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The Application of Ethiopian Transfer Pricing Rules on Multinational Enterprise: Consistency of the Practice with the Ethiopian Transfer Pricing Rules.

A Thesis Submitted in Partial Fulfillment of the requirement for the Award of a Masters of Laws (LL.M) Degree

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Declaration

I, **TARIKU ADUGNA RAYA**, do hereby declare that this thesis is my original work and has not been presented for a degree in any other university. To the best of my knowledge and belief, I also declare that any information used here has been duly acknowledged and cited.

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Dedication

This work has been dedicated to my Mother WORKITU SHUKUR ABDO, whose thirst for academic excellence for our family is unquenchable. May this small achievement be a beacon of light for many of her offspring to see the light at the end of the tunnel and then move beyond this point.

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List of Abbreviations

AACCSA	Addis Ababa Chamber of Commerce and Sectorial Associations
ALP	Arm's Length Principle
APA	Advance Pricing Agreement
BAPA	Bilateral Advance Pricing Agreement
BEPS	Base Erosion and Profit Shifting
BRICS	Brazil, Russia, India, China and South Africa
CCAs	Cost-contribution agreements
EC	European Commission
EIC	Ethiopian Investment Commission
ERCA	the Ethiopian Custom and Revenue Authority
G20	Group of 20
GATT	General Agreement on Trade and Tarif
GDP	Gross Domestic Product
GFA	Global Formulary Apportionment
GTP	Growth and Transformation Plan
HMRC	Her Majesty Revenue and Customs
IRS	The US Internal Revenue Service
ITP	Income Tax Proclamation
LTO	Large Tax Payers Branch Office
MAP	Mutual Agreement Procedure
MNE	Multinational Enterprise
MNE's	Multinational Entreprises
MoFED	Ministry of Finance and Economic Development
MoR	Ministry of Revenue
MTC	Model Tax Convention
NEPAD	New Partnership for Africa's Development
OECD	the Organization for Economic Co-operation and Development
PT	Presumptive Taxation
TP	Transfer Pricing
TPD	Transfer Pricing Documentation
TPG	Transfer Pricing Guidelines
TPM	Transfer Pricing Method
TPMs	Transfer Pricing Methods
TPR	Transfer Pricing Regulation
U.K.	United Kingdom
U.S.	United State
UN	United Nation
UN MDTC	United Nation Model Double Tax Convention between Developed and Developing Countries
UNCTAD	The United Nations Conference on Trade and Development
USD	Untied State Dollar
WBG	World Bank Group

Abstract

Ethiopia, like the rest of the world, in an effort to protect its tax base, has enacted a transfer pricing directive requiring, among other things, that inter-company transactions be conducted at arm's length price & to direct and adjust profits in cases where transactions between related persons differed from those between unrelated persons as well as to provide a legal basis for Advance Pricing Agreement to be entered into between a taxpayer and the tax collecting organ. However, due to the very nature of TP transactions, lack of comparable data and lack of administrative capacity, the determination of the correct arm's length price has remained a major challenge in Ethiopia, not only for the taxpayers, but for the tax authority as well.

The main objective of this paper is to provide an overview of the newly adopted transfer pricing directive as well as the legal and institutional framework for TP Administration in Ethiopia and to analyze the practical application of transfer pricing rule on MNEs. So, the paper commences by briefly discussing the salient features of Transfer pricing of MNEs in general and Ethiopian TP Directive in particular. The paper then devoted to examine the practical application of transfer pricing rule on MNEs and analysis its consistence with the directives. In addition, the paper critically evaluates the existing institutional framework for the implementation of transfer pricing regulations.

The key findings made includes the fact that the actual implementation of the directive is far from realization due to different factors such as lack of administrative capacity to conduct effective and efficient audit; lack of well-equipped and qualified experts; lack of sufficient and reliable comparable data; lack of advanced communication technology and information exchange mechanisms as well as lack of effective organizational structures and etc. The paper also highlights some issues that need to be strengthen and future challenges in implementing the regulations. Some recommendations are also provided at the end of the paper to the tax authority and policy makers to enhance and improve the administration of TP on MNEs

In conclusion, the study establishes that the current legal and institutional framework for transfer pricing in Ethiopia is far from practical application, inadequate and in need of reforms. In this regard, recommendations are made for strengthening the legal, policy and institutional framework for TP in Ethiopian in line with developing countries best practices.

CHAPTER ONE: INTRODUCTION

1.1. Background of the Study

Rapid development in technology, transportation and communication has resulted in an increasing number of multinational enterprises (MNEs)[1] and intra-group transactions between different countries. Following this development, Transfer pricing (TP) has emerged in the global economy as one of the most important tax issues for multinational enterprises and with globalization and the growth in electronic commerce in the future, it is expected to become an even more significant issue in international taxation. MNEs are companies that have the flexibility to place enterprises and activities anywhere in the world and have an active role in managing these investments.[2] Thus, TP, the pricing of transactions between group members[3], remains the most important international tax issue MNEs face and also presents increasingly complicated problems to tax administrations, particularly in developing countries like Ethiopia.

Transfer pricing is a way of shifting taxable income from a company that is located in a high-tax jurisdiction to another company that belongs to the same organization but is located in a low-tax jurisdiction. This is done by strategically setting the transfer prices of international transactions between related companies.[4] Transfer pricing is one of the most significant problems in modern international taxation.[5] Multinational enterprises identify TP as the "most important tax issue they face", and most MNEs believe that TP will be "absolutely critical" or "very important" to them in the coming years.[6] Likewise, tax authorities around the world place the transfer pricing problem high on their agenda though this is not wholly true for Ethiopia.

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[1] In 2004 Christopher Bartlett, Sumantra Ghoshal and Julian Birkinshaw defined Multinational Enterprises (MNE's) as companies that have direct investments of significance in several countries, and an active role in managing these investments. Mentioned in Ann Tonje Helland, Application of Transfer Pricing: efficiency and taxation, master's thesis in Industrial Economics, University of Stavanger, 2010, P.7

[2] UN practical Manual on Transfer pricing for Developing Countries (2012), sec 1.2.2, available at http://www.un.org/esa/ffd/tax/documents/bgrd_lp.htm, accessed on 12th August 2018

[3] Phat Tan Nguyen Transfer Pricing: The Vietnamese System in the Light of the OECD Guidelines and the Systems in certain Developed and Developing countries, Jonkoping International Business School, JIBS Dissertation Series, 2009

[4] Myron S. Scholes et Al., Taxes and Business Strategy 326 (3d. Ed. 2005); Hubert Hamaekers, *Introduction to Transfer Pricing,* The Tax Treatment of Transfer Pricing 1, 9 and 10 (Maurice H. Collins et al., eds., 2006).

[5] Reuven S. AVi- Yonah, International Tax as International Law: An Analysis of the International Tax Regime, Cambridge University Press, 2007,

[6] Ernst & Young, 2007–2008 Global Transfer Pricing Survey 9-10 (Dec. 2007), citied in Yehonatan Givati, Resolving Legal Uncertainty: The Unfulfilled Promise of Advance Tax Rulings, Virginia Tax Review, vol. 29:137, p 169

Today, Transfer Pricing has become the most important tax issue for both taxpayers (MNEs) and tax administrations because they determine in large part the income and expenses and therefore taxable profits of associated enterprises in different tax jurisdictions.[7] It's important for MNEs because complying with different transfer pricing rules and dealing with administrative procedures may create uncertainty and result in double taxation, penalties and a high administrative burden.[8] It is also important for tax authorities since the application of transfer pricing rules on MNE's is not an easy task and creates complicated problems to tax administrations particularly in developing countries like Ethiopia.

Thus, many countries have adopted transfer pricing legislations that apply in regulating or adjusting income taxes of domestic and multinational taxpayers. However, important differences in domestic transfer pricing rules and practices remain. Complying with different transfer pricing rules and dealing with various national tax authorities may create uncertainty and result in double taxation, penalties and a high administrative burden for MNEs. On the other hand, it is legitimate for countries to adequately levy taxes on incomes generated by members of MNEs in their territories.[9] However, it is not proper to treat transfer pricing solely as tax avoidance mechanism all the time. Transfer pricing does not automatically indicate tax evasion or tax avoidance by the taxpayer.[10] Hence, transfer pricing is not, in itself, illegal or necessarily abusive. What is illegal or abusive is transfer mispricing or transfer pricing manipulation or abusive transfer pricing.[11] The term "mispricing" is used to signify the pricing which is not in accordance with the arm's length standard[12]

In this regard, the Organization for Economic Co-operation and Development (OECD) has made useful efforts to develop a common approach to the application of the arm's length principle (ALP), which governs the tax treatment of transfer prices. Accordingly, many states have adopted transfer pricing rules that apply in determining or adjusting income taxes of domestic and multinational taxpayers[13].

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[7] J. Philip Van Hilten, Transfer Pricing Policy in the International Tax System, Past and Present and a Quick Look in the Fiscal Crystal Ball, 10 GEO. MASON L. REV. 709,

[8] Phat Tan Nguyen Transfer Pricing: supra note, 3

[9] Phat Tan Nguyen Transfer Pricing: supra note, 3

[10] Lee Sheppard, Transfer pricing is the leading edge of what is wrong with international tax, 2012, Available at www.taxjustice.net/.../front-content.php... accessed on 5th August 2018

[11] Ibid

[12] UN practical Manual on Transfer pricing for Developing Countries (2012) ii Para 3, Supra note 2

[13] *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010): O*ECD Publication, Paris.

Ethiopia also adopted new transfer pricing rules in the form of Directive issued by the Ministry of Finance and Economic Development (MoFED).[14] The Directive provides detailed guidance as to the application of Article 29 of the old Income Tax Proclamation (ITP) 286/2002 which requires taxpayers to ensure transactions between related persons to be conducted at arm's length. The Directive is largely consistent with international standards and provides MNE's doing business in Ethiopia with clarity concerning the application of Ethiopia's transfer pricing rules as well as the possibility of obtaining certainty through an advance pricing agreement (APA)[15]

Before the enactment of Transfer pricing directive, Ethiopia had introduced some provisions governing TP in both the Custom and Income tax Proclamations. The proclamations require related com panies to make their transactions at arm's length. The principal substantive law governing TP in Ethiopia is the new income tax proclamation no 979/2016. Accordingly, Article 79 of the new income tax proclamation requires business carried on between a non-resident and related Ethiopian resident to be conducted at arm's length. Furthermore, the Ethiopian Customs and Revenue Authority (ERCA) is given the power to adjust the profits of Ethiopian resident to the profits which would be expected to have accrued to it had the business been conducted between independent persons dealing at arm's length price.

Article 79/2 of the Ethiopian new income tax proclamation gives MoFED the power to make directives to provide guidelines for transfer pricing and to specify requirements necessary for the better carrying out of the provisions of the article. Even though the ministry did not enact a new transfer pricing directive based on the new proclamation, the previous Transfer Pricing Directives issued in 2015 is still applicable based on the application of Art 101/6 of Procl. No. 979/2016.[16] Therefore, the paper will assess the Application of Ethiopian Transfer Pricing rules on MNEs in general and test the consistency of such rules with the practice in particular.

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[14] Directive issued to provide rules on transfer pricing no 43/2015, federal democratic republic of Ethiopia, Ministry of Finance and Economic Development, Addis Ababa, Ethiopia, 2015, here in under referred as Ethiopian Transfer Pricing Directive No 43/2015.

[15] Ibid, Transfer Pricing Directive No 43/2015, Article 12.

[16] Regulations and Directives issued under the repealed laws shall continue to apply to the extent that they are not inconsistent with this proclamation and until such time as they are replaced by new regulation and directives.

1.2 Statement of the Problem

In the globalized economy, the importance of transfer pricing is reinforced by the fact that close to half of international trade occurs between related entities.[17] Much of this trade is conducted by multinational enterprises (MNEs), and it is estimated that as much as 2/3 of all cross-border business transactions take place between companies belonging to the same group.[18] With rapid globalizations, developing countries are increasingly opening their borders to international trade and investment. Such cross-border trade and investment is vital to economic development. It is also essential that developing countries are able to collect taxes on the profits that multinational enterprises earn in their respective countries and do so in a way that does not discourage or distort international trade and investment.

Nevertheless, tax evasion is the main headache for many countries. Tax evasion is the general term used for the evasion of taxes by illegal means. In this respect, since MNEs carry out large operations on global level, they may adopt methods susceptible to international tax avoidance mechanisms one of which pertains to transfer pricing rules.[19]

Currently, a significant amount of global trade consists of international transfers of goods and services and capital and intangibles within MNEs. As a result, a good investment climate is required for developing countries as a basis for future economic growth and wealth. To achieve this, the TP provisions in developing countries should be streamlined with internationally accepted standards taking into account the context of developing counties.[20]

Furthermore, the 2012 UN Manual stated that "TP rules are essential for developing countries to provide a climate of certainty and an environment for increased cross border trade without forgetting that the tax administration is not losing out on critical tax revenue".[21] The Manual points out that countries with less developed tax systems and tax administrations risk absorbing the effect of stronger enforcement of TP.[22] Despite limited resources, the tax authorities in

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[17]Otto B. Martinson, Ted D. Englebrecht, and Carla Mitchell, How Multinational Firms Can Profit from Sophisticated Transfer Pricing Strategies, The Journal of Corporate Accounting and Finance/Winter 1999.

[18] OECD, Developing Capacity of Transfer Pricing, task force on tax and development work on transfer pricing, available at https://www.oecd.org/tax/tax-global/developing-capacity-in-transfer-pricing-flyer.pdf, accessed on may 3, 2019.

[19] Beebeejaun A, The Efficiency of Transfer Pricing Rules as a Corrective Mechanism of Income Tax Avoidance, Department of Law, University of Mauritius, Reduiit, Mauritius, Journal of Civil and Legal Sciences Vol. 17(1):237, Jan 30, 2018

[20] Mark Hegmair, Nicolas Boehlke and Abdallah Ali-Nakyea, International transfer pricing in developing countries: Ghana rising; international transfer pricing journal, November/December 2013,

[21] UN practical Manual on Transfer pricing for Developing Countries (2012) sec 1.2.14, supra note 2

[22] Ibid UN practical Manual on Transfer pricing for Developing Countries (2012) sec 1.3.9,

developing countries must find strength to improve their grasp on TP. If not, they may lose out on taxable income especially considering the tightening competition of international tax authorities for their slice from the cake of the taxable profit of MNEs.

On the other hand, MNEs utilize international TP policies to achieve various objectives like minimizing their worldwide tax liabilities, minimizing import duties, bolstering a subsidiary's financial condition, by-passing government placed restrictions on capital flows and adjustment for currency fluctuations.[23] Consequently, most countries have introduced and are introducing Transfer Pricing and Base erosion and profit shifting (BEPS) rules into their tax legislations. This is done to ensure that the profits reported by MNEs in their jurisdictions are computed in line with internationally accepted TP principles, to counter any inappropriate or abusive TP by MNEs and to avoid BEPS practices done by these taxpayers.[24]

In most countries that have Transfer pricing regulations (TPRs), the benchmark adopted to deal with transfer mispricing is through Arm's Length Principle. The Conventional ALP requires that TP between associated enterprises should be the same as if the two companies involved in the transaction were two unrelated parties negotiating in the market by the market price rather than part of the same corporate structure or related entities dealing with each other[25].

The OECD and the United Nations Tax Committee have both recognized the "arm's length principle" and the principle is being used as the basis for bilateral tax treaties between governments. The arm's length principle, although theoretically seems adequate for preventing manipulative use of transfer pricing,[26] is in fact difficult to employ. In many cases, it is difficult to identify comparable transactions and no single "correct" transfer price can be determined.[27] Due to this, applying the arm's length principle encompasses inherent legal uncertainty and the problem will be acute for developing countries like Ethiopia.

Furthermore, companies have an incentive to manipulate the prices in such a way that they could reduce their tax liabilities. And since the tax authorities are aware of this, there is a lot of disputes regarding transfer pricing within companies. Thus, though countries employ different mechanisms to determine what the price for controlled transactions should be, tax authorities are generally supposed to rely on an arm's length transaction. Hence, the writer will

[23] Ibid, UN practical Manual on Transfer pricing for Developing Countries (2012) sec 1.3.12,
[24] OECD, Action Plan on Base Erosion and Profit Shifting, 2013, available at https://www.oecd.org/ctp/BEPSActionPlan.pdf, accessed may January 12, 2019
[25] OECD (2010), supra note 13
[26] Stanley I. Langbein, *The Unitary Method and the Myth of Arm's Length*, 30 TAX NOTES 625 (Feb. 17, 1986).
[27] Reuven S. Avi–Yonah, *The Structure of International Taxation: A Proposal for Simplification*, 74 (1996).

discuss the legal and institutional framework of Ethiopian tax authority in dealing with transfer mispricing and analyze the Practical application of the arm's length principle.

Moreover, since the tax authorities in developing countries still need to establish TP legislation and to develop resource and skills to conduct effective TP, complying with internationally accepted TP standards developed by OECD[28] would put them at disadvantage. This is because, developing countries with little or no administrative capacity and expertise are disadvantaged in the global competition for tax revenue as TP is the area of international taxation in which developing countries with weak administrative capacities are disadvantaged by lack of capacity and resources.[29]

In addition, considering the issue of TP from the perspective of benefit it lends to MNEs, it would be desirable if all countries were able adhere to a compatible set of rules regarding TP to minimize the risk of transfer pricing adjustment and double taxation. That is why many developing countries have included in their tax legislations some of the measures requested by the OECD TPG.[30] However, some developing countries do not have the incentive to enforce TPR for fear of driving FDI away to other jurisdictions.[31]

Ethiopia has introduced Transfer Pricing Directive which is closely aligned with the principles enshrined under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of 2010 (OECD Guidelines). Moreover, an effective application of TP requires a functioning tax administration structures as well as an operative and well-organized tax authority. Thus, the paper is devoted to examining the practical application of transfer pricing rule on MNEs. Furthermore, the paper will also examine the availability of comparable data, skilled manpower and other resource as well as the existence of comprehensive transfer pricing legislations and the effective and efficient application thereof.

