the 1960 Ethiopian Commercial Code. The two types of companies are obviously the share company³⁷ and the private limited company.³⁸ And corporate tax, in the context of this study, refers to the tax of these two companies and their respective shareholders. The scope of this study is thus limited to the tax issues and implications that emanate from the feature of these two entities (share and private limited companies).

1.D Literature Review

The topic “Corporate tax” is almost a neglected area in the Ethiopian legal system. To the knowledge of the researcher, there is no single domestically written literature on the subject. It is

³³ Id.

³⁴ Id.

³⁵ Id., at 134. Employees, however, earns and get taxed and they try to live on what is left. Id.

³⁶ Id.

³⁷ See Art 5, 10, 210,-226, 304-509, and Arts 544-560 of the 1960 ETHIOPIAN COMMERCIAL CODE for share companies and their treatment in the Ethiopian law.

³⁸ See Arts 5, 10, 210-225 510-543 and Arts 544-560 Id.

however, a developed topic and area of interest in the international literature. Various books have been written, studies carried out, laws enacted and treaties ratified in the area of corporate tax. Yet, it is difficult to secure access to most of these materials apart from reading them in bibliographies attached to books written on the subject.³⁹ Therefore, the reference made to the international literature on corporate taxation is limited to few books available in the Addis Ababa University Law Library, Civil Service College Library, the Library of the Ministry of the Finance and Economic Development, and the Library of the Federal Revenue and Customs Authority and to online materials on the subject.

1.E Research Methods

The selection of a method or methods is based on what kind of information is sought, from whom and under what circumstances. As a result, there is no rule that says that only one method must be used in an investigation. The general trend in this regard is that using more than one method can have substantial advantage, even though it almost inevitably adds to the time and fund investment required. Using a single method and finding a pretty clear-cut result may delude investigators into believing that they have found the right answer.

On the above background, the methods used in this research are a sort of multiple methods that include literature review, documentary resource, interviews, discussions,⁴⁰ and comparative analysis.

1.F Significance of the Study

This research assesses the treatment of corporate tax in the Ethiopian tax law. This research will thus be significant in bringing the issue of corporate tax into the attention of the tax authority, corporate taxpayers, and legal scholars. This in turn will be significant in scrutinizing further corporate tax issues the result of which could probably trigger other scholars to undergo further researches on the subject. This research could also be significant in providing a reference material for those who are interested in the area.

1.G Limitation of The Study

³⁹ See MARJAANA HELMINEN, *THE DIVIDEND CONCEPT IN INTERNATIONAL TAX LAW: DIVIDEND PAYMENTS BETWEEN CORPORATE ENTITIES* (1999).

⁴⁰ . By document, in the context of this study, it is meant, primarily, written documents, whether it be legal text (constitution, proclamation, regulation, or directive), court case reports, commentaries, journals, series, books, published or unpublished research papers, magazines newspapers or whatever.

This research has come across with some limitations, which have possibly affected the outcome. For one thing, there are no researches conducted or written materials that are related with corporate tax in the Ethiopian context. There is also lack of awareness on the subject even among the lawyers of the tax authority. So the research has been influenced from the shortage of relevant reference materials and informed responses for the interviews, and discussions. This would in turn have affected the authoritativeness of the information derived from the interviews and discussions. In the capacity of the researcher, for instance, it was difficult and even impossible to find a single specialized corporate tax lawyer in the city- Addis Ababa. All this and other constraints could therefore, have probably put negative influence on making the research full-fledged.

Predicting the existence of such limitations from the outset, however, the researcher has made the utmost efforts in minimizing the impact of such constraints by, for example, diversifying the sources of information and referring to the available and accessible literatures on corporate taxation.

1.H Organization of the Thesis

This study attempts to assess the extent of the treatment of corporate tax in the Ethiopian tax law. The study approaches the subject in the sequence that follows. The work is divided into four Chapters. As a prelude to the study, Chapter one introduces the background of the problem, statement of the problem, aim, objective and scope of the study, research methods, significance of the study, and limitation of the study.

Chapter two briefly covers the conceptual, and theoretical framework of corporate formation. This Chapter explores the concept ‘corporate tax’ and definitional features thereof, the economics of corporate tax (rationale and theories of corporate tax), the law of corporate tax (policy issues), corporate formation, corporate capital and corporate financing.

Chapter three deals with the corporate middle life events and the respective tax issues thereof. In this Chapter, an attempt is made to briefly assess the corporate income, dividends, retention of dividends, and capital gains and the tax issues related to all these events.

Chapter three assesses liquidation, and reorganization transactions such as acquisition, merger and division and the tax issues related to each act. Finally, a section of conclusion and recommendations is provided towards the end of the Paper. This section tries to briefly

summarize the conclusions and culminates with the part dealing with the outlined recommendations.

Chapter 2: CONCEPTUAL AND THEORETICAL FRAMEWORK

2.A The Concept ‘Corporate Taxation’: Its Definitional Features

From the fact that man is a social animal stems the demand for living together near one another. This mode of life gives birth to various modes of thought. According to Robert L. Raymond, the basis of all groups is merely such a mode of thought.⁴¹ The corporation is a sort of grouping. The germ of the corporate idea thus lies merely in a mode of thought; in thinking of several as a group, as one.⁴² And the starting-point of the corporation in temporal affairs was simply that certain people lived near one another.⁴³

Its germ having been laid in a mode of thought resulting from the fact of living together, the word “corporate” has been defined as “united into one forming one body constituted of many individuals; to form into one body; to incorporate; to embody; to unite or to join in one body.”⁴⁴ The key term in this definition is the word “body” and refers to the organization⁴⁵ or

⁴¹ See Robert L. Raymond, *The Genesis of the Corporation*, 1963 HARV.L.REV.351, 351.

⁴² *Id.*

⁴³ *Id.* at 356.

⁴⁴ See *THE OXFORD ENGLISH DICTIONARY* (2nd ed. Clarendon Press 1989), S.V., “Corporate”.

⁴⁵ Note that the term “Organization” is here used in the context it is used in the phrase “business organization”. See, e.g., COMMERCIAL CODE [COM.C] book II (Eth.)

association⁴⁶ of individuals formed for different purposes. Such purposes could, for example, be spiritual, social, and political or business related. The same is true with the term “Corporate”. Professor Bahru Zewde has, for example, used the term corporate as:

In the So-called Zemena Mesafent, or in its English rendering “the Era of the Princes” (c.1770-1855) the nobility vied for control of the monarch rather than as a corporate entity.⁴⁷

In this paper, however the word “body” is used in the context that it has in law as defined in the Oxford English Dictionary which is provided as “[a]n artificial person created by legal authority for certain ends; a corporation ...”⁴⁸ The word “corporate” is also limited to its definition in the legal context. So for the purpose of this paper, the phrase “corporate body” is strictly intended to refer to the business entities that are entirely engaged in commercial business activities and which are also considered as entities subject to corporate taxation.

2.A.1 Defining Entities Subject to Corporate Taxation

The taxation of business organizations generally falls into two basic models-“Corporate” taxation and “Partnership” taxation.⁴⁹ Corporate taxation typically imposes a tax on the income of certain types of business organizations and also taxes the profits distributed to the holders of the ownership interests.⁵⁰ The partnership taxation model, on the other hand, taxes the income derived by the organization directly to the owners whether or not distributed. It is a “flow-through” model under which the partnership is not a taxable entity.⁵¹ That is the partnership-level tax consequences are “passed through” to investors.⁵² This “pass-through” or “flow-through” approach results in a single layer of taxation- at the partner level.⁵³ In a pass-through regime of partnership taxation, everything that occurs at the partnership level (income, gain, loss, deduction, credit) passes through pro rata to the partners.⁵⁴ Most importantly, the income of the

⁴⁶ Note that the word “association” is used here in the context it is used in art. 404 of the Civil Code. See CIVIL CODE [CIV.C] art. 404 (Eth.).

⁴⁷ See BAHEU ZEWDE, *The Burden of History: The Constraints, and Challenges of Democratization Process in Ethiopia*, in SOCIETY, STATE AND HISTORY: SELECTED ESSAYS 323, 328(2008) (Emphasis added).

⁴⁸ See supra note 44, at 355, S.V., “body”.

⁴⁹ See HUGH J. AULT, *COMPAREATIVE INCOME TAXATION: A STRUCTURAL ANALYSIS* 285(Kluwer Law International 1997). Note that these two models do not exhaust the possible patterns of the taxation of business organizations. Despite this, however, most of the issues in taxation of business organization revolves around corporate and partnership patterns. Id.

⁵⁰ see Id.

⁵¹ See LEANDRA LEDERMAN, *UNDERSTANDING CORPORATE TAXATION* 4 (2002).

⁵² Id.

⁵³ Id.

⁵⁴ Id.,at 179.

partnership is not taxed to the partnership.⁵⁵ Instead, the income (or lose) of the partnership is included in the tax return of the individual partners.⁵⁶ Because the pass-through principle of partnership taxation is based on the assumption that the income of the partnership should be taxed directly to individual partners in much the same as if they had earned it directly.⁵⁷

Many countries have rules that allow the income and loss of the commercial partnerships to be passed through directly to the partners and have highly developed principles dealing with partnership taxation.⁵⁸ In the partnership model of taxation, the commercial law classification of business organization is determinative of the tax regime.⁵⁹ The Pass-through principles of taxation generally apply to the forms of business organizations that fall under the category 'partnerships' in commercial law. In other countries, specially in Japan, and France, for example, there are no specific rules dealing with the taxation of partnerships.⁶⁰ In the United Kingdom, there are limited statutory provisions dealing with partnerships.⁶¹

As stated above corporate taxation imposes a tax on the income of certain types of business organizations. A basic structural decision in the design of corporate taxation is thus the determination of types of entities that should be subject to the corporate taxation regime.⁶² In this regard, there are two approaches. Some states follow more closely the commercial or business organization law classification. Accordingly they subject incorporated entities to the 'corporate' taxation regime and the partnerships (unincorporated ones) to the 'partnership' taxation regime.⁶³ Whereas other states provide, in their tax law, specific tax rules that classify entities for tax purpose regardless of the classification of business organizations in their respective commercial laws.⁶⁴ Some of the states in this category subject the partnership to the corporate taxation regime with out any other option whereas others exclude the partnership from the corporate taxation or give it an option to choose between the two regimes of the taxation of business

⁵⁵ See

⁵⁵ DAVID J. SHAKOW, THE TAXATION OF CORPORATIONS AND THEIR SHARE HOLDERS 118(1991).

⁵⁶ Id.

⁵⁷ Id.

⁵⁸ See AULT, supra note 49 at 354. The United States, for example , has the most highly articulated set of rules. Id

⁵⁹ Id.

⁶⁰ Id.

⁶¹ Id..

⁶² Id, at 289.

⁶³ In this respect, Sweden, Canada and the United States of America could be mentioned as examples. Note, however, that there are exceptions and variations even in these systems. The indication here is to the very general trend of the regimes. See Id, at 289-290.

⁶⁴ Examples of states that pursue this approach include Germany, the Netherlands, France, Japan, and Australia. See Id at 290-292.

organizations.⁶⁵ The countries that dichotomize the taxation of business organizations into the two models- partnership and corporate- provide two separate sets of rules that govern these models of taxation. That is, the partnership taxation is governed by a separate set of rules and that of corporate taxation by other set of rules.⁶⁶ Those countries that put the partnership under the corporate taxation, however, provide no specific rules dealing with taxation of partnerships (examples in this category include Japan, France, and the United Kingdom).

When we see the development of the Ethiopian tax law from the perspective of defining entities subject to the corporate taxation we come across with a sort of catch-all terms that embrace all the entities that are intended to be the subject to the corporate tax regime. The first income tax law of Ethiopia – the Personal and Business Tax Proclamation No. 60 of 1944 defined taxable entities in terms of the word “business” which includes any company, incorporated or registered under any law then in force in Ethiopia or elsewhere, and any firm, partnership or other body of persons whether corporate or unincorporated.⁶⁷ This Proclamation does not, however, make distinction between personal and corporate tax. This Proclamation was replaced by Proclamation No.107 of 1949 and the later Proclamation defined the term “business” to mean any commercial or industrial activity pursued by any person or company incorporated or registered under any law then in force in Ethiopia or abroad as well as any commercial firm, association, company, society, or body of persons whether corporate or unincorporated, excluding organizations having no lucrative aims still without making distinction between personal and corporate taxation.⁶⁸

Proclamation No. 107 of 1949 was replaced by Decree No. 19 of 1956. This Decree divided taxable entities for the first time into two- incorporated bodies and other persons. The Decree defined the term “body” to mean incorporated body and the term “person” to mean a natural person as well as other kinds of associations except incorporated bodies.⁶⁹ In this Proclamation, partnership tax was merged with the individual tax. Proclamation No 173 of 1961

⁶⁵ Japan, for example subjects all organization which constitute “judicial entities”, including general and limit partnerships formed under the Japans Commercial Code to the corporate taxation; German and France on the other hand exclude partnerships from the corporate taxation regime Id.

⁶⁶ Such rules extend from the definition of entities that fall under the partnership taxation model to the liquidation of partnerships and tax issues thereof. The same is true for the corporate taxation model. In this regard the United States could be taken as a typical example. See AULT, *supra* note 49, at 354.

⁶⁷ See Art.2 of the PERSONAL AND BUSINESS TAX PROCLAMATION NO.60/1944.

⁶⁸ Note here that a shift has been the meaning of in the meaning of the term “business” from business as entities to business as an activity pursued by entities.

⁶⁹ See Art 3 (c) and 2 (d) of DECREE No. 19/1956.

replaced Decree No. 19/1956. This proclamation also made distinction between personal and corporate taxation and defined the term “body” to mean any incorporated body with limited liability and the term “person” to mean any natural person and all forms of associations, including partnerships, but excluding incorporated bodies with limited liabilities⁷⁰ Then Proclamation No 255/1967 followed similar pattern. Proclamation No. 155 of 1978 amended the previous Income Tax Proclamation and followed similar pattern. It, however, replaced the word “body” with the term “organization” which was intended to mean any government or privately owned judicial person or association that carries out business activities excluding cooperative society.⁷¹ All the tax proclamations that were enacted after this Proclamation also followed similar pattern in defining taxable entities as “organizations” and other “persons”.⁷² As can be seen from the tax Proclamations that were enacted before 2002, entities that are subject to the corporate tax in Ethiopia have been and are still being defined in one word-“body/organization”- and corporate taxation impliedly as the “taxation of bodies/organizations”. Most of these Tax Proclamations limited the scope of corporate taxation to the incorporated entities and put the partnership under the category of individual tax. As part of the previous pattern, the current Income Tax Proclamation which puts all the entities subject to corporate taxation in the catch all term-“Body” defines the term “Body”, for the purpose of the tax law, as:

... any company, registered partnership, entity formed under foreign law resembling a company or registered partnership, or any public enterprise or public financial agency that carries out business activities including body of persons corporate or unincorporated whether created or recognized under a law in force in Ethiopia or else where and any foreign body’s business agent doing business in Ethiopia on behalf of the principal.⁷³

The entities in this definition are:

1. any company;
2. any registered partnership;
3. any entity formed under foreign law resembling a company;

⁷⁰ See Art 3 (a)(b) and Art 12 (b) (i) of the INCOME TAX PROCLAMATION NO. 173 of 1961.

⁷¹ See Art 2(1(a)(1) of PROCLAMATION NO. 155/1978.

⁷² See Council of State Special DecreeNo.18/1990; PROCLAMATION NO.107/1994; PROCLAMATION NO.36/1996; and PROCLAMATION NO.286/2002.

⁷³ See Article 2(2) of the INCOME TAX PROCLAMATION NO. 286/2002. Also see Article 2(6) of the TURNOVER TAX PROCLAMATION NO. 308/2002; Article 2(3) of the EXCISE TAX PROCLAMATION NO. 307/2002; Article 2(5) of the VALUE ADDED TAX PROCLAMATION NO. 285/2002 and others for the definition of the term “Body”.

