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**LEGAL AND PRACTICAL ISSUES RELATING TO CAPITAL GAINS TAX: THE
CASE OF ADDIS ABABA CITY ADMINISTRATION**

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Declaration

This is to announce that this thesis is my original work and it has not been presented to any degree in other university and all relevant materials used for the thesis is properly cited.

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Acknowledgment

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Acronyms

AACA – Addis Ababa City Administration

AAC – Addis Ababa City

CGT – Capital Gains Tax

HPR – House of People Representative

HoF – House of Federation

FDRE – Federal Democratic Republic of Ethiopia

Abstract

Capital gains tax (hereinafter CGT) is a tax imposed on the disposal of capital assets like buildings, shares, bonds, minerals, and petroleum rights or information. To effectively implement CGT, legal and practical problems should be resolved properly. In Ethiopia, the problem with CGT commences from the power of taxation of CGT. The Federal Democratic Republic of Ethiopia (hereinafter FDRE) Constitution which in detail illustrates the taxation power of federal and Regional Governments fails to expressly designate CGT. Nevertheless, both the Federal Government and Addis Ababa City Administration (hereinafter AACA) are imposing CGT.

That being the case, there are practical and legal problems concerning CGT. This thesis specifically studies the legal and practical problems in AACA, the constitutional and legal basis of the city administration to impose and collect CGT. To appropriately address all issues both doctrinal and qualitative methods of conducting research have been used. Hence, domestic laws, national and international documents have been consulted. The finding reveals that there is no constitutional ground for the Federal Government and AACA to impose CGT. It also discloses key legal and practical problems concerning the valuation of capital assets, deduction of costs, inflation adjustment, and inconsistency between different laws, and the like. Most of the practical problem arises due to lack of awareness. The problems cause the government to lose a significant amount of revenue, as well as affect taxpayers' legal rights.

Based on the finding, the thesis recommends the designation of CGT by the joint House of Federation (hereinafter HoF) and House of People Representative (hereinafter HPR). The practices and laws that affect CGT's effective implementation should be reconsidered, and serious awareness creation should be made to the tax collecting officers and the taxpayers.

CHAPTER ONE

INTRODUCTION

1.1-Background of the study

Taxation is the main source of government revenue in most of the world. The primary function of taxation is to raise revenue for the government for its public expenditure.¹ CGT is one of the major tax sources of revenue for the government. CGT is a tax levied on gain upon disposal of capital assets like shares, bonds, and buildings held for a commercial purpose is disposed of. In Ethiopia, the modern history of taxation in general, CGT in particular is a recent development.

Since 1995 Ethiopia follows a federal state structure where power and responsibility are shared between state and Federal Government. In federal-state fiscal federalism is important in improving service delivery, promoting equitable distribution of resources, managing conflicts emanating from resource claims, and enhancing transparency and accountability.² Considering this fact, the FDRE Constitution illustrates the taxation power of each level of government, their concurrent power, and undesignated power.³But, CGT is not expressly designated in the constitution. The joint house of HPR and HoF which are empowered to determine over undesignated tax do not decide over CGT. But, the Federal, Regional, and Addis Ababa City (hereinafter AAC) governments are imposing and collecting CGT without a constitutional basis.

AACA charter empowers the city administration to impose and collect CGT on the property situated in the city.⁴ As CGT is the main source of revenue for the government, its administration requires special emphasis. So, far there is no research done to deal with a legal and practical problem in AACA on CGT. However, there are a lot of disparities between the law and practice on CGT. These disparities put at disadvantageous position both the taxpayers and governments. The rule of capital asset valuation, inflation adjustment, deduction of costs, imposition of CGT

¹Gareth D. Myles, *Economic Growth and the Role of Taxation*, Organization for Economic Development and Economic Cooperation (2007) 3

²Solomon Negussie, *Fiscal Federalism and Decentralization in Selected IGAD Member Countries* (2016) 11

³Constitution of the Federal Democratic Republic of Ethiopia Proclamation, 1995, Art.96-98, Proclamation No. 1 Neg. Gaz., 1st Year No 1

⁴Addis Ababa City Government Revised Charter Proclamation, 2003, Art 52(17), Proclamation No. 361, Neg. Gaz., 9th Year No. 86

for residential buildings and buildings that are under construction, and other practical and legal issues need serious investigation. So, this paper will deal with each issue by consulting different national and international jurisprudence.

1.2- Statement of Problem

In a federal state structure as responsibility is shared between the federal and state government, there should be a taxation power reserved for the two lairs of government.⁵ In Ethiopia, the taxation power of government emanates from the constitution. This is because; exclusive power of the federal and state government, their concurrent power, and undesignated power of taxation are expressly stipulated in the constitution.⁶ The constitution has detailed provisions in distributing taxation power between the Federal and Regional Governments. But it does not expressly give the power of CGT to the Federal or Regional Government. Hence as provided in the constitution it needs a two-thirds majority vote of the joint session of the HoF and the HPR to determine the exercise of powers of taxation which has not been specifically provided in the Constitution.⁷ So far, the joint house did not determine who should exercise taxation power on CGT. However, with no express constitutional power, the Federal Government and AACCA collect and imposes CGT.

AAC council is authorized to enact a proclamation on taxation power reserved to it by the charter.⁸ But, the city does not have a major law on taxation in general and CGT in particular. It uses the Federal Government laws and directives as it is. In a democratic state, the public should give their consent for the taxation through their representatives. The principle of tax legality also dictates that there should not be taxation without representation.⁹ In addition to this, in the absence of clear law by the city council, how does the city administration determine capital assets subject to CGT in the city and how does the city differentiate its taxation power from the

⁵ Solomon Neguse (n 2) 10.

⁶ FDRE Constitution (n 3) Art.96-99.

⁷ Ibid, Art.99.

⁸ Addis Ababa City Government Revised Charter (n 4) Art 14(1)(e).

⁹ Alekaw Dargie, 'Legality Principle of Taxation in Ethiopia: At the State of Porosity or Its Non-existent from Inception,' P.3 <<https://ssrn.com/abstract=2733017>> accessed on 15 August 2021

Federal Government, and what if the taxpayer disagrees to pay CGT based on the federal law is an issue that needs to be addressed.