[28] OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2010). International Organization's Documentation IBFD

[29] J.K Sundaram, Transfer Pricing is a Financing for Development Issue (friedrich Ebert Stiftung 2012) available at http://library.fes.de/pdf-files/iez/global/08938.pdf

[30] OECD Report on Harmful Tax Competition: An Emerging Global Issue (1998), available at https://ntanet.org/NTJ/51/3/ntj-v51n03p601-08-oecd-report-harmful-tax.pdf?v=%CE%B1 , Accessed on August 20,2018

[31] Transfer Pricing Abuses and Developing Countries, published in the 1988 United Nations Report entitled International Income Taxation and Developing Countries

1.3 Literature Review

This study interrogates the Ethiopian existing legal and institutional frame work on Transfer Pricing rules and its application on Multinational Enterprise. First, there has been very little research done in the area of transfer pricing in developing countries at large and almost none in Ethiopia mainly due to the unavailability of intra-firm trade data.[32] Second, there lacks systematic attempt in developing countries to collect and analyze relevant data in one information repository database making it available for multiple uses. In addition, the lack of any government sponsored studies like those in Colombo, Greece and Sri Lanka may be the reason for the absence of transfer pricing studies in many developing countries.

In contrast, there are numerous studies on transfer pricing carried out in developed countries. This is primarily due to the detailed statistical information on intra-firm trade made available in most developed countries and stringent laws requiring greater transparency and reporting. Among this studies, *Onsando Omari*[33] analyzed the transfer pricing legislation of South Africa and compared it with the OECD Transfer Pricing Guidelines. The author concluded by observing that OECD Transfer Pricing has some inherent weaknesses in their application such that there is no right or wrong answer to a transfer pricing problem[34]. Onsando, however, acknowledged that South Africa has extensively borrowed from the OECD Transfer Pricing Guidelines although it is not a member of OECD. The author proposes, inter alia, the improvement of South African transfer pricing legislation in terms of embracing Advance Price Arrangement (APA) as a mechanism for expedient resolution of transfer pricing disputes.

Moreover, *Joseph*[35] observed that even member countries of the OECD recognize that the existing system of transfer pricing under the arm's-length standard is far from perfect particularly when applied in the context of developing economies. The OECD therefore has undertaken an active program to improve the operation, implementation and administration of arm's-length-based transfer pricing in the context of developing economies.

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[32] Monica Singhania, *International Research Journal of Finance and Economics* ISSN 1450-2887 Issue 40 (2010) on p.3

[33] Onsando, O. A., *The OECD Transfer Pricing Guidelines: An analysis of their application in the South African Legal Regime.* (2007), *Available* at omarionsando@vahoo.com, accessed on august 2nd, 2018

[34] Ibid

[35] Joseph, L. A., Mary, C. B., Caroline, S: *The Arm's-Length Principle and Developing Economies: Tax Management Transfer Pricing Report 495.* (2011), p. 14. Available at http://www.bna.eom/corp/index.html#V

Joseph L. Andrus and another,[36] in "*The Arm's-Length Principle & Developing Economies"*[37] have stated that critics have questioned whether transfer-pricing rules based on the arm's-length principle are appropriate for use in developing economies. These critics have made the following suggestions: The arm's-length principle is too easily manipulated by multinational enterprises and therefore gives rise to a loss of tax revenues in developing economies. Furthermore, effective administration and enforcement of transfer pricing rules based on the arm's-length principle is not possible for developing economies because it requires resources and knowledge of comparable transactions that either do not exist or exceed the capacity of many developing economy tax administrations to identify. Alternatives to the arm’s length principle would protect the tax base in developing economies more effectively and place fewer demands on the resource-constrained tax authorities, without detrimental consequences for adopting such alternatives.

Moreover*, Rick Michelle*[38] observed that OECD Transfer Pricing Guidelines are too complex and costly for developing countries to implement. Consequently, the developing countries may lose the tax revenues. According to David Spencer, the problem with the arm’s length principle is that it is very hard to get evidence or information about comparable transactions of independent companies. In many cases, multinationals have been formed and are effective because they are in situations where there are no comparable transactions. The author cited examples from automobile and large pharmaceutical companies for which there are no independent subsidiaries from which to obtain data for benchmarking.

Thus, developing countries including Ethiopia require a simple model for addressing transfer pricing issues. Comparable data from developed economies does not represent the realities in the developing economies. As such, the use of such comparables results in facilitating erosion of tax base and capital flight from developing to developed economies.

To date**,** very limited research has been done on Transfer pricing rules and related issues in Ethiopia. The writer identified only two Articles in this respect. Accordingly, the first Article

[36] Joseph L. Andrus heads the transfer pricing unit within the OECD's Centre for Tax Policy and Administration (CTPA). Mary C. Bennett, former head of the CTPA's tax treaty, transfer pricing, and financial transactions division, is a partner with Baker & McKenzie in Washington, D.C. Caroline Silberstein, former head of the CTPA's transfer pricing unit, is a partner with Baker & McKenzie in Paris.
[37] Joseph, L. and Another (2011): *The Arm's-Length Principle and Developing Economies, Tax Management Transfer Pricing Report 495.* p.2
[38] D- I Kick, M. (2011) *OECD Tax Rules Called Too Complex, Costly to Help Developing Countries Nab Evaders:* daily Tax Report 10/06/2011

on the newly enacted Directive on Transfer Pricing was written by *Joel Cooper*[39] *and Monia Volpato* entitled "*Comprehensive Directive on Transfer Pricing*" published on International Transfer Pricing Journal[40] and printed by New York University Law School on June 26 2017. Although the article provided a general overview about the newly enacted transfer Pricing directive,[41] it is very shallow in approach and provided only a summary of the directive and nothing more. The paper thus discussed roughly about the legal frame work upon which the new directive is based on, the Arm's Length principle and the Arm's Length range, the scope of application, the issue of Comparability, TP and the Selection of Transfer Pricing methods as well as sources of information and transfer price documentation. The article also deals with the relevancy of the OECD guideline and the possibility to seek an Advance Pricing Agreements (APA). However, the paper failed to critically analyze such key features in light of the OECD transfer pricing guidelines and examine its practical application in detail.

Another Article entitled "*Ethiopian Law on Transfer Pricing, A Critical Examination*"[42] was written by *Yosef Alemu Gebregzizbher.*[43] This paper discussed the issue of TP on MNEs from perspective of foreign direct investment. The writer discussed about the relevancy of the concepts of TP to Ethiopian tax system and the basic precepts of TP and TP methods that exist in the Ethiopian Income and Custom Proclamations. In addition, the writer deals with the convergence-divergence nature of the Income tax and Custom proclamation in terms of regulating TP. However, the paper based its analyses on TP provisions provided in the old income tax[44] and customs proclamation[45] which do not have relevance now as they are repealed by the new income tax proclamation, custom proclamation and transfer pricing directive.[46] The paper also failed to address the institutional framework for TP administration. Therefore, my research will try to fill the above gaps.

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[39] Joel Lachlan Cooper is Co-Head International Transfer Pricing Group at DLA Piper, based in London, United Kingdom. Previously, he worked as a technical specialist at the World Bank Group, advising governments on transfer pricing legislation and providing technical leadership on international policy issues (working with OECD. IMF, WCO, etc.), as a manager with IBFD International Tax Training in Amsterdam, the Netherlands, and as adviser with a Big4 firm in Australia.

[40] The article is Available on https://www.ibfd.org/IBFD-Products/Journal-Articles/International-Transfer-Pricing-Journal/collections/itpj/html/itpj_2017_01_et_1.html, accessed on April 04, 2019

[41] Ethiopian Transfer Pricing Directive no 43/2015, supra note 14.

[42] Available on https://heinonline.org/HOL/LandingPage?handle=hein.journals/jimma5&div=10&id=&page= accessed on April 04, 2019

[43] Yosef Alemu Gebregziabher, LLB, LLM, Lecturer, Jima University School of law.

[44] Ethiopia Federal Income Tax Proclamation No 286/2002, Fed. Negarit. Gazeta, 8th year, No.34, Addis Ababa, July 4th, 2002, here in under referred as Income Tax Proclamation No 286/2002.

[45] Customs Proclamation No 622/2009, Fed. Negarit. Gazeta, 15th year, No.27, Addis Ababa, Feb. 19th, 2002

[46] Ethiopian Transfer Pricing Directives no 43/2015, supra note 14.

1.4 Research Questions

The research study will strive to answer the following research questions

1. How the Ethiopia Law addresses the issue of Transfer Pricing in general and current Legal and Institutional Frameworks for TP administration in particular
2. What are the legal loops, practical gaps and challenges Ethiopia tax collecting organ faces, in the application and administration of its Transfer Pricing Rules on MNEs?
3. What sort of changes and steps should Ethiopia take in order to address those challenges and to improve and simplify TPR and make less burdensome to taxpayers and easy to administer?

1.5 Objectives of the Study

1.5.1 General objectives

The general objective of the study is to assess the existing Legal and Institutional Framework on Transfer Pricing Rules of Ethiopia and its application on MNEs and to forward proposals to address TP administration challenges and to improve and simplify TPR so as to make less burdensome to taxpayers and easy to administer.

1.5.2 Specific objectives

1. To examina the issue of Transfer Pricing and the current Legal and Institutional Frameworks for TP administration
2. To appraise the legal loopholes, practical gaps and challenges Ethiopia tax collecting organ faces in the application and administration of its Transfer Pricing Rules on MNEs.
3. To propose the changes and steps Ethiopia should take in order to address those challenges and to improve and simplify TPR and make less burdensome to taxpayers and easy to administer

1.6 Significance of The Study

Transfer pricing law is in its infant stage in Ethiopia. Both Ethiopian tax authority and tax practitioners are still grappling with this complex issue of transfer pricing. Prior to the enactment of the new income tax Procl. No 979/2016 and transfer pricing directive No 43/2015, Ethiopian relied on income tax procl. No. 286/2002 article 29 as the only law dealing with transfer pricing. This study will recommend for easy application and comprehensive transfer pricing legislation and tax authority structure for successful application of TPR.

As taxation is the single largest source of government revenue. MNE's contribution to tax revenue and gross domestic product (GDP) is also significant. Thus, this study has come up with suggestions which, if adopted, will contribute to improving the existing transfer pricing legal regime to make it more simple, relevant and acceptable to stakeholders**.** This has been done taking into account the fact that MNE's play important roles in job creation, investment, technology transfer, and corporate social responsibility.

This study also appraises the legal and institutional framework on transfer pricing rules in Ethiopia and evaluates whether or not it is adequate and effective for this purpose. The findings of the study are expected to form the basis for proposals to strengthen the legal and institutional framework for transfer pricing in Ethiopia.

Although Ethiopia is a non-member state of OECD, it has adopted TP rules based on the OECD guidelines. This strongly suggests that these guidelines provide the foundation of the approach taken in transfer pricing issues in Ethiopia. Therefore, an analysis of the manner and extent to which Ethiopia has adopted the OECD guidelines on transfer pricing will substantially contribute towards taxpayers understanding the application of current policy and the improvement of the existing regime.

The study also makes recommendations which, if acted upon, will contribute to transforming the existing regime and make it more relevant and acceptable. The extent to which the existing regime effectively serves the interests of the stakeholders is a central criterion in determining relevance. Hence, this study will clarify the law on transfer pricing and transfer pricing dispute settlements as well as its applications on the ground thereby making recommendations, which if taken, will contribute to reforming the existing regime

1.7 Research Methods

The research paper will employ a mixed method (the appropriate mix of qualitative and quantitative methods) in order to collect full and thorough information to assess the Ethiopian existing legal and institutional frame work on Transfer Pricing rules and its application on Multinational Enterprises. The paper will follow an empirical method because it has appeared to be the most suitable way for addressing issues relating to the application of Ethiopian TPR on MNEs and its consistency with the practice.

Due to the nature of the study which requires acquiring deep information from the informants and a thorough legislative and case analysis by using interpretive approach so as to assess the application of TPR on MNEs and its consistency with the practice, the paper will predominantly focus on qualitative method. However, some quantitative method will also be used to acquire practical information such as the number of registered MNEs, the amount of tax collected form these MNEs and the tax would have been collected from MNEs had TPR been correctly implemented as well as the administration costs and the like to come up with comprehensive findings.

However, the paper focuses more on qualitative research methodology because it is much more flexible compared to the quantitative method. Qualitative method does not try to acquire a representative sample but rather seeks to interview those who are knowledgeable and who might be able to provide valuable and exhaustive information. The answers of the open-ended questions give a lot of details and lead to the deeper and more profound understanding of the existing legal and institutional frame work on Transfer Pricing Rules of Ethiopia and its application on Multinational Enterprises.

The paper will also collect and present some qualitative data obtained from Ethiopian Ministry of Revenue (EMoR), Ministry of Finance and Economic Development (MoFED), Ministry of Trade (MoT), Ethiopian Investment Commission (EIC), Addis Ababa Chamber of Commerce and Sectorial Associations (AACCSA) as well as some purposively selected professionals and individuals who worked for MNEs registered in Ethiopia as they can provide valuable information to assess the application of Transfer Pricing rules and its consistency with the practice. In addition to interviewing the tax officials, tax lawyers, tax auditors, tax professors as well as MNEs representatives, business communities and professionals, the paper also uses secondary data sources.

1.7.1 Sampling

The sampling method used in this study will be purposive sampling. Therefore, in selecting the concerned participants, the writer will employ purposive sampling technique based on the participants' experience, position, expertise, education, and other attributes so as to acquire generalizable information capable of addressing the research questions of the study. The participants will be selected based on their engagement and involvement in the administration and the application of TPR on MNEs and its consistency with the practice. In collecting data, the paper will use semi-structured depth interviews, documentary analysis including the OECD transfer pricing guidelines recommendations, legislative analysis and personal observation. To some extent, informal observations are also utilized to supplement the formal data.

1.7.2 Data Analysis

The primary and secondary data collected from qualitative and quantitative analysis as well as information obtained from interviews will first be organized and prepared for data analysis. This includes a verbatim transcription of the interview recordings. The writer will sift through the raw data and will manually code it. The coded data will be analyzed to identify recurring themes. These recurring themes will be described and interpreted. The experiences of some purposively selected countries on the application of TPR on MNEs will also be used in the discussion to be made based on their success and their relevance to Ethiopia.

1.7.3 Ethical Consideration

In conducting the study, the following ethical considerations will be employed:

- **Consent;** all the participants of the study will be requested for their free and full consent before their participation in the study.
- **Privacy and Confidentiality;** the informants will be informed that any confidential information acquired from them would be kept secret and will not be used for purposes other than the objective of the study.
- **Anonymity of the participants;** participants will be told in advance that their identity would not be disclosed.
- **Proper acknowledgement;** proper acknowledgement of their contribution to the study will be made.

CHAPTER TWO:

2. GENERAL OVERVIEW OF TRANSFER PRICING

2.1 Introduction

The world economy has been significantly internationalized since the end of World War II. This phenomenon is revealed in the fact that a large percentage of the world's economic products is generated by international business activity, mostly undertaken by MNEs.[47] MNEs are groups of companies, which have the flexibility to place their enterprises and activities anywhere in the world. They generally operate worldwide through locally incorporated subsidiaries or PEs.[48] The structure of transactions within MNE group or TP is determined by a combination of the market and group driven forces which can differ from the open market conditions operating between independent entities. So, majority of international transactions are no longer governed entirely by market forces, but by forces which are driven by the common interests of the entities of a group which necessitates to establish the right price, called the *transfer price*, for intra-group or cross-border transfer of goods, intangibles and services.

Thus, TP is on the radar in both developed and developing countries and could be defined as the structuring and pricing of transaction between members of the same controlled group. Hence TP refers to the price that is assumed to have been charged by one part of a company for products and services it provides to another part of the same company, in order to calculate each division's profit and loss separately.[49] It's the general term used to connate all aspects of intercompany pricing arrangements b/n related business firms including transfers of tangible and intangible goods.[50] The UN defines transfer price as the value attached to transfers of goods, services and technology between related entities such as partner and subsidiary corporations and brother/ sister corporations.[51] The 1995 OECD report defined TP as, *the transfer prices at which an enterprise transfers physical goods and intangible property or*

[47] Jian Li and Alan Paisey, International Transfer Pricing in Asia Pacific, Perspectives on Trade between Australia, New Zealand and Chine, P1
[48] United Nation Practical Manual on Transfer Pricing, for Developing Countries, 2017, New York, 2017 p 1
[49] Kurham (2000), *'General Concept of Transfer Pricing,'* p. 1, available at: http://wwwhmaconsultants.com/pdf/t-price.pdf. (last accessed 24t November, 2018).
[50] Oyedele, T., Curtis, A., Sweigart, E., and Smallwood, R. The Impact of Nigeria's New Transfer Pricing Rules on Multinational Enterprises. Lexis Nesis Emerging Issues Analysis, Research Solutions March 2013.
[51] United Nations (1979), *'Model Double Taxation Convention between Developed and Developing Countries,' (ST/SG/AC.8/L.29),* p. 3, available at: http://www.un.org/esalffd/documents/DoubleTaxation.pdf, last accessed 24 November 2018).

provides services to associated enterprises.[52] TP therefore refers to the setting of prices at which transactions occur involving the transfer of property or services b/n associated enterprises, forming part of an MNE group.

For purposes of business, Transfer price refers to the amount charged by one segment of an organization for product/service that it supplies to another segment of the same organization, or It refers to intra-firm trade which involves the sale or transfer of tangible and intangible goods between related companies in two or more countries.[53] Hence, TP refers to the setting, analysis, documentation, and adjustment of charges made between related parties for goods, services, or use of property including the intangible property one.[54]

Although TP is sometimes inaccurately presented as a tax avoidance practice or technique, the term refers to a set of substantive and administrative regulatory requirements imposed by governments on certain taxpayers.[55] However, aggressive intragroup pricing especially for debt and intangibles has played a major role in corporate tax avoidance,[56] and in such cases, TP might describe the artificial manipulation of internal prices within a MNE with the intention of creating a tax advantage.[57] So, to combat the problem of mispricing, tax authorities in many countries can adjust intragroup transfer prices that differ from what would have been charged by unrelated enterprises dealing at arm's length.[58]

Therefore, the need for States to monitor TP to avoid the illegitimate erosion of their tax base and the risk of double taxation faced by intercompany transactions, TP has become a key question for MNEs and tax administrations. Especially for developing country like Ethiopia, TPR is important to provide a climate of certainty and environment for international trade and at the same time maximize tax revenue, which is of paramount importance. That is why, OECD and WB recommend intragroup pricing rules based on the ALP, and many countries have adopted similar measures through bilateral treaties and domestic legislation, or administrative practice.