4. any entity formed under foreign law resembling registered partnership;
5. any public enterprise that carries out business activities;
6. any public financial agency that carries out business activities;
7. any body of persons corporate created under a law in force in Ethiopia;
8. any body of persons corporate recognized under a law in force in Ethiopia;
9. any body of persons corporate created under a law in force elsewhere;
10. any body of persons corporate recognized under a law in force elsewhere;
11. any body of persons unincorporated created under a law in force in Ethiopia;
12. any body of persons unincorporated recognized under a law in force in Ethiopia;
13. any body of persons unincorporated created under a law in force elsewhere;
14. any body of persons unincorporated recognized under a law in force elsewhere;
- and
15. any foreign body's business agent doing business in Ethiopia on behalf of the principal.

As can be seen from the wording of the list, the Income Tax Proclamation subjects all legal entities, corporate or unincorporated, that carry out business activities to the corporate tax regime. By so doing, the current Income Tax Proclamation pursues a unitary approach for the taxation of business organization.

The first item in the above list-"any company"- refers to the private and share companies. According to Article 98(3) of the FDRE Constitution, the Federal and State governments have concurrent power to jointly levy and collect taxes on the profits of such companies and on dividends due to shareholders of the companies.⁷⁴

The second item in the list-any registered partnership-is, however, not clear. What does it mean by "registered partnership"? Does the Commercial Code include an entity known by the phrase "registered partnership"? Does it really refer to the partnerships understood in the Commercial Code? According to one of the drafters of the current Income Tax Proclamation professor Alan Sheik, the phrase "registered partnership" is intended to refer to the 'private limited companies'.⁷⁵ However, private

⁷⁴ See Art 98(2) of the FDRE Constitution.

⁷⁵ Interview with Ato Samuel Taddes, Legal Expert, Ethiopian Revenue and Customs authority, 26/10/2009 Addis Ababa.

limited companies are also expressly mentioned in the Income Tax Proclamation.⁷⁶ According to Article 100(1) of the Commercial Code “[a]ny Ethiopian or foreign persons or business organizations carrying out commercial activities in the Empire of Ethiopia shall be registered (emphasis added). Reading this article with articles 285 and 299 of the same brings us to argue that registration requirement is mandatory to both the general and limited partnerships when engaged in carrying out commercial activities and thus they automatically become “registered partnerships”. Accordingly, it may be argued that the phrase “registered partnerships refers to these partnerships-general and limited partnerships-as are provided in the Commercial Code. According to some lawyers, however this argument is weak.⁷⁷ The later argues that the phrase “registered partnership” in the Income Tax Proclamation does not correspond to the Commercial Code context of partnerships.⁷⁸ This phrase refers to foreign entities that closely resemble to companies. In foreign jurisdictions, “registered partnership” has the context of companies. So the inclusion of the phrase “registered partnership” might have resulted due to the fact that the drafter of the Income Tax Proclamation has little awareness of the Commercial Code.⁷⁹ There is no entity in the Commercial Code that corresponds to “registered partnerships” as provided in the Tax Proclamation⁸⁰. Thus, including “registered partnership in the Tax Law while such entity is non-existing in the Commercial Code does not give sense.⁸¹ If this is the case, even the fourth item in the list of the entities included in the definition of the term “body”-any entity formed under foreign law resembling registered partnership-will also have no sense, for the resemblance issue will be difficult to ascertain.

For commercial law purpose, Book II of the 1960 Commercial Code provides six forms of business organizations: ordinary partnership, joint venture, general partnership, limited partnership, share companies, and private limited companies.⁸² Among these, the share companies and private limited companies fall under the Federal

⁷⁶ See Article 34(1) of PROCLAMATION NO.286/2002.

⁷⁷ Interview with Taddese Lencho, a Lecturer in AAU FOL and currently a PhD candidate, Addis Ababa, 22/10/2009.

⁷⁸ Id.

⁷⁹ Id.

⁸⁰ Id.

⁸¹ Id.

⁸² See Art. 212 (1) of the 1960 COMMERCIAL CODE.

and State governments' concurrent power of taxation.⁸³ The other forms of business organization are, however, not mentioned in the FDRE Constitution. From the Commercial Code's perspective, the FDRE Constitution recognizes only individual traders⁸⁴, and companies. The government-Federal or State-that has the taxation jurisdiction for partnerships-general and limited-and joint venture is not specified. While this is the situation in the FDRE Constitution, the tax Proclamations include a "registered partnership" as an entity that is subject to the tax consequences of the "body".

Be the case as it may and setting aside the Constitutional issues for the time being, it can be concluded that the taxation of business organizations in Ethiopia is a mono model-corporate taxation- for the current Income Tax Proclamation subjects all legal entities-corporate or unincorporated-in Ethiopia to the corporate taxation by including them in the catch-all term "body". In addition, the Income Tax Proclamation nowhere provides pass-through provisions that regulate the taxation of partnerships. It classifies the taxation of business income only into two categories- bodies and other persons.

This approach of the Ethiopian Tax law closely relates with the situation in Japan. In Japan, all organizations, which constitute "juridical entities", are generally subject to the corporate taxation regime.⁸⁵ Both the general and limited partnerships formed under the Japanese Commercial Code are juridical entities and are thus subject to the corporate tax.⁸⁶ The "undisclosed association" which are similar to the Joint Venture in the Ethiopian context are not subject to the corporate tax in Japan unlike the case in Ethiopia.⁸⁷

The Ethiopian approach, however contradicts with jurisdictions that exclude partnerships (both general and limited) from the scope of the corporate taxation regime. In Germany and France, for example, general and limited commercial partnerships are not subject to the corporate tax in their respective municipal laws.⁸⁸ When such entities intend to engage in business activities in Ethiopia, however, they will be subjected to the Ethiopian Corporate Tax regime for

⁸³ See Art 98(2) of the FDRE CONSTITUTION.

⁸⁴ See Art 97(4) of the FDRE CONSTITUTION.

⁸⁵ See AULT, *supra* note 49, at 291-292.

⁸⁶ *Id.*

⁸⁷ *Id.* In Ethiopia joint ventures are also subject to the corporate taxation, for they are included in the definition of the term "Body" through the phrase "body of personsunincorporated".

⁸⁸ *Id.*

they resemble to a registered partnership in the Ethiopian context (general or limited partnership) or they may fall under the phrase “body of persons corporate or unincorporated”.⁸⁹

So far, we have seen the definition of the term “corporate” and the entities that are subject to the corporate taxation. Now let us define the second term in the phrase “corporate taxation”. Taxation according to the Black’s Law dictionary is the imposition or assessment of tax; the means by which the state obtains the revenue required for its activities.⁹⁰ And tax, according to the same dictionary is a monetary charge imposed by government on persons, entities, transactions or property to yield public revenue.⁹¹ Crowe more comprehensively defines the later term as follows:

A tax is a compulsory contribution to the government, imposed in the common interest of all, for the purpose of defraying the expenses incurred in carrying out the public functions, or imposed for the purpose of regulation, without reference to the special benefits conferred on the one making the payment.⁹²

According to McGee, a more comprehensive, and accurate, definition of taxes might be the compulsory taking of property by government, without regard to whether the proceeds are used to further public or private interests.⁹³

From the preceding definitions of the terms ‘corporate’, and ‘taxation’ and the discussion on the ‘entities subject to corporate taxation’, it follows that ‘corporate taxation’ is the tax on the profits of the entities that are subject to the corporate taxation regime. In this regard, Hillman defined the phrase ‘corporate taxation’ as “a tax on the profits of firms” without specifying the types of such firms.⁹⁴ And Shakow defined it as an income tax paid by corporation⁹⁵ again without defining what corporations are. In the context of this paper, the phrase “corporate taxation” is intended to refer to the income taxes that are paid by the forms of business organizations that are subject to the corporate tax regime under the tax law.⁹⁶

⁸⁹ See Articles 100, 285, and 299 of the COMMERCIAL CODE and Article 2(6) of the INCOME TAX PROCLAMATION NO. 286/2002.

⁹⁰ BLACK’S LAW DICTIONARY 1500 (8th ed. 2004), S.V., “Taxation”.

⁹¹ Id, at 1496, S.V., “Tax”.

⁹² See MARTIN T. CROWE quoted in ROBERT W. MCGEE, THE PHILOSOPHY OF TAXATION AND PUBLIC FINANCE 16 n. 9 (2004).

⁹³ See MC GEE, Id.

⁹⁴ ARYE L. HILLMAN, PUBLIC FINANCE AND PUBLIC POLICY: RESPONSIBILITIES AND LIMITATIONS OF GOVERNMENT 496(2003).

⁹⁵ SHAKOW, *supra* note 55, at 1(1991).

⁹⁶ According to the Encyclopedia Britannica, the phrase tax law refers to the body of rule under which the public authority has a claim on taxpayers, requiring them to transfer to the public authority part of their income or property ; And in the context of Article 2(2) the FEDERAL INLAND REVENUE AUTHORITY ESTABLISHMENT PROCLAMATION NO. 61/1997 defines the phrases for taxes and duties for collection by the Federal government.

In the Ethiopian context such forms of business organizations that are required to be subject to the corporate tax regime are all forms of business organizations, as provided and understood in the context of the Commercial Code, if they are engaged in carrying out commercial business activities.⁹⁷ However, the list of entities that are subject to the corporate taxation in the Ethiopian tax law are not limited to the above mentioned forms of business organizations.⁹⁸ Although the corporate tax regime in the Ethiopian tax law extends to all these entities, the scope of this Paper is limited to the part of the corporate taxation that deals with the tax issues of the two forms of companies-private limited and share companies as understood in the context of the Commercial Code.⁹⁹ In this regard, the term ‘company’ is used throughout this Paper interchangeably with the word ‘corporation’. The word ‘corporation’ comes from the Latin term ‘corporare’ which means ‘to form into a body’.¹⁰⁰ In the literature of corporations, various authors have defined the word ‘corporation’ differently. To mention some from the broad list, McConnell and Brue defined it as:

A corporation is legal creation that can acquire resources, own assets, produce and sell products, incur debts, extend credit, sue and be sued, and perform the functions of any other type of enterprise. A corporation is distinct and separate from the individual stockholders who own it. Hired managers run most corporations.¹⁰¹

According to Kahn and Lehman, a corporation is a mechanism through which individuals combine their capital and human resources in a joint enterprise and then share the net profits.¹⁰² And Laro and Pratt defined it as profit-seeking enterprise of persons and assets organized by rules that has a separate legal personality and powers to do all things necessary to conduct business.¹⁰³ A common thread that runs through the definitions of the term ‘corporation’ is that it is a ‘legal entity’. According to the American Bar Foundation’s Model Business Corporation Act, this ‘legal entity’ attribute gives a corporation the power:

a) to have perpetual succession unless a limited period of duration is stated in its articles of incorporation, b) to sue and be sued, complain and defend in its

⁹⁷ Note that when general and limited partnerships are engaged in commercial business activities they are duty bound to get registered. See Art 100(1) of COMMERCIAL CODE.

⁹⁸ See the list (1-15) below the definition of the term “body”.

⁹⁹ See Articles 10(2), 210-226, and 304-543 of the COMMERCIAL CODE.

¹⁰⁰ See AMBIRAJAN, *supra* note 19, at 3.

¹⁰¹ CAMPBELL R. MC CONNELL AND STANLEY L. BRUE, *ECONOMICS: PRINCIPLES, PROBLEMS, AND POLICIES* 76 (15th ed., 2002).

¹⁰² DOUGLAS A. KAHAN & JEFFERY S. LEHMAN, *CORPORATE INCOME TAXATION* 19(4th ed., 2002).

¹⁰³ See DAVID LARO AND SHANNON P. PRATT, *BUSINESS VALUATION AND TAXES: PROCEDURE, LAW, AND PERSPECTIVE* 72(2005).

corporate name, c) to have corporate seal, d) to purchase, take, receive, lease or otherwise acquire, own, hold, improve, use and otherwise deal in and with real or personal property, or any interest therein, wherever situated, e) to sale, convey, mortgage, pledge, lease, exchange, transfer, and otherwise dispose of all or any part of its property and assets, f) to lend money, g) to purchase, take, receive, subscribe for, or otherwise use and deal in and with shares or other interests in, or obligations of other domestic or foreign corporation, h) to make contracts and guarantees and incur liabilities, borrow money at such rates of interests as the corporation may determine, issue its notes, bonds, and other obligations and secure any of its obligations by mortgage, pledge of all or all or any of its property, franchises, and income, i) to lend money for its corporate purposes, invest and reinvest its funds, and take hold real and personal property as security for the payment of funds so loaned or invested, j) to conduct its business, carry on its operations, and have officers, k) to elect or appoint officers and agents of the corporation, and define their duties and fix their compensation, l) to make and alter by-laws, m) to make donations, n) to indemnify any director or officer or any person who may have served at its request, o) to pay pension and establish pension plans, pension trust, profit sharing plans, and other incentive plans for any or all of its directors, officers and employees, p) to cease its corporate activities, and surrender its corporate franchise q) to have and exercise all powers necessary or convenient to effect any or all of the purposes for which the corporation is organized.¹⁰⁴

According to Seyoum Yohannes Tesfay, “the share company in Ethiopia has all the attributes of full corporate personality as is known in the west.”¹⁰⁵ The attributes of full corporate personality as is known in the west could be borrowed from the list provided by the American Bar Foundation as mentioned above. It thus follows, and seems logical, that the share company in Ethiopia has the powers listed above (a-q) resulted from its attributes of legal personality. The private limited company, being a hybrid of a share company and a partnership, does not, however, share some of the attributes of a share company.¹⁰⁶ Nonetheless, it offers limited liability to its members similar to that of a corporation and this attribute is significant for the private limited company to be similarly grouped with the share company in the study of corporate taxation, for it is widely held that the corporate tax is a “fee” for the limited liability privilege of companies. In this regard, it will be appropriate to quote Schlunk who says:

Perhaps the most obvious benefits that the corporate organizational form provides to some of its participants, the shareholders, that historically they could not achieve easily absent such form is *limited liability*. Since the sovereign enacts the legislation that makes limited liability possible, it conceivably could levy a tax

¹⁰⁴ AMERICAN BAR FOUNDATION, MODEL BUSINESS CORPORATION ACT ANNOTATED, Vol. 1 S1-42, at 1-42 (1960).

¹⁰⁵ Seyoum Yohannes Tesfay, On Formation of a Share Company in Ethiopia, XXII (1) JOURNAL OF ETHIOPIAN LAW 102-127, at 105 (July 2008).

¹⁰⁶ A private limited company may not, for example issue its own notes.

perhaps even an income tax, as a “fee” for the provision of such benefit.¹⁰⁷
(Emphasis added)

2.B The Economics of Corporate Taxation: Rationale and Theories of Corporate Taxation

It is Common to think that the tax system allows the government to divide the burden of governing among its citizens.¹⁰⁸ However, it is difficult to measure how the benefits of public goods are apportioned among individuals and entities.¹⁰⁹ In other words, it cannot be accurately determined how much a citizen or an entity benefits from a network of highways, a public school system, military, police, and fire protection.¹¹⁰

A corporation tax as we saw earlier is a tax paid by the corporation from its resources, income, or capital. But the question is why should the corporation be taxed? From a legal point of view, corporations have the attribute of legal personality and this attribute entitles them the powers to do all things necessary to conduct a business.¹¹¹ Moreover, corporations enjoy special privileges. The liability of the shareholders is limited, the corporations have a lease of almost perpetual life, transfer of ownership can be effected with easy facility, the source of financing can be very diffused, the possibilities of incorporate affiliations are endless,¹¹² and centralized management.¹¹³ These privileges are quite apart from and in addition to the other services, which the government (state) renders through its law, like maintenance of law and order, assurance of security of property, etc., which corporations need as much as mere individuals. Such benefits and special privileges enable corporations to function in business smoothly and effectively, to grow in size, and to reap large profits from business. Thus, the possession of such attributes as a juristic personality and the enjoyment of limited liability make a corporation rather distinct from other entities that can engage in business activities and render it capable of being taxed.¹¹⁴

¹⁰⁷ See Heruig J. Schlunk, I Come not to Praise the Corporate Income Tax, But to Save it TAX LAW REVIEW (Spring 2003).

¹⁰⁸ SHAKOW, *supra* note 55, at 1.