To avoid CGT parties involved in the transfer of capital assets intentionally under-value the disposal price of the capital assets. To know the accurate gain the law should come up with proper means of valuation of a capital asset. Otherwise, the tax will be vulnerable to tax avoidance. Currently, the tax law provides that where the tax authority rejects a document produced by the taxpayer, the amount of gain on the disposal of a capital asset will be assessed based on fair market value.¹⁰ However, practically the valuation mechanism in the AACA does not show the real market value of a building. Hence, the taxpayers are freely avoiding tax and the city administration is losing a great sum of money.

AAC tax authority delegates its CGT collection power over the disposal of building for the AACA land administration office. To implement its tax collection power and guide its service delivery there is a directive enacted for the land administration office. However, there is some contradiction between this directive and the tax laws. Under the CGT laws, disposal of private buildings used less than two years¹¹ and disposal of a building that is under construction will be subject to CGT.¹² On the other hand, in the directives enacted for AAC land administration, disposal of residential buildings used for less than two years will not call for CGT. And disposal of building under the construction stage is taxable based on the type and level of construction. Accordingly, if the building is on construction for the residential purpose it is exempted from CGT while building used for commercial purposes is subject to CGT only where the level of the building is above 50%.¹³

In a given tax system tax should be neutral and free from bias based on a form of business activities.¹⁴ But there is a lack of fairness with regards to inflation adjustment on the disposal of a capital asset. This is because the CGT directive allows inflation adjustment for disposal of building while it prohibits the adjustment for purpose of alienation of share and bond. However,

¹⁰CGT Implementation Directive No8/2011 E.C, Art 8(3).

¹¹ Federal Income Tax Proclamation, 2016, Art 59(7)(A), Proclamation No 979, Neg. Gaz., Year 22, No.104

¹²CGT Implementation Directive (n 10)Art. 10(1).

¹³AACA Land Holding Administration Service Directive No 12/2004 E.C, Art 30.4.

¹⁴OECD, *Fundamental principles of taxation, in Addressing the Tax Challenges of the Digital Economy* (2014)30

the effect of inflation for both types of business activity is similar. It reduces the purchasing power of money and the gain is mere paper gain. This leads to unfairness between the taxpayers.

In assessing CGT, the whole amount of consideration obtained on the disposal of a capital asset will not be taxable. The tax law permits deductions, previous losses, and inflation adjustments. However, practically there is some deduction taken into account while others are not. So, this thesis will analyze which costs are deductible, how does the practice deal with previous loss and inflation adjustment while imposing CGT issues that need to be investigated?

1.3- Research Questions

This research mainly aims at investigating constitutional, legal, and practical problems in AACA concerning CGT. So, to assess those issues it seeks to answer the following research question. These are:

- 1- Which level of government is empowered to impose and collect CGT in the FDRE Constitution? What does the practice look like?
- 2- What is the legal source of AACA to impose and collect CGT? Can AACA use federal tax laws to determine the rate and capital asset that is subject to CGT?
- 3- Are there rules that govern the valuation of buildings for CGT purposes in Ethiopia? How do the rules, if any, govern the valuation of buildings? What does the practice of valuation in AACA look like in light of the law?
- 4- How does the tax authority deal with deductible costs, loss, and inflation in calculating CGT? How does the tax law deal with an inflation adjustment for different types of capital assets?
- 5- How does the AAC land administration bureau deal with the disposal of residential buildings and buildings under construction?

1.4- Objective of the study

The general objective of this research is to assess the constitutionality of imposing and collecting CGT and to assess legal and practical problems concerning CGT in AACA. Within that major objective, it also has the following specific objectives: -

- To analyze the constitutional status of CGT;
- To analyze the CGT taxation power of AACA;
- To scrutinize the rules and practice of valuation;

- To analyze the consistency of the tax law on CGT with other directives.
- To investigate specific problems related to deductions, previous loss, and inflation adjustment concerning CGT.

1.5- Significance of the Study

The thesis is important to dig out the constitutional power of imposing and collecting CGT and legal and practical problems related to CGT. Hence, the Addis Ababa tax authority and the federal tax authority can fulfill their legal and practical problem on CGT. Judges, prosecutors, legal counselors, and other legal practitioners may use the recommendations to solve the usual practical problems of the area. It is also vital to the taxpayers in creating awareness of their rights and responsibility concerning CGT. It also plays a role to provoke further researches on CGT. It initiates other researchers to look into legal and practical problems related to CGT in different parts of the country.

1.6- Literature review

So far there are various researches written on Ethiopian income tax laws. However, with regards to CGT, there are only limited researches. In this regard, Serkalem Eshiete in his LLM thesis has written on constitutional and administrative issues concerning CGT. His thesis is limited to the Case of the Bahir Dar City Administration. In this thesis, he addressed the constitutional, legal, and practical problems of CGT in Bahir Dar city administration. However, his thesis is limited to looking at the practice of Bahir Dar city. This thesis differently entertains the practice in AACAA.

Dr. Tadese Lencho also in one of his articles stated that in Ethiopia, CGT is an undesignated tax¹⁵ and in his Ph.D. dissertation, assessed legal problems related to the valuation of buildings and shares.¹⁶ He stated that, because the law did not allow the tax authority to override price fixed by the taxpayers, they are easily avoiding payment of high CGT by reducing the value of the building and shares.¹⁷ Currently, even if the law authorizes the tax authority to override the price fixed by the taxpayers, still the taxpayers are avoiding CGT. Hence, this thesis will address what

¹⁵ Taddese Lencho, 'Income Tax Assignment Under the Ethiopian Constitution: Issues to Worry About,' (2010) Vol. 4 No.1, Mizan Law Review, 44

¹⁶ Taddese Lencho, 'The Ethiopian Income Tax System: Policy, Law and Practice,' (PHD dissertation, University of Alabama 2014) 498-499

¹⁷ Ibid, 502-503.

is the possible legal and practical gap that creates this problem and come up with a possible solution.