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[52] OECD Report (1995), *'Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations:* p. 9, available at: http://www.oecd.org/documenU34/0.3746.en. (last accessed on 15 November, 2018).
[53] Tang, Roger Y.W. (1997). Intrafirm trade and global transfer pricing regulations. Westport, Connecticut: Quorum Books.
[54] UN Practical Manual on Transfer Pricing for Developing Countries, (2012) supra note 2
[55] Falk, Daniel, "Transfer Pricing: Alternative Practical Strategies," 19, (BNA) TP Report, (Nov. 18, 2010)
[56] *Measuring and Monitoring BEPS, Action 11 - 2015 Final Report. Paris: OECD Publishing. 2015. p. 151–156.*
[57] Miller, A. & Lynne, O. (2012). Principles of International Taxation (3rd ed.). West Sussex: Bloomsbury Professional.
[58] *Cooper, Joel; Fox, Randall; Loeprick, Jan; Mohindra, Komal. 2016. Transfer Pricing and Developing Economies: A Handbook for Policy Makers and Practitioners. Washington, DC: World Bank. © World Bank.*

2.2 Basic Issues Underlying Transfer Pricing

Multinational TP and international taxation are two highly interrelated issues. From the point of view of taxation, International TP can be defined as the pricing process of goods and services transferred between related companies of a MNE system across different tax jurisdictions.[59] The amount of taxes paid in each jurisdiction is therefore subject to the internal price that is assigned to the goods involved. In any all cross-border tax scenario, there are three parties involved in the transaction, i.e., the multinational group taken as a whole and the tax authorities of the two countries. When the first country's tax authority taxes an entity of the MNE group, it has an effect on the other country's tax base. In other words, the issues related to jurisdiction, allocation and valuation comes to the forefront in cross-border tax situations or cross border and intra group transaction. That is why the UN member's tax committee consider jurisdictional, allocation and valuation as the basic issues for MNEs transfer pricing[60]

2.2.1 Jurisdictional Issues

Jurisdictional issues in transfer pricing deals with the challenges of which country should tax the MNEs income. The issue become more challenging where the tax base arises in more than one country and where both countries claim the right to tax. In such scenario, to avoid double taxation to MNE's, one of the countries has to give tax relief. Therefore, issues like which government should tax the MNE's income or give tax relief or which one among the countries is the destination of transfer or which one is the source of the transfer are some jurisdictional issues which arise as a result of cross-border transactions.

An enhanced dimension to the jurisdictional issue is the spectra of TP manipulation as some MNEs engage in practices that seek to reduce their overall tax bills.[61] This may involve profit shifting through TP. The aim of reducing taxation may be a key motive influencing MNEs in the setting of transfer prices for intra-group transactions and their goal is reducing a MNE's worldwide taxation by shifting profits from associated entities in higher tax countries to associated entities in relatively lower tax countries through either under charging or over charging the associated entity for intra-group trade. The net result is to maximize an international enterprise's after-tax profits by reducing the MNE's worldwide taxation.

[59] UN Practical Manual on Transfer Pricing for Developing and Countries, Department of Economic & Social Affairs, United Nations, New York, 2017, p 27
[60] Ibid
[61] ibid

Moreover, MNEs may engage in such practices to use a tax benefit, such as a tax loss, in a jurisdiction it operates, which may be either a current year loss or a loss that has been carried forward from a prior year by an associated company. They may take advantage of an associated company's tax losses before they expire, in situations where losses can only be carried forward for a certain number of years. Even if there are no restrictions on carrying- forward tax losses by an associated company, MNE has an incentive to use the losses as quickly as possible.[62]

2.2.2 Allocation issues

In term of allocation issues, there are two perspectives to be considered i.e. MNEs and Government. From the perspectives of MNCs, their resources especially taxable profits need to be allocated with maximum efficiency and with utmost good faith in the most optimal manner as well, whereas for the government, the allocation of costs and income from the MNCs resources needs to be addressed to compute the tax judiciously. Sometimes these diverse perspectives tend to be a "tug-of-war" between the countries in the allocation of costs and resources in the hope towards maximizing the tax base in their respective states. Furthermore, many of the resources for MNEs which are sources of competitive advantage for them (MNEs) cannot be disentangled from the global income of the MNEs for tax purpose especially in the case of intangible and service-related intra-group transactions.

2.2.3 Valuation issues

The mere allocation of income and expenses to one or more members of the MNEs group are insufficient; hence, the income and expenses must also be valued extensively and it is a key issue in transfer pricing. Besides, there is a tension between the common goals of the MNEs and the overall economic and social goals of countries.[63] That is why international taxation is an open-ended problem with transfer pricing at its heart. To summarize, TPR are indispensable for both developing and developed countries in order to protect their tax base and to eliminate double taxation. Specifically, for developing countries, it provides a climate of certainty and environment for increased cross-border trade while at the same time it ensures that the country is not missing critical tax revenue. Thus, TP is of paramount importance and hence detailed TPRs are necessary.

[62] UN Practical Manual on Transfer Pricing, 2017, supra note
[63] Ibid

2.3 The Arm's Length Principle

As discussed above, Transfer Pricing is currently recognized as the international tax issue by both MNEs and tax authorities and tax authorities around the world increase scrutiny in their tax audits especially on those related party transactions as the result of their increasing concerns on transfer pricing role in tax avoidance. Thus, the provision of Transfer Pricing has been introduced in those countries to ensure that income arising from an International Transaction between Associated Enterprises is computed having regard to the Arm's Length Price.[64]

The *Arm's Length Principle* (ALP) of transfer pricing states that the amount charged by one related party to another for a given product must be the same as if the parties were not related.[65] So a transfer price should be the same as if the two companies involved were indeed two independents, not part of the same corporate structure. An arm's-length price for a transaction is therefore what the price of that transaction would be on the open market.[66] Arm's length principle is a known separate entity approach because transactions within an MNC group are separated, each entity being considered an independent entity in the market and its transactions with related entities being treated as if they were unrelated and separate. These transactions are in turn compared to arm's length transactions in the market that have been affected in similar circumstances between comparable parties in uncontrolled situations.[67] Accordingly, the ALP is found in Article 9 of the OECD Model Tax Convention and it is the framework for bilateral treaties between OECD countries, & many non-OECD governments, too.

Article 9 of the OECD and UN Models contains two basic rules. Paragraph 1 provides authority for a state to include in the profits of an enterprise amounts that would have accrued to it if the conditions made or imposed in its commercial or financial relations with an associated enterprise had not differed from the conditions that would be made between independent enterprises. Paragraph 2 deals with a balancing adjustment in the other state. It is on its term's mandatory: the other state shall make an appropriate adjustment if it has taxed the profits so included in the taxable profits by the first state.

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[64] Joseph Andrus, Transfer Pricing and the Arm's length principle, http://www.worldcommercereview.com/publications/article_pdf/625

[65] Black, H C, *Black's Law Dictionary* 6th ed (1990), p. 109

[66] Bhat Gabapati, Transfer Pricing, Tax Heavens and Global Governance German Development Institute, p 16, available at: http://www.taxjustice.net/cms/upload/pdffTJN 09 Bhat Transfer Pricing.pdf, (last accessed 24 November 2018).

[67] Bhat Ganapati (2009), *'Transfer pricing, Tax Havens and Global Govemance',* German Development Institute, p 16, available at: http://www.taxjustice.net/cms/upload/pdffTJN 09 Bhat Transfer Pricing.pdf,

The ALP as it is found in para. 1 of Article 9 of the OECD Model Tax Convention provides:

"where *conditions* are *made* or *imposed between the two enterprises in their commercial* or *financial relations which differ from* those *which would be made between independent enterprises, then any profits which would, but for* those *conditions, have accrued to one of the enterprises, but, by reason of* those *conditions, have not* so *accrued, may be included in the profits of that enterprise and taxed accordingly.*[68]

According to OECD and many nation's legislations, if the transfer price does not represent true market condition, the income adjustment made by tax authorities is likely to be taken place.[69] Such adjustment can be done by establishing the commercial and financial conditions that are expected to be incurred in the transaction's b/n the independent parties. In order to adjust the price in accordance with the ALP, separate entity approach shall be applied.[70] The separate entity approach will treat the members of MNEs as if they are separate independent parties. Therefore, all companies within the jurisdiction will be treated similarly for tax purposes. This is to prevent the MNEs from taking tax advantages of tax break through mergers, acquisitions or even tax holidays, thus, promote the competition in business environment.[71]

However, applying transfer pricing rules based on the arm's length principle is not easy, even with the help of the OECD's guidelines. It is sometimes difficult for tax Administrations and taxpayers to implement the arm's length principle since the MNEs may engage in the businesses where the adequacy of data may not be available or it is not always possible and certainly takes valuable time to find comparable market transactions to set an acceptable transfer price. In addition, it may not be possible to obtain information from independent enterprises because of confidentiality concerns or it may relevant may simply not exist, or there may be no comparable independent enterprises.[72] Therefore, the principle requires lots of judgement on both parts of tax authorities & taxpayers when it comes to setting the appropriate transfer price, the price at which can be accepted by both tax authorities and taxpayers.

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[68] OECD, Model Tax Convention on Income and on Capital: (OECD Publishing, 2010) art 9
[69] ibid
[70] Saurabh Malhothra, Transfer Pricing: Arm's Length And Alternative Methods http://www.manupatrafast.com/articles/PopOpenArticle.aspx?ID=54fb5991-3f92-433f-971f-ddd47118602b&txtsearch=Subject:%20Taxation
[71] OECD Transfer Pricing Guidelines 2010, supra note, 13
[72] OECD (2017) Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration, OECD, July 2017, here in under referred as OECD Transfer Pricing Guidelines 2017, page 37

2.3.1 Alternatives to Arm's Length Principle

A *presumptive taxation (PT)* as an alternative approach is provided in the law of some countries. Presumptive taxation provisions, such as those of Japan, give tax authorities the power to *presume* an arm's length price based on information gathered by the authorities, and to reassess the taxpayer's taxable income on that basis.[73] However, such provisions are generally only regarded as applicable in case of the taxpayer's failure to provide documentation on the arm's length price within a reasonable time.[74] Presumptive taxation is usually provided for as a last resort to fight against the manipulation of TP. However, as TP adjustments in relation to foreign transactions generally create a risk of international double taxation, most countries therefore structure such statutes carefully in a manner consistent with the ALP.

Global Formulary Apportionment

The other alternative to arm's length principle is "*Global Formulary Apportionment, (GFA)*" which would allocate the global profits of an MNE group on a consolidated basis among the associated enterprises in different countries on the basis of a predetermined and mechanistic formula.[75] There would be 3 essential components to applying GFA: determining the unit to be taxed, i.e. which of the subsidiaries and branches of an MNE group should comprise the global taxable entity; accurately determining the global profits; and establishing the formula to be used to allocate the global profits of the unit. Even though some scholars claim that GFA would provide greater administrative convenience and certainty for taxpayers, and take the position that MNE group must be considered on a consolidated basis to reflect the business realities of the r/n ships among the associated enterprises in the group, the approach has not been applied as b/n countries though it has been attempted by some local taxing jurisdictions[76].

Most OECD member countries do not accept global formulary apportionment and do not consider it as a realistic alternative to the arm's length principle[77]as the most significant concern with GFA is the difficulty of implementing the system in a manner that both protects against double taxation & ensures single taxation. Even if some countries are willing to accept GFA, there would be disagreements as each country may want to emphasize or include d/t factors in the formula based on the activities or factors that predominate in its jurisdiction. Each country

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[73] United Nation Practical Manual on Transfer Pricing for Developing and Countries, Department of Economic & Social Affairs, United Nations, New York, 2013, pp
[74] Ibid
[75] OECD Transfer Pricing Guidelines 2017, Supra note 72, page 39
[76] Ibid OECD Transfer Pricing Guidelines 2017, page 39
[77] Ibid OECD Transfer Pricing Guidelines 2017 page 38

will have a strong incentive to devise formulae or formula weights that will maximize that country's own revenue. Furthermore, tax administrations would have to consider jointly how to address the potential for artificially shifting the production factors used in the formula[78]

The transition to a global formulary apportionment system therefore would present enormous political & administrative complexity and require a level of international cooperation that is unrealistic to expect in the field of international taxation. Such multilateral coordination would require the inclusion of all major countries where MNEs operate. If all the major countries failed to agree to move to GFA, MNEs would be faced with the burden of complying with two totally different systems

2.3.2 Associated Enterprises

The transfer pricing rules and the power of the tax authorities to adjust profits between enterprises do only apply when the parties are considered "associated enterprises.[79] To be qualified as an associated enterprise under the tax laws of many countries brings certain provisions and requirements, like documentation requirements, reversed burden of proof and penalties.[80] The definition of the term is therefore of great importance when determining the applicability of an international transfer pricing rule. Art. 9 OECD states three trigger factors to determine if enterprises are to be considered "associated"; participation in capital, participation in management and participation in control.[81] The requirement of control in the above article is defined as being to "participate directly or indirectly in the management, control or capital of an enterprise"[82] However, Neither Art. 9 itself nor the Model Treaties contain any definition or explanation of the term "participation in control" or how the three terms relate to each other. This may be because TP issues are relevant only if special conditions have been made or imposed between two parties. Thus, the degree of control as a threshold for triggering transfer pricing legislation has in effect been left to domestic legislation.

Several countries apply a 50 % shareholding threshold as the degree of participation and have a broad definition of the notion of control, which leads to that, the parties may be considered associated even in mere open-market situations where a degree of control exists. This means that the countries having a broad definition in their domestic law may require adjustments of

[78] OECD Transfer Pricing Guidelines 2017, Supra note 72
[79] UN Practical Manual on Transfer Pricing for Developing and Countries 2013, supra note 2, pp 63
[80] Isabel Carendi och, Associated Enterprises, what is the meaning of Participation in control, master's thesis within International Tax Law, Jonkoping International Business School, may 30, 2016, unpublished
[81] OECD Transfer Pricing Guidelines 2017, Supra note 72 para 9, p17
[82] Ibid, OECD Transfer Pricing Guidelines 2017, para 11, p.17

transactions between parties that are not associated in the meaning of Art. 9 OECD which may violate the internationally accepted double taxation avoidance agreement. Sometimes, countries with higher thresholds may employ substantive rules on control as a subsidiary test and may focus on other elements than shareholding, such as dependency of input materials, allocation networks, financial and human resources, etc on other group members.

For developing countries, analysis of control might be an important challenge in administering their TP legislation effectively. In addition, factors for identifying control should be carefully examined because evaluation of those factors requires complicated fact-finding procedures, which might differ depending on industry sector, geographic characteristics, product cycle, etc.

2.3.3 Comparability

The application of the ALP relies on two basic concepts of *independence* and *comparability*. In defining ALP, the OECD guidelines states that the application of the ALP is generally based on a comparison of the conditions in a controlled transaction with the conditions in transactions b/n independent enterprises.[83] In order for such comparisons to be useful, the economically relevant characteristics of the situations being compared must be sufficiently comparable.[84] Hence, it is necessary to establish the comparability of the transaction between the related-party with the independent parties. To meet the requirement of comparability, the OECD states that there shall be no significant difference b/n the transactions being compared since the purpose of this comparability analysis is to obtain the highest degree of comparability of the transactions. otherwise, the appropriate adjustment shall be made to eliminate such difference.

Thus, to establish the transfer price that will be justifiable for the tax purpose, it is important to find the arm's length price of the comparable transactions under comparable circumstances of the independent parties. As the arm's length price relies on the reliability & comparability of the transaction, OECD guidelines provide five comparability factors in the OECD Transfer Pricing Guidelines that can be taken into consideration in determining arm's length price.[85]

These factors are 1[st] the characteristic of goods and services, 2[nd] functional analysis of the transaction, i.e., functions performed by the entity including assets used or economic activities

[83] Article 9 of the, *'OECD Model Tax Convention supra note 68*
[84] OECD *'Transfer Pricing Guidelines'* cited in Paul Balkus et al (2005), *'Using Comparables With Significant Inter-Company Sales,'* (4th Edition), p. 15, available at *http.//www.kpmgtaxwatch.comlpublintll TransferPricingGuide,pdf,* (last accessed on April 13, 2018).
[85] OECD Transfer Pricing Guidelines 2017, Supra note 72 *p.* 9–1

like design, manufacturing, assembly, research and development etc undertaken and risk like market risks, risk of loss with investment and property, credit risks, exchange risks or interest rate variability etc involved, 3rd analysis of contractual terms, 4th analysis of economic circumstances comparability like geographic location & size of market, extent of competition, availability of substitute goods and services, level of demand and supply, consumer purchasing power, production cost, date and time of transactions etc and 5th analysis of business strategies like innovation & development of new product, degree of diversification etc.[86]

2.4 Transfer Pricing Methods (TPM)

TPM are means of establishing arm's length prices or profits from transactions between associated enterprises.[87] To mitigate double taxation and to protect the nation's tax base as well as to determine the appropriate transfer price, there is the need to use a suitable method to reach on the arm's length price. Currently, there are several methods that MNEs and tax administrations can use to determine accurate ALP for transaction b/n associated enterprises.[88] For this, the OECD TPG have been widely accepted in principle to determine the appropriate transfer price, including in the UN Model Double Tax Convention[89] even if few countries, especially developing countries, find it very difficult to implement such guidelines in practice.

The OECD Guideline requires MNEs to follow the ALP, which requires the price of goods, services or intangible assets being transferred between related-party to be similar as those were traded in the opened market under the similar circumstance. If the transfer price set by MNEs does not followed the ALP, it can be deemed as mispriced by the tax authorities, which can be subjected to the price adjustment and tax penalty imposed by the tax authorities.