¹⁰⁹ See McCONNELL and BRUE *supra* note 101, at 618.

¹¹⁰ *Id.*

¹¹¹ See the discussion under Section 1.A above.

¹¹² See GOODE in AMBRAJAN, *supra* note 19, at 9.

¹¹³ See LEWIS D SOLOMON ET AL, CORPORATIONS LAW AND POLICY: MATERIALS AND PROBLEMS, 1 (3rd Ed., 1994); KAHAN AND LEHMAN, *supra* note 101, at 58-59 ; and LARO & PRATT, *supra* note 102, at 72-73.

¹¹⁴ See *supra* note 111.

From an economic perspective however, the above legal notion makes little sense.¹¹⁵ In this regard, some have sometimes said that economists cannot agree about anything, but many economists do agree on one important issue: While collecting many taxes through businesses is clearly convenient, there is little justification for taxing business as such. In the end, all taxes have an economic impact on people.¹¹⁶ In other words, only real people can pay tax.¹¹⁷ Policy makers have, thus, little to gain and potentially much to lose by confusing the issue and pretending to tax companies and not people.¹¹⁸

In addition, the corporate income tax has a detrimental effect on economic growth.¹¹⁹ Because not every unit of money that is taken in the form of taxes is available for investment and this in turn makes business corporations less competitive in the market. Besides, the corporate income tax causes financial distortions by favoring non-corporate enterprises over corporations,¹²⁰ encouraging debt financing over equity financing,¹²¹ and by favoring retained earnings over paying dividends.¹²² Corporations can take a tax deduction for the interest they may pay but cannot deduct dividend payments.¹²³ They can avoid the tax at the shareholder level if they retain their earnings rather than pay dividends.¹²⁴ Business entities can avoid the

¹¹⁵ See HARVEY S ROSON PUBLIC FINANCE 422 (2002).

¹¹⁶ See Richard M Bird, 'Local Business Taxes' in the WORLD BANK, PERSPECTIVES OF FISCAL FEDERALISM 225 (Richard M. Bird & Francois Vaillancourt eds. 2006).

¹¹⁷ HARVAY, supra note 115, at 421.

¹¹⁸ Bird, supra note 116.

¹¹⁹ MCGEE, supra note 92, at 216.

¹²⁰ A partnership, for example, is considered as an aggregate of individuals rather than a separate taxpayer entity where as a corporation is a taxpayer separate from its shareholders. See SOLOMON ET AL, supra note 113, at 171; LEDERMAN, supra note 51, at 3 ; AND STEPHEN A. LIND ET AL, FUNDAMENTALS OF CORPORATE TAXATION 39(5th Ed., 2002).

¹²¹ Tax laws provide a corporation with a powerful incentive to rely as heavily as possible on debt finance. Because unlike dividend payments, payments of interests are deductible and the repayment of a debt is normally not taxable to the creditor. See SOLOMON ET AL, supra note 113, at 229; and SHAKOW, supra note 55 , at 102.

¹²² In order to avoid the double taxation that accompanies the corporate form of business organization, corporations may seek to retain earnings. See LEDERMAN, supra note 51 at 3.

¹²³ This is also true in the Ethiopian case. Interest that is not in excess of the rate used between the National Bank of Ethiopia and the Commercial banks increased by two percentage points is deductible where as declared dividends and paid-out profit share are not-deductible. See Art 21(1(d and e)) of PROCLAMATION NO. 286/2002. Interest paid to shareholders on loans and advances shall not be deductible to the extent that the loan or advances in respect of which the interest paid exceeds on average during the tax period four times the amount of the share capital. But this is not applicable to banks and insurance companies. See Art 2(3) of the same Proclamation.

¹²⁴ See Art 22 (1(d)) of PROCLAMATION NO 286/2002. The *acontrario* reading of this sub-article implies that if dividends are not declared and if profit shares are not paid-out, the 10% dividend tax will not be enforced in the tax year. See Art 34 of the same.

corporate tax quagmire by doing business as a partnership, but partnership form exposes the owners to unlimited liability and makes it more difficult to raise capital, and thus grow.¹²⁵

A tax system that encourages some and discourages others, according to McGee, provides incentives and sanctions for corporate executives to make decisions based on tax avoidance rather than sound business practice.¹²⁶ As a result, resources are allocated in a way that is different from what allocation would be in the absence of incentives and sanctions. To this effect, one study has concluded that the corporate tax is the least efficient than major taxes.¹²⁷

From a political perspective, the corporate tax may be analyzed from two interest points. Many politicians, and indeed the public in most countries seem to think that business taxes, especially those on large corporations, are not among the worst, but rather, the best, of all taxes.¹²⁸ One naïve version of this argument, according to Richard M. Bird, is that because corporations are separate legal persons and some of them have a lot of money, they must have substantial ability to pay taxes and should therefore do so.¹²⁹

From the corporations perspective, it is politically argued that only real people, not things, can pay taxes.¹³⁰ Where as individuals can vote, corporation cannot, so it is politically unfair to assess a tax on persons who cannot vote and thus persons without political representation.¹³¹ Despite this perspective and strong economic arguments to the contrary, however, the popular feelings are that businesses in general and large corporations in particular, should pay taxes much larger than can possibly be justified on benefit grounds.¹³²

So if the corporate tax is “bad” in the sense that from a legal perspective, it violates the right to property (for it is coercive); from an economic perspective, it is hidden, inefficient, misallocates resources and retards economic growth; and from a political perspective being a tax on entities that cannot vote and thus cannot be represented, why then should business corporate entities be subjected to a special tax regime (the corporate taxation regime)? Is it not sufficient to tax the income of the owners of the corporation via the personal income tax?

¹²⁵ MCGEE, *supra* note 92, at 216.

¹²⁶ *Id.*

¹²⁷ *Id.*, at 215.

¹²⁸ Bird, *supra* note 116, at 228.

¹²⁹ *Id.*

¹³⁰ *Id.*

¹³¹ MCGEE, *supra* note 92, at 215.

¹³² Bird, *supra* note 116, at 228. Note here however, that the problem with such popular feelings is that the corporate tax is a hidden tax in the sense that those who ultimately pay it do not know that they are paying it. Because, in the end the burden of corporate tax may fall on workers, consumers, suppliers or some combinations thereof. *Id.*

As stated above most forms of business taxation on corporations tend to impose economic costs by distorting decisions on much matters as the decision to incorporate, the debt-equity ratio, and the dividend policy along with where and how to invest.¹³³ Besides, business taxes on corporations may also impose significant costs and barriers to the expansion of new firms. Overall, economic arguments are sufficiently well founded to persuade many economists that based on efficiency grounds, taxes on corporations have few advantages.¹³⁴ Stated otherwise, the corporate tax is only one of many distortions affecting the allocation of resources under private ownership.¹³⁵ According to Arye L. Hillman, the only justification for the existence of corporate taxation is the simple revenue motive.¹³⁶ In addition to this, several grounds have been formulated, though none of them is completely satisfactory, to the question why should the business corporations be taxed.¹³⁷ Some of such grounds on which corporations are supposed to be taxed include financial theory, benefit theory, social costs, social control, and ability to pay theory.¹³⁸

According to the financial theory, the reason usually given for taxing the corporations is the already established nature of the corporation tax. That is, the corporation tax is there, it has been there, and therefore it should be there.¹³⁹ In addition since the corporation tax is easily productive of substantial revenue to the government with comparatively little administrative inconvenience and expenditure, there should be no reason why it should be scrapped.¹⁴⁰ Moreover, corporation taxes, unlike other taxes-direct as well as indirect-that fall on individuals, are unlikely to evoke much opposition from the large mass of the people, except when the increased taxes come to be clearly reflected in the higher price levels of the products of the corporations. Besides, the corporation tax gives variety to the tax structure. Because the more widely distributed, the more diversified the incidence of taxation, the less intensively is it likely

¹³³ Id, at 225.

¹³⁴ Id.

¹³⁵ SIJBREN CNOSSEN & HANDS WERNER SINN, PUBLIC FINANCE AND PUBLIC POLICY IN THE NEW CENTURY 202 (2003).

¹³⁶ HILLMAN, *supra* note 94, at 500.

¹³⁷ AMBIRAJAN, *supra* note 19, at 7.

¹³⁸ Id, at 51.

¹³⁹ “The corporation tax has somehow come to be established, and let us not now upset it” is the core theme for the financial ground for the taxation of corporations. Id.

¹⁴⁰ According to Ambirajan, the corporation tax brings a sizeable share of the total revenue as compared with other taxes. In the US, for example, the federal corporation income tax accounted for 6.4 percent of GDP in 1951. See Joel Slemrod, The Economics of Corporate Tax Selfishness, available online at <<http://www.bus.umich.edu/otpr/wp2004.pdf>> (Accessed on 27/06/09).

to be felt at any point.¹⁴¹ The main, if not sole, objective of corporate taxation, according to the financial theory, is, therefore, financial, and not social, ethical or administrative. The corporate tax is an effective means of increasing the volume of revenue and this is all that we know and all that we need to know about it according to this theory.¹⁴²

Another theory which is commonly advanced in defense of the corporate taxation is the benefit or privilege theory.¹⁴³ According to this theory, the corporation should pay a price for the privilege of being allowed to exist and to function under the corporate form with its unique advantages.¹⁴⁴ And it is a general principle of taxation that those who benefit most from the government need to finance them. It is thus stated that the corporate tax is a “fee” on the privilege of doing business in a corporate capacity.¹⁴⁵ In other words, corporations are benefited from the special attributes of corporate capacity and powers stemmed therefrom, and are hence proper subjects for special taxation- corporate taxation.¹⁴⁶

It is not possible, however to evaluate the benefit received by corporations from the government services, and thus the ‘benefit’ theory fails to offer any guidance what so ever regarding the manner in which corporations should be taxed.¹⁴⁷ For one thing there is no calculus to measure the value of the ‘benefits’ conferred on corporation. For the other, if the corporate taxation is based on the benefit of incorporation, the imposition should be called a ‘fee’ rather than tax. It is thus hardly possible to advance a logical argument for the defense of corporate taxation on the ground of the benefit or privilege theory.

According to the ‘social costs’ theory, the government incurs two sets of costs- one indicating positive gain to the company and another indicating responsibility for loss to the community. For the former, the government spends vast sums on technical and professional education, public health and sanitation programmers. For the later, the government incurs vast amount of money again for the rehabilitation of pollution of rivers, forestations, smoke in the industrial towns, etc problems caused by business corporations. As a result, the government is

¹⁴¹ AMBIRAJAN, *supra* note 19, at 8.

¹⁴² *Id.*

¹⁴³ This theory was originally formulated by Thomas Adams in 1917. See *Id.*

¹⁴⁴ Note that the benefit received principle of taxation asserts that households and businesses should purchase the goods and services of government in the same way they buy other commodities. See MC CONNELL AND BRUE *supra* note 101, at 618. For more detailed discussion of the benefit principle, see RICHARD A. MUSGRAVE AND PEGGY B. MUSGRAVE, *PUBLIC FINANCE IN THEORY AND PRACTICE* 239 ff (1980).

¹⁴⁵ See AMBIRAJAN, *supra* note 19, at 9 (foot note omitted)

¹⁴⁶ *Id.*, at 10.

¹⁴⁷ *Id.*, at 11.

entitled to claim a share in the profits made by the companies via the corporation taxes on the basis of the social costs theory.¹⁴⁸ The problem of social costs, however, caused not only by corporations but also by all types of economic activities. And thus it is not possible to mathematically measure the share of social costs that could be a basis for the justification of corporation tax. This in turn makes the social cost theory to be vague and remote justification for corporate taxation.¹⁴⁹

According to the social-political theory, which emphasizes on the equality of income, the corporations should be taxed so as to effectively reduce the heavy concentration of wealth they have and to spend the revenue derived from the taxation of corporations on the upliftment of the poorer sections of the community with a view to raising their economic status.¹⁵⁰ But this approach does not take into account the variable economic status of the individual shareholders, as distinct from the total economic status of the corporation as a whole. That is, even though the corporation itself may be rich, if the individual shareholders are far from being rich, then any tax on the corporation will tend to be regressive and the whole socio-political purpose of such taxation will be frustrated.¹⁵¹

Another doctrine often advanced in defiance of corporate taxation is the so called 'ability to pay theory'.¹⁵² According to this theory, corporations ought to be taxed because, being affluent, they can afford to pay the taxes.¹⁵³ It is, however, argued that the distinction between corporations and the shareholders who constitute them is only a legal fiction.¹⁵⁴ Taxes imposed on the corporation are not born by them; it is the shareholders who feel the pinch.¹⁵⁵ In fact, according to Bird, it is not only the shareholders who feel the pinch but rather, in addition to the shareholders in the shape of decreased dividends, the corporate taxes are also born by workers in the form of decreased wages, by the consumers in the shape of increased prices, and by the

¹⁴⁸ Id, 13.

¹⁴⁹ Id.

¹⁵⁰ Id, 14.

¹⁵¹ Id.

¹⁵² Id, at 17.

¹⁵³ In this regard, the taxation according to the ability to pay calls for corporations with equal capital to pay the same, while corporation with greater ability should pay more. The former is referred as horizontal and the later as vertical equity. See MUSGRAVE AND MUSGRAVE, *supra* note 144, at 242; MCCONNELL AND BRUE, *supra* note 101 at p 619; and AMBRIGAN, *supra* note 19, at 17.

¹⁵⁴ And according to Roymond, the concept 'fiction' connotes something far removed more than is necessary. A corporation is really a collection of flesh-and-blood individuals who have an identity of interest in certain affairs. Neither the individuals nor the relation they bear to one another is fictitious. See Roymond, *supra* note 41, at 13.

¹⁵⁵ AMBIRAJAN, *supra* note 19, at 18.

corporate suppliers in the form of decreased demand and decreased price.¹⁵⁶ Ultimately, therefore, there could be no sound argument based on the theory of ability to pay in defense of the corporate taxation.

In conclusion, no one of the above theories can conclusively form the basis for corporate taxation¹⁵⁷ and there are no rational justifications for its continuance other than the simple revenue motive.¹⁵⁸

2.C The Law of Corporate Tax : Policy Issues- Integration Vs. Separation

In many countries , the same income tax law applies to both individuals and legal entities , but particular provisions (concerning rates of tax , for example) distinguish between the income of individuals on the one hand and that of companies on the other .¹⁵⁹ In other countries, separate tax laws are applied to incomes of individuals and companies.¹⁶⁰ In this regard, a major policy issue encountered while framing a tax law is the choice between separate taxation system (also called classical system) and integrated taxation system.

In the classical or separate corporate tax system, income tax is levied separately, both on company and on shareholders.¹⁶¹ According to Mc Lure, the corporate source income under this system is subjected to three more or less distinct tax regimes. First, all such income is subjected to a flat-rate corporation income tax. Second, any dividends paid from corporate-source income are subjected to the dividend tax or are included to the gross income of the dividend recipient and taxed at the marginal rate based upon his/her entire individual taxable income. Third, tax is assessed upon the long-term capital gains to the shareholders, including those attributable to the retention of net corporate-source income by the corporation.¹⁶²

If, however, the assumption that ‘the corporate tax is born by shareholders’ is considered to be valid, the classical (separate) corporate tax system poses problems. For one reason, a separate tax on corporation income cannot be justified under commonly accepted canons

¹⁵⁶ Bird, *supra* note 116 at 228; and AMBIRAJAN *supra* note 19, at 18.

¹⁵⁷ *Id.* at 19.

¹⁵⁸ HILLMAN, *supra* note 93, at 500.

¹⁵⁹ King, *supra* note 22, at 149-151.

¹⁶⁰ *Id.*

¹⁶¹ *Id.* at 149.

¹⁶² MC LURE “Integration of the Personal and Corporate Income Taxes: The Missing Element in Recent Tax Reform Proposals,” 88 *HERV. L. REV.* 532(1975), in Tadese Lencho, *Reading Materials for the Study of Law of Public Finance*, Compiled in November 2006, Law Library, Addis Ababa University Faculty of Law.