In general, though the above literature deals with CGT, it does not address all issues about CGT. This thesis unlike the above focuses on a legal and practical problem related to CGT in AACA and discusses the constitutionality of CGT in detail. Accordingly, it will focus on the legal power of AACA on collecting and imposing CGT which is not studied so far. It will also deal with practical and administrative problems in the AACA concerning CGT. It deals with a problem relating to the valuation capital asset, inflation adjustment, deduction, the problem relating to disposal of building under construction, residential building, and the like.

1.7- Limitation of the Study

In doing this paper, one of the challenges was to support the thesis with a court case from AACA. I tried a lot looking for a case but I could not find it. One of the probable reasons is that most of the time parties to the contract agree less than the market value of the asset and the tax paid is minimal. So, there is no reason to claim those rights provided under the law. In addition to this as the research is carried out in line with my regular job there would be time constraints. With all those limitations the researcher conducts the thesis by looking for the best solution.

1.8- Methodology

As the title of the thesis speaks itself, the thesis deals with a legal and practical problem concerning CGT. To address the research questions both doctrinal and qualitative methods of conducting research have been used.

On the doctrinal part of the research legal instruments are used. Accordingly, the current constitution, income tax proclamation, regulation, directive, and circulars have been examined properly. This is important to have a better understanding of the existing legal issues on CGT. As secondary sources, a review of domestic and international documents like textbooks, journals, report papers, online materials, and the like has been conducted. Hence, as an instrument of data collection document analysis, legislative analysis, and literature analysis of reliable sources on the area has been conducted.

For the qualitative part, the paper purports to use primary sources of data collected by the researcher. Hence, interviews with scholars in the fields, the tax authorities in AAC and the

Federal Government, and concerned organs to collect CGT like that of the AAC land administration officials have been conducted. These help to dig out the practical problem in the area of CGT and to provide a possible solution for the problems.

The data gathered has been analyzed and interpreted qualitatively. In analyzing data collected based on primary and secondary sources, first, the data has been edited and classified into a different class. To give meaning to the data it has been summarized and arranged in a meaningful pattern. The data is interpreted by comparing the findings of the interview and with the findings of the literature review.

1.9- Organization of the Paper

To properly make in-depth research the paper is organized into four chapters. The first chapter deals with the proposal of the research. The second chapter is about a general overview of CGT under international jurisprudence. The third chapter deals with CGT under the Ethiopian income tax regime and the practice of AACA. This chapter deals with the history of CGT in Ethiopia, the Constitutionality of CGT, and the power of AACA in imposing CGT, and a detailed discussion on CGT under the Federal Income Tax Proclamation is conducted. The last chapter sets the conclusion of the work and possible recommendations that could avoid or minimize the research problem.

CHAPTER TWO

GENERAL OVERVIEW OF CAPITAL GAINS TAX

2.1. Introduction

This chapter discusses the general overview of CGT by consulting different countries' experiences. As a result, it begins with a definition of CGT. The main arguments for and against CGT, as well as the CGT rate, are thoroughly explored. The remainder of the chapter covers methods for taxing capital gains, valuation of capital assets, deductible costs, rollover relief in the computation of CGT, and inflation adjustment.

2.2. Definition of CGT

CGT has no universally accepted definition. However, different materials define capital gains in their country context. Capital gain is defined by Black's law dictionary as profit realized from the sale or exchange of a capital asset.¹⁸ A capital asset is any property owned by a taxpayer, such as a home, car, mining rights, precious metals, stocks, or bonds.¹⁹ CGT is defined in Section 1221 of the United States Internal Revenue Code of 1954 as the disposal of a capital asset. The phrase "capital asset" is defined in the code as property owned by the taxpayer, whether or not it is related to his trade or business.²⁰ This definition is too broad, as a result, the code has several exclusions.²¹ A capital gain is a gain arising from the sale, exchange, transfer, or relinquishment of a capital asset, or the extinguishment of any rights in such an asset, or its compulsory acquisition under any law.²² Those capital assets trigger CGT are different in the country's situation. However, most of the time the CGT is a tax that applies when capital assets, such as a commercial building, a car, stocks, bonds, mining rights, precious metals, and substantial farmland, are sold, exchanged, or transferred.

¹⁸Henry Campbell Black, *M. A. Black's law Dictionary, Definitions of the Terms and Phrases of American and English Jurisprudence, Ancient and Modern*, 6th ed, (1990) 209

¹⁹ Ibid, 117.

²⁰Stanley S. Surrey, 'Definitional Problems in Capital Gains Taxation, Harvard Law Review,' Vol. 69, No. 6 (1956)988

²¹Richard Slitor, 'Problems of definition under the capital gain tax, National Tax Journal,' Vol. 10, No. 1 (1957), 31

²²R G Sarien and O P Chawla, 'The Capital Gains Tax in India' (1963)454

Capital gain is the difference between the money earned from disposing of the asset and all deductions incurred for the capital asset.²³ So, in calculating CGT, the whole money received from the disposal of a capital asset is not subject to tax; rather it is the gain that is subject to tax. Increases in the value of a capital asset can occur as a consequence of the owner's efforts or without his effort as a result of inflation, asset demand, politics, competitor weakness, and other factors.²⁴ Whatever is the cause for an increase in capital gain, so long as there is increment there will be CGT. However, some deductions should be taken into consideration.

There is a distinction between income and capital gain. To express the distinction between capital and income there is an old metaphor which is said “capital is tree while income is a fruit of a tree.”²⁵ There is also the saying “capital is the "thing" and income the flow from it.”²⁶ In this sense, income from the disposal of the building is capital gain while regular income from the building is income. Capital gain is income from capital consisting of realized proceeds generated by an asset.²⁷ Because capital gain refers to the proceeds from the sale of an asset, it is a realization of the anticipated increase in income that the asset will produce in the future.²⁸ Income is certain since it is the outcome of past events. The distinction between capital and income, according to Judge Learned Hand, is between long-term riches and more or less sporadic revenues.²⁹ Capital gain refers to non-recurring or one-time earnings from transactions that are not part of a person's regular business, whereas income refers to continuous profits.³⁰ The land is capital in the sense that it yields income, and the regular harvest from that land is income.³¹ On the other hand, the gain obtained by the sale or exchange of the land is capital gain.