There are some acceptable TPM exist, providing a conceptual framework for the determination of the arm's length price. In this respect, OECD outlines five main TPM that MNEs and tax administrations can use. The OECD guideline aims at searching the method that is most appropriate for the transactions in question. In choosing the best method, the tax authorities and taxpayers need to consider the strength and weakness of the methods, the reliability of the data, sufficiency of comparable transactions as well as the reliability and accuracy of the

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86 OECD *'Transfer Pricing Guidelines'* cited in Paul Balkus et al (2005), *'Using Comparables With Significant Inter-Company Sales,'* (5th Edition), p. 15,.
87 UN Practical Manual on Transfer Pricing 2017, supra note 59
88 Wolfgang Schon, 'Transfer Pricing – Business Incentives, International taxation and Corporate Law' (Working Paper No 2011-5, Max Planck Institute for Tax Law and Public Finance, 2011) p 6.
89 Committee of Experts on International Cooperation in Tax Matters, United Nations, 'Practical Manual', Supra note n 2, p 3

adjustment made to eliminate the significant differences between the transactions. Generally, TPMs are divided in to Traditional Transaction Methods and Transactional Profit Methods[90]

Traditional transaction methods measure terms and conditions of actual transactions between independent enterprises and compares these with those of a controlled transaction. So, this comparison can be made on the basis of direct measures such as the price of a transaction or on the basis of indirect measures such as gross margins realized on a particular transaction.[91] On the other hand, the transactional profit methods don't measure the terms and conditions of actual transactions. Actually, these methods measure the net operating profits realized from controlled transactions and compare that profit level to the profit level realized by independent enterprises that are engaged in comparable transactions. The transactional profit methods are less precise than the traditional transaction methods, but much more often applied. The reason is that application of the traditional transaction methods, which is preferred, requires detailed information and in practice this information is not easy to find. In short, while traditional transaction methods rely on actual transactions, traditional profits method rely on profit levels.

2.4.1 Comparable Uncontrolled Price Method (CUP)

The comparable uncontrolled price method (CUP) is grouped by the OECD as a traditional transaction method. It compares the transfer price for transactions between business units within an MNE and that charged for comparable transfers between the MNE and unrelated organizations.[92] Under this method, the first step is to identify the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction.[93] Then such price is to be adjusted on account of differences, which could materially affect the price in the open market,[94] If the two transactions result in different prices, then this suggests that the ALP may not be implemented in the commercial and financial conditions of the associated enterprises. In such circumstances, the OECD says the price in the transaction between unrelated parties may need to be substituted for the price in the controlled transaction.

[90] OECD Transfer Pricing Guidelines 2017, supra note 72, page 38
[91] Centre for Tax Policy and Administration, OECD, *Transfer Pricing Methods* (2010) pp 2-8; OECD,
[92] Eden & Smith, 2001
[93] Muhammad Khalid Malik (2006), *'Tax Avoidance by Multinational Enterprises through Transfer Pricing,'* p.
[94] Chris Adam and Peter Graham (1999), *'Transfer Pricing: A UK Perspective",* (Butterworths, London, Edinburgh & Dublin) p. 11-12.

2.4.2 Resale Price Method (RPM)

RPM is the other traditional transaction method uses to reach on the appropriate TP.[95] This method starts by looking at the resale price of a product that has been bought from an associated enterprise and then sold onto an independent party. The price of the transaction where the item is resold to the independent enterprise is called the resale price. The method then requires the resale price margin to be identified, which is the amount of money the party reselling the product would require to cover the costs of the associated selling and operating expenses. The TPM also includes the amount the reseller would need to make a fair profit, taking into account the functions it performed (including assets used and risks assumed). This gross resale price margin is deducted from the resale price and that is why the RPM is also known as the Resale minus Method.[96] Thus, the amount that remains after the margin has been subtracted and fair adjustments have been made is ALP for the original transaction b/n related entities.

2.4.3 Cost Plus Method (CPM)

The TPM is a traditional transaction method that analyzes a controlled transaction between an associated supplier and purchaser. The first step under this method is to determine the direct and indirect cost of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise. The next step is to determine the normal gross profit mark-up to such costs computed according to the same accounting norms of unrelated enterprise in connection with the same or similar comparable uncontrolled transaction.[97] The said normal gross profit mark-up is to be adjusted on account of functional & other differences if any, w/c could materially affect such profit mark-up in the open market, b/n the transactions being compared or b/n the enterprises entering into such transaction.[98] Such profit mark-up is to be added in the cost calculated as per the first step.

The CPM is often used when semi-finished goods are transacted between associated parties or when related entities have long-term arrangements for buy and supply.[99] The supplier's costs are added to a markup for the product or service so that the supplier makes an appropriate profit

[95] Tristan Sacha Lord (2008), *'Transfer Pricing in South African Income Tax Law,'* p. 15, a Dissertation for Post Graduate Diploma in Income Tax Law, p. 20, available at: http://hdl.handle.netl2165/320, November 2011).
[96] OECD (1997), *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations*
[97] Brian J. Arnold and Michael J. Mcintyre (2002), *'Intemational Tax Primer',* 2nd Edition, (Kluwer Law International, the Hague/London/New York), p. 62.
[98] Chris Adam and Peter Graham (1999), *'Transfer Pricing: A UK Perspective",* (Butterworths, London, Edinburgh & Dublin) p 21
[99] Brian J. Arnold and Michael J. Mcintyre (2002), *'Intemational Tax Primer',* 2nd Edition, (Kluwer Law International, the Hague/London/New York), p. 62.

that takes into account the functions they performed and the current conditions of the market. The combined price is the arm's length price for the transaction.[100] The CPM generally compares gross profits to the cost of sales. The first step is to determine the costs incurred by the supplier in a controlled transaction for products transferred to an associated purchaser. Secondly, an appropriate mark-up has to be added to this cost, to make an appropriate profit in light of the functions performed. After adding this (market-based) mark-up to these costs, a price can be considered at arm's length.[101]

2.4.4 Transactional Net Margin Method (TNMM)

The TNMM is one of two transactional profit methods outlined by the OECD for determining transfer pricing.[102] The TNMM is transactional methods outlined by the OECD for determining TP. These types of methods assess the profits from particular controlled transactions. The TNMM involves assessing net profit against an "appropriate base", such as sales or assets, that results from a controlled transaction. The OECD states that, in order to be accurate, the taxpayer should use the same net profit indicator that they would apply in comparable uncontrolled transactions. Taxpayer can use comparables data to find the net margin that would have been earned by independent enterprises in comparable transactions. The taxpayer also needs to carry out a functional analysis of the transactions to assesses their comparability.

Under this method, if required, firstly, the combined net profit may be partially allocated to each enterprise on the basis of basic market return for similar types of transaction by independent enterprises and thereafter the residual net profit may be split amongst the enterprises in proportion to their relative contribution and the total of both shall be taken to be the profit arising to the enterprise from the international transaction.[103]

2.4.5 Transactional Profit Split Method (TPSM)

The second transactional profit method outlined by the OECD is the TPSM.[104] Under this method, the first step is to determine the combined net profit of the associated enterprise arising

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[100] Chris Adam and Peter Graham (1999), *'Transfer Pricing: A UK Perspective",* (Butterworths, London, Edinburgh & Dublin) p 21

[101] *The Income (Transfer Pricing) Rules, 2006',* the cost plus method, in which costs are assessed using the costs incurred by the supplier of a product in a controlled transaction, with a mark-up added to make an appropriate profit in light of the functions performed, and the assets used and risks assumed by the supplier;

[102] Ibid

[103] Brian J. Arnold and Michael J. Mcintyre (2002), *'Intemational Tax Primer',* 2nd Edition, (Kluwer Law International, the Hague/London/New York), p. 62.

[104] David Kokic – Conceptual Profit Shifting Matrix Transfer Pricing Methodology OECD March 2, 2006 p.1-2

from the international transaction in which the enterprises are engaged. After that the relative contribution made by each of the associated enterprise the combined net profit is evaluated on the basis of the functions performed, assets employed, reliable external data & risks assumed by each enterprise. The combined net profit is then split amongst the enterprises in proportion of their relative contributions & such apportioned profit shall be taken into account to arrive at the arm's length price to the international transaction. Here, if required, 1st, the combined net profit may be partially allocated to each enterprise on the basis of basic market return for similar types of transaction by independent enterprises and thereafter the residual net profit may be split amongst the enterprises in proportion to their relative contribution and the total of both shall be taken to be the profit arising to the enterprise from the international transaction.[105]

2.6 Documentation requirements

Transfer pricing documentation (TPD) broadly discussed under chapter V of OECD transfer pricing Guideline.[106] Generally, TPD refers to a report justifying the setting of the transfer prices in uncontrolled transaction b/n associated enterprises & the fact that the TP price/margin is set at arm's length. To prepare TPD, the statutory documentation requirements are usually in place in many States[107] though few states, prefer the preparation of TPD on a voluntary basis. The main concern for MNEs regarding TPD is the risk of overburdening the them with unreasonably high costs in obtaining relevant documentation or in an exhaustive search for comparables that may not exist. Ideally, the taxpayer should not be expected to provide more documentation than is objectively required for a reasonable determination by the tax authorities whether or not the tax payer has complied with the ALP.

Thus, to address the issue of documentation, the OECD introduced a standardized approach to the TPD in the 2017 TP Guidelines as a result of the BEPS project. The Guidelines recommend adopting a three-tiered standardized approach to TPD that includes a master file containing standardized information relevant for entire group; a local file containing country-specific information for local associated enterprises, and a Country-by-Country Report containing certain information relating to the global allocation of group's income taxes and economic activity within the group[108]

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[105] Brian J. Arnold and Michael J. Mcintyre (2002), *'Intemational Tax Primer',* 2nd Edition, (Kluwer Law International, the Hague/London/New York), p. 62.
[106] OECD *Transfer Pricing Guidelines 2017, supra note 72, para 5.1 to 5.62* p. 229-246
[107] Ibid OECD *Transfer Pricing Guidelines 2017, para 5.3* p. 229
[108] OECD *Transfer Pricing Guidelines 2017, supra note 72, para 5.16 p.* 233 or Section C, Chapter V, 7

Broadly, the information or documents that the taxpayer needs to provide can be classified as

1. *The Master File (Enterprise-related documents)* which will have details like the ownership/ shareholding pattern of the taxpayer, the business profile of the MNE, industry profile etc;
2. *The Local File (transaction-specific* documents) which will have the details of each international transaction, functional analysis of the taxpayer and associated enterprises, record of uncontrolled transactions for each international transactions etc, and
3. *The Country-by-Country Report (computation-related* documents) which is an additional high-level report required from large MNE and contains a detail like the nature of each international transaction and the rationale for selecting the method for each international transaction, actual computation of the arm's length price, factors and assumptions influencing the determination of the arm's length price etc.)

Further, the TP Guidelines identify three objectives of TPD requirements.[109] These objectives are first, ensuring that taxpayer's transfer pricing policy is at arm's length; second, providing tax authorities with the information necessary to perform transfer pricing risk assessment; and third providing tax authorities with the information required to conduct a thorough audit of the transfer pricing practices of the entities to tax in their jurisdiction. From the taxpayer's perspective, the primary purpose of the TPD creation is the penalty protection and protection from transfer pricing adjustments.[110] In accordance with the arm's length standard, the tax authority has a right to make a primary adjustment, if the commercial or financial relations in controlled transaction differ from those that would be made between independent enterprises.

However, there are other benefits from the preparation of TPD including: a higher degree of certainty with respect to penalty protection and primary adjustment; a useful proof-tool of the arm's length standard during tax proceedings, which increases the nature of the taxpayer's approach in the area of TP and in the case of MAP or APA procedures. TPD also can eliminate problems during TP audits; and the better cooperation with tax authorities may resulting in shorter tax audits.[111] Despite the benefits that the TPD can bring, the preparation of TPD is considered burdensome, time- consuming and expensive. However, the TPD is one of the required documents in the case of dispute prevention in the form of APA or MAP, which can be used to eliminate the double taxation that could arise from a TPA (primary adjustment).

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[109] Ibid OECD *Transfer Pricing Guidelines 2017, supra note 72, para 5.5 p.* 230 or Section A, Chapter V, 7
[110] Veronika Solilova and Danuse Nerudova, tranafer pricin in SMEs Critical analysis and practical solutions, Springer International publishing AG, (2018) P. 39-40
[111] Ibid, Veronika Solilova and Danuse Nerudova, tranafer pricin in SMEs Critical analysis and practical solutions.

CHAPTER THREE:

3 THE LEGAL FRAMEWORK OF TRANSFER PRICING IN ETHIOPIA AND ITS APPLICATION

3.1 Introduction

Ethiopia is the second most populous nation in Africa after Nigeria with about 110 million people[112] and is the fastest growing economy in the region. However, it is also one of the poorest country with a per capita income of 783 US dollars. Ethiopia aims to reach middle-income status by 2025.[113] As one of the fast-growing economy, Ethiopia has set astonishing goals to be achieved in the Growth and Transformation Plan (GTP 1) and is pushing forward with the remaining to be achieved in Growth and Transformation Plan (GTP 2). While most developing countries are endowed with resources, they face fiscal deficit problems which makes them depend on foreign assistance to finance their development program.

The basic responsibility of every government is to provide for the welfare of its' citizens. The citizens expect the government to provide basic infrastructure and amenities that would support their economic activities. For the government to fulfill the welfare responsibility as enshrined in the constitution,[114] financial commitment is required and that could be provided by the government through the imposition of tax. NEPAD–OECD African Investment Initiative Report dated (2009)[115] cited that taxation is central to the current economic development agenda. The report witnessed that tax provides a stable flow of revenue to finance development priorities such as strengthening physical infrastructure. However, evidences indicate that developing countries are not financing their development mainly from taxation.

For instance, according to IMF report of (2016)[116] the ratio of taxation revenue to GDP in Ethiopia was 11.47 percent which is lower than standard of East African Countries (19%) and that of Sub-Saharan African countries (16%). As a result, the increasing budget deficit has

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[112] World Population review, the latest United Nations estimation of Ethiopia population, 2019, available on http://worldpopulationreview.com/countries/ethiopia-population/ accessed on may 8, 2019.

[113] The world bank 2019 report, available on https://www.worldbank.org/en/country/ethiopia/overview, accessed on may 8, 2019

[114] FDRE constitution, Proclamation No 1/1995, FED. NEGARIT GAZETTE, 1st Year, here in under referred as FDRE Constitution.

[115] NEPAD - OECD (2009) African Investment Initiative. Taxation for Investment and Development: An overview of policy challenges in Africa.

[116] International Monetary Fund (2016). IMF Executive Board Concludes 2016 Article IV Consultation with the Federal Democratic Republic of Ethiopia. Press Release No. 16/443. Washington, D. C. 20431 USA.

raised concerns regarding the sustainability of government debt, the control of inflation and exchange rate and the fiscal program in general.[117] A number of factors contribute to such a weak contribution of taxation to the economic progress of developing nations. To tackle this problem, the government imposes tax as a major and important source of public revenue. However, the imposition of tax did not bring the required result due to reasons such as lack of clear understanding about the tax system by the tax payers; the tax payers' inability to comply with tax obligation; the hostility between tax payers and tax officials as well as inabilities of tax collecting organs or use of complex tax avoidance schemes by tax payers. For instance, most MNE's may not be contributing their fair share of taxes in developing countries as a result of transfer mispricing and other complex tax avoidance schemes. For these reasons, the actual amount of tax is not being collected properly.[118]

Ethiopia hosted a number of MNEs in the past twenty-five years. As the date received from Ethiopian Investment commission (EIC) indicated, starting from September 12, 1996 up to March 13, 2019, more than 424 FDI projects were issued a license to do business in Ethiopia. Accordingly, a total capital of 7,921,919, 000 USD has been injected into the country. This has created 15,124 permanent employments & 33,838 temporary employment job opportunities.[119]

Furthermore, the recent decision of the government to open state-owned companies and the set of fiscal & non-fiscal incentives to encourage FDI has inspired the MNEs to invest in Ethiopia. This has attracted 143 FDI in the last five months of 2018 fiscal calendar year alone.[120] This achievement has enabled the country to receive large amount of FDI thereby creating employment opportunities and technology transfer. However, the country did not generate enough revenue through taxation of MNEs and as such is still facing balance of payment problems. Most MNEs and their allies may use TP mechanisms and other complex tax avoidance schemes thereby letting the government lose a lot of revenue. This MNEs may use aggressive tax planning techniques including TP to shift part of their profits from Ethiopia to other jurisdictions. Hence, given the high profile of MNEs in the local economies of many developing countries, it may undermine the legitimacy of local institutions and discourage

[117] World Bank. (2013), Global Monitoring Report 2013, Policies and Actions for achieving the MDGs and related outcomes. Washington DC: World Bank.

[118] Tadele B. (2015). Analysis of Tax Buoyancy and Its Determinants in Ethiopia (Cointegration Approach) Journal of Economics and Sustainable Development Vol.6, No.3, ISSN 2222-1700 (Paper) ISSN 2222-2855

[119] Data gathered from the Ethiopian Investment Authority. The data can be accessed from the data collection center of the Authority free of charge.

[120] The Ethiopian Investment Commission (EIC) said it has issued licenses to 94 foreign investment projects in the last five months who registered a total capital of 23.6 billion birr ($843 million at current exchange rate). Ethiopia has attracted a total FDI of $3.75 billion, last Ethiopian fiscal calendar ended July 7, 2018.

voluntary compliance by other taxpayers unless such institutions have an effectively functioning TPR, necessary institutional infrastructure and required experts.

Thus, Ethiopia and many developing countries face practical difficulties in effectively implementing TPR. These are difficulties of: Drafting clear legislations and guidelines; Building tax administration expertise and experience in TP that would enable them carry out effective audits; Obtaining the much-needed information from taxpayers in order to select cases for audits; Obtaining public information on arm's length conditions in place for independent enterprises conducting comparable transactions under comparable circumstances.

3.2 The Legal Framework of Transfer Pricing in Ethiopia

Although transfer pricing is predominantly an international tax matter, TP issues can, and do, arise in a purely domestic context in a transaction involving related resident taxpayers. The international tax treaties and model tax conventions only regulates the basic conditions for adjustment of TP and advise the application of ALP but do not go into the particulars of TP rules.[121] Moreover, it is generally understood that Article 9 of the tax treaties is not "self-executing" as to domestic application. That is, it does not create a TP regime in a country where such a regime does not already exist. Therefore, when considering the legal framework for TP, reference to both domestic legislation & the relevant international legal framework is required.