(principles) of taxation.¹⁶³ For a second reason, it creates economic distortions¹⁶⁴ and is inequitable.¹⁶⁵ Yet for another reason, it distorts incentives in four main reasons-discourages business from incorporating, encourages debt financing rather than equity finance, encourages retention of income rather than distributing them to shareholders, and finally the classical corporate tax system reduces the incentive to invest and may therefore inhibit growth.¹⁶⁶ In addition, the classical corporate tax system may also encourage corporations to disguise distributions as deductible payments of interests, rent, or salary.¹⁶⁷

Most of the problems posed by the classical system of corporate tax system stem from the double (or triple) tax attribute of this system. As a result, the double tax on corporate profit has always been controversial.¹⁶⁸ Such controversies have reduced to arguments for and against the classical corporate tax system. And the arguments against the system have in turn reduced to the integration of the corporate-level and shareholder-level taxes.

The case for integrating individual and corporate income taxes rests on two basic propositions.¹⁶⁹ The first is that taxation should be levied, as a matter of fiscal equity according to the “ability to pay”-as measured by income.¹⁷⁰ The second is that corporate entities do not have an ability to pay taxes, in the relevant sense, they are simply a “conduit” through which income flows to individuals who are their ultimate owners.¹⁷¹ Combined, these propositions appear to suggest that corporate income should only be taxed in the hands of the individuals to whom it accrues.¹⁷²

There are however arguments in favor of retaining the classical corporate tax system which are in fact forwarded against the integrated corporate tax system. Classic proponents of the retention of the separate corporate tax system have argued that the concentration of economic

¹⁶³ In this respect, McLure contends that the classical corporate tax system specially violates the canon of equity in its two forms- horizontal and vertical- and the ability to pay canon. *Id.*

¹⁶⁴ The US Treasury Department, for example, pointed out three distortions caused by the classical corporate tax system: (1) Whether to invest in a non-corporate form rather than the corporate form (2) Whether to finance investments with debt rather than equity, and (3) Whether to retain rather distribute earnings. Treasury Department Report, “Integration of the Individual and Corporate system, Taxing Business Income Once” 3(4 DTR G-2 Sp. Supp., 1/7/92) in LENDERMAN *supra* note 51, at 345.

¹⁶⁵ LIND, ET AL, *supra* note 120, at 29.

¹⁶⁶ King, *supra* note 22, at 149-150.

¹⁶⁷ LENDERMAN, *supra* note 51., at 345.

¹⁶⁸ LIND, ET AT, *supra* note 120, at 29.

¹⁶⁹ King, *supra* note 22, at 149.

¹⁷⁰ *Id.*

¹⁷¹ *Id.*

¹⁷² *Id.*

power represented by the earnings of companies is an appropriate object of a tax system that purports to be built on principles of fairness and ability to pay.¹⁷³ Because the corporation is not a mere conduit for personal income. But rather a corporation is a legal entity with an existence of its own, a powerful factor in economic and social decision making, operated by professional management subject to little control by the individual shareholder.¹⁷⁴ From this, it is concluded that, being a separate entity, the corporation also has a separate taxable capacity, which is properly subject to a separate and tax. Whether profits after tax are distributed or retained is irrelevant in this context.¹⁷⁵ These classical views of the corporate tax are, however, hardly tenable. Corporations do indeed act as distinct decision-making units. But in the end, all taxes must be borne by people (natural persons), and that the concepts of equitable taxation and ability to pay can be applied to people only.¹⁷⁶

“Integration” means adjustment of the corporate tax system in such a manner that corporate source profits are taxed at the personal rate, whether they are retained by the firm or distributed to the shareholders.¹⁷⁷ According to the integrationist position, income should be taxed as a whole under a global income concept, independently of its source.¹⁷⁸ To that effect, the integrationists have provided a range of techniques for achieving integration. In fact, these techniques differ in terms of whether (1) double taxation is mitigated with respect to both retained and distributed assets; and (2) the actual taxpayer on corporate earnings is the corporation or the shareholder.¹⁷⁹

The purest form of integration is referred to as full or complete integration and in effect represents the tax system applicable to partnerships.¹⁸⁰ Under full integration there is no imposition of any corporate-level tax at all but would treat the corporation as a “conduit” allocating all items of income, deduction, and credit among the shareholders each year. This approach is sometimes described as “partnership method”.¹⁸¹ Traditionally, “full integration” has been used to denote an arrangement under which the incomes of corporations, both distributed

¹⁷³ LIND, ET AL *supra* note 120, at 29.

¹⁷⁴ MUSGRAVE AND MUSGRAVE, *supra* note 144, at 400-401.

¹⁷⁵ *Id.*

¹⁷⁶ MUSGRAVE AND MUSGRAVE, *supra* note 144, at 339-401.

¹⁷⁷ *Id.* at 399-400

¹⁷⁸ *Id.* at 399.

¹⁷⁹ LIND ET AL, *supra* note 120, at 31.

¹⁸⁰ *Id.*

¹⁸¹ KAHN AND LEHMAN, *supra* note 102, at 37.

and retained, would be attributed in an appropriate manner to the individuals who are their ultimate owners. “Full integration” in this sense, may be an ideal arrangement in principle but it is administratively impracticable for various reasons.¹⁸² As a result, no country has tried to apply a full integration scheme to the taxation of corporate income except in the case of small companies with limited number of owners.¹⁸³

In particular circumstances, however, full integration can be achieved by several methods unlike the above partnership method. One such system would be to abolish the corporate income tax completely and let shareholders pay taxes under the personal income tax on the dividend received plus net accrued capital gains on shares that is, on a comprehensive income base.¹⁸⁴ Second, full integration could be achieved in the special case where the personal income tax is levied at a single rate, by levying tax on corporate income at the same rate, while exempting dividends and capital gains on company shares from the personal tax.¹⁸⁵ There are also other forms of integration such as the partial integration via a deduction for dividends paid in a similar manner to the case of imputation system.¹⁸⁶

From the above policy issues perspective, where does the Ethiopian case fall? The taxation of companies in Ethiopia falls in the classical approach. Companies’ income is taxed separately at 30% flat rate. Then, the distribution of the net company income to shareholders as dividend is again taxed at 10% flat rate. As stated repeatedly, the investors in companies are the shareholders, and thus the taxation of the income of company at any level ultimately affects the shareholders. Therefore, it can be logically said that the incomes of companies is in effect, subject to a 40% flat rate tax-30% at the company level, and 10% on dividend distribution. This

¹⁸² Such reasons, for example include (1)that there would be an enormous amount of information reporting required, (2)that attributing retained earning to different owners is problematic when there are different classes of corporate security holders with heterogeneous claims such as ordinary share, and convertible notes, (3) that tracing the ultimate owner can be difficult, and (4) that it could result in shareholders being liable to pay large amount of taxes see Indian Corporate Tax Reform, at 119 available at <<http://www.finmin.nic.in/kelkar/chpsdt.pdf>> (accessed on 28, 08,2008).

¹⁸³ In the United States, for example, certain companies with no more than 35 shareholders can qualify to be taxed in a similar way to partnerships, with their income being allocated directly to their shareholders. See KAHN AND LEHMAN, *supra* note 102, at 119.

¹⁸⁴ Note however, that such a system is extremely burdensome in terms of both administrative and compliance cost. *Id.*

¹⁸⁵ *Id.*

¹⁸⁶ For further methods of integration see Harvey P. Dale, Corporate Integration and Tax-Exempt Organizations (1990), pp 2-5. Available online at <http://www.archive.nyu.edu/bitstream/2451/23365/2/HPD.CorpInt.90.pdf> (accessed on 11/08/2009 at 5:40pm); LIND, ET AT. *supra* note 120, at 30-36; AMBIRAJAN, *supra* note 19; King, *supra* note 22, at 149-151; and KAHN & LEHMAN *supra* note 102,at 30-39.

40% is greater than the maximum threshold progressive tax rate (35%) that is levied on the individual business income.

In the interviews made with the officials and lawyers of the Ethiopian Revenue and Customs authority, it was learned that the current Income Tax Proclamation has the objective of encouraging organized business entities¹⁸⁷. The Proclamation tries to achieve this by lowering the tax rate of bodies to be 30%, which is in fact loss by 5% than the maximum progressive threshold rate of the individual tax. But in effect, this is misleading. This Proclamation instead discourages organizational business by discrimination between the corporate tax and individual tax. Any amount of company income is subject to 40% aggregate income tax. The current Income Tax Proclamation does not provide exempt threshold for bodies (unlike for “other taxpayers”).

While this is the case in the Income Tax Proclamation, then how would potential shareholders (company investors) be attracted to invest in organized business (companies)? As stated earlier, organizational form of doing business is an ideal mechanism of bringing the scattered capital of the members of the society together in order to invest in enterprises that need a certain level of capital requisite. In this regard, there is a growing consensus that organized private sector investment—both domestic and foreign, and both large-scale and small, has a vital role to play in driving economic growth and helping to alleviate poverty.¹⁸⁸ In Ethiopia, the advancement of economic development is one of the ultimate goals of the Nations, Nationalities and peoples of Ethiopia¹⁸⁹. In order to accelerate this goal, it has become necessary to encourage and promote investment.¹⁹⁰ Investment means expenditure of capital by an investor to establish a new enterprise, expand, or update one that already exists.¹⁹¹ Currently, the population number in Ethiopia goes beyond 77 million. But the total number of share companies in all sectors of the economy is just 508; private limited companies just 13, 687; partnerships just 539; joint ventures just 27; and public companies just 202.¹⁹² If we compare the current number of companies in Ethiopia with the number of companies in two countries from the west, where there are more

¹⁸⁷ See Interview, *supra* note 31.

¹⁸⁸ Nelson, Jane Leveraging the Development Impact of Business in the Fight Against Global Poverty, P.1, available online at http://www.brookings.edu/global/200508blum_nelson.pdf (accessed on 25/08/2009)

¹⁸⁹ See Preamble of FDRE CONSTITUTION.

¹⁹⁰ See Preamble of Investment Proclamation No 280/2002.

¹⁹¹ See Art 2(1) Id.

¹⁹² Source: Information technology department of the Federal Revenue and Customs Authority, 02, 11, 2009.

than 18 million companies in the United States and 1.5 million companies in the United Kingdom¹⁹³, we get ourselves down near zero. So what is wrong in Ethiopia? Could it be because the tax law fails to do its job in encouraging corporate business? Yes, it could be one, and probably the primary one. One of the functions of tax law is leading the flow of resources in a certain manner by providing, for example, clear and specific incentives. Lowering the tax rate and eliminating the double or triple tax on corporate income can be one. So is there a need to integrate the corporate tax and individual tax in the form of dividend and capital gains tax in Ethiopia in order to encourage corporate business? What is the effect of the classical system of corporate taxation in the current Income Tax Proclamation? These questions need further studies, but any ways we need to be serious on the issues of corporate business.

2.D Corporate Formation

In order to commence business operations, a corporation needs assets. It normally acquires these assets-known as the initial “capital” of a corporation-by issuing shares of stock in exchange for cash or other property or by borrowing.¹⁹⁴ If a corporation is formed by the transfer of cash to the corporation in exchange for the issuance of its shares, the taxpayer will have a tax basis in the shares equal to that amount.¹⁹⁵ From a corporate law point of view, the amount received will usually be accounted for as paid in capital. In some systems, the corporate law treatment of the capital contribution and its possible subsequent repayment will affect the tax rules applicable to the shareholder and to the corporation. In other jurisdictions, the corporate law treatment is irrelevant for tax purposes.¹⁹⁶

If appreciated or depreciated property is transferred in exchange for shares on formation, the transfer would in principle be an exchange causing gain or loss realization by the shareholder. Several systems take this approach and require taxation as the general rule in these circumstance.¹⁹⁷ In France, Germany, the Netherlands, Japan and Canada, for example, the transfer of assets to a corporation on formation is generally a taxable event.¹⁹⁸ In the United States system, however, neither gain nor loss will in general be taken into account regardless of

¹⁹³ See EWAN MACL N TYRE, BUSINESS LAW 475 (2nd ed. 2005).

¹⁹⁴ In this incidence taxpayers transfer property to a corporation in exchange for the corporation’s stock. See SHAKOW *supra* note, p. 55; and LIND, ET AL, *supra* note, 120, at 51.

¹⁹⁵ See AULT, *supra* note 49, at 292.

¹⁹⁶ *Id.*

¹⁹⁷ *Id.* at 293.

¹⁹⁸ *Id.* at 293-298.

the nature of property transferred. In the United Kingdom, capital gains tax is available if there is a transfer of an entire business by an individual in exchange for shares. And the Australian rules on formation distinguish between types of property transferred and are not comprehensive.¹⁹⁹

When seen from this perspective the Ethiopian Tax Law provides that gain or loss is recognized when business assets are transferred in any manner.²⁰⁰ That is, if appreciated property is transferred in exchange for shares, for example, gain will be recognized. And if depreciated business asset is transferred in exchange for the same, loss will be recognized. The Income Tax Proclamation does not, however, specify as to what the effect of such gain or loss will be nor does it put a limit on the types of business assets to be transferred and the mode of transfer. The question now is, whether such gain would be subject to the tax rate provided under Article 37 of the same? And does the loss recognized on the transfer benefit from the loss carry forward provisions as provided under Article 28 of the Proclamation?

Article 24(1) of the Proclamation deals with the transfer of business assets without specifying the kinds of such assets so far as the assets have been put in the business.²⁰¹ Article 37, however, deals with the gain on transfer of certain investment property by the specified manner of transfer (sale or gift) and the property to be transferred-building held for business, factory, office, and shares of companies.²⁰² The effect of the transfer under Article 37 is also specified-income tax is payable on gains obtained from the transfer. So, from their respective wordings, there is no correspondence between these two articles. And accordingly it seems appropriate to conclude that the gain recognized by the transfer of business assets under Article 24(1) is not taxable under Article 37(1). Analogically, the loss recognized by such transfer will not also be carried forward as per Article 28 of the Income Tax Proclamation. In this regard the practice conforms with this interpretation of Article 24. In the interviews and discussions made with the lawyers and officials of the Tax Authority²⁰³, it was learned that corporate (company) formation in Ethiopia presently is a zero tax transaction except for the stamp duty fees. Private corporate lawyers and officials also share this view.²⁰⁴ Comparatively, the practical trend pursued in Ethiopia follows the position taken by the United States system. In the United States

¹⁹⁹ Id,

²⁰⁰ See Art 24(1) of the INCOME TAX PROCLAMATION NO. 286/2002.

²⁰¹ See Art 24(1) of PROCLAMATION NO. 286/2002 in its Amharic version.

²⁰² See Art 37(1) (a, b) of PROCLAMATION NO. 286/2002.

²⁰³ See Interviews, supra note 31.

²⁰⁴ Interviews with Ato Sololmon Tesfeye, Libya Oil Limited Financial Manager; and Ato Tadele G/hiwot, Total Ethiopia Share Company, Treasury Section Head.

system, neither gain nor loss is taken in to account on the corporate formation regardless of the nature of property transferred. The same is true in Ethiopia. The mere act of organizing a company and incorporating it under the Ethiopian Commercial Code is not a taxable event, even when gain or loss is recognized on the transfer of business assets.²⁰⁵

2.E Corporate Capital Structure, Corporate Finance and Tax Implications

The corporate form of organization plays a vital role in the formation of capital.²⁰⁶ Through this form of organization, it became possible to combine and bring together the small-scattered savings of tens, hundreds or even thousands of members of the public into “huge” sums of finance (fund) in order to create capital.²⁰⁷ Inversely, the concept of capital plays a large role in the law of business organizations, particularly those with limited liability-private and share companies for example.²⁰⁸ Investment decisions by firms are greatly influenced by the amount of capital available.²⁰⁹ In addition to the influence of investment decisions, the capital of an organization also serves as a general security for the debt of the organization.²¹⁰

Corporate capital structure refers to the pattern along which the interests of the investors of a business organization are allocated.²¹¹ The partnership and corporation patterns of business

²⁰⁵ For a deeper analysis of the tax consequence of a corporate formation see LEDERMAN, *supra* note 51, at 19-55.

²⁰⁶ Article 2(2) of the INVESTMENT PROCLAMATION NO. 280/2002 defines the term “capital” to mean local or foreign currency, negotiable instruments, machinery or equipment buildings, initial working capital, property rights, patent rights, or other business assets.