²³ <file:///E:/New%20folder/user/Desktop/Thesis/11STM_Attachment2_%20capital%20gains%20tax.pdf> accessed 12 February 2021

²⁴ Ibid

²⁵ Yoseph M. Edrey, ‘What are capital gain and capital loss anyway, Virginia Tax Review,’ Vol. 24:141, P.144

²⁶ Walter J Blum, 'A Handy Summary of the Capital Gains Arguments' (1957) 35 Taxes 247, P.248

²⁷ Yoseph M. Edrey (n 25)147.

²⁸ Ibid148.

²⁹ Marjorie E. Kornhauser, ‘The Origins of Capital Gains Taxation: What's Law Got to Do with It,’ Southwestern Law Review, (1985), Vol. 39,P.887

³⁰ Ibid

³¹ Ibid

CGT is distinct because it needs the realization or the appearance of an anticipated realization.³² It is unique because it is paid voluntarily at the time of realization. It is taxed at a different rate than ordinary income depending on how long it has been maintained. It could alternatively be exempted from tax or simply taxed on a portion of the gain. To mitigate the effects of inflation, it is subject to inflation adjustment. It is also different from property tax because CGT is a tax on income that is obtained by deducting different costs of capital assets from the sale price, whereas the latter is a tax that is applied to the total value of a property transaction and must be paid to complete the transfer of title to another party.³³

2.3-Arguments on CGT

Scholars do not unanimously agree on the taxation of capital gain. There is an argument against and for CGT. An intermediate position between the two extremes argues that there should be CGT but with preferential treatment. Those arguments are explained in detail as follows: -

2.3.1-Argument for CGT

Many factors necessitate the imposition of CGT. Some of the common justifications for taxing capital gains may be related to the basic grounds for levying a tax. The following are some of those reasons, among others:

- (i) Broadening the tax base - The current trend in many countries is to broaden tax bases while lowering rates. This is because expanding the tax base has lower economic costs than a rise in tax rates on income items;³⁴
- (ii) The requirement for horizontal equity – in horizontal equity, regardless of the way income is generated, individuals in similar economic conditions should shoulder the same tax burden.³⁵ If there is no tax on capital-generating taxpayers are encouraged to shift their investments away from those that generate income and toward those that

³²Noel B Cunningham and Deborah H Schenk, 'The Case for a Capital Gains Preference' (1993) 48 Tax L Rev 319, P.322

³³Samuel S. Jibao, *Property taxation, capital gains tax, and mining rights tax in Zambia Current performance and options for reform* (2016) 15

³⁴<https://www.un.org/development/desa/financing/sites/www.un.org.development.desa.financing/files/2020-03/AttachmentB_CapitalGains.pdf> accessed 12 February 2021

³⁵ OECD (n 14) 31.

- generate capital gains. This could distort the economy, erode the tax base, result in an artificial allocation of resources, and pose a risk to the tax system's integrity.³⁶
- (iii) The need to bring vertical equity – Vertical equity requires that taxpayers in a better situation should bear a greater burden of taxation.³⁷ Most of the time capital gains generating asset requires high income. Thus, it is believed that those people who engage in this sector are high-income earners compared to the others.³⁸ For these reasons, the taxation over capital gain is thought to bring vertical equity.
 - (iv) There is gainshort of the owner's effort.³⁹ An increase in capital gain is assumed to be the result of enhancement made over the asset. However, without the asset owner's work, growth in capital profits could result from community projects such as the construction of roads, the installation of power, harbors, and the like.⁴⁰ The capital asset owner who is a beneficiary of social infrastructure should pay the tax.

2.3.2-Argument against CGT

Contrary to those who argue for CGT, this argument ignores taxation of capital gain. The common reasons for not taxing capital gain are:

- (i) Inflation – Most of the time capital assets will be held for many years and many amounts of capital gain result from inflation. Taxation of capital gain in an inflationary economy is not taxation of gain rather it is the taxation of fictitious income.⁴¹ In the presence of inflation, some capital gains simply reflect the higher cost of reproducing the capital.⁴² The taxation of such nominal capital gains reduces

³⁶Chris Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?' *Journal of Australian Taxation* (2002) 121

³⁷ OECD (n 14)31.

³⁸Herbert G. Grubel, 'The case for the elimination of capital gains taxes in Canada,' P.8-9

<https://www.fraserinstitute.org/sites/default/files/IntlEvidenceNoCapitalGainsTaxSec1.pdf> accessed 15 May 2021

³⁹Juanita D. Amatong, *Taxation of Capital Gains in Developing Countries, Staff Papers (International Monetary Fund)*, Vol. 15, No. 2 (1968).354

⁴⁰Ibid

⁴¹Walter J Blum (n 26)255.

⁴²Herbert G. Grubel (n 38)

the country's productive capacity even more severely than does the taxation of real capital gains.⁴³

- (ii) Encouraging investments- where there is no CGT investor could be initiated to engage on investment.⁴⁴ This is because where there is no CGT it allows them to appear at a minimum economic cost. In a given country encouraging investment is thought to bring jobs opportunity and economic growth. In addition to this absence of CGT in a given country could create a competitive investment advantage over the other country.⁴⁵ However, if there is CGT investor will be discouraged to dispose of its capital asset and this will create a lock-in effect.
- (iii) Difficulty to administer - A wide-ranging CGT may be difficult to manage and the potential savings and investment distortions and other efficiency implications that may arise from a partial CGT are economically harmful.⁴⁶ The difficulty of controlling among others includes difficulties in identifying all possible disposal events, with high compliance costs for taxpayers and administering them for the revenue administration.⁴⁷

2.3.3- Middle Position Arguments on CGT

Unlike the above two polarized points, there is a third argument on CGT that supportsthe preferential treatment of CGT by reducing the tax rate. The reasons that back this argument are illustrated as follows:Reducing the tax rate of CGT would raise revenue for the government, increase investment, minimize the lock-in effect, and encourage investors to engage in productivity sectors that will have societal benefit.⁴⁸

⁴³ Ibid

⁴⁴ <file:///E:/New%20folder/user/Desktop/Thesis/11STM_Attachment2_%20capital%20gains%20tax.pdf> accessed 12 February 2021

⁴⁵ Ibid

⁴⁶ Ibid

⁴⁷ Ibid

⁴⁸ Stephen Moore and John Silvia, 'The ABCs of the Capital Gains Tax, Cato Institute Policy Analysis No. 242,' 1995, <<file:///E:/New%20folder/user/Desktop/Thesis/ABCs%20of%20capital%20gain%20tax.pdf>> accessed 19 April 2021

In general, one could trump over the treats of introducing CGT by mitigating the amount of tax. Otherwise, the absence of a CGT creates economic distortion by encouraging taxpayers to convert taxable income into tax-free capital gains. Furthermore, CGT is significant to bring horizontal and vertical equity, and it could also help the government meet its revenue objectives. Hence, there should be CGT with a reduced tax rate.