In Ethiopia, before the enactment of the new TP Directive[122] and the new ITP,[123] the only reference to regulation of TP for direct taxation purpose was made under article 29 of the ITP No. 286/2002. The proclamation empowered ERCA to: Direct and adjust profits in cases where transactions between related persons differed from those between unrelated persons and to Enter into agreements in advance when specific conditions would not differ from those existing among non-related persons.[124] So, the former entitlement provided for the application of the ALP in transactions between related persons, while the latter provided a legal basis for APAs to be entered into between a taxpayer and the ERCA. No further guidance was provided on the actual application of the ALP until the enactment of TP directive in 2015, despite the pre-condition provided under the proclamation for the issuance of the directive by MoFED

[121] OECD model tax convention, supra note 68, Article 9
[122] Ethiopian Transfer Pricing Directive No 43/2015, supra note 14
[123] Federal Income tax proclamation No.979/2016, Fed. Negarit. Gazeta, 22th year, No.104, Addis Ababa, August 18th, 2016, herein under referred as Federal Income Tax Proclamation No 979/2016
[124] Federal Income tax proclamation No.286/2002, supra note 44

3.3 Transfer Pricing in The Custom and VAT proclamations

At international level, unlike TP for direct taxes where there is no single body of international law or specific international instrument, the custom authorities apply the relevant provision of the WTO Customs valuation agreement.[125] Even though, practices in applying certain provisions of these international standards at the national levels by customs may vary to a certain degree, as a basic principle, a cross border transaction between related parties and associated enterprises is supposed to be made on the market price or fair value.[126]

In Ethiopia too, the customs value of the goods is the basis for imposing custom duties. Consequently, the amount of customs duty on each item depends on the customs value for the good. That is, a higher customs value results in higher tax revenues to the tax authorities and the vice versa. According to the Customs Proclamation,[127] transaction value is the primary valuation method used to determine the customs value of imported goods.[128] The transaction value is defined in the Proclamation as the price actually paid or payable for the goods.[129]

However, transaction value, which is the primarily chosen method of valuation in GATT and Customs Proclamation, may not be accepted by the customs authorities due to various justifiable reasons. Whenever this happens, the customs value of good is determined using the transaction value of identical goods.[130] Nevertheless, when goods identical to the product being assessed do not exist in the market, the transaction value of similar goods shall be taken as a third alternative transactional value of the good.[131] Moreover, if the above methods fail, the tax authority may use the deductive, the computed or the fallback method. When the parties involved in international trade are related parties, the transaction value must pass either of the circumstances of sale test value in order to be accepted as the customs value for the goods. If the importer fails to prove either one of the tests, ERCA can determine the customs value of the goods. But nothing is provided in the Proclamation concerning the issue as to how ERCA determines the customs value of the goods. Yet, ERCA determines it based on estimation.[132]

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[125] Custom duty, tariff and taxes in Ethiopia, available at 'https://www.2merkato.com/articles/customs/69-customs-duty-tariff-and-taxes-in-ethiopia' accessed on 04/07/2019.
[126] Winham, Gilbert R. *International Trade and the Tokyo Round Negotiation* (1986).106, Sheri Rosenow and Brian J. O'Shea,*A Handbook on the WTO Customs Valuation Agreement*(2010)5,
[127] Customs Proclamation No. 859/2014, Fed. Negarit. Gazeta, 20th year, No.82, Addis Ababa, July 9th, 2014, Art 89
[128] Ibid, Customs Proclamation No. 859/2014, art 90
[129] Article 1(1) of the Agreement *on Implementation of Article VII of the GATT 1994*
[130] Customs Proclamation No. 859/2014, Supra note 127, Article.91.
[131] Ibid, Customs Proclamation No. 859/2014, Article 92.
[132] Yosef Alemu Gebregzizbher, Ethiopian Law on Transfer Pricing, A Critical Examination, supra note 45.

The issue of TP can also arise in relation to VAT to a certain extent. First of all, the determination of the acceptable transfer price and subsequent adjustments to be made to it under transfer pricing and customs value determination can affect the amount of VAT to be levied and charged on cross-border transactions.[133] For VAT purposes, the taxable amount for the supply of goods or services is represented by the consideration actually received by the supplier & there should be a direct link b/n the supply and the consideration received. The consideration thus equals the subjective value actually received and not the value estimated according to objective criteria reflecting the market value of the goods or services. Hence, to prevent tax evasion, the VAT proclamations or directive permits to levy VAT on a transaction based on its open market value rather than the consideration actually paid. This rule could be seen as reflecting the ALP for VAT purposes. however, Ethiopia is still collecting VAT on the consideration actually paid[134]

Thus, as TP adjustments by the tax authorities or by the taxpayer might have VAT implications if they constitute a consideration for a supply. This, could lead to an increase or decrease in the VAT taxable amount of that transaction. Therefore, the researcher recommends that there should be a supply in exchange for consideration and a direct link must be established b/n them.

3.4 The Current Transfer Pricing Directive

In 2011, the OECD's Task Force on Tax and Development[135] began a programme of support for developing countries seeking to implement or to strengthen their transfer pricing rules. The work has assisted countries putting in place measures designed to protect their tax bases supporting efforts towards a transparent and predictable investment climate through the introduction of rules that create certainty and consistency for business. Support initiatives have been put in place in Ethiopia, Botswana, Cambodia, Colombia, Ghana, Jamaica, Kenya, Malawi, Morocco, Peru, Rwanda, Sri Lanka, Tunisia, Vietnam, Zambia and Zimbabwe.[136] In addition to the OECD, The European Commission and Word Bank Group have been working together in different Projects ensuring coherent and coordinated support

133 Ibid,
134 Value Added Proclamation No 285/2002, Fed. Negarit. Gazeta, 8th year, No.33, Addis Ababa, July 4th, 2002.
135 The OECD's Task Force on Tax and Development brings together all major stakeholders on tax and development, including representatives from developed and developing countries, international organizations, business, NGOs. It is co-chaired by senior officials from an OECD and a non-OECD country, and is supported by a Secretariat - incorporating extensive government transfer pricing experience – managed jointly by the OECD's Centre for Tax Policy and Administration and Development Coordination Directorate, with staffing and other costs met by the OECD and donor contributions.
136 OECD, Developing Capacity of Transfer Pricing, supra note 18

Even though the output of the program in Ethiopia is not as effective as other countries like Colombia, Vietnam, Zambia or Kenya where a significant amount of tax revenue was obtained by transfer pricing adjustment as a result of audits of MNEs. This has assisted Ethiopia to introduce Transfer Pricing rules in the form of Directive 43/2015. The directive was issued by the MoFED[137] and it provides some detailed guidance as to the application of Article 29 of the old ITP No. 286/2002 which requires taxpayers to ensure transactions between related persons are conducted at arm's length and is effective as of 12 October 2015.[138]

The directive has the objective of observing the ALP and considers that comprehensive and sufficient TP rules are needed to facilitate the proper implementation of the ALP based on international best practice and guidance like the OECD transfer pricing guidelines as it is stated under its preamble.[139] Furthermore, the directive has five parts that deals with TP substantive provisions, transfer pricing application to specific transactions, documentation requirements, administrative procedures and final provisions. Be that as it may, in the following sections, the research will examine the salient features of the directives and forward its recommendations.

First of all, the directive is not yet publicly available and only the Amharic version is uploaded on the MoFED official website. This being the first challenge, the Amharic version nomenclature of directive says "በማስተላለፊያ ዋጋ የሚደረግ ግብይትን ለመከላከል የወጣ መመሪያ'' which is not the right nomenclature according to the researcher. The researcher also believes that the phrase "በማስተላለፊያ ዋጋ" has to be changed by "በማሸጋገሪያ ዋጋ" and the phrase "ለመከላከል" has to be changed by "ለመቆጣጠር" as the objective of the directive is not to protect rather to control and make sure that transactions between related parties observe the arm's length principle.

Likewise, the third paragraph of the preamble of both the Amharic and English version makes reference to the income tax proclamation. However, the country follows federal form of government structure[140] and the regional states have the power to enact their own income tax proclamations.[141] Therefore, the researcher recommends to make the reference clearer and more specific by adding federal to the income tax proclamation even though the directive under article 2/5 defines the income tax proclamation as the federal income tax proclamation.

[137] Ethiopian Transfer pricing directive, supra note 14, Article 20
[138] Ibid
[139] Ethiopian Transfer Pricing Directive, supra note 14, preamble of the directive.
[140] FRDE constitution, supra note 173, Article 50/1
[141] Ibid, FRDE constitution, Article 52/1/e and art 97

The other inconsistency between the Amharic and English version is observed under Article 2/11 of the proclamation concerning the definition given to "Tax Authority." While the English version defines it as 'tax authority of the Federal Democratic Republic of Ethiopia', the Amharic version includes both the federal & regional tax authority.[142] This is wrong according to the writer's opinion because the directive is a federal directive and is only applicable to federal tax payers alone. Besides, there are many terms under article 2 of the directive that are repealed or amended by the Tax administration proclamation and the new ITP.

3.4.1 Scope of Application of Transfer Pricing Rules in Ethiopia

The Federal and Regional Government have the power to issue income tax laws in respect of income base reserved to each respectively by the constitution.[143] Yet, owing to the dominance of the Federal Government in the income tax legislation, federal income tax legislation tends to cover income sources that are reserved by the constitution to the Regional Governments in Ethiopia.[144] Be that as it may, the Ethiopian TP Directive No 43/2015 was issued based on article 29 of the Federal ITP No 286/2002. Thus, the directive shall be applicable, at least in principle, on federal tax payers as it is issued by federal institution based on a federal law.

Moreover, Article 3 of the Directives attempted to clarify the scope of article 29 of the ITP.[145] Accordingly, the provision specified the application of the Directive to the transactions between resident tax-payers and their related non-resident entities (international transactions). the provisions specified the application of the Directive to any transactions between two related resident taxpayers having an annual turnover of more than 500,000 Ethiopian Birr.[146]

Nevertheless, the provision lacks clarity on the application of the Directives on international transactions with an annual turnover of less than 500,000 Birr. Even though article 3 provides for the application of the directive which concerns the pricing of any international transaction by related persons, the researcher recommends for the need to limit or qualify its application, as the case may be, on tax payers above certain annual gross sale or on Category A tax payers alone.

[142] Transfer pricing directive, Article 2/11, የታክስ ባለስልጣን ማለት የፌደራል ወይም የክልል የታክስ ባለስልጣን ማለት ነው።
[143] FRDE constitution, supra note 114, Article 96 and the following.
[144] Taddese Lencho, Income Tax Assignment under the Ethiopian Constitution; issues to worry about, Mizan law Review, vol. 4 no.1 March 2010
[145] Federal Income tax proclamation 286/2002, Supra note, 44
[146] Ethiopian Transfer Pricing Directive, supra note 14, article 3.

In addition, as the Directive clearly provides, its scope of application is based on the annual turnover or gross sale. Hence, it tried to include "Category A" tax payers under the ambit of the directive. However, the Directive didn't provide any minimum amount of transactions between related persons or between controlled transactions. Therefore, in addition to the annual turnover, the minimum amount of transaction among related parties or the amount of controlled transactions has to be considered for the application of transfer pricing directive.

By doing so, first, the tax collecting authority will save time and energy by disregarding immaterial controlled transactions, (transactions below certain threshold) between related parties and focus on the main transactions. Second, it will reduce the compliance burden of tax payers for immaterial controlled transactions thereby relieving them from high cost they would incur in obtaining transfer pricing documentation and comparable data. Third, the Transfer Pricing Unit is not yet well established and lacks sufficient administrative, technical and auditing capacity to conduct effective and efficient audits and therefore priority has to be given for major controlled transactions. The new ITP elucidates the scope by requiring the application of Transfer Pricing Directive to a permanent establishment of a non- resident in Ethiopia or to a permanent establishment of a resident of Ethiopia outside Ethiopia.[147] The proclamation also requires the application of the directive to transactions that takes place wholly in Ethiopia.[148]

3.4.2 The Arm's Length Principle

As it was discussed under section 2.5, The UN and OECD guidelines state that the ALP grants state the right to adjust the profits of associated companies to reflect an arm's length profit and this should be done as if the parties were independent from each other. Both provisions guide related parties and the tax authorities to ensure that the conditions of parties dealing at arm's length are met for transactions between such related parties. Moreover, there is general international consensus that the arm's length principle has become the international transfer pricing standard of most countries and of almost all tax treaties.

The new ITP defines "Arm's Length Transaction" as transaction between independent persons who are dealing at the arm's length with each other.[149] And the TP directive obliges tax payers engaged in a transaction with related persons to comply with ALP.[150] Furthermore, one of the most significant aspects of the TP directive is the introduction of a definition of the

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[147] Federal income tax proclamation, No. 797/2017, supra note 134, article 79/3
[148] Ibid Federal income tax proclamation, No 797/2017, article 79/4
[149] Ibid Federal income tax proclamation, No 797/2017, article, 79/6
[150] Ethiopian Transfer Pricing Directive, supra note 14, article 4/1

ALP.[151] This requires that a taxpayer carrying out a transaction with a related party determine its taxable profits by reference to comparable transactions between unrelated parties carried out under comparable circumstances.[152] It also specified the likelihood for TP adjustment where the controlled transactions are not performed in compliance with the ALP.[153]

Therefore, it's very important to identify the compliance of controlled transaction with the ALP and to determine the quantum of any TP adjustment. The power of the tax authority to adjust profit between enterprises do only apply when the parties are related persons.[154] To be qualified as related person, there are certain requirements provided under our tax laws. Thus, for TP purposes, the directive under article 2/9 of the same cross refers the meaning of related persons to article 2/4 of ITP no 286/2002. But it's inapplicable & repealed[155]so the appropriate definition of related persons is found under article 4 of Tax Administration Proclamation.

Accordingly, the proclamation provides that two persons/enterprises are related persons (Associated Enterprises) where the relationship that exists between them is such that one person may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of the other. Furthermore, two persons are considered related when both parsons/enterprises may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of a third persons/enterprises.[156] To identify whether a person/enterprise reasonably acts in accordance with the directions, requests, suggestions, or wishes of another has to be objectively determined having regards to all the circumstances. Additionally, a company/enterprise and member of the enterprise are related if the member controls 25% or more of the voting, dividend, or capital rights in the Enterprise.[157]

The other question is how the tax authority determines whether the controlled transaction is in compliance with the ALP or not. There is no simple and easy answer to for it. However, the directive provides that members of MNEs shall be considered as if they were separate and independent enterprises and the attention focuses on the nature of the transaction's b/n them. Hence the comparison between the terms and conditions of controlled transactions those of independent transactions is the basis for the ALP.

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151 Joel Cooper and Monia Volpato, Comprehensive Directive on Transfer Pricing Adopted; supra note, 40, p 61
152 Ethiopian Transfer Pricing Directive, supra note 14, article 4/2
153 Ibid transfer pricing directive, article 4/3
154 United Nation Practical Manual on Transfer Pricing for Developing and Countries, 2013, pp 63,
155 Federal Income Tax Proclamation No 979/2017, Supra note, 134, article 100/1/a
156 Tax administration proclamation No 983/2017, article 4/1
157 Tax administration proclamation No 983/2017, article 4/3/b

3.4.3 Comparability Analysis and Comparable Information

The Application of the ALP is generally based a comparison of the conditions in a controlled transaction with the conditions in transactions between independent enterprises.[158] Hence, in order to perform comparability analysis, it is necessary to identify independent transactions comparable to the controlled transactions which are subject to tax examination procedure of the tax administration. To meet the requirement of comparability, the TP Directive states that there shall be no significant difference between the transactions being compared that could have material impact on the financial indicator under the appropriate TPM since the purpose of this comparability analysis is to obtain the highest degree of comparability of the transactions.[159] However, if any such difference exists, it can be eliminated by adjusting the financial indicator of the uncontrolled transaction to eliminate the effect of the difference on comparability.[160] But, when applying and auditing the transfer prices, it is only rarely possible to find fully comparable transactions in respect of conditions and circumstances under which these transactions are realized. Hence, in most cases, it is necessary to make adjustments.

However, comparability adjustments should be made only if they are expected to increase the reliability of the results by taking into account: the materiality of the difference for which the adjustment is being considered, the quality of the data subject to adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustment.[161] Furthermore, the directive provides five factors that need to be considered in determining comparability[162] which includes, 1, the characteristics of the property such as their physical features, quality, reliability, market availability and etc; 2, functions performed.[163] such as production activities, research and development, distribution, advertising, financing and management functions etc; 3, Contractual terms and conditions of the transaction; 4, Economic and market circumstances such as geographic location, market size, competition level, availability of similar products, supply and demand levels, purchasing power, production and transportation costs etc; and 5, Business strategy pursued by the parties to the transaction.[164]

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[158] Ethiopian Transfer Pricing Directive, supra note 14, article 4/3; Article 9 of the, *'OECD Model Tax Convention*

[159] Ethiopian Transfer Pricing Directive, supra note 14, article 5/1/a; OECD *'Transfer Pricing Guidelines 2010 supra note 13*

[160] Ibid Ethiopian Transfer Pricing Directive, article 5/1/b

[161] Ibid Ethiopian Transfer Pricing Directive, article 5/3/a-d

[162] Ibid Ethiopian Transfer Pricing Directive, article 5/2/a-e

[163] Ethiopian Transfer Pricing Directive, supra note 14, article 5/2/b

[164] Ibid

Finally, in assessing whether the transfer prices between associated enterprises have been set up in accordance with the ALP, the researcher recommends to consider and take into account other facts such as whether the declared transaction has been actually realized; or whether the controlled transaction is not closely related to another one; or whether there are no mutual compensations included in the contractual terms and use the comparison of data from several taxable periods such as development of profits in the recent years as well as comparison of profits and losses within the whole group of the associated enterprises.