²⁰⁷ See S.S. Huebner, Scope and Function of the Stock Market, 35(3) THE ANNALS OF THE AMERICAN ACADAMY 483 (May 1910), in TILAHUN TESHOME, LL.M BUSINESS LAW COURE MATERIALS BASIC READINGS (Compiled in April 2006). It should be noted here that the term “capital” as used by economists refers not to money but real capital-all tools, machinery, equipment, factory, storage, transportation, and distribution facilities-that are used in producing consumer goods and services. The term money capital or financial capital is simply a means for purchasing real capital. As a result money in itself is not an economic resource. See Mc CONNELL & BRUE *supra* note 100, at 169. In the context of company law, the term “capital” represents only the value of the transfers (contributions) made by the members of business organization. See EVERT F. GOLDBERG, THE COMMERCIAL CODE OF ETHIOPIA: SELECTED TOPICS 21(1972).

²⁰⁸ GOLDBERG, at 89.

²⁰⁹ See McCONNELL & BRUE, *supra* note 101, at 169.

²¹⁰ See GOLDBERG, *supra* note 207, at 43.

²¹¹ Note that those who finance a corporation or any other economic enterprise generally are interested in the enterprise to the right to receive income from the firm’s operations; right to share in the firm’s assets if the firm becomes insolvent or liquidates voluntarily; and need to protect their investment from the inevitable risk of the business. See SOLOMON ET. AL *supra* note 113, at, 222.

organizations rely on different mechanisms to allocate such interests.²¹² In a partnership, investors' interests are determined by the partnership agreement.²¹³ In a corporation, the terms of investors' interests are embodied in the securities they own.²¹⁴ That is, corporate securities are the vehicles by means of which those who provide capital to the firm specify their interests in the firm's management, income stream and assets and protect themselves against risk.²¹⁵

Corporate financing is predominantly made through corporate securities.²¹⁶ Such corporate securities can be divided into two broad categories: equity securities and debt securities.²¹⁷ In general, equity securities represent more or less permanent commitments of capital to a corporation and can be in the form of common and preferred stocks, while debt securities represent capital invested for a limited number of years and are usually denoted in the form of bonds and debentures.²¹⁸ From risk standpoint, holders of equity securities, bear more risk because their claims to income are contingent on the corporation's earning a profit. In addition, their right in the corporation's asset are subordinated to the claims of both trade creditors and holders of the corporation's debt securities.²¹⁹ Holders of debt securities, when compared with equity holders, however bear less risk.²²⁰ Their claims to income are fixed, and the corporation is obligated to repay their capital at some future date.²²¹ Moreover, debt holders' rights may be secured by a lien on some or all of the firm's assets or by contractual agreements restricting the firm's operations.²²²

The theoretical basis for modern thinking on capital structure lies on the Modigliani-Miller theorem, which states that "in a perfect market,²²³ how a firm is financed is irrelevant to

²¹² Id.

²¹³ Id.

²¹⁴ Id.

²¹⁵ Id.

²¹⁶ See HELEMINEN, *supra* note 38, at 251. Note that corporate financing is also made through loans (bank loans for example) and retained earnings. See generally Keith Berlin, *Investment Opportunities within the Capital Structure* (Fund Evaluation Group, LLC, 2006).

²¹⁷ SOLOMON ET AL, *supra* note 113 at 222.

²¹⁸ Id. Debt securities represent liabilities of a corporation and constituted a part of a corporation's long-term capital structure. However they differ from other liabilities, such as the claims of trade creditors, who sell goods and services with the expectation of being paid with in a short period of time or the claims of financial institutions that lend money to corporations on a short-term basis. See Id, at 226-227.

²¹⁹ Id.

²²⁰ Id.

²²¹ Id.

²²² Id

²²³ Where expectations and business risk are homogeneous, there exist perpetual cash flows, and where there exist perfect capital market (perfect competition where everyone is a price maker; firms and investors can borrow and lend at the same rate; equal access to all relevant information and; no transaction cost-taxes or bankruptcy costs).

its value.”²²⁴ In other words if capital markets are perfect (which means corporate tax rate, interest tax rate on debt, and dividend tax rate are all equal to zero), it does not matter whether the firm finances with debt or equity.²²⁵ This theoretical assumption provides the base with which to examine real world reasons why capital structure is relevant. And in the real world a company’s value is affected by the capital structure it employs and capital structure is affected by market imperfections.²²⁶ Corporate tax was the first such imperfection that was introduced in the Modigliani-Miller theorem.²²⁷ From corporate capital structure point of view, the main features of corporate taxation in the classical corporate taxation system²²⁸ are that corporate income is taxed at a corporate tax rate, interest is deductible and is paid out of income before taxes, and equity payout (dividend) is not deductible and is paid from the residual remaining after corporate taxation.²²⁹ In the classical system, interest, dividends, and capital gains income are taxed upon receipt by investors. By providing corporations with a deduction for interest paid but no deduction for dividend distributions paid, the tax law favors debt over equity in capital structure.²³⁰ As a result, the optimal capital structure that maximizes the value of a firm consists of 100% debt finance, putting equity to be the marginal source of fund if at all used.²³¹

The tax benefit of debt finance is however challenged when a second imperfection is introduced in the theoretical ideal market. When bankruptcy costs are taken into consideration there will be a cost of financing with debt. According to Kraus and Litzenberger, firms should, while framing the capital structure, trade-off bankruptcy costs with the tax advantages of debt finance to arrive at an optimal capital structure that involves less than 100% debt.²³² Regardless of the bankruptcy cost of debt finance however, the basic trade-off implications, according to Graham, remain similar to those in the Modigliani-Miller theorem: that the incentive to finance

See Adrienn Herczeg, Determining the Optimal Capital Structure by Agricultural Enterprise, available at <http://www.mace-events.org/4293-MACE/version/last/part/19/data/?branch=main&language=en> (accessed on 02/09/2009).

²²⁴ See John R. Graham, A Review of Taxes and Corporate Finance, *Foundation and Trends in Finance*, Vol. 1 No. 7(2006) 577 down loaded from <<http://faculty.fuqua.duke.edu/~jgraham/website/TaxReviewNOWZacFinal.pdf>> on request from John R. Graham through e-mail written on 02-09-2009 by the Author.

²²⁵ Id. In this theoretical framework, the value of the firm equals the value of equity plus the value of debt and the total value is not affected by the proportions of debt and equity Id, at 578.

²²⁶ Herczeg, supra note 223.

²²⁷ Id, at 3.

²²⁸ See discussion under section 2.D for “Classical System” above.

²²⁹ See Graham, supra note 224, at 576.

²³⁰ See LEDERMAN, supra note 50, at 57.

²³¹ See Herczeg, supra note 223; and Graham, supra note 224, at 576. Note that so far the only imperfection introduced in the perfect market is “corporate taxation”

²³² See Graham, supra note 224, at 579.

with debt increases with the corporate tax rate; and that the firm value increases with the use of debt (up to the point where the marginal cost of bankruptcy equals the marginal benefit of debt finance).²³³ Therefore, the value of the firm still increases with the use of debt because of tax benefits if factors other than corporate taxation and bankruptcy costs are kept constant²³⁴ and corporations have a tax incentive to finance with debt that increases with the corporate marginal tax rate.²³⁵

If the cost of asymmetric information is involved in the market, business will prefer internal finance when available, and debt is preferred over equity when internal debt is depleted, and when it is no longer sensible to issue any more debt, equity is issued.²³⁶ To minimize the problems that might arise from the relative advantages of debt finance over the equity finance in the capital structure of companies,²³⁷ several countries have reduced or eliminated the double taxation of distributed corporate income through the adoption of some type of imputation system.²³⁸ Under the imputation system, the tax paid by a corporation on its income is imputed (attributed) to the shareholders and treated as a credit against the tax payable by shareholders on dividends.²³⁹ In effect, the corporate tax is treated as a withholding tax paid by the corporation on behalf of the shareholders.²⁴⁰ In addition to the imputation system, several countries have adopted thin capitalization rules in response to the bias in favor of debt compared with equity.²⁴¹ Under this rules, the deduction for interest paid by a company to shareholders is denied to the extent that the company is financed excessively by debt.²⁴² In this regard, some countries have adopted statutory thin capitalization rules; others rely on administrative guidelines or

²³³ Id.

²³⁴ Id.

²³⁵ Id., at 580.

²³⁶ Id., at 580-596.

²³⁷ Note here that the advantage of paying interests on the debt finance to paying dividends constitutes an inherent bias in favor of debt financing in the capital structure of companies. See Id.

²³⁸ See BRIAN J. ARNOLD & MICHAEL J. MCINTYRE, *INTERNATIONAL TAX PRIMER* 83 (2nd ed. Kluwer Law International, 2002).

²³⁹ Id., at 84.

²⁴⁰ Id.

²⁴¹ Id., at 85.

²⁴² Id. The term “thin capitalization” in this context refers to the situation when a company’s share capital is small in relation to its debt; and the thin capitalization rules refer to the restrictions on the deductibility of interest payments made by corporations with excessive ratios to their substantial shareholders.

practices.²⁴³ Still others try to deal with the problems of thin capitalization by general anti-avoidance rules.²⁴⁴

A debt to equity ratio for purpose of thin capitalization rules can be established either as a fixed ratio or by reference to the average debt to equity ratio of corporations engaged in a particular business sector.²⁴⁵ Most countries use a fixed debt to equity ratio of 2:1 or 3:1, and some times a higher ratio for financial institutions.²⁴⁶ The effect of the application of thin capitalization rules is generally that excessive debt is not deductible.²⁴⁷ In some countries, this excessive interest is considered as a dividend.²⁴⁸

In this regard, some countries have provided specific rule dealing with the debt equity distinction in their tax laws through the adoption of thin capitalization rules. While others simply follow the civil or commercial law characterization of obligations as debt or equity for tax purposes with out providing specific rules in their respective tax laws.²⁴⁹ France, and Germany, for example, are of the first type where as Japan, The Netherlands, Sweden, United Kingdom, Canada and the Untied States fall in the second category.²⁵⁰

In the Ethiopian case, it is provided that “declared dividends and paid-out profit shares shall not be deductible”.²⁵¹ Interest, on the other hand, is deductible so far as it is not in excess of the rate used between the National Bank of Ethiopia and the Commercial banks’ increased by two percentage points²⁵² and provided that such interest is paid to lending institutions recognized by the National Bank of Ethiopia or to foreign banks permitted to lend to enterprises in Ethiopia up on the fulfillment of some conditions.²⁵³ In addition to this, interest paid to shareholders of companies other than banks and insurance companies on loans and advances are not deductible to the extent that the loan or advances in respect of which the interest paid exceeds on average

²⁴³ Id.

²⁴⁴ Id.

²⁴⁵ Id., at 86.

²⁴⁶ Id.

²⁴⁷ Id.

²⁴⁸ Id.

²⁴⁹ See HUGH J. AULT, *supra* note 49, at 298-302.

²⁵⁰ Id.

²⁵¹ See Art. 21 (1, d) of the INCOME TAX PROCLAMATION, NO 286/2002.

²⁵² Art 21 (1, e) Id. cum Art A of the COUNCIL OF MINISTERS INCOME TAX REGULATION NO. 78/2002.

²⁵³ See Art 10(1, 2, 3) of REGULATION NO. 78/2002. Such conditions are specified under Art 10(3) (a, b) and say that the lending bank shall, prior to the granting of any loan to any such person, file a declaration in writhing with the Tax Authority with in it informs said Authority concerning all loans granted to any person liable to pay income tax in Ethiopia; and the borrower shall withheld 10% from the gross interest payable to the Tax Authority within two months of the end of the fiscal year.

during the tax period four times the amount of the share capital.²⁵⁴ These provisions of the tax law are a sort of thin capitalization rules expressed in terms of debt source and interest rate. Through such provisions, the Ethiopian tax law tries to regulate the capital structure of companies for tax purpose-though indirectly however-without touching the issue of debt-to-share ratio in the corporate capital structure. Subject to the limitations on debt source and interest rate, therefore, companies are free to pursue any ratio of debt to share arrangement in their capital structure. From this one may infer that the Ethiopian tax law is indifferent in the issue of corporate capital structure-be it debt biased, or share dominated or any otherwise arrangement.

Chapter 3: Corporate Middle Life Events and Tax Issues

In Chapter two we discussed the theoretical and conceptual framework of corporate taxation and the tax issues related with the corporate birth (formation). This chapter is devoted to the corporate middle life events and tax-issues thereof and dwells in the assessment of the Income Tax Proclamation No.286/2002 and the Income Tax Regulation No 78/2002 in their respective treatment of the corporate middle life events and Tax issues related thereto.

3.A. Corporate Income Tax

3.A.1 Definition

Corporate income tax is a tax imposed on the profits of a company²⁵⁵ earned during a tax year.²⁵⁶ The tax year of a company is the accounting year of the company.²⁵⁷ Accounting year according to Misrak Tesfaye is a 12-month period selected by the management of a business to show the operating results of the business.²⁵⁸ Generally, a company reports its profits to its shareholders and creditors, among which the tax authority could be one, at the end of its accounting year. These properly reported profits constitute the income of the company. The income of a company is essentially derived from business activities or activities recognized as trade to which it is engaged.²⁵⁹ Neither the current Income Tax Proclamation nor the Income Tax Regulation provides separate definitions for corporate income or corporate income tax. The

²⁵⁴ See Art. 21(3) of PROCLAMATION No. 286/2002.

²⁵⁵ See Art 98(2) of the FDRE CONSTITUTION.

²⁵⁶ See Art 64 of the INCOME TAX PROCLAMATION No. 286/2002.

²⁵⁷ See Id. Art 64(2).

²⁵⁸ See MISRAK TESFAYE, ETHIOPIAN TAX ACCOUNTING: THEORY AND PRACTICE 21 (2008).

²⁵⁹ See Art 8(3) cum with Art 2(6) of the INCOME PROCLAMATION No. 286/2002. For the list of the activities recognized as trade in Ethiopia see Article 5 of the 1960 COMMERCIAL CODE together with the APPENDIX of the COMMERCIAL REGISTRATION AND BUSINESS LICENSING PROCLAMATION NO 67/1997.

Income Tax Proclamation²⁶⁰ instead provides the definition of the general terms ‘income’ and ‘taxable income’.

‘Income’, according to the Income Tax Proclamation, is defined as every sort of economic benefit including nonrecurring gains in cash or in kind, from whatever source derived and in whatever form paid or credited.²⁶¹ And ‘taxable income’ is defined as the amount of income subject to tax after deduction of all expenses and other deductible items allowed under the same Proclamation and the Income Tax Regulation No 78/2002.²⁶² From the above general definition of income it follows that the income of a company is going to be every sort of economic benefit including non-recurring gains in cash or in kind, from whatever source derived and in whatever form paid or credited in the course of the business activities of the company for which it is engaged. This income is however computed on the basis of separate schedules where the corporate income is put in to different independent baskets. Such form of tax computation pattern is commonly known as scheduler tax system.²⁶³ In a scheduler tax computation system, the loss incurred in a certain business is not offset with income on another business and tax is computed on each type of schedule independently. Thus, the ‘taxable income’ of a company in Ethiopia will be defined as the amount of corporate income that will be subject to the corporate income tax on the different schedules after deduction of all expenses and other deductible items allowed under each schedule as provided in Proclamation No 286/2002 and Regulation No 78/2002 as are relevant for companies (bodies).

3.A.2 Determination of Taxable Corporate Income

The basis for the determination of the corporate income tax liability is the taxable corporate income as defined above under 3.A.1. Such taxable corporate income is determined on the accrual basis of accounting.²⁶⁴ In this regard, Article 58(3) of the Income Tax Proclamation

²⁶⁰ See Art 2 (10, 11) of the INCOME TAX PROCLAMATION NO 286/2002.

²⁶¹ See Art 2(10) Id.

²⁶² See Art 2(11) Id.