2.4. Rate of CGT

In CGT the inclusion of gains in taxable income is largely discretionary from the point of view of the taxpayer. As a result, capital gains income is more susceptible to tax rates than other types of income.⁴⁹ Most of the time, the rate of CGT could be a flat rate and progressive rate.⁵⁰ A flat rate is the same whether or not all of the gains are realized in one year, it is easy, and a taxpayer is less concerned about spreading the realization of capital gains across time.⁵¹ However, it may discriminate against low-income groups while benefiting taxpayers in higher income brackets.

The progressive tax rate is considered to be fair because CGT increases with the income of the taxpayer. The fact that CGT is paid by high-income taxpayers strengthens the fairness.⁵² The argument against a progressive tax structure is that it will burden the taxpayer unnecessarily by forcing him into a higher income tax bracket.⁵³ It may also have an impact on a capital flight because progressive rates encourage asset sales to be postponed to decrease tax burdens, hence inhibiting capital mobility.⁵⁴

Regarding the rate of CGT, there are two broadly opposing views. One of these views holds that under Schanz-Haig-Simons comprehensive income concepts capital gains should be subject to the same rate of tax as ordinary income.⁵⁵ They argue that preferential treatment of CGT supports the wealthy taxpayers than the poor and affects the integrity of the tax system that the taxpayer

⁴⁹Lawrence Lindsey, *Rates, Realizations, and Revenues of Capital Gains*, University of Chicago Press, 1987, P.17

⁵⁰ Juanita D. Amatong (n 39) 367

⁵¹Ibid

⁵² Ibid 369.

⁵³ Ibid

⁵⁴ Ibid 370.

⁵⁵John Minas and Youngdeok Lim, 'Taxing capital gains – views from Australia, Canada and the United States,' *E Journal of Tax Research*, Volume 11, Number 2, (2013) 192

may divert their business from income-generating activity to capital generating activity.⁵⁶ On the other hand, the opposing view is that capital gains should be taxed at preferential rates.⁵⁷ They support their assertion that preferential treatment encourages investment, productivity, the realization of a capital asset, entrepreneurship, and risk-taking.⁵⁸ They also claim that preferential rate treatment will increase the realization of CGT and increase revenue for the government.⁵⁹

High transfer tax rates are likely to incentivize buyers and sellers to falsify sales prices, thus weakening the tax system.⁶⁰ Investors will be deterred from selling assets and reinvesting the proceeds on other assets if CGT is highly charged. As a result, favorable tax treatment encourages investment funds to move around. Exempting gains, on the other hand, generates incentives to convert investment and ordinary income into tax-free capital gains.⁶¹

2.5- Computation of CGT

A capital gain or loss is the difference between the base cost of an asset and the consideration realized upon disposal.⁶² Among other things, the base cost covers costs immediately incurred in the acquisition of an asset, as well as improvement, and other costs. The amount of money earned by transferring the capital asset is the consideration gained on disposal. In addition to this in the computation of CGT, there are deductions, exemption, roll-over relief, and inflation should be taken into account. The following part will deal with each of them in detail.

2.5.1- Method of Taxing CGT

In collecting CGT countries follow different methods of taxing. There are realization-based approaches, accrual-based approaches, and hybrid approach approaches.

A- A realization based on CGT

⁵⁶ Ibid

⁵⁷ Ibid

⁵⁸ Ibid

⁵⁹ Noel B Cunningham and Deborah H Schenk (n 32) 321.

⁶⁰ Samuel S. Jibao (n 33) 15.

⁶¹ OECD Tax Policy Studies, 'Taxation of Capital Gains of Individuals, Policy Considerations and Approaches,' No 14, (2006) 104

⁶² Commissioner for the South African Revenue Service, 'Guide to Capital Gains Tax' (2000) 14

An asset is said to be realized where it is disposed of. A realization-based system allows the taxpayer to defer payment of CGT until disposal of the capital asset.⁶³ The tax will be imposed when the asset is disposed of. Any acts that result in the creation, variation, transfer, or extinction of an asset are referred to as disposition.⁶⁴ These acts of disposal among others include sale, donation, exchange canceled, redeemed, relinquished, destroyed, lost, expire, or surrendered. The problem with the realization method is it accumulates income in the year of realization. In a progressive income tax system, the bunching of capital gains pushes the taxpayer into a high-income group, subjecting him to a higher marginal rate.⁶⁵ However, taxing capital gain when realized has the advantage of working with the money that should be paid where accrued. By taxing gains only on realization, the government has granted the asset holder an interest-free loan of the tax on his accrued gains.⁶⁶

In a realization-based system so long as the person keeps his property there is no taxation. This tendency to postpone disposing of an asset to avoid paying taxes will create a "lock-in."⁶⁷ Hence, a tax upon these gains creates deterrence to changing capital assets. This will freeze investments and lead to inefficient use of assets.⁶⁸ To mitigate the lock-in effect different countries use a different mechanism like that of reducing the tax rate, rollover relief, and the like.

B- An accrual-based CGT

The accrual method does not expect the realization of a capital asset. The net accrued gain or loss on capital assets that happens during a period is included in the tax base, regardless of whether or not realization occurs.⁶⁹ The capital asset will be usually assessed, and if there is a gain, the tax will be applied; however, if there is a loss, it will be carried forward to the following period. Particularly in the developed country where there is enough computerized data that shows the

⁶³Michael C Durst, 'Inflation and the Tax Code: Guidelines for Policymaking' (1988) 73 Minn L Rev 1217, at 1226

⁶⁴<<https://sataxguide.wordpress.com/capital-gains-tax/>>accessed 19 May 2021

⁶⁵ Juanita D. Amatong (n 39)356.