In comparing and evaluating circumstances which could influence the level of transfer prices, we should not always use absolute values but we nearly always use certain price range whereof the prices of comparable products or services are located. In this regard, our TP directive specifies the 'Arm's Length Range' under article 10. Accordingly, it provides that an arm's length range is a range of relevant financial indicator figure (price, margins or profit shares) produced by the application of the most appropriate TPD to a number of the controlled transaction based on a comparability analysis.[165] Thus, if the controlled transaction is within the arm's length range, no adjustment shall be made on such transaction by the tax authority.[166] But if the relevant financial indicators derived from controlled transaction falls outside of the range, the Tax authority may make an adjustment to the taxable income of the tax payer.[167]

Concerning source of information on comparable uncontrolled transactions, article 11 provides guidance as to the possible sources of information which include internal uncontrolled transactions and external uncontrolled transactions. Thus, if internal uncontrolled transactions, where one of the parties to the controlled transaction is also a party to the uncontrolled transaction and external uncontrolled transactions, which are uncontrolled transactions to which neither of the parties to the controlled transaction is a party, could be possible source of information[168] But if the information concerning comparable external uncontrolled transaction is not available to a tax payer, the Tax Authority shall not make an adjustment based on such information. In the absence of information on uncontrolled transactions from the same geographic market as the controlled transaction, comparable uncontrolled transactions from other geographic markets may be accepted by the Tax Authority. A determination of whether comparables from other geographic markets are reliable has to be made on a case by case basis.

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165 Ethiopian Transfer Pricing Directive, supra note 14, article 10/1
166 Ibid, Transfer pricing directive article 10/2
167 Ibid, Transfer pricing directive article 10/3
168 Ibid, Transfer pricing directive article 11/1/a & b

3.4.4 Approved Transfer Pricing Methods and Its Selection.

Ethiopian TP laws requires MNEs to follow the ALP. And if the transfer price set by MNEs does not followed the ALP, it can be deemed as inappropriate/mispriced by the tax authorities which can be subjected to the price adjustment.[169] Nonetheless, the key question is how one can apply the ALP in practice to determine the arm's length price of a transactions. Article 6 of the Directive specifies five methods that are considered to be approved TPM that MNEs and Tax Authority can make use of.[170] These methods are consistent with the TPM elaborated in the OECD Guidelines. According to the directive, the approved TPD are the following:

I. Comparable Uncontrolled Price Method (CUP)

Comparable uncontrolled price method consists of comparing the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction(s).[171] Therefore, under this method, the first step is to identify the price charged or paid for property transferred or services provided in a comparable uncontrolled transaction. Then such price is to be adjusted on account of differences, which could materially affect the price in the open market, if any, between the transactions being compared or between the enterprises entering into such transactions. Such adjusted price can be called an arm's length price computed under this method.[172]

The CUP method is the directive's most preferred method in situations where comparable data is available.[173] This method is considered to be the most direct way for determining the arm's length price since it involves direct price comparison. As the result, minor difference on goods or services being transferred can significantly affect the price of the transaction therefore it may be difficult to find the comparables under this method. Thus, the CUP is most readily used in transactions involving commodity products where the degree of similarity of goods is high. In order to apply this method, taxpayers and ERCA can search for either external or internal comparables. However, getting the relevant comparable data remains the main challenge for ERCA and even a single TP audit has not been made based on this method yet[174]

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[169] Ethiopian Transfer Pricing Directive, supra note 14, article 4
[170] Ibid, Transfer pricing directive article 6/1/a-e
[171] Ibid, Transfer pricing directive article, 6/1/a
[172] OECD *'Transfer Pricing Guidelines 2010, Supra note 13, p.11* -15,
[173] Ethiopian Transfer Pricing Directive, supra note14, article 7/3
[174] Interview with Mr. Zeleke Alemu, Law Enforcement and Compliance Directorate Director Large Taxpayers Branch Office, an interview made on April 16, 2019, from 10:00 – 11:00 Am, held at LTO

II. Resale Price Method (RPM)

RPM is a traditional transaction method like CUP and it consists of comparing the resale margin that a purchaser of property in a controlled transaction earns from reselling that property in an uncontrolled transaction with the resale margin that is earned in comparable uncontrolled purchase and resale transactions.[175] Therefore, the first step under this method is to identify the price at which property purchased or services obtained by the enterprise from an Associated enterprise is resold or are provided to an unrelated enterprise. Then from such resale price, the amount of a normal gross profit margin accruing to the enterprise or to an unrelated enterprise from the same or similar transaction is to be reduced. The price so arrived at is further reduced by the expenses incurred by the enterprise in connection with the said transaction.[176] Then such price is to be adjusted to take into account the functional and other differences which could materially affect the amount of gross profit margin in the open market between the transactions being compared or between the enterprises entering into such transactions.

The resale price method requires resale price margins to be comparable in order for an arm's length price to be identified.[177] This means that factors such as whether a warranty is offered and how it is applied must be taken into account. If a distributor offers a warranty and sells the product at a higher price to account for that warranty, then they will make a higher gross profit margin than the distributor that does not offer a warranty and sells the product at a lower price. For the two transactions to be comparable, the taxpayer must make accurate adjustments to the transaction cost to account for the margin discrepancy. But it is always difficult for ERCA to get a relevant comparable data & other necessary information needed to make the adjustment.

III. Cost Plus Method (CPM)

Cost plus method is also another traditional transaction method. It consists of comparing the mark up on those costs directly and indirectly incurred in the supply of property or services in a controlled transaction with the mark up on those costs directly and indirectly incurred in the supply of property or services in a comparable uncontrolled transaction.[178] Therefore, under this method, the first step is to determine the direct and indirect cost of production incurred by the enterprise in respect of property transferred or services provided to an associated enterprise.

[175] Ethiopian Transfer Pricing Directive, supra note 14, article, 6/1/b
[176] Ibid
[177] Chris Adam and Peter Graham (1999), *'Transfer Pricing: A UK Perspective",* (Butterworths, London, Edinburgh & Dublin) p. 11-12.
[178] Ethiopian Transfer Pricing Directive, supra note 14, article, 6/1/c

The next step is to determine the normal gross profit mark-up to such costs computed according to the same accounting norms of the enterprise or unrelated enterprise in connection with the same or similar comparable uncontrolled transaction.[179] The said normal gross profit mark-up is to be adjusted on account of functional and other differences if any, which could materially affect such profit mark-up in the open market between the transactions being compared or between the enterprises entering into such transactions.[180] Such profit mark-up is to be added in the cost calculated as per the first step. The sum so arrived at can be called an arm's length price computed under this method. The application of the CPM requires the identification of a mark-up on costs applied for comparable transactions between independent enterprises.[181]

IV. Transactional Net Margin Method (TNMM)

TNMM is a transactional profit method & it consists of comparing the net profit margin relative to an appropriate base (costs, sales, assets) that one party to the transaction (the tested party)[182] achieves in a controlled transaction with the net profit margin relative to the same base achieved in one or more comparable uncontrolled transactions.[183]Thus, under this method, first the net profit margin realized by the enterprise from a transaction entered into with a related-person is computed in relation to costs incurred, sales effected, assets employed or any other relevant base. Then the net profit margin realized by the enterprise or by an unrelated enterprise from a comparable uncontrolled transaction is computed with regard to the same base

If an adjustment is needed for a gross profit markup to be comparable but the information on the relevant costs are not available, then taxpayers can use the TNPM & indicators to assess the transaction. This approach can be taken when the functions performed by comparable entities are slightly d/t. For example, if an independent enterprise offers technical support for the sale of a piece of IT equipment, the cost of the support is included in the price of the product but cannot be easily separated from it. A related person may sell the same product but may not offer support. So, the gross margins are not comparables. By examining net margins, associated enterprises can more easily identify the difference in TP in relation to the functions performed.

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179 Brian J. Arnold and Michael J. Mcintyre (2002), *'Intemational Tax Primer',* 2nd Edition, (Kluwer Law International, the Hague/London/New York), p. 62.

180 Chris Adam and Peter Graham (1999), *'Transfer Pricing: A UK Perspective",* (Butterworths, London, Edinburgh & Dublin) p 21

181 Transfer pricing directive article, supra note 14, Article 6/1/d

182 According to transfer pricing directive article, 2/14, Tested party is the party to the controlled transaction for which the financial indicator is tested under the RPM, CPM or TNMM, as applicable.

183 Transfer pricing directive, supra note 14, article, 6/1/c

V. Transactional Profit Split Methods (TPSM)

Transaction Profit Split Methods are other forms of Transactional profit methods & consist of allocating to each related person participating in a controlled transaction the portion of common profit (or loss) derived from such transaction that an unrelated person would expect to earn from engaging in a comparable uncontrolled transaction.[184] Therefore under this method, the first step is to determine the combined net profit of the associated enterprises arising from the international transactions in which the enterprises are engaged. Then, the relative contribution made by each of the associated enterprises and the combined net profit is evaluated on the basis of the functions performed, assets employed or to be employed, reliable external data and risks assumed by each enterprise. The combined net profit is then split amongst the enterprises in proportion to their relative contributions and such apportioned profit shall be taken into account to arrive at the arm's length price in relation to the international transaction.

The directive also provides for the application of TPSM if it is possible to determine the ALP for some of the functions performed by one or both of the related persons in connection with the transaction using any of approved method described above, based on the common residual profit/loss that results once such functions are so remunerated. The directive also provides that the tax payer may use TPM other than the five approved methods above provided that none of them can reasonably be applied and the other methods' result is consistent with the ALP.[185]

These criteria are consistent with the guidance on method selection provided in the OECD guidelines.[186] As is also the case in the OECD Guidelines, the Directive specifies a preference for the comparable uncontrolled price method or the resale price or cost-plus method in cases where such methods can be applied with equal reliability to one or more of the methods. Accordingly, it stated that comparable uncontrolled price method is the most preferred TPD if CUP can be applied with equal reliability with any other of the above described methods by taking in to consideration the criteria described under article 7/2.[187] Similarly it also gives preference to the application of traditional methods (RPM and CPM) over transactional profit methods (TNMM and TPSM) where they can be applied with equal reliability by taking into consideration the criteria described above.[188]

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[184] Ethiopian Transfer Pricing Directive, supra note 14, article, 6/1/d
[185] Transfer pricing directive article, supra note 14, Article 6/2; Joel cooper, supra note 40
[186] OECD Transfer Pricing Guidelines 2010, Supra note 13
[187] Ibid
[188] Transfer pricing directive article, 7/3.

It is also important to notice that there is no single method that is suitable to every transaction in every circumstance. The taxpayer must select the method that provides the best estimate of an arm's length price for the transaction in question.[189] Furthermore, in order to choose the most appropriate method, it is not necessary to analyze every method for the transactions in question.[190] However, taxpayers are recommended to keep the transfer pricing documentation on hands. TPD may contain information regarding the establishment of the transfer price, such reason support for choosing and rejecting particular TPMs, basis information on the business industry, and reason for entering the related-party transactions.[191] The directive also makes clear that ERCA must respect the method applied by the tax payers unless the authority can prove that the method applied is not the most appropriate one.[192]

3.4.5 Transfer Pricing Documentation

In Ethiopia, the TPD requirement is provided under part three of the directive.[193] Thus, the directive requires the tax payers to have contemporaneous documentation that verifies that the transaction with associated enterprise are consistent with the ALP. The directive also provides nine principal documents that are required to complete TPD requirements and the languages to submit such documents[194]

However, the directive failed to clearly specify the forms and approaches to Transfer pricing documentations. As it was discussed under section 2.6.1, the OECD has introduced three tiered standardized approach to TPD in order to achieve the objectives of TPD requirement.[195] As it is stated in the OECD guideline 2017, transfer pricing documentation requirement have the objective of assessing the taxpayers compliance with the arm's length principle; providing the tax administration with the information necessary to conduct an informed transfer price risk assessment and enabling the authority to conduct a thorough transfer pricing audit.[196] So, to achieve these objectives, the OECD guidelines recommends a three-tiered standardized approach which includes, first a Master File containing standardized information relevant for the entire group; second, a Local File containing country-specific information for local associated enterprises and third a Country-

[189] Transfer pricing directive article 7/1
[190] Transfer pricing directive article 7/4
[191] Transfer pricing directive article 15.
[192] Transfer pricing directive article 7/5
[193] Transfer pricing directive article 15.
[194] Transfer pricing directive article 15/2
[195] OECD Transfer Pricing Guideline *2017, supra note 72, para 5.16 p.* 233 or Section C, Chapter V,.
[196] OECD Transfer Pricing Guideline *2017, supra note 72*; OECD/G20 Base Erosion and Profit shifting Project; Guidance on Transfer Pricing Documentation and Country-by-Country Reporting, 2017

by-Country Report containing certain information relating to the global allocation of group's income taxes and economic activity within the group.[197]

The non-inclusion of three-tiered standardized approach to TPD in the Ethiopian transfer pricing directive is probably due to the background of the directives which was enacted based on the 2010 OECD guideline.[198] Furthermore, the 2010 OECD guideline did not provide for the list of documents to be included in TPD packages and didn't have a clear guidance with respect to the link between the process for documenting transfer pricing, the administration of penalties and the burden of proof which creates the main challenge on both tax payers and tax authority or ERCA in the administration of transfer pricing. Be that as it may, Article 15 of the directive provides that taxpayers must have in place con temporary documentation to verify compliance with the ALP. In addition, sub article two lists nine elements that must be included in the documentation.

Accordingly, the provision requires for an overview of the taxpayer's business operations and organizational chart;[199] a description of the group's organizational and operational structure;[200] a description of the controlled transaction including the five comparability factors;[201] an explanation of the selection of the most appropriate method and, where relevant, the tested party and financial indicator used;[202] a comparability analysis including description of the process to identify the comparable uncontrolled transactions and their descriptions, the basis for rejecting internal comparables as well as an explanation of any comparability adjustments;[203] details of industry analysis, economic analysis, budgets and projections relied on;[204] details of any APA in other countries that are applicable to the controlled transactions;[205] a conclusion as to consistency of the conditions of the controlled transactions with the ALP, including details of any adjustment made to ensure compliance;[206] and any other information that may have a material impact on the determination of the taxpayers compliance with the ALP.[207]

According to the directive, the required documentation can be submitted in Amharic or

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[197] OECD Transfer Pricing Guideline *2017, supra note 72, para 5.16 p.* 233 or Section C, Chapter V, 7
[198] OECD Transfer Pricing Guideline 2010; see the preamble of Transfer pricing directive and article 18
[199] Transfer pricing directive article, 15/2/a
[200] Transfer pricing directive article, 15/2/b
[201] Transfer pricing directive article, 15/2/c
[202] Transfer pricing directive article, 15/2/d
[203] Transfer pricing directive article, 15/2/e
[204] Transfer pricing directive article, 15/2/f
[205] Transfer pricing directive article, 15/2/g
[206] Transfer pricing directive article, 15/2/h
[207] Transfer pricing directive article, 15/2/i

English, and is considered to be contemporaneous if it is in place at the filing date for statutory tax returns.[208] Additionally, article 15.5 of the Directive provides that the TPD must be provided within 45 days upon written request by the tax authorities. The Directive also grants the tax authorities the possibility to request further information even beyond the documentation to the taxpayer in the course of an audit.[209]

3.4.6 Transfer pricing Adjustment

If the tax authorities are of the opinion that the related party transactions are not conducted in an arm's length manner, an adjustment to taxable income will be made and it may result in economic double taxation.[210] So, TP adjustment is an adjustment made by tax authority after making a determination that a transfer price in controlled transactions b/n associated enterprise is incorrect or where an allocation of profits fails to conform to the arm's length principle.[211] broadly speaking, Transfer Pricing adjustments have the following three types.

Primary Adjustment is the first types of adjustment that a tax administration in the first jurisdiction makes to a company's taxable profits as a result of applying ALP to transaction involving an associated enterprise in a second tax jurisdiction.[212] This type of adjustment is considered to be the first adjustment made by tax administration in accordance with the ALP.[213] Secondary adjustment is a consequence of primary adjustment which is based on the premises that if controlled transaction had been undertaken on an arm's length basis, the situation would have been d/t from what it is even after making the primary adjustment.[214] it typically create constructive transaction which may be in the form of dividends, equity contributions or loan.

The 3rd type of adjustment is called Corresponding Adjustment. it is an adjustment to the tax liability of associated enterprise in second tax jurisdiction, made by the tax administration of the first state, so that the allocation of profits of two jurisdiction is consistent.[215] Hence it has the aim to maintain symmetry in the transaction. While both adjustments lead to double taxation, corresponding adjustments will mitigate or eliminates the impact of double taxation. The UN & OECD guidelines have provided a MAP framework under which treaty obligations

[208] Transfer pricing directive article, 15/4
[209] Transfer pricing directive article, 15/6
[210] UN Practical Manual on Transfer Pricing, supra note 59, para 1.8.3, p, 28
[211] OECD Model Tax Convention, supra note 53, article 9 para 2.
[212] OECD Transfer Pricing Guideline 2017, supra note 72, p 25
[213] Ibid, OECD Transfer Pricing Guideline 2017, supra note 72, Chapter IV, para 4.29, p 180
[214] Ibid OECD Transfer Pricing Guideline 2017, supra note 72, Chapter IV, para 4.32, p 182
[215] Ibid OECD Transfer Pricing Guideline 2017, supra note 72, Chapter IV, para 4.34, p 183

b/n nations are expected to be fully implemented.[216] MAP allow competent authorities of both states to resolve issues of economic & juridical double taxation. In this regard, Ethiopian TP Directive contains a specific provision dealing with corresponding adjustment. The Directive under article 16 provides that where a primary adjustmentis made to a domestic transaction, the tax authorities shall make a corresponding adjustment. However, the provisions failed to provide the detail guidance on its application for domestic transactions.

On the other hand, it provides the detail procedures and requirements for applying a corresponding adjustment for international transactions where a TP adjustment is made by a foreign tax authority. Specifically, corresponding adjustment can be made only where a primary adjustment to controlled transaction is made by foreign tax authority that has a relief of economic double taxation treaty with Ethiopia and where the adjustment results in the taxation of an amount of profit on which the party to the controlled transaction has already been charged in Ethiopia. Then, Ethiopian tax authority, after examining the consistency of the adjustment made with the ALP both in principle and as regards to the amount, will make appropriate adjustments to the amount of the tax charged on those profits.[217]

Additionally, the request by the taxpayer to apply for a corresponding adjustment must include: the name and other contact information of the related party; evidence of the tax residence of the related party; the year(s) in which the adjusted transactions took place; the amount of the requested corresponding adjustment and the amounts of the adjustment made by the tax administration of the tax treaty partner; evidence and the basis for the adjustment made by the other tax administration, as well as details of comparability factors and the TPM applied; and confirmation that the associated party will not, or is unable to, pursue any further recourse under the domestic law of the tax treaty partner that may result in the reduction or revision of the adjustment made by the tax administration of the tax treaty partner.[218] But the request for such adjustment shall be made within the applicable time period for making a request for the case to be resolved by a way of mutual agreement procedure under the applicable tax treaty[219] which is two years in most of double tax avoidance treaties. As of May 2019, Ethiopia has concluded a Double Taxation Avoidance Treaties (DTTs) with more than 29 countries.[220]

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[216] Ibid OECD Transfer Pricing Guideline 2017, supra note 55, Chapter IV, para 4.35, p 184
[217] Ethiopian Transfer Pricing Directive, supra note 14, article 17/1
[218] Ibid Transfer pricing directive article 17/2
[219] Ibid Transfer pricing directive article 17/3
[220] An interview with W/ro. Roman, Legal Service Directorate Director at Ethiopian Ministry of Finance; an interview made on April 17, 2019, from 10:30- 11:00 Am, held at Ethiopian Ministry of Finance.