²⁶³ Note that there are two basic types of tax computation systems-Global Tax system and Scheduler Tax system. In a global tax system, tax is computed on aggregate of all income that the taxpayer derives from difference sources in the world. The loss incurred in a certain business is offset by income on another business and tax is computed on aggregate of all income that the taxpayer derived from difference sources in the world. The loss incurred in a certain business is offset by income on another business and tax is computed on the final aggregate balance. The reverse is true in the scheduler tax system. See Gebrie, *supra* note 5, at 16.

²⁶⁴ See Arts 15 (a) and 19 (1) of the INCOME TAX PROCLAMATION NO. 286/2002. Note that the corresponding business income taxes for individuals and unincorporated businesses ranges from 10%-35% (it is progressive). See Schedule “C” of Id., following Art 19 of the same.

provides that a company shall account for tax purposes on an accrual basis.²⁶⁵ In an accrual basis revenues are accounted for when they are earned and the taxpayer generally reports taxable income in the year it is earned.²⁶⁶

The corporate taxable income involves the determination of gross revenue, exemptions and deductible expenses. Gross revenue includes all revenue receipts arising from the course of the company whether they are recurrent or non-recurring in nature.²⁶⁷ The receipts may be in cash or in kind and should be part of a consideration for goods or services.²⁶⁸

Exemptions are corporate revenues on which corporate income tax is not payable. They are excluded from gross revenues in the computation of corporate tax liability.²⁶⁹ Deductible expenses on the other hand are corporate expenses incurred for the purpose of earning, securing and maintaining the corporate income and are thus allowed for deduction from gross corporate taxable revenues.²⁷⁰

The income tax laws²⁷¹ classify deductible corporate expenses into three categories-fully deductible corporate expenses,²⁷² deductibles based on conditions,²⁷³ and non-deductible expenses.²⁷⁴ Fully deductible corporate expenses include direct cost of producing the income,²⁷⁵ general and administrative expenses²⁷⁶ and, insurance premium directly connected with the corporate business activity.²⁷⁷ Commissions paid,²⁷⁸ promotional expenses,²⁷⁹ payment to the foreign head office,²⁸⁰ and payments to manager or managers of a private limited company,²⁸¹

²⁶⁵ Id.

²⁶⁶ See MISRAK, *supra* note 258, at 155.

²⁶⁷ Id. at 156.

²⁶⁸ Id. at 157.

²⁶⁹ See Art 30 of PROCLAMATION NO. 286/2002 for the specific revenues exempted from the payment of business income tax.

²⁷⁰ See Art 20 of PROCLAMATION NO. 286/2002. For the full list of deductible expenses see Art 8 of REGULATION NO 78/2002.

²⁷¹ Income Tax laws in this context refers to PROCLAMATION NO. 286/2009 and REGULATION NO. 78/2002.

²⁷² See Art 8 of the INCOME TAX REGULATION NO. 78/2002.

²⁷³ See Arts 21-27 of the INCOME TAX PROCLAMATION NO. 286/2002 and Art 8 of the INCOME TAX REGULATION NO. 78/2002.

²⁷⁴ See Art 21 of PROCLAMATION NO. 286/2002 and Art 9 of REGULATION NO. 78/2002.

²⁷⁵ See Art 8(1) of REGULATION NO. 78/2002.

²⁷⁶ See Art 8(2) Id.

²⁷⁷ See Art 8(3) Id.

²⁷⁸ See Art 8(5) Id.

²⁷⁹ See Art 8(4) Id.

²⁸⁰ See Art 8(6) Id.

²⁸¹ See Art 8(7) Id.

representation allowance,²⁸² company's contribution to provident (pension) fund,²⁸³ special reserves for companies engaged in the financial sector,²⁸⁴ participation deduction (reinvestment relief),²⁸⁵ bad debts,²⁸⁶ donations and gifts,²⁸⁷ interest on borrowed capital,²⁸⁸ and depreciation are all types of corporate deductible expenses based on certain respective conditions. In the determination of the corporate income subject to corporate tax in Ethiopia the following falls in the list of the category of non-deductible corporate expenses: capital expenditure;²⁸⁹ additional investment;²⁹⁰ dividend and profit shares;²⁹¹ entertainment expenses,²⁹² penalties and punitive damages;²⁹³ damages recoverable by insurance and business unrelated loss;²⁹⁴ corporate profit tax and Value Added Tax;²⁹⁵ and corporate expenditures exceeding the limits or violating conditions.²⁹⁶ The determined taxable corporate income is taxed a flat rate 30% corporate tax.²⁹⁷

3.A.3 Comparison of Corporate Tax Rates

When this tax rate is compared with the tax rates on bodies in the tax proclamations enacted over the years, it is higher than some and lower than others. In the first Income Tax Proclamation No. 60/1944 and Proclamation No. 107/1949, there was no separate tax rate provided for companies. In these Proclamations, the business income tax rates for companies and individuals were the same subject to variation in rates on other factors such as traders, retailers and groups of activities. Decree No.19/1956 for the first time provided separate tax for incorporated bodies at 15% flat rate. This trend continues until to-date, but the rates vary. Proclamation No.173/1961 provided 16% flat rate tax on bodies corporate; and Proclamation No.255/1967 20%. So when compared with these three laws, the tax rate on bodies corporate in the current Income Tax Proclamation is higher. Proclamation No. 155 of 1978 and Council of

²⁸² See Art 21(1) (j) of the INCOME TAX PROCLAMATION NO. 286/2002.

²⁸³ See Art 21 (1) (c) Id.

²⁸⁴ See Art 26 Id.

²⁸⁵ See Art 27 Id.

²⁸⁶ See Art 25 Id.

²⁸⁷ See Art 21 (1) (n) Id.

²⁸⁸ See Art 21 (1) (e) Id cum Art 10 REGULATION NO. 87/2002, Art 21(3) of PROCLAMATION NO. 286/2002

²⁸⁹ See Art 21 (1) (a)) of PROCLAMATION NO. 286/2002.

²⁹⁰ See Art 21(1) (b) Id.

²⁹¹ See Art 21(1) (d)) Id.

²⁹² See Art 21(a) (m)) Id.

²⁹³ See Art 21 (1(g)) Id.

²⁹⁴ See Art 21 (1(f)) Id.

²⁹⁵ See Art 21 (1(g)) Id.

²⁹⁶ See Art 21 (1(e)) Id.

²⁹⁷ See Art 19(1) of the INCOME TAX PROCLAMATION NO 286/2002.

State Special Decree No.18/1990, on the other hand, provide 50% flat rate tax on the taxable income of “organizations”. These rapid increase in the tax rate of bodies corporate resulted due to the ideological change in the political economy that took place during those years. Proclamation No.107/1994 reduced the tax rate in bodies corporate from 50% to 40%. Proclamation No.36/1996 again reduced the corporate tax rate on “organizations” from 40% to 35%. These reductions in the tax rates of bodies corporate again resulted from changes in ideology of political economy. Anyways, the current tax rate on bodies can be said a little bit less than the rates provided in tax laws enacted during the Socialist Regime but it is 200% high than the rates provided during the Imperial era..

3.B. Dividend in General

It is said that a corporation derives no greater pleasure than through making distributions to its shareholders in the form of dividends.²⁹⁸ That is, a corporation feeds its shareholders upon dividends.²⁹⁹ The legal concept dividend is based on company law and it is in general a distribution made by a corporation to its shareholders based on the decision of the shareholders’ meeting.³⁰⁰ Corporate taxes are levied on different economic transactions that are regulated by company law and as a general principle, it is accepted that corporate tax law respects the general principles of company law terms such as ‘dividend’ and ‘distribution’.³⁰¹ In fact, corporate tax law is sometimes regarded as an additional part of company law.³⁰² Thus, corporate tax law terms and concepts often correspond to the same company law terms and concepts.³⁰³ The different objectives of company law and tax law may however give rise for differences in the context of terms and concepts used in tax law and company law.³⁰⁴ That is, a tax law concept may in some respects be broader and in other respects narrower than the concept of company law.³⁰⁵ What is a lawful dividend under company law may, for example, not necessarily be a

²⁹⁸ See LIND ET AL, *supra* note 120, at 144.

²⁹⁹ See *Id.*, Note, however, that closely held companies resist paying dividends and extend considerable energy to avoid the sting of the double tax. In fact, even many public companies choose to retain profit for use in their business. *Id.* (footnote omitted).

³⁰⁰ See HELMINEN, *supra* note 39, at 69 (footnote omitted).

³⁰¹ *Id.* Note that the term ‘distribution of profits’ is understood to have a somewhat broader meaning than the term ‘dividend’. In company law, the former term is used to mean any distribution of company profits no matter who the recipient is. *Id.*, at 74.

³⁰² *Id.*

³⁰³ *Id.*

³⁰⁴ *Id.*

³⁰⁵ *Id.*, at 72.

dividend for tax law purpose, and what is an unlawful dividend from a company law perspective may be a lawful dividend from tax law standpoint.³⁰⁶

As a result, the meaning of the tax law term ‘dividend’ differs from the company law term of dividend in some countries, and in others, the term has the same meaning in both tax law and company law. Those countries that allow the term dividend to have different meaning in company law and tax law provide a definition section in their tax laws whereas those countries that accept the tax law to follow company law exclude definition section for the term dividend in their tax laws. Examples of countries that include definition section of the term dividend in their tax laws include the United States the Internal Revenue Code section 316(a) of which provides that a dividend is any current and/or accumulated earnings and profits;³⁰⁷ Canada which defines dividend for tax law purpose as any distribution made by a corporation that is not in liquidation;³⁰⁸ United Kingdom where dividend covers almost all transfers of assets from corporation to shareholder other than an authorized return of capital;³⁰⁹ and the Netherlands where dividend for tax law purpose is understood as any economic benefit received by the shareholder.³¹⁰ Sweden, Germany, and Australia are examples of countries that do not provide definition sections for the term dividend in their respective tax laws.³¹¹

When we see the Ethiopian case from this perspective, the tax law defines the term dividend as the “profit of a company that is paid to the shareholder based on shares of stock they have owned”.³¹² In the company law context, dividend is the payment made to shareholders (from the company) from net profits as shown in the approved balance sheet.³¹³ The relevant article of the Commercial Code in this regard provides as “[d]ividends may only be paid to shareholders from net profit shown in the approved balance sheet”.³¹⁴ As can be seen from the wording of this article, the company law context of the word ‘dividend’ is very restrictive than the tax law context.

³⁰⁶ Id.

³⁰⁷ Id, at 71.

³⁰⁸ AULT, *supra* note 49, at 303.

³⁰⁹ Id.

³¹⁰ Id.

³¹¹ See HELMINEN, *supra* note 39, at 75-77.

³¹² See Art. 2(5) Directive No 21/2009 for the execution of income tax free privileges, Federal Revenue and Customs Authority.

³¹³ See Art 458 (1) of the COMMERCIAL CODE. Note that the approval of the balance sheet is made by the meeting of shareholders. See Arts 419(1) and 460 of the COMMERCIAL CODE.

³¹⁴ See Id., Art 458(1).

In the company law, the term ‘dividend’ is used for both the share and private limited company.³¹⁵ The same is true with the terms ‘share’ and ‘shareholders’.³¹⁶ In the tax law however, the term ‘dividend’ is limited to be applicable only to share companies.³¹⁷ The phrase ‘withdrawal of profits’ is used for private limited companies instead of ‘dividend’.³¹⁸ Despite the introduction of new phrase for private limited companies however, the tax rate applicable to both ‘dividends’ and ‘withdrawal of profits’ is the same and is ten percent flat rate.³¹⁹

3.C. Distribution of Dividends

Each time a company earns a profit, it pays income tax to the government. After this tax has been paid, the company is left with its net profit.³²⁰ The company has several options for this net profit it can expand operations by reinvesting it in the business, repurchase the company’s share, pay down debt, purchase investments, acquire other businesses, or return the money to the owners of the business (shareholders) by paying dividend.³²¹

Unfortunately, there is a strong disincentive to give the cash to the owners.³²² If the company were to pay a dividend the owners (shareholders) would have to pay taxes on the dividends they receive from the company, despite the fact that the company has already paid income tax on those earnings.³²³ In most jurisdictions worldwide, dividend payments are considered ordinary income and are taxed as such, the same as if the taxpayer had earned the income working at a job.³²⁴ Other jurisdictions separate dividend income and characterize it as something other than ordinary income subject to different tax rates if taxed at all.³²⁵

From a tax standpoint, dividend distributions often combine the worst of all possible words: they are fully taxable to a shareholder but are not deductible by the distributing

³¹⁵ See Id., Arts 458 and 540.

³¹⁶ See Id., Arts 325 ff and 521 ff .

³¹⁷ See Art 34(1) of the INCOME TAX PROCLAMATION NO. 286/2002.

³¹⁸ Id. Note however the title of Article 34 of PROCLAMATION NO. 286/2002 is ‘Dividends’ not ‘dividends and withdrawals of profits’. See Art 6(h) Id. Art 21 (1, d) Id.

³¹⁹ Id.

³²⁰ See Taxes and Dividend Policy at http://beginnersinvest.about.com/or/dividendsdrips1/a/aa040904_3.htm (accessed 27/08/2009 at 6:00pm).

³²¹ Id.

³²² Id.

³²³ Id.

³²⁴ See LIND ET AL, *supra* note 120, at 145.

³²⁵ Id. The following are some examples of tax rates on dividends: There are no taxes on dividends in Hong Kong and Iran (0% tax); In China and Israel it is 20%; in Italy 12.25%, in Turkey 15%, in Bulgaria 5%, in USA 15%, in Ethiopia 10%.

corporation.³²⁶ To avoid the double tax, corporations often attempt to distribute earnings in a form that may be deductible at the corporate level.³²⁷ Notable examples include a corporation's payment of: (a) excessive compensation to shareholders or their relatives; (b) expenses paid for the personal benefit of shareholders; (c) excessive rent for corporate use of shareholder property; (d) interest on shareholder debt that in substance represents equity; (e) labeling what in reality is a distribution as a loan to shareholder;³²⁸ (f) unreasonable salaries in closely held corporations in which the key employees are also shareholders and; (g) raising money for the corporation with debt rather than stock.³²⁹

Dividend received by corporate shareholders are treated more generously for tax purpose than dividend received by individuals.³³⁰ If corporate shareholders were taxed on the dividends they receive, corporate profits would be subjected to a minimum of three levels of taxation-once when earned, a second time when received as dividends by the corporate shareholder, and again when distributed to the ultimate non-corporate shareholder.³³¹ To alleviate this multiple taxation, tax laws generally permit corporate shareholders to deduct fully or partially the dividends received from other corporations.

In Ethiopia dividend income for tax purpose are ,as stated earlier, of two types: income received in the form of cash dividends by shareholders out of profits of the share company, and withdrawals of profit shares by owners of the private limited company.³³² The distribution of profits by a share company or private limited company to their respective shareholders is subject to a tax at flat rate of 10%, and this tax is a final tax in lieu of income tax.³³³ The dividend payers-share company and private limited company-are legally under obligation to withhold the required tax and pay to the Tax Authority within 15 days starting from the end of the month of payment.³³⁴

3.D. Retention of Dividends

³²⁶ Id, at 161.

³²⁷ Id.

³²⁸ Id.

³²⁹ See SHAKOW, *supra* note 55, at 99, 102.

³³⁰ See LIND ET AL, *supra* note 120, at 166.

³³¹ Id.

³³² See Art. 21(1,d) and Art 34 of PROCLAMATION NO. 286/2002. Also see MISRAK, *supra* note 258, at 274.

³³³ See Art 34. Id.

³³⁴ Id.

It is customary for corporations not to distribute by way of dividends all the net profits earned by them.³³⁵ The amount thus kept back from the shareholders is utilized mainly for the expansion of the business. According to Ambirajan such ploughing back of profits into the business is a sine qua non for the healthy growth of the corporate sector.³³⁶

But sometimes profits are left undistributed for quite another reasons which are not justified by commercial needs of the company. In other words, companies retain profits in order to avoid dividend tax on distributions. When undistributed profits are not regulated by the tax law, i.e. when such profits are not taxed for example, there may result discrimination among dividend taxpayers and misallocation of investment resources.³³⁷

When seen from this case, the Ethiopian tax law encourages companies to retain profits even when the retention was not justified by commercial needs of the company. Our tax law nowhere address the issue of retention of dividends/‘paid out’ profit shares. The law regulates only ‘declared’ dividends and ‘paid-out’ profit shares.³³⁸ In the interviews and discussions made with the tax authority officials it was learned that the practice is also the same with the law.³³⁹ The declaration of dividends or paying-out of profit shares is fully under the discretionary power of the respective individual company-share or private limited. The Tax Authority comes to collect its dividend taxes only when it is informed by the companies that dividend is declared or profit shares are paid-out.