⁶⁶Meyer W Bucovetsky, *Inflation and the Personal Tax Base: The Capital Gains Issue* (1977) 81

⁶⁷ Ibid

⁶⁸ Marjorie E. Kornhauser (n 27)869.

⁶⁹ Juanita D. Amatong (n 39) 356.

value of the comparable item it is not difficult to implement this method.⁷⁰ The accrual system of taxation is preferred over the realization method because it reduces the tax's lock-in impact; it generates more money for the government, and it taxes a closer approximation of economic income for the taxpayers.⁷¹ However, it has drawbacks in that it necessitates regular capital asset valuation, creates liquidity issues, and its compliance costs may outweigh its benefits.⁷² Most countries in the world prefer the realization method of taxation over accrual options.⁷³

C- Hybrid approach of taxing CGT

This option employs a combination of realization and accrual methods, which can be used on a case-by-case basis. It is preferable to adopt the realization strategy when valuing a specific asset is challenging and there is a cash flow issue.⁷⁴ The accrual basis of taxation can be used in cases where valuation and cash flow are not issues. Real property is likely to have both valuation and cash flow problems and, as such, would be taxed on realization. There would not, however, be any problems regularly valuing publicly listed shares.⁷⁵ However, taxing listed shares on an accrual basis may create an incentive for companies not to list and a preference by investors for unlisted shares.

2.5.2- Valuation of a Capital Asset

CGT usually applies after a capital asset has been held for a long period. As a result, determining the proceeds of disposal necessitates determining both the base and disposal values of the item sold.⁷⁶ The initial value is required to determine the tax basis of the assets used to calculate the capital gain. To determine the tax basis value of the assets, there are two options. These are: (1) determining the asset's acquisition cost and (2) determining the asset's market worth at the time

⁷⁰John G Head, 'Capital Gains Tax and Capital Income Taxation' (1987) 4 *Austl Tax F* 35, 45

⁷¹ *Ibid*

⁷² OECD (n 61) 104.

⁷³ *Ibid*

⁷⁴Policy Advice Division of the Inland Revenue Department, *The taxation of capital gains, Background paper for Session 3 of the Victoria University of Wellington Tax Working Group*(2009) 39

⁷⁵ *Ibid*

⁷⁶ Juanita D. Amatong (n 39).

of appointment.⁷⁷ The amount or value of the payment paid for the asset, plus incidental costs of acquisition and capital expenditures on the asset after the acquisition, is referred to as acquisition cost.⁷⁸ However, determining the acquisition cost is not an easy task, especially in developing countries where there is a poor recording system and a lack of compiled information, it requires going back many years to reconstruct what the asset was worth at the time of acquisition.⁷⁹

There is also a problem of valuation where an asset is disposed of. While the asset is sold the seller to avoid payment of tax underestimates the disposal value of the asset. Because of this, an independent evaluator is frequently necessary.⁸⁰ The disposal value of an asset could be acquired by using market value, presumptive estimation, cadastral value.⁸¹

2.6- Deductible Costs, Exemption, and Rollover Relief in the Computation of CGT

A- Deductible Costs

The whole money acquired from the disposal of capital assets is not subject to CGT rather it is only the gain that is subject to CGT. To generate gain from capital assets there will be different costs and expenses. The international practice shows that those costs incurred to generate CGT will be deducted from consideration obtained on disposal of the asset. In CGT the base cost of an asset consists of three basic components: expenses incurred in the acquisition of an asset, costs incurred in the improvement of an asset, and costs in the acquisition and disposal of an asset.⁸² The costs incurred in acquiring an asset are known as acquisition costs. When purchasing an asset, the cost of purchasing the item is referred to as acquisition costs. If the asset was obtained by a gift, the donor's original base cost is carried forward.⁸³

Any expenditure incurred and directly related to the acquisition or disposal of an asset is referred to as incidental costs of acquisition and disposal.⁸⁴ The cost of retaining title or rights to the

⁷⁷ Ibid

⁷⁸ Ibid

⁷⁹ Ibid

⁸⁰ Ibid

⁸¹ Ibid

⁸² Samuel S. Jibao (n 33) 29.

⁸³ Commissioner for the South African Revenue Service (n 62) 8.

⁸⁴ Ibid

capital asset is more closely tied to legal fees incurred in connection with a court fight over the preservation of your right or title to an asset you possess is also deductible.⁸⁵ Furthermore, costs paid to improve or enhance the asset's value are deductible as long as the improvement or enhancement is still reflected in the state or nature of the asset at the time of disposal.⁸⁶

B- Exemption

A capital gain that is not subject to CGT is not taxable, and a loss cannot be used to offset a capital gain. For the sake of equity and fairness, assets that generate capital gains shall be excluded from CGT. The assets that are free from CGT vary depending on the country's regulations. In some countries, a capital gain exemption can be obtained by omitting a portion of the gain. While some countries exempt CGT on property acquired before the enactment of CGT legislation, others do not.⁸⁷ However, most of the time the common exemptions are: the principal private residence of the taxpayer, his spouse, and dependent children is exempted from CGT; private motor vehicles, depreciating assets used solely for taxable purposes, award, compensation for damage, winnings, or losses from gambling, a game or a competition with prizes, shares of certain profits, shares in a pooled development fund, insurance payment, testamentary gifts are exempted from CGT.⁸⁸

C- Rollover relief of certain capital gains

A rollover occurs when a CGT liability is not triggered by the sale or transfer of ownership but is instead deferred until a later CGT event.⁸⁹ The pre-exchange initial cost incurred to acquire the asset is rolled over in all circumstances. A country could make rollover relief due to different reasons associated with valuation or cash flow problem, competitiveness concerns, and for efficiency purposes and the like.⁹⁰ Rollover could be the same asset rollovers or replacement asset rollovers. The same asset rollover has the effect of discarding the disposed-of asset for current CGT purposes and passing on the CGT attribute of the rolled-over asset from one

⁸⁵ Ibid9.

⁸⁶ Ibid

⁸⁷ Ibid,11-12.