3.4.7 Advance Pricing Agreement

The other important mechanism is APA which is a mutual arrangement between taxpayer/s and tax administration intended to provide or solve potential TP disputes.[221] So, a tax payer can preempt an audit & enter into an APA with the tax authority or can wait for a TP adjustment audit. An APA is essentially a long-term contract which is initiated by taxpayers and involves formal negotiations b/n the taxpayer and one or more tax administrations which identifies the TPM to be used for the identified transactions for some number of future years. It supplements the administrative, judicial, and treaty mechanisms for resolving transfer pricing disputes.[222]

Currently, APAs are becoming an increasingly popular tool for both taxpayers and tax authorities to proactively manage and address TP issues. In recent years, an increasing number of countries including many emerging and developing economies have been introducing the possibility under their respective domestic law for taxpayers to seek APAs. However, in Africa, the possibilities to seek an APA are still very limited. Ethiopia has followed the trend observed on other continents and has introduced rules and procedures concerning APAs in the Directive.[223] Under the prior legislation, there was a theoretical legal basis for an APA without further guidance. But, the provision on APAs has been substantially improved as a result of the new rules. Hence, a taxpayer may request the authority for an APA to determine appropriate set of criteria for the determination of arm's length conditions for future controlled transactions over a fixed period of time, which may be unilateral, bilateral or multilateral.[224] A unilateral APA is an agreement between a taxpayer and tax administration of the country where it is subject to taxation.[225] The risk associated with unilateral APA is that foreign tax administrations may not recognize it. Bilateral APAs involves an agreement b/n a taxpayer and both tax administration while multilateral APAs involve an agreement b/n MNEs & more than two tax administrations. Because of concerns over double taxation, most countries prefer bilateral or multilateral APAs and indeed some countries will not grant a unilateral APA to taxpayers in their jurisdictions.[226]

The taxpayer's request to apply for an APA must be accompanied by the description of the taxpayer's activities and transaction and a comparability analysis as well as an economic

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[221] *Guidelines for conducting Advance Pricing Arrangement under the mutual agreement procedure ("MAP APAs"),* OECD Publishing. Paris. Para 3
[222] OECD (2017): *OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations:* Publication, Paris. Para 4.147
[223] Ethiopian Transfer pricing directive, supra note 14, article 12
[224] Ibid, Transfer pricing directive article 12/1
[225] *OECD* Transfer Pricing Guideline 2017, supra note 72: Para 4.140, page 215
[226] Ibid OECD, Transfer Pricing Guideline 2017, para. 4.141 p. 216.

analysis, the identification of other countries seeking a bilateral or multilateral APA, and the scope of the agreement and proposed duration which may not exceed five fiscal periods beginning after the date of approval.[227] The authority will consider the request and make an appropriate decision by taking into account the taxpayers' compliance with the article and the expected benefits form the APA,[228] or in consultation with the competent authorities of the countries of related persons.[229] Where the Tax Authority approves the taxpayers' proposal or changes with taxpayers' consent and formalizes the APA, then no Transfer pricing adjustment will be made to such controlled transaction within the scope of the arrangements as long as the taxpayers follows the terms of the arrangements for the maximum of five years.[230]

3.4.8 Relevance of the OECD Guidelines

The OECD Transfer Pricing Guidelines for Multinational Enterprise & Tax administration has acquired international consensus on TP. And even though Ethiopia is not an OECD Member, the Directive is heavily influenced by the principles elaborated in the Guidelines. The Directive specifies that the OECD Guidelines are a source of interpretation for the Directive, but in case of any differences or conflicts with domestic law, the domestic law will take precedence.[231]

3.5 The Practical Application of Transfer Pricing in Ethiopian

Although the Ethiopian Transfer Pricing Directive is largely consistent with international standards[232] and provides MNE's doing business in Ethiopia with some clarity concerning the application of Ethiopia's TP rules as well as the possibility to obtain certainty through an advance pricing agreement, the actual implementation of the directive is far from realization. In Ethiopia, in addition to lack of administrative capacity to conduct effective and efficient audits, there are many reasons for non-implementation of TP directives even after almost four years from its enactment. In fact, the implementation of the ALP is a bit difficult for country like Ethiopia, where the availability of adequate and reliable comparable data is in question. Moreover, it is very difficult to obtain data from independent enterprises due to confidentiality concerns and due to non-existence of relevant comparable data. The Tax Authority did not also buy any database for comparable information as those databases are expensive.

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[227] Ethiopian Transfer pricing directive, supra note 14, article 12/2
[228] Ibid, Transfer pricing directive article 12/3
[229] Ibid, Transfer pricing directive article 12/4
[230] Ibid, Transfer pricing directive article 12/5 and 12/6
[231] Ethiopian Transfer Pricing Directive, supra note 14, article 18
[232] OECD *Transfer Pricing Guidelines for Multinational Enterprises and Tax Administration* 2010, supra note 13

However, as the selection of relevant TPM depends on analysis carried out, it is impossible to determine strictly, which method should be used in specific cases. The appropriateness of each method must be assessed, in relation to the functional & risk profile of the enterprise. That is why ERCA did not made any TP audit in practice so for by using any of the above-mentioned TPM, due to the non-availability comparable data to determine the correct transfer price.[233]

For the purpose of declaring Annual Return on TP, ERCA, prepared TP Declaration form. The form is made to be a part of business income tax and mining income tax declaration and requires a taxpayer with an annual aggregate international controlled transaction exceeding 500,000 birrs to complete it. Among other things, the declaration form requires such taxpayer to fill and describe the details such as the tax payer's principal business activities and their international controlled transactions; particulars of transactions b/n non-resident related persons with which the taxpayer had transaction with; resident persons with PE abroad; details of the performance of the taxpayers with Associated Enterprises, where applicable including, details of international controlled transaction that gives rise to income or deductible expenses, loans, transaction of capital nature and with non-monetary consideration as well as the TPM used to reach on the Arm's length price are also among the requirements.[234]

However, when we come in to the application and enforcement mechanisms of TPD, the directive seems defective. Even though the directive requires the taxpayer to submit the relevant TPD (in relation to their controlled transaction) to the tax authority within 45 days of the written request being duly issued by the tax authority,[235] there is no clear enforcement mechanism under the directive, as it lacks penalty clause. The directive lacks both administrative and penal sanctions. So, if the taxpayers fail to comply with TPD requirements or is not willing to submit the required documents within the specified time, the directive did not have any obviously and sufficiently identified enforcement mechanisms.

Furthermore, the directive does not clearly force taxpayers to fill the Transfer Pricing Declaration Form prepared by ECRA, while they fill the annual return on TP at the end of each fiscal year. Hence, non-availability of penalty clause and lack of clear provision in the directive that forces the taxpayers to fill and submit the TP declaration form to the tax authority is the major challenge in application of TPD requirements.

[233] Interview with Birhan Tatek, Senior Auditor of Transfer Pricing Process Unit Large Taxpayers Branch Office, an interview made on May 6, 2019, from 9:00 – 10:00 Am, held at LTO.
[234] Ethiopian Revenues and Customs Authority Transfer Pricing Declaration Form, ERCA, 2015
[235] Ethiopian Transfer Pricing Directive, supra note 14, article, 15/5

Even though there is a general penalty provision that imposes an administrative penalty in respect of the application of a tax avoidance provision to a taxpayer including TP issues under the new Tax Administration Proclamation,[236] it doesn't have a deterrence effect as the penalty is not enough to force the taxpayers to comply with TPD requirements.[237] Though, *Tax Avoidance Provision* is defined under article 2/33 of tax administration proclamation to include the TP provision under article 79 of the new ITP,[238] it is not enough as there is a need to have a specific penalty provision for non-compliance with TPD requirements. Thus, the researcher recommends for the amendment and inclusion of specific penalty provisions under the TP directive for non-compliance with documentation and reporting requirements.

Furthermore, the researcher recommends that such penalty provisions shall be designed to provide disincentives for non-compliance in order to make tax underpayments and other types of non-compliance more costly than compliance. Generally, in the area of TP, specific penalty provision could be related for failure to comply with the documentation requirements including for not preparing or maintaining required TPD; or for not preparing TPD by the time for the making of the tax return; or for not retaining TPD for certain specified period of time; or for not submitting TPD within 45 days from written request by the ERCA; or for Providing any documentation or information that the taxpayer knows to be false or misleading. As opposed to administrative or civil penalties, there are also a possibilities of imposing criminal penalties for cases of very significant fraud. Therefore, the researcher recommends to take in to consideration these issues during the process of amending TP directive to include specific penalty provisions for non-compliance with documentation and reporting requirements.

In relation to APA, though it is a powerful tool to eliminate uncertainty for businesses and enhance the relationship with the tax authorities which must ensure the confidentiality of information during the course of the process, the time of implementing the APA provision is made conditional up on the issuance of circular by MoFED to ERCA.[239] However, The circular is not yet prepared and ERCA did not enter into any APA.[240] Hence, there is no application of APA in Ethiopia in practice so far.

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[236] Tax administration proclamation No 983/2016, art 111, tax avoidance penalty
[237] Ethiopian Federal Tax Administration Proclamation No 983/2016, Technical Note, Ministry of finance and Economic Cooperation, February 2018, page 16.
[238] tax avoidance means the tax avoidance provisions of new ITP article 78 on income splitting, article 79 on transfer pricing, article 80 on general anti-avoidance rule for income tax, & a provision in the VAT proclamation providing for a general anti-avoidance rule.
[239] Ibid, article 12/1, The time of implementing this article will be determined by the minister with a letter.
[240] Interview with Mr. Zeleke Alemu, supra note 174.

CHAPTER FOUR:
4 INSTITUTIONAL FRAMEWORK FOR TRANSFER PRICING ADMINISTRATION IN ETHIOPIA
4.1 The Ministry of Finance

Ministry of finance[241] or the then Ministry of Finance and Economic Development (MoFED) is the main institution behind strategic economic financial planning of the Ethiopian economy as well as administration of national and international accounts.[242] Furthermore, MoFED is vested with the power to issue different directives and circulars (law of letters) to implement tax laws and policy; sign international treaties including bilateral double taxation avoidance treaties; and interpret ambiguous articles for implementation by ERCA and taxpayers.[243] In Particular, the ITPs empowered MoFED to issue TP Directive and circular on APA.[244]

The legal Service Directorate, and the tax policy center are the are main two organ under ministry that works on tax related issues. The Legal Service Directorate is specifically empowered to prepare tax law regulations, directives and model tax laws; to provides legal explanations and advance ruling, to participate on agreements and negotiations including double tax avoidance agreements, to prepare explanatory notes for ratifications, etc.[245]

Furthermore, MoFED as the main tax policy maker of the government institution, has recently established a tax policy department comprised with local experts in that area. The department is expected to reviews tax policy of the country from time to time and ensure its enforceability, understandability and equitability to both ERCA and every taxpayer including MNEs. Currently MoFED has amended close to 9 new directive and 6 more directive are being amended, based on the new ITP, though, TP Directive amendment is not yet started.[246] In doing so it has close relation with tax collecting authority but did not have tax administration role as both domestic and international tax administration role is given to ERCA.[247] However, the two institutions have a de-facto relationship in tax affaires in general and tax administration in particular. Thus, it is unreasonable to institutionally separate ERCA from MoFED.

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241 Ministry of Finance and Economic Development is replaced by ministry of Finance procl. No 1097/2018
242 Ministry of Finance and Economic Development, http://theredddesk.org/countries/actors/ministry-finance-and-economic-development-ethiopia, Accessed on Jan 12, 2018
243 Federal Income Tax Proclamation No 286/2002, supra note 44
244 Ibid, Federal income Tax Proclamation No 286/2002, art 29.
245 Ministry of Finance, http://www.mofed.gov.et/web/guest/the-ministry, Assessed on may 2, 2019
246 An Interview with Habtamu Lemma, Senior Legal Office of Legal Service Directorate at Ethiopian Ministry of Finance, an interview made on April 17, 2019, from 1:30-2:30 Pm, held at Ethiopian Ministry of Finance.
247 Ibid

4.2 The Ministry of Revenue

The Ministry of revenue[248] or the then Ethiopian Revenues and Customs Authority is the body responsible for collecting revenue from Customs duties as well as from domestic and international taxes.[249] Furthermore, ERCA was established with the objectives of establishing modern revenue assessment and collection system; rendering fair, efficient and quality service; assessing, collecting and accounting for all revenues in accordance with tax laws as well as enforcing tax laws by preventing and controlling tax fraud and tax evasion.

With regard to Instructional Frameworks of Ministry of Revenue, the Minster is organized in at head office and branch office level with headquarters in Addis Ababa. Even though, the researcher did not find any relevant Directorate or unit which works on TP administration in the headquarters. The Large Tax Payers Branch Office (LTO) has, at list on the structure/paper, a department called "International Tax Issues Auditing Unit." to deal with international tax issues in general. Previously, following the issuance of TP Directive, LTO tried to establish an 'International Tax Audit Team' under the Auditing Process Unit, to deal with international transfer pricing audits.[250] However, in June 2018, International Transfer Pricing Unit were re-established by LTO as independent audit unit, under 'Law Enforcement and Compliance Directorate'[251] and currently the mandate to administer transfer pricing given to this unit.

4.3 The Transfer Pricing Process unit

As it is discussed above, Transfer Pricing Unit were established under the Large tax payers branch office, to deal with the issues of TP. The TP unit mandated, among others things, with collecting and organizing information about MNEs incorporated in Ethiopia and analyzing sources of information including from foreign source; analyzing, specifying and supervising the level of risk involved in controlled transaction; analyzing and approving controlled transaction, if it is consistent with the ALP or notifying the taxpayer for adjustment made and additional payment required; as well as recommending other measures to be taken, if the tax audit findings reveals major fraud or commission of crime. However, the unit have only six employees and all are auditors with only accounting background. [252]

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[248] Ethiopian Revenue and Custom Authority is replaced by Ministry of Revenue, by procl. No 1097/2018
[249] Ethiopian Revenue and Custom Authority http://www.erca.gov.et/index.php/about-us#objective-of-authority
[250] An interview with Gizaw Bekuretsion, Tax Audit Process Unit Coordinator, Large Taxpayers Branch Office, an interview made of May 07, 2019, from 9:00-10:00 Am, held at LTO.
[251] Annex 1, the organizational structure of Large Tax Payers Branch Office
[252] An interview with Birhan Tatek, supra note 233.

4.4 Administration of Transfer Pricing in Ethiopia

In Ethiopia, the concept of international tax administration in general and TP administration in particular, is a recent phenomenon. They developed at a time when cross-border flows of goods, services, and capital become important with the current development of the country. Arrangements to deal with international trade, capital flows as well as TP have been added to national tax systems. Inevitably, these arrangements tend to be complex and problematic that requires additional mechanisms, to have a comparable date; a degree of cooperation between governments for information exchange as well as a well-equipped and well-staffed department.

In this regard, the new ITP and the new Tax Administration Proclamation provides certain rules and procedure concerning the administration of TP in more detail than their predecessor.[253] However, the practice on the ground is still far from the merit of the law. Despite the fact that, the new ITP[254] devote a full chapter for international taxation and anti-tax avoidance rules including TP each, tax administration authority doesn't have effective independent department which specifically works on it. Moreover '*ERCA's priority is collection of taxes from custom duties and domestic taxes, and that's why the auditing department is doing only general audit but not transfer pricing'* as Gizaw Bekuretsion, mentioned on the interview[255]

Be that as it is, after Transfer Pricing Team was established under the Auditing department and then became an independent Transfer Pricing Process Unit, under Law Enforcement and Compliance Directorate, there were some attempts to administer Transfer Pricing, with some success and many failures. Among other things, the TP Unit, tried to identify the population. According to Birhan Tatek,[256] the first activity of the unit was to identify those related Persons that are incorporated in Ethiopia. However, identified them was and still is a major challenge for the department as the they don't have any relevant and reliable data on the issue. She informed the researcher that, the TP Unit attempted to use certain indicators like the name of the company or the name of the CEO (if s/he is a foreign), as well as their personal knowledge any other available information from others sources to identify MNEs.[257]

[253] Ethiopian Federal Income Tax Proclamation No. 286/2002, supra note 44
[254] Tax Administration Proclamation No. 983/2017
[255] An interview with Gizaw Bekuretsion, Tax Audit Process Unit Coordinator, Large Taxpayers Branch Office, on an interview made on may 6, 2019, from 10:00 – 11:00 Am, held at head
[256] An interview with Birhan Tatek, supra note 233
[257] Ibid, an interview with Birhan Tatek.

Thus, she said, the TP unit is able to identify 179 MNEs until the date of interview, even though the figure is not yet completed and not yet confirmed whether such taxpayers are actually related party according to the definition provided under tax administration.[258] In this regard, the data the researchers obtained from Investment commissions showed that there are more than 424 MNEs that secured investment permit from the commission until March 13, 2019.[259] Therefore, the Researcher recommends for effective exchange of information and coordinative work among ERCA, EIC and Trade Minister working on registration and licensing MNEs.