However, an exception practically occurred in two tax cases on dividend. These two cases are related with the net profit remittances of two branches of multinational companies. In the first case,³⁴⁰ where Shell Ethiopia Limited was a respondent and the Inland Revenue Administration appellant, an issue was raised whether Shell Ethiopia Limited, a branch of the foreign company then, has the power to declare dividends. In this issue, the appellate court held that since Shell Ethiopia is a branch of the foreign company, it has no power of declaring dividends apart from simply reemitting the net profit of the branch to the foreign company. In other words, it is up to the shareholders of the foreign company whether to declare dividend distribution or not. A branch like the Shell Ethiopia Limited in the above case is not separately

³³⁵ See AMBIRAJAN, *supra* note 19, at 34.

³³⁶ *Id.*

³³⁷ *Id.*

³³⁸ See Art 21(1,d), 34(1) of PROCLAMATION NO 286/2002

³³⁹ See Interview, *supra* notes 30 & 31.

³⁴⁰ See Internal Revenue Administration Vs. Shell Ethiopia Limited, supreme court civil File No. 4/78 EC.

incorporated but rather a simple corporate presence of the foreign company in the locus of the branch-Ethiopia. The property and activities of a branch are actually the property and activities of the company of which the branch is a part. The foreign corporation is thus the formal taxpayer with respect to the income of its branches.³⁴¹

The same issue was raised in the case between the Federal Inland Revenue Authority and Total Ethiopia Share Company.³⁴² In this case the respondent (Total Ethiopia Share Company) argued that it has no power under any circumstances to declare dividends for it was acting as a branch on behalf of the controlling company in France (Total Meruses/A). The appellate court, however, reversed the tax Appeal Commission's decision by saying that the source of the tax is in Ethiopia.³⁴³

After this case, the Tax Authority claimed that all oil companies have to pay the corresponding dividend tax for all the net corporate profit they reemit in the years up to 2004. Amid of this, all the oil companies working in Ethiopia gathered and agreed to enter in to a negotiable agreement with the Tax Authority in the issue of dividend tax. Finally, an agreement was reached between the oil companies and the tax authority. In this agreement, the tax authority agreed to forgo its accumulated dividend tax claims for the years preceding 2004, and the oil company agreed to pay as dividend tax 10% of the "branch" net income every year starting in 2004 when they reemit the net profit of the "branch"/subsidiary.³⁴⁴ But yet the law is as it is-the declaration of dividend distribution remains discretionary to the companies; and the dividend issue of subsidiary companies is not regulated under the tax law.

3.E. Capital Gains

Capital gains are gains from the sale or exchanges of a capital asset.³⁴⁵ According to Ambirajan, capital gains are the profit that one makes in selling any of one's assets which are not offered for sale in the usual way of business, and capital losses are the decline in the market value of such assets.³⁴⁶ Assets in this context refer to corporation securities (such as debt and

³⁴¹ See ARNOLD & MCINTYRE, *supra* note 338, at 73.

³⁴² See Federal Inland Revenue Authority Vs. Total Ethiopia Share Company, Federal Supreme Court, Civil applet File No. 18682 (June 29, 1997 EC.)

³⁴³ The decision of the Appellate courts on the two cases has been annexed in this Paper so a reference may be made to that.

³⁴⁴ See Interview and Discussion with Ato Solomon Tesfaye, *supra* note 204.

³⁴⁵ LEDERMAN, *supra* note 51, at 13.

³⁴⁶ See AMBIRAJAN, *supra* note 19, at 38. Note that the term asset refers to anything of monetary value owned by a firm or individual. See MC CONNEL & BRUE, *supra* note 101, at G-2.

share securities), real estate, government bonds, and interest in partnerships.³⁴⁷ Again in the context of this paper assets refer to corporate capital assets. So capital gains represent a real increment in the economic value of such corporate capital assets and are the gain realized when the assets are transferred for a price greater than the price originally paid for them.³⁴⁸

Capital gains tax is a tax charged on capital gains, the profits realized on the transfer of corporate capital assets that were purchased at a lower price. Not all countries implement a capital gains tax and those that implement have different rates of taxation.³⁴⁹ Countries that do not charge capital gains tax include Argentina, Barbados, Hong Kong, Malaysia, Netherlands, and Norway.³⁵⁰ And those that levy capital gains tax include Brazil 15%, Bulgaria 10%, China 10%, Estonia 21%, Finland 28% France 16%, German 25%, Hungary 20%, Iceland 10%, India 15%, Italy 12.5%, Lithuania 15%, Poland 19%, Spain 18%, Sweden 30%, United Kingdom 18%, and the United States 15%.³⁵¹

In Ethiopia capital gains taxes are of two types. The first category refers to the capital gains tax payable on the gains obtained from the transfer (sale or gift) of building held for business, factory, and office.³⁵² When gain is realized³⁵³ on the transfer of such properties, a 15% (fifteen percent) flat rate tax is charged on the gain.³⁵⁴ Note here that only the realized gain is subject to the 15% tax rate. The value of the property before the gain is realized constitutes the capital or the basis for the gain. The point where the capital gain separates itself from the capital or basis is the actual transfer of the property.³⁵⁵ The second type of capital gain tax is imposed on the transfer of shares of companies. Transfers of shares of companies are subject to a flat rate capital gains tax of 30% (thirty percent).³⁵⁶

As can be seen from the above, capital gain tax arise when there is a realized gain and capital gain in turn arises when two conditions are satisfied that is, when there is a capital asset building held for business, factory, office and shares of companies; and when there is transfer

³⁴⁷ See Id.

³⁴⁸ See Id., at G-3.

³⁴⁹ See Capital Gains Tax at <http://en.wikipedia.org/wiki/Capital_gains_tax> (accessed on 6/27/2009).

³⁵⁰ Id.

³⁵¹ Id. Note that there are variations in the rates of taxes referred after countries. Some are flat rates and some are progressive ones. For the progressive rates, the rate given here is the initial rate.

³⁵² See Art 37 of the INCOME TAX PROCLAMATION NO. 286/2002.

³⁵³ Note that when assets used in a business are sold, exchanged, or otherwise transferred gain or lose is recognized. See Art 24(1) of PROCLAMATION NO. 286/2002.

³⁵⁴ Id. Art 37 (1, a).

³⁵⁵ See AMBIRAJAN, *supra* note 19, at 39.

³⁵⁶ Art 37 (1,b) of the INCOME TAX PROCLAMATION NO. 286/2002.

(sale or gift). In other words, if these conditions are not cumulatively fulfilled, no capital gain and thus no capital gain tax would arise. According to the Income Tax Proclamation capital gains obtained from the transfer of building held for residence, if such building is fully used for dwelling for two years prior to the date of alienation, are exempted from capital gain tax.³⁵⁷ In addition to this any exchange of shares in a resident company³⁵⁸ which is a party to a reorganization³⁵⁹ in exchange for share in another resident company which is also a party to the reorganization is not considered as a transfer (disposal) of shares and thus there is no capital gain tax imposed thereof.³⁶⁰

The basis for the capital gain tax is the historical cost of the building or the par-value of the share as appropriate and, as mentioned above, the gain obtained from the transfer of capital assets (building held for business, factory, office, shares of company) is the gain realized over such historical cost of the building or the par-value of the shares.³⁶¹

As stated above when shares of companies are sold, exchanged, or otherwise transferred, a 30% flat rate tax is imposed on the gain recognized on such transfer. In practice, however there is no systematic framework where shares of companies can be sold, exchanged, or otherwise transferred. In other words, there is no regulated stock market for the transactions of shares. Currently shares are sold in the companies that issue them. Thus, share transactions are scattered, unorganized and poorly regulated and are prone to tax evasion practices. In an interview made with Ato Mekone Ayele, it was learned that parties to a share transaction are not aware of the 30% capital gain tax on the recognized gain when a share is transferred. And when such parties are informed of the 30% tax they say that they have forgone the transfer transaction.³⁶²

Chapter 4: Corporate End Life Events and Tax Issues

4.A. Liquidation

³⁵⁷ See Article 37(2) of PROCLAMATION NO. 286/2002, and Art 16 of REGULATION NO. 78/2002.

³⁵⁸ A resident company is a company that has its principal office and its place of effective management in Ethiopia and/or is registered in the trade register of the Ministry of Trade and Industry or Trade bureaux of the Regional Governments as appropriate. See Art 5(3) of PROCLAMATION NO. 286/2002.

³⁵⁹ The term “reorganization” is defined in Art. 24(4) of PROCLAMATION NO. 286/2002. For detailed discussion of the term see the next chapter of this paper *infra*.

³⁶⁰ See Art 37(4) of PROCLAMATION NO. 286/2002.

³⁶¹ See Art 15 of REGULATION NO. 78/2002 for deeper understanding of the methods of calculating Gain obtained from the transfer of capital assets.

³⁶² See Interview with Ato Mekonen Ayele, *supra* note 30.

The liquidation of the corporation is the last opportunity to tax at the shareholder level any undistributed corporate profits that have not yet borne shareholder tax.³⁶³ The liquidation of a corporation is also an occasion to tax the shareholder on the appreciation in value of his share investment.³⁶⁴ Before discussing these two aspects of liquidation, it would be appropriate to define the term liquidation.

Liquidation according to the Black's law dictionary is "the act or process of setting or making clear, and fixed that which before was uncertain or unascertained"³⁶⁵ and the UNCITRAL legislative Guide on Insolvency Law defines the term liquidation as "proceedings to sell and dispose of assets for distribution to creditors in accordance with the insolvency law".³⁶⁶ Corporate liquidation may be partial or complete. Partial liquidation involves a distribution of corporate assets to shareholders in return for their share.³⁶⁷ This is true, for example, where part of the stocks of the company are redeemed, or when one of two or more active trades or businesses engaged in the company are terminated, or when there are series of distributions leading to a complete liquidation, one of the series of such distributions could be regarded as partial liquidation.³⁶⁸

A liquidation event is considered as complete liquidation when the corporation ceases to be a going concern³⁶⁹ and its activities are merely for the purpose of winding up its affairs, paying its debts, and distributing any remaining balance to its shareholders.³⁷⁰ A parent company may also wish to arrange its holdings by liquidating or selling the stock of a subsidiary and this event can be considered a complete liquidation in that regard.³⁷¹

³⁶³ See AULT, supra note 49, at 320-221.

³⁶⁴ Id. at 221.

³⁶⁵ See BLACK'S LAW DICTIONARY, supra note 90, S.V., "Liquidation"

³⁶⁶ See UNCITRAL LEGISLATIVE GUIDE ON INSOLVENCY LAW 5(2005).

³⁶⁷ See LEDERMAN, supra note 51, at 157.

³⁶⁸ See Id at 157-158.

³⁶⁹ The phrase 'going concern' refers to the idea that a company will continue to operate indefinitely, and will not go out of business and liquidate its assets. And for this to happen, the company must be able to generate and/or raise enough resources to stay operational. See Definition of 'going concern' at <http://www.investorwords.com> (accessed on 08/07/2009).

³⁷⁰ See LEND ET AL, supra note 120, at 310. Note here that legal dissolution is not required for a liquidation to be complete, and a transaction will be treated as a liquidation even if the corporation retains a nominal amount of assets or continues to operate the business outside of corporate solutions.

³⁷¹ Id.

Liquidation transactions, whether partial or complete, raise tax issues at the shareholder and corporate levels.³⁷² Many countries use the occasion of the liquidation to tax the accumulated corporate profits as a dividend and to allow the repayment of the paid-in capital on a tax-free basis.³⁷³ If there is a capital gain, an increase in value of a share from its par value, a capital gain tax is charged on such gain.

When seen from liquidation standpoint the Ethiopian tax law provides that the tax withheld under proclamation 286/2002 does not form part of the estate in liquidation and that the tax authority has a first claim before any distribution is made.³⁷⁴ Tax withheld under proclamation No 282/2002 include tax on employment income, tax on schedule “D” income which includes royalty income³⁷⁵, income from rendering of technical service,³⁷⁶ income from games of chance³⁷⁷, dividend income³⁷⁸, interest income on deposits³⁷⁹ and a withholding income on payment (2%)³⁸⁰ and on import (3%).³⁸¹ As stated above the liquidation event gives the tax authority the chance to collect the accumulated corporate net profit as a dividend, and if there is an increase in value of capital assets to tax the gain on such increase. As to the issue of dividend tax in liquidation, the tax authority has a first claim before any distribution is made. The priority issue of capital gains tax in liquidation is, however, not regulated. In fact, it is lawful for the tax authority to seize the property of taxpayers when taxpayers are susceptible to liquidation. According to Ato Reta Alemayehu, the tax authority does not wait idle when it is informed that a taxpayer is going to liquidate. In such circumstance, the tax authority immediately takes seizure measures and tries to secure its tax claims prior to the full-fledged liquidation proceedings.³⁸²

³⁷² Id.

³⁷³ See AULT, *supra* note 49, at 321. Examples of such countries include Canada, Japan, France, Australia, German, the Netherlands and Sweden see Id, at 321-324.

³⁷⁴ See Art 82 of PROCLAMATION NO. 286/2002.

³⁷⁵ See Art 31 Id.

³⁷⁶ See Art 32 Id.

³⁷⁷ See Art 33 Id.

³⁷⁸ See Art 34 Id.

³⁷⁹ See Art 36 Id.

³⁸⁰ See Art 53 Id.

³⁸¹ See Art 52 Id.

³⁸² Interview and Discussion with Ato Reta Alemayehu, a senior Public Prosecutor, Ethiopian Revenue and Customs Authority, 28/10/2009.

4.B Corporate Reorganization

4.B.1 General

The term “reorganization” generally is associated with the rehabilitation of a bankrupt company.³⁸³ And in that context it refers to the process by which the financial well-being and viability of a debtor’s business can be restored and the business continues to operate, using various means possibly including remission of debt, debt rescheduling, debt-equity conversions and sale of the business (or part of it) as a going concern.³⁸⁴ In the tax law context however, the term “reorganization” is used to describe corporate combinations or readjustments which include transactions such as corporate mergers, acquisitions, divisions, changes in capital structure and other similar rearrangements of corporate affairs.³⁸⁵ The rationale for the inclusion of reorganization provisions in the law of corporate taxation basically reflects the broader policies of non-recognition (*No gain or loss shall be recognized if property is transferred to a corporation by one or more persons solely in exchange for stock in such corporation and immediately after the exchange such person or persons are in control of the corporation.* The sale or exchange of an asset at a gain or loss that is not recognized for tax purposes. A shareholder of a company that is acquired by another company in a stock-only purchase is not required to recognize the transaction for tax purposes unless and until the new shares are sold.).³⁸⁶ Reorganization transactions are mere readjustments of a continuing interest in property, although in modified corporate form, and the new property received is substantially a continuation of the old investment still unliquidated.³⁸⁷ Stated otherwise, while the form of the investment may change, that change may not be deemed a sufficient modification of the continuity of ownership interest to require a recognition of gain or allow a recognition of loss.³⁸⁸ Note however that to the extent a shareholder liquidates a corporate investment, recognition of gain or loss is appropriate.³⁸⁹

³⁸³ See, LEND ET AL, supra note 120, at 406.

³⁸⁴ UNCITRAL, supra note 365, at 7.

³⁸⁵ See AULT, supra note 49, at 326 and LEND ET AL, supra note 120, at 406-407.

³⁸⁶ See, LEND ET AL supra note 120, at 405.

³⁸⁷ Id (footnote omitted).

³⁸⁸ AULT, supra note 49, at 324.

³⁸⁹ See, LEND ET AL supra note 120, at 405.