⁸⁸ Ibid

⁸⁹ Ibid

⁹⁰ OECD (n 61) 108.

company to another.⁹¹ When an asset is transferred within a family, when business assets are sold to an employee or a member of the same partnership, and when assets are transferred from a sole trader or partnership business to a wholly-owned corporation, the same asset rollover applies.⁹²

When a taxpayer sells an asset and replaces it with, in most situations, a similar item, replacement asset rollovers apply. This rollover involves, among other things, the replacement of asset-for-shares, asset-for-asset, and share-for-share transactions.⁹³ The policy rationale is to avoid depletion of business capital through a tax charge on the disposal of the old asset, to eliminate a taxation obstacle to the continued growth of successful businesses.⁹⁴

2.6.4- Inflation Adjustment

The impact of inflation on the tax system cannot be underestimated. The best method to lessen the effect of inflation on the tax system is to bring inflation under control.⁹⁵ When this isn't practicable, it's typically preferable to adjust the tax structure in some way to inflation.⁹⁶ This is because it is argued that a rise in the value of capital assets during inflation is not real gain rather it is merely a paper gain.⁹⁷ The problem of inflation emerges when the consideration from the sale of a capital asset is measured in inflated currency while the costs are measured in pre-inflation currency.⁹⁸ Inflation increases the nominal worth of assets without increasing the true value.⁹⁹ Hence capital gain obtained by merely subtracting the acquisition cost from the sales price without adjusting for inflation will increase the paper amount of gain.¹⁰⁰ The preferable tax system is a system that is not affected by the currency's basic purchasing power.

⁹¹OECD (n 61) 109.

⁹²Ibid

⁹³Ibid

⁹⁴Ibid

⁹⁵Victor Thuronyi, 'Adjusting Tax for Inflation,' (1996) <<https://www.elibrary.imf.org/view/books/071/06711-9781557755872-en/ch13.xml>> accessed 10 June 2021

⁹⁶ Ibid

⁹⁷Juanita D. Amatong (n 39) 356.

⁹⁸Michael C Durst (n 63) 1224.

⁹⁹ Juanita D. Amatong (n 39) 356.

¹⁰⁰ Victor Thuronyi (n 95).

The problem of inflation is serious in a country that employs the realization method of taxing capital gain.¹⁰¹ This is because, in the realization method, the capital gain is gain obtained after several years. On the other hand, the problem is less acute in an accrual system. Different countries use different mechanisms to adjust CGT for inflation. Taper relief and indexation are used in UK and France; while many other countries counter the effect of inflation by reducing rates of tax on capital gains.¹⁰² A country may index its tax base or increase the tax base to accumulate inflation.

¹⁰¹Stephen Moore and John Silvia (n 48)

¹⁰²John Bossons, 'Inflation, Indexation and the Capital Gains Tax' (1985) 2 Austl Tax F 249, 253

CHAPTER THREE

CAPITAL GAINS TAX UNDER THE ETHIOPIAN INCOME TAX REGIME AND THE PRACTICE OF ADDIS ABABA CITY ADMINISTRATION

3.1- Introduction

This chapter discusses the legal regime of CGT in Ethiopia and the practice in AACCA. Accordingly, the chapter commences with the historical background of CGT in Ethiopia and then assesses the status of CGT under the FDRE Constitution. It also deals with the legal power of AACCA to impose CGT in the city. Then a brief discussion on CGT in Ethiopian income tax law is conducted. Accordingly, an asset subject to CGT, rate of CGT, the way computation of CGT is made, deduction, exemption, and rollover relief made to CGT, valuation of a capital asset, inflation adjustment and methods for taxing CGT and the practical problems in AAC is discussed in detail

3.2- History of CGT in Ethiopia

The modern history of taxation in Ethiopia goes back to the 1950s.¹⁰³ Before 1941 Ethiopian tax system was not systematically organized. Income tax was officially introduced in 1944 on personal incomes, rents, and business profits.¹⁰⁴ Article 2(2) of the then Income-tax Proclamation defined income as ‘every income earned or unearned, accruing from or received’ in the Empire. The income tax amendment proclamation during the Derg regime also defines income as every sort of revenue, from whatever source derived and in whatever form paid.¹⁰⁵ Hence the then income tax laws showed that the definition of income is too broad that it incorporates CGT from the disposal of a capital asset. However, as the base and rate of CGT are not determined the tax was not paid.¹⁰⁶

¹⁰³Almayehu Geda & Abebe Shimeles, *Taxes and Tax Reform in Ethiopia*, (1990-2003) 2

¹⁰⁴ Peter Schwab, *The Tax System of Ethiopia*, *The American Journal of Economics and Sociology*, Vol. 29, No. 1 (1970) 82

¹⁰⁵Income Tax proclamation no 173/1961, Art 3(e) .

¹⁰⁶Serkalem Eshetie, ‘Constitutional and Administrative issues in Relation to Capital Gains Tax in Ethiopia: The Case of Bahirdar City Administration,’ (LLM Thesis, Bahir Dar University 2016) 37

In Ethiopia's history, the first special separate CGT proclamation and directive for the implementation of CGT proclamation was introduced during the transitional period in 1994. As mentioned in the preamble of the proclamation, the first rationale for the introduction of the CGT proclamation where the development of the private sector that will lay down the basis for an expansion of capital asset transaction.¹⁰⁷The other rationales for the introduction of the proclamation were maintaining neutrality and equitability in the tax system and generating income by broadening the tax base.¹⁰⁸

In 2002 Ethiopia made inclusive tax reforms that introduce new income-tax laws. The 2002 income tax laws repealed the transitional period CGT proclamation and brought CGT under schedule D of the proclamation.¹⁰⁹ Currently, the 2002 income tax proclamation is repealed and replaced by the new Federal income taxproclamation and the Federal Tax Administration Proclamation.¹¹⁰ The current proclamation likes the 2002 income tax proclamation incorporates CGT in a single provision under schedule D. The content of the article will be discussed in the following section in detail.