Even if, the TP Unit did not undertake any TP Audit yet, it attempted to do some initial works like transfer pricing risk assessments, identification of related parson transactions and general audit for 67 selected MNEs, to check whether their controlled transaction was consistence with the ALP. Nevertheless, due to non-compliance with the documentation requirement, the TP Unit was unable make full TP Audit and only limited to check whether the claimed technical service is actually provided. Accordingly, the TP Unit, made a Price Adjustment only for three related companies based on service transactions by rejecting technical, management and consultant fees.[260] Then two of the companies lodged a complaint against rejection of the expenses and now their cases are being entertained by Tax Appeal Commission.[261]

Furthermore, even if, TP Unit identified five company's-controlled transaction in relation to sales and purchase, is suspicious for transfer mispricing, due to lack of comparable date and other relevant information, their issue is kept pending. In this regard, she mentioned as example the case of horticulture MNEs where they did not find the sale price for flowers in Holland, even though they know the price they declared in Ethiopia is below market price; and the case of brewery factors where they can't find comparable data on purchase price of bottles.[262]

The other important activity performed after the establishment of the TP Unit is related with capacity building activities. According to Mr zeleke, the authority signed a two years capacity building contract with Her Majesty Revenue and Customs (HMRC) to get special training for a week in each three months. The OECD experts also gave a short-term training; However, the trainings are now stopped as the TP unit did not show any progress to that effect and being hold until the unit is able to identify the population/MNEs and comparable data.[263]

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[258] Tax administration proclamation No 983/2017, article 4/1
[259] Freely available data with no fees, at EIC
[260] An interview with Birhan Tatek, Senior Auditor of Transfer Pricing Process Unit, supra note 233
[261] Ibid An interview with Birhan Tatek, Senior Auditor of Transfer Pricing Process Unit,
[262] Ibid An interview with Birhan Tatek, Senior Auditor of Transfer Pricing Process Unit,
[263] An interview with Mr Zeleke Alemu, supra note 174

4.5 The main Challenges for Implementing Transfer Pricing in Ethiopia.

The goal of every tax administration is to collect taxes imposed under various tax laws effectively and efficiently. However, to achieve this goal, having well-equipped and qualified expertise as well as required technology is a pre request. Especially when the issue is related to TP of MNEs, the situation become the worst as administration of TP requires, among other thing, efficient information exchange; advanced communication technology; availability of comparable data; effective organizational structure; developed tax compliance culture; and qualified expertise and functional dispute resolution mechanisms.[264]

In Ethiopia, as it is discussed above, the tax authority does not have any department for TP administration at the headquarters. Likewise, the Transfer Pricing Unit established under LTO is under staffed, only six employees including the process owner, all with simply accounting background. Even if, all of them are senior auditors, as Transfer Pricing Audit is different form General Audit, there is a need for special and continuous capacity building trainings (including international trainings) for effective and efficient Transfer Pricing Administration.

Additionally, TP administration is not only about TP audit and therefore, the Transfer Pricing Unit should be staffed with Transfer Pricing Professionals with law and economics background to deal with legal, intelligence and investigation issues. In addition to proper staffing of TP unit with well training and well qualified personnel, there is a need to create effective coordination and information exchange with different organs including, Head office, Customs Commission, Investment Commissions, Trade Minister and other relevant organs.

The other important issues required to implement ALP is availability of comparability data. Comparability analysis is the key for choosing the most appropriate transfer pricing method and it is a critical element of evidence, especially during TP audit. Even though obtaining comparable data to defend the price used in controlled transaction is rest on taxpayers, the source of information for external comparable data should be made available by tax authority. The most common source of external comparable data in many countries are databases. Ethiopia did not buy any database yet,[265] and it makes TP administration very difficult. Mr. Zeleke explained that the Purchase price of such database is very expensive and Ethiopian TP

[264] An interview with Menelik, formal Higher Prosecutor at ERCA, and now serves as private lawyer and tax consultant, an interview made on April 18, 2019, from 10:00-11:00 Am, held at his Office located on bole road.
[265] Interview with Mr zeleke Alemu, supra note 174.

Unit is not yet ready to administer it. So, he said their priory right now is a capacity building of the unit but not administering TP audit.[266] However, as the government has a mandate to insure the availability of comparable data, the writer recommends that the authority should make available as least one database to be used by taxpayers as external comparables.

Furthermore, any Transfer Pricing Administration organ must have the ability to obtain, within a reasonable period, all the relevant information including external comparables, functions and financial results of controlled transactions for effective International Transfer Pricing audit.[267] Its therefore important that the tax administration organ is able to obtain directly or through information exchange mechanisms, information that extends beyond the country's border.[268] In this regard, Ethiopia has signed more than 29 bilateral double tax avoidance treaties and almost all them provides a provisions for information exchange mechanisms. Nevertheless only 9 of them are operational until now, as signed treaties need ratification from both countries' legislative organ and the communication of ratification to that effect.[269]

Additionally, lack of advanced communication technology and effective organizational structure is also the challenges that the Ethiopian tax administration organ in general and transfer pricing in particular are facing. Specially lack of effective coordination and advanced communication between TP Unit under LTO and headquarter as well as between ERCA and other government organ is the major challenge for effective and efficient TP Administration.

Similarly lack of enforcement mechanisms for transfer pricing documentation requirements and lacks of penalty clause under the directive, discouraged taxpayers form complying with the requirements as they will not be willing to submit the required documents within the specified time. Besides the directive did not clearly force them to fill TP declaration form at the end of tax year. Therefore, there is a need to amend the directive to include both.

Finally, the requirement for the issuance of circular, for the application of Advance Pricing Arrangements is made a requirement under the directive. The ministry did not enact such circular and its application remains ineffective. Therefore, there is a need to build ERCA's capacity to deal with APA and then the ministry shall authorize ERCA to administer APA by a letter, so that the possible difficulties in finding comparables and TP audit may be minimized.

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[266] Ibid interview with Mr. Zeleke Alemu
[267] OECD Guidance on Transfer Pricing Documentation and country-by-country reporting, page 14
[268] Ibid OECD Guidance on Transfer Pricing Documentation and country-by-country reporting
[269] An interview with Mr Habtamu Lemma, supra note 246

CHAPTER FOUR:

CONCLUSION AND RECOMMENDATIONS

5.1 Conclusion

Transfer pricing is currently recognized as the most important international tax issue by both MNEs and tax authorities and tax authorities around the world increase scrutiny in their tax audits especially on those related-party transactions as the result of their increasing concerns on transfer pricing role in tax avoidance. For this, the OECD has come up with the internationally accepted principle called arm's length principle, which states that the price of the related-party transactions shall be similar as those transactions taken in the opened market, and if not, appropriate adjustment shall be made to eliminate such differences.

However, both tax administrations and taxpayers often have difficulty in obtaining adequate information to apply the ALP. Because the ALP usually requires taxpayers and tax authorities to evaluate uncontrolled transactions and the business activities of independent enterprises, and to compare these with the transactions and activities of associated enterprises, it can demand a substantial amount of data which is the major problem in most of the developing countries, including Ethiopia. Be that at it is, many states including Ethiopia, have adopted TP rules that apply in determining or adjusting income taxes of domestic and multinational taxpayers as well as approved TPM generally in accordance with the OECD Transfer Pricing Guidelines.

Though the Ethiopian TP Directive is largely Consistent with internationally accepted OECD guidelines and provides MNEs with some clarity concerning the application of TP rules as well as the possibility of obtain certainty though an APA, the actual implementation of the directive is far from realization due to lack of administrative capacity to conduct effective and efficient audit; lack of well-equipped and qualified experts; lack of sufficient and reliable comparable data; lack of advanced communication technology and information exchange mechanisms as well as lack of effective organizational structures and etc.

Therefore, it is possible to conclude that there is no application of TP rules and TP audits in Ethiopian, as the country lacks effective and efficient TP administration organ in addition to lack of effective enforcement mechanisms and penalty for failure to discharge TPD requirement; lack of blessing from MoFED with the letter, to administer APA; failure of the whole system in identifying related persons and related person transactions; lack of sufficient and reliable comparable data as well as lack of necessary infrastructure; and etc.

5.1 Recommendations

Based on the aforesaid discussion, the researcher would like to recommend the followings

1. In terms of scope of application, the directive is based on the annual turnover or gross sale alone and it didn't provide any minimum amount of transactions between related persons or between controlled transactions. Therefore, in addition to the annual turnover, the minimum amount of transaction among related parties or the amount of controlled transactions has to be considered for the application of transfer pricing directive.
2. Lack of enforcement mechanisms for transfer pricing documentation requirements due to the non-availability of penalty clause and lack of clear provision in the directive that forces the taxpayers to fill and submit the TP declaration form to the tax authority is the major challenge in application of TPD requirements. Therefore, there is an urgent need for the amendment and inclusion of specific penalty provisions under the TP directive for non-compliance with documentation and reporting requirements.
3. In relation to the application of Advance Pricing Agreement, the time for commencement of its implementation is made conditional up on the issuance of circular by MoFED to ERCA, under the directive. However, due to non-issuance of the circular by MoFED, ERCA could not enter into any APA. Therefore, the Ministry of Finance should authorize Ministry of Revenue with a letter to administer APA and the Ministry of Revenue need to build it's capacity to deal with APA before entering in to any Advance Pricing Agreements.
4. The availability of comparability data is the key for choosing the most appropriate TPM and it is a critical element of evidence, especially during TP audit and the most common source of external comparable data in many countries are databases. However, Ethiopia did not buy any database yet and it makes TP Audit very difficult. Therefore, Ethiopian Tax collecting organ need to purchase a database for comparable information, Even though purchasing of such database is expensive
5. For effective TP administration, TP Unit should ascertain its population and ERCA should put in place a mechanism to identify Related party and related party transactions. Therefore, there is a need to create effective coordination and information exchange with different organs including, Head office, Customs Commission, Ethiopian Investment Commissions, Trade Minister and other relevant organs.
6. The TP Unit should be staffed with TP Professionals with law and economics background as well to deal with legal, intelligence & investigation issues; and it should have an effective organizational structure; advanced communication technology and qualified experts.

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Interviews

- An interview with Birhan Tatek, Senior Auditor of Transfer Pricing Process Unit, Large Taxpayers Branch Office, an interview made on May 06, 2019, from 9:00 – 10:00 Am, held at LTO
- An interview with Gizaw Bekuretsion, Tax Auditor Process Unit Coordinator, Large Taxpayers Branch Office, an interview made on May 07, 2019, from 9:00 – 10:00 Am, held at LTO
- An interview with Habtamu Lemma, Senior Legal Officer of Legal Service Directorate at Ethiopian Ministry of Finance, an interview made on April 17, 2019, from 1:30- 2:30 PM, held at Ethiopian Ministry of Finance
- An interview with Menelik; Formal Higher Prosecutor at ERCA, and now serves as Lawyer and Tax consultant, an interview made on April 19, 2017, from 10:00 – 11:00 Am, held at his Office located
- An interview with Roman; Legal Service Directorate Director at Ethiopian Minister of Finance, an interview made on April 17, 2019, from 10:30- 11:00 Am, held at Ethiopian Ministry of Finance.
- An interview with Tilahun Esmael, Higher Investment Consultant at Ethiopian Investment Commission, an interview made on April 18, 2019, from 10:30- 11:00 Am, held at Ethiopian Investment Commission.
- An interview with Zeleke Alemu Law Enforcement and Compliance Directorate director, Large Taxpayers Branch Office, an interview made on April 16, 2019, from 10:00 – 11:00 Am, held at LTO

ANNEXS

Annex 1: Organizational Structure of Large Tax Payers Branch Office

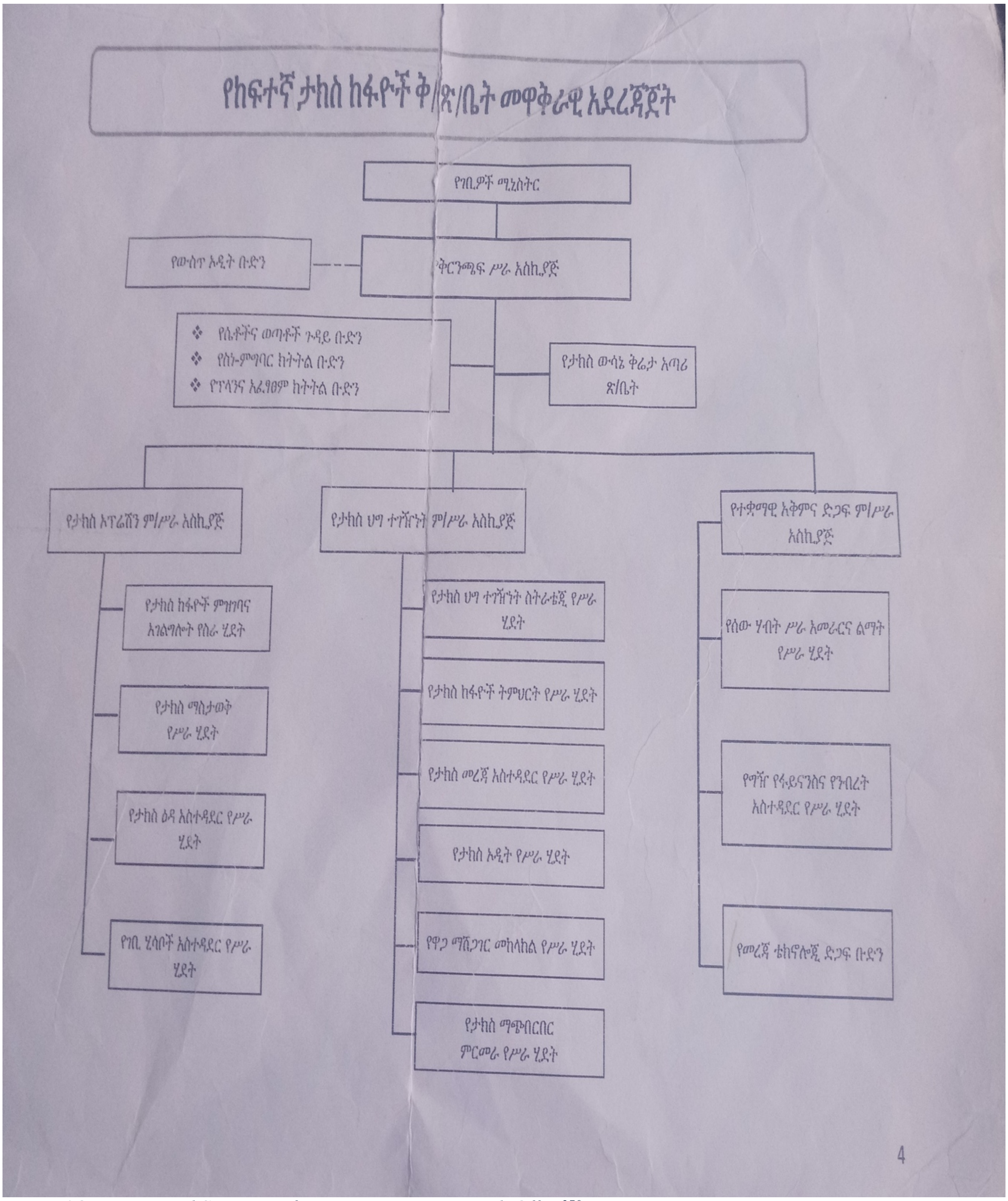

Figure 1Organizational Structure of Large Tax Payers Branch Office[270]

[270] Source,

Annex 2: Ethiopia-Foreign Direct Investment, Percent of GDP

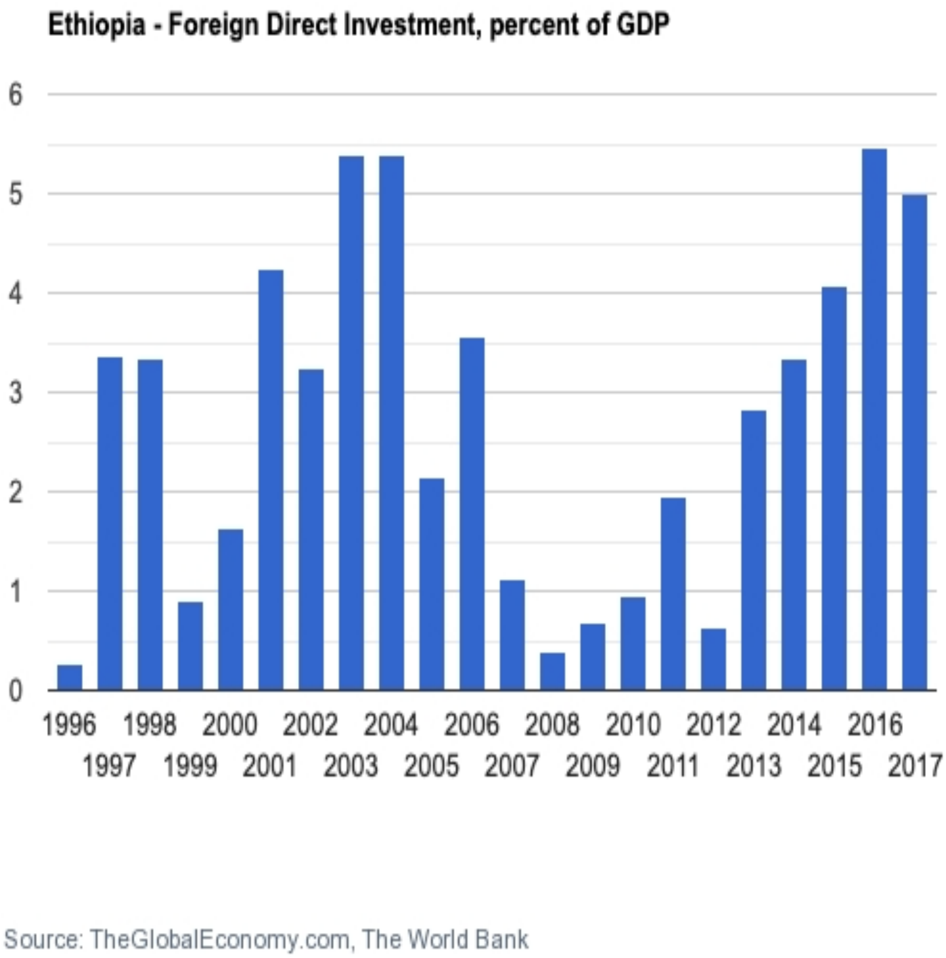

Figure 2Ethiopia: Foreign Direct Investment, Percentages of GDP, measurement: percent, source: world bank,:[271]

[271] Ethiopia: Foreign Direct Investment, Percentages of GDP, measurement: percent, source: world bank, available on https://www.theglobaleconomy.com/Ethiopia/Foreign_Direct_Investment/
Accessed on may 8, 2019