In the Ethiopian case, transfers of business assets among companies, which are parties to a reorganization transaction, are not treated as a disposal of the property.³⁹⁰ The policy reason behind this is clear-as stated above-it is the policy of non-recognition. This policy is clearly stated under Article 24(3) of the Income Tax Proclamation as:

The value of business assets held by a company or companies which are parties to a reorganization is the same as the value of such assets immediately before the reorganization. Similarly, the balance value of any depreciation categories shall be carried over.³⁹¹

This means that neither gain nor loss is recognized when business assets are transferred among companies which are parties to a reorganization transaction.

The Income Tax Proclamation defines the term “reorganization” in terms of four reorganization transactions-merger, acquisition, division and a spin off- in the following manner:

“reorganization” means:

- (a) a merger of two or more resident companies;
- (b) the acquisition or takeover of fifty (50%) or more of the voting shares and fifty percent (50%) or more of all other shares by value of a resident company solely in exchange for shares of a party to the reorganization;
- (c) the acquisition of fifty percent (50%) or more of the assets of a resident company by another resident company solely in exchange for voting participations with no preferential rights as to dividends of a party to the reorganization;
- (d) a division of resident company into [two] or more resident companies; or
- (e) a spin-off.³⁹²

All these reorganization transactions in general are tax-free transactions, for no gain or loss is recognized in such transaction so far as their respective principal objectives are not tax avoidance.³⁹³

4.B.2 Merger

In a typical merger transaction, an existing corporation disappears and its assets and liabilities are taken over by another corporation which continues the business activities of the

³⁹⁰ See Art. 24(2) of PROCLAMATION NO. 286/2002.

³⁹¹ Id Art 24(3) (emphasis added).

³⁹² Id. Also Art 37(4,5) of PROCLAMATION NO 286/2002.(emphasis added) A spin-off resembles a dividend-type distribution of share and involves the pro rata distribution of the shares of a company’s subsidiary to its shareholders

³⁹³ Id.

disappearing corporation.³⁹⁴ The shareholders of the disappearing corporation may continue as shareholders of the continuing corporation may receive cash, property, or creditor interests in the continuing corporation for all or a part of their shares.³⁹⁵ Note that in merger there are at least two companies-the target company (the disappearing one) and the acquiring company (the continuing one). The assets and liabilities of the target company are transferred to the acquiring company without the need for deeds or bills of sale, and the target company dissolves by the operation of law.³⁹⁶ Target shareholders exchange their share for share of the acquiring company. Each target shareholder takes a basis in the new shares that, in general, is the old share basis.³⁹⁷ The shareholders of the acquiring company do not exchange their shares in a merger.³⁹⁸

In many systems, when a company goes out of existence in connection with merger, its tax attributes are transferred to the successor company.³⁹⁹ The tax attributes transferred typically include the tax cost of assets, accumulated profits, reserves and provisions, and loss carried forward.⁴⁰⁰

In the Ethiopian case, merger is one form of reorganization, and merger transactions in general are tax-free. That is, business assets, accumulated profits, reserves and loss carried forward will be transferred to the successor company without regarding tax issues. Merger transactions that deal with the transfer of such affairs among companies are not treated as disposal of these affairs and thus neither gain nor loss is recognized by the shareholders of the target company, the target company or the acquiring company.⁴⁰¹

4.B.3. Acquisition

³⁹⁴ See AULT, *supra* note 49, at 325.

³⁹⁵ *Id.*

³⁹⁶ See generally OESTERLE, MERGER AND ACQUISITIONS IN A NETSHEL (2001) quoted in AULT, *supra* note 49, at 400, footnote 2.

³⁹⁷ See LEDERMAN, *supra* note 51, at 235.

³⁹⁸ *Id.*

³⁹⁹ See AULT, *supra* note 49, at 340.

⁴⁰⁰ *Id.* Loss carry forward is an accounting technique that applies the current year's net operating losses to future years' profits in order to reduce tax liability. In Ethiopia, business firms can carry forward the loss for two periods, in which each consists of three years. See GEBRIE, *supra* note 5, at 247-248. See also Art 28(3) of PROCLAMATION NO. 286/2002.

⁴⁰¹ See generally Art 24 of PROCLAMATION NO. 286/2002.

One of the most critical questions in an acquisition is whether the transaction should be structured as an asset purchase or a share purchase.⁴⁰² From this perspective, acquisition is of two types-acquisitions of shares and acquisition of assets.

4.B.3.1. Acquisition of shares

When shares in a company are acquired there is no need for the conveyance of individual assets and liabilities.⁴⁰³ Title to assets and liabilities constituting the business is unaffected by acquisition and such assets and liabilities remain within the company.⁴⁰⁴ Only the shares in the company need to be transferred.

In Ethiopia the acquisition of shares is provided under article 24(4, b) of the Income Tax Proclamation and is treated as one type of reorganization and thus it has no tax implication.⁴⁰⁵

4.B.3.2. Acquisition of Assets

Acquisition of assets is a type of reorganization where the assets and liabilities of the company to be acquired are transferred to the acquiring company.

In asset acquisition, the assets and liabilities to be acquired have to be defined in the acquisition agreement as precisely as possible.⁴⁰⁶ In this regard, the financial statements of the company may serve as a starting point for the purpose of defining the assets and liabilities. In any case of asset acquisition transaction, it must be possible to determine, from the acquisition agreement, the assets subject to transfer.⁴⁰⁷ This may be done, for example, by listing the assets in schedules to the acquisition agreement.⁴⁰⁸

Asset acquisition in Ethiopia is a form of reorganization where fifty percent or more of the assets of a resident company is acquired solely in exchange for voting participations with no preferential rights as the dividends.⁴⁰⁹ Apart from providing that asset acquisition is a form of reorganization, the Income Tax Proclamation fails to provide as to how such assets are to be defined, limited and transferred. Nor does it regulate the fate of the corresponding liabilities to the assets subject to acquisition. Nevertheless, asset acquisition has no tax implication.

⁴⁰² See DIETER BEINERT, CORPORATE ACQUISITION AND MERGER IN GERMANY 62 (2nd ed. 1997).

⁴⁰³ Id., at 62.

⁴⁰⁴ See Art. 24(4(b)) of PROCLAMATION NO. 286/2002.

⁴⁰⁵ See Art. 24.

⁴⁰⁶ BEINERT, supra note 401, at 56.

⁴⁰⁷ Id.

⁴⁰⁸ Id.

⁴⁰⁹ See Art 24(4(c)) of PROCLAMATION NO. 286/2002.

4.B.4 Corporate Division

Corporate division refers to a variety of reorganization transactions in which a business or businesses that were conducted through one corporation or through a parent corporation and its subsidiary is divided into two or more separate companies directly owned by the parent corporation's shareholders.⁴¹⁰ There are three commonly known types of corporate divisions in a parent subsidiary arrangement.⁴¹¹ These are spin-off, split off, and split-up.⁴¹² A spin-off resembles a dividend-type distribution of share and involves the pro rata distribution of the shares of a company's subsidiary to its shareholders.⁴¹³

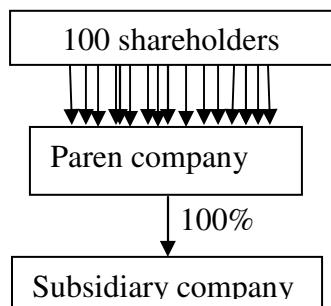


Fig 1 Before division

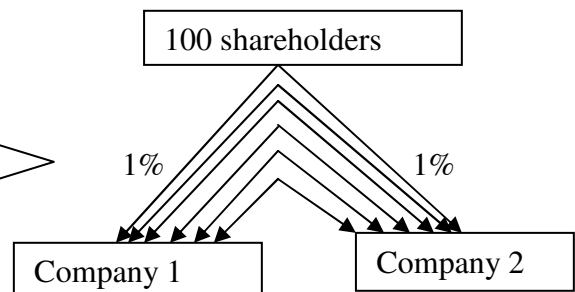
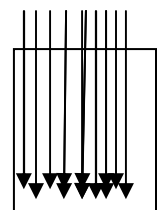
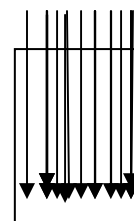
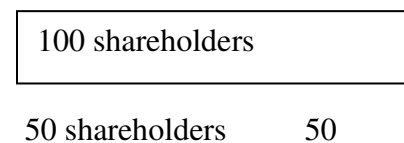
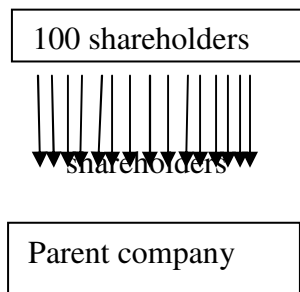


Fig 2 After division

A split-off on the other hand resembles redemption.⁴¹⁴ It refers to the distribution by a parent company to one or more of its shareholders of a controlling interest in its subsidiary in exchange for the surrender by the shareholders of some or all of their shares in the parent company.⁴¹⁵ Graphically



⁴¹⁰ See LEND ET AL, *supra* note 120, at 507.

⁴¹¹ Id.

⁴¹² Id.

⁴¹³ LEDERMAN, *supra* note 51, at 267-268.

⁴¹⁴ Id., at 267, 369.

⁴¹⁵ Id.

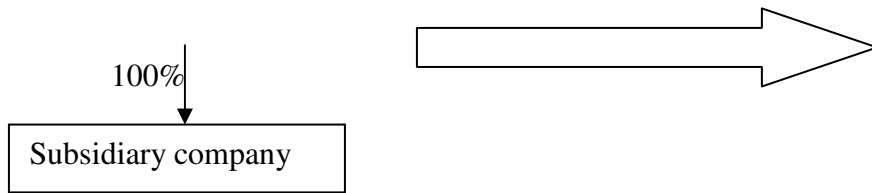


Fig 3 Before division



Fig 4 After division

A split-off is often done on a non-pro rata basis and results in a change in the ownership of the distributing company.⁴¹⁶ And a split-up resembles a liquidating distribution. It involves the liquidation of the parent company in which it distributes to its shareholders the share of two or more subsidiary companies.⁴¹⁷ Graphically:

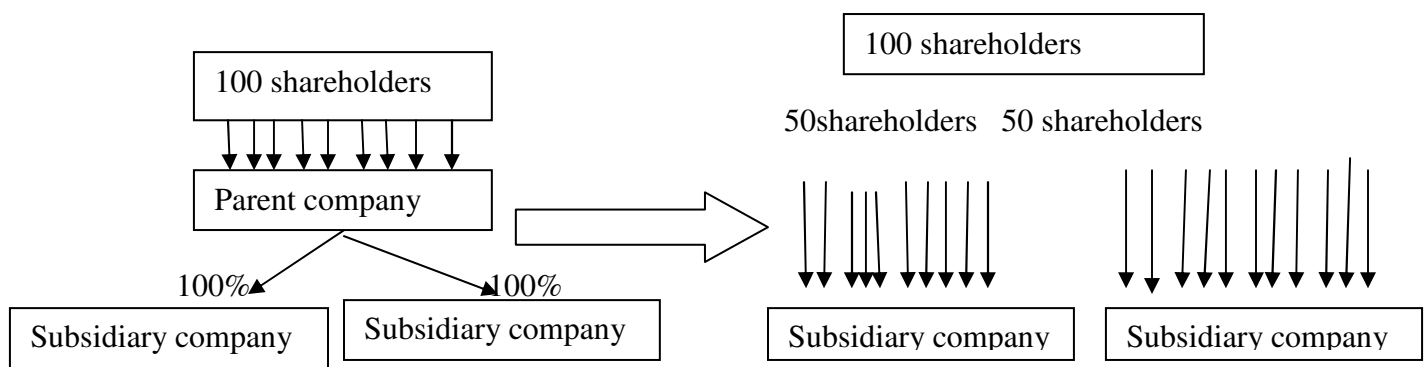


Fig 3 Before division

Fig 4 After division

In the Ethiopian tax law, “division” and “spin-off” are considered as two separate aspects of re-organization. And the remaining two types of corporate division-split-off and split-up- are not included in the items listed under the definition of the term “reorganization”. Being included in definition of “reorganization”, corporate division and spin-off are non-recognition transactions and are thus tax-free. That is, corporate division does not have tax implication in the current Ethiopian Tax law.⁴¹⁸

Conclusion and Recommendation

Economic progress to a great extent hinges on capital formation, accumulation, and investing by the private sector. The real key for capital formation, accumulation and investment lies on a legal framework that encourages a continuous and accelerated proliferation of the corporate form of business organizations-share companies and private limited companies among

⁴¹⁶ See AULT, supra note 49, at 335, footnote 3.

⁴¹⁷ See LEDERMAN, supra note 51, at 267, 270.

⁴¹⁸ See Art 24 of PROCLAMATION NO. 286/2002.

others. The law of corporate taxation takes the lion share of such legal framework and the remaining goes to the commercial law, investment law and others.

The core research question of this Paper, as has been stated in the Introduction chapter, is assessing how corporate taxation is treated in the Ethiopian tax law. The assessment question is discussed from Chapter two up to Chapter four, by dividing the corporate life (just for convenience) into three-corporate birth, corporate middle life, and corporate end life. Chapter two, by providing the conceptual and theoretical framework and by assessing the corporate birth transactions and corporate capital structure, demonstrates that the problem of the treatment of corporate taxation in Ethiopia begins with the definition of the entities that are subject to the corporate taxation regime. Chapter three, which assesses the corporate middle life events and tax issues thereof, also shows that the problem of the treatment of corporate taxation pushes its way through the corporate middle life. Finally, Chapter four assesses the treatment of corporate end life events and repeats the same story.

This Paper has highlighted some of the most important corporate transactions and their respective tax treatment. The assessment focus on some of the tax issues which are related to the corporate formation and capital gain issues, corporate income tax and dividend tax, corporate liquidation, and reorganization transactions. As discussed in the respective Chapters where these events fall, the current Income Tax Proclamation does not treat these events properly. For one thing, the Income Tax Proclamation lacks consistency with the Constitution and Commercial Code. For the other, it fails to provide clear and easily distinguishable and understandable provisions that are devoted for the regulation of corporate taxation. This Paper argues that overall, the current treatment of corporate taxation blurs the incentive for the corporate form of doing business in Ethiopia.

The nature of the law of corporate taxation (together with other laws) has the capacity in directing the flow of private capital and investment from all over the world. So if wisely used, it can be used to facilitate the process of economic progress. But if entities subject to corporate taxation are not clearly defined in a manner that keeps consistency with other laws of the state in question; if the policy issue of double taxation is not clearly manifested in the law of corporate taxation in a manner that attracts members of the public to invest in corporate businesses and foreign companies to extend their business in the state in question; if the effect of corporate formation transactions is not clearly specified in a manner that attracts corporate investment; if

the issues of corporate capital structure and corporate financing and their respective tax implications are not properly addressed in a manner that attracts corporate business investment; if corporate middle life events such as corporate income tax, dividend, transfer of shares and the capital gains resulted therefrom and tax issues thereof are not properly regulated in a manner that attracts corporate business to flourish; if corporate end life events such as liquidation, reorganization transactions and their respective tax issues are not clearly regulated in a manner that respects the property rights of corporate investors (share holders); and if the law of corporate taxation is not well developed and known by the potential corporate investors, corporate lawyers, and the tax authority official and lawyers, how can the law of corporate taxation help the process of economic development by directing the flow of capital in a desired manner?

In order to use the law of corporate taxation as a tool that accelerates the process of economic development, Ethiopia needs an ideal law that addresses the above question. In addition to that, the Paper submits the following points for consideration:

1. Separate law for corporate taxation;
2. Reduction of the rate of corporate income tax and capital gains tax and elimination of double taxation;
3. Consistency of terminologies and concepts with other laws of the country;
4. Inclusion of the law of corporate taxation in law schools as a separate subject;
5. Regulation of stock exchange; and
6. Establishment of separate agency for corporate business.

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ANNEX

DECLARATION

I declare that this LL.M Thesis is my original work and has not been presented for a degree in any University and all resources used in the Thesis are duly acknowledged.

Name: Berhane G/Mariam

Signature:

Date:

Place: Addis Ababa University

This LL.M Thesis has been submitted for examination with my approval as an advisor.

Advisor's Name: Professor Tilahun Teshome

Siniture:

Date:

Place: Addis Ababa University