3.3- The Status of CGT Under the FDRE Constitution

In afederal system, each level of government is autonomous within their tertiary. To carry out their responsibility, the two levels of government are required to bear their financial expenditures.¹¹¹ To meet their financial need, they are empowered to share revenue taking into account the federal arrangement.¹¹²FDRE Constitution has detailed and specific provisions on the division of taxation power between the federal and state government. The stance of the constitution on illustrating taxation power is good because the taxpayer should pay tax based on clear law.The Constitution classifies taxation powers as federal exclusive, state exclusive, concurrent power, and undesignated power of taxation.¹¹³ Taxation power which is not

¹⁰⁷A Proclamation to Provide for the Payment of Tax on Gains from Capital, 1994, Neg. Gaz., Proc No. 108, 54th year, No. 4.

¹⁰⁸Ibid

¹⁰⁹Income Tax Proclamation, 2002, Art. 37, Proclamation No.286, Neg. Gaz., 8thYear No. 34

¹¹⁰ Federal Income tax proclamation (n 11).

¹¹¹FDRE Constitution (n 3) Art 94(1).

¹¹²Ibid, Art 95.

¹¹³Ibid, Art.96-98.

exclusively reserved for federal, state, or concurrently to both federal and state government is undesignated power of taxation.

In the FDRE Constitution, CGT is not expressly designated to the state and Federal Government. However, reading through the constitutional provision one may argue that some taxes on capital assets are designated. To begin with, disposal of mining and petroleum rights or information that calls for CGT,¹¹⁴ Article 98(3) of the constitution provides that income derived from large-scale mining and petroleum operation will fall under the concurrent jurisdiction of the federal and Regional Government (emphasis added). While income derived from small-scale mining operations is left for the Regional Government.¹¹⁵ However, what is designated in the constitution is taxation over income derived from the operations of mining and petroleum. Income derived from an operation is different from income derived from the disposal of an asset. The Ethiopian mining proclamation defines the phrase mining operation as “any activity associated with or connected to reconnaissance, exploration, retention or mining.”¹¹⁶ The petroleum operation is also defined in light of petroleum activities.¹¹⁷ This implies that the income from an operation is meant to income from usual activities of mining and petroleum. The act of disposing of mining and petroleum rights/information is not a mining or petroleum activity, but rather it is something that ends someone's mining or petroleum operation right.

The other taxable capital asset that arguably seems designated under the FDRE Constitution is CGT imposed on the ‘building’. Regarding this issue article 97(6) of the Constitution provides that “Regional Government could levy and collect income derived from private houses and other properties within the State.” The constitutional minutes also show that the Regional Government is entitled to collect tax over the private house.¹¹⁸ From the wording of the constitution, the phrase ‘income derived from private houses’ could mean income derived from rental, disposal, or any other income generated from a private house. Income could be recurrent or non-recurrent income. The term ‘house’ is defined in the black’s law dictionary as “structure that

¹¹⁴Federal Income Tax Proclamation (n 11) Article 59(1) & 2(13).

¹¹⁵FDRE Constitution (n 3) Art 97(8).

¹¹⁶Mining Operations Proclamation, 2010, Art 2(21), Proclamation No. 678, Neg. Gaz., 16th Year No.45

¹¹⁷Petroleum and Petroleum Products Supply Operation Proclamation, 2014, Art 2(3) Proclamation No.838, 20th Year No 64

¹¹⁸Ethiopian Constitutional Minutes, Volume 6, 1994, P.6 & 8

servestolive quarters for one or more families or persons.”¹¹⁹ Compared to the term house, the word building has a broad definition that it includes "a permanent or temporary structure used for living, office, manufacturing, or any other function."¹²⁰ The Oxford dictionary also defines “private house as private home different from shop, office or public building.”¹²¹ Thus, the constitution lacks clarity on whether the term private house extends to a commercial building or not. But taxation over income derived from residential houses belongs to the Regional Government. This being the case most of the time CGT is imposed on the disposal of a commercial building. But as it will be discussed later there is an instance where it could be imposed on a residential building.

The other taxable capital asset that needs investigation of constitutional provisions is, CGT levied on the disposal of shares and bonds. Here we have to take note that it is only a transfer of share or bond by shareholder or bondholder that is subject to CGT. The profit obtained by disposal of shares and bonds by a company is taxable under schedule C not under schedule D.¹²² One may argue that the transfer of shares and bonds by shareholders or bondholders is incorporated under Article 98(2) of the constitution. But the provision does not incorporate the transfer of shares and bonds by a shareholder or bondholder. Because the Article reads that “the federal and state government shall jointly levy and collect tax on profits of companies and dividends due to shareholder.”¹²³ Disposal of share and bond by a shareholder or bondholder is neither profit of the companies nor dividends to shareholder. Thus, CGT over the transfer of shares and bonds is an undesignated tax under the FDRE Constitution.

In general, CGT is not expressly designated in the constitution. In the constitution, the joint house of HoF and HPR is empowered to determine by a two-thirds majority vote on the exercise of powers of taxation that have not been specifically provided for in the Constitution.¹²⁴ This mechanism is believed to be a wise and farsighted strategy because it helps to avoid the need for

¹¹⁹Henry Campbell Black (n 18) 739.

¹²⁰Ethiopian Building Proclamation, 2009, Art 2(2), Proclamation No. 624, Neg. Gaz. 15th Year No.31

¹²¹<https://www.lexico.com/definition/private_house> accessed 5 September 2021

¹²²CGT Implementation Directive (n 10) Art 11.

¹²³FDRE Constitution (n 3) Art 98(2).

¹²⁴Ibid, Art 99.

constitutional revision if a new tax source emerges.¹²⁵ So far, the joint house-made intervention and designate excise taxes on private enterprises, income taxes on royalties from the exercise of copyrights and patents, and income taxes on interest from bank deposits.¹²⁶ But, it did not decide on who should levy and collect CGT. However, the practice in our country shows that without an express constitutional basis and decision of the joint house, the two levels of government including AACA are levying and collecting CGT. This practice is not in line with the principle of tax legality which dictates there should not be taxation without the consent of the public.¹²⁷ The consent of the public for a tax is mainly expressed in the constitution. This is important to protect taxpayers from arbitrary tax imposition by the tax authority. In a democratic state, the public should give their consent for the tax that could be expressed either in the constitution or in the subsequent delegation.¹²⁸ No person should be compelled to pay tax without its consent. These being the constitutional issues the next section deals with legal and practical gaps in details.

3.4- The Power of AACA on Imposing and Collecting CGT

In a federal system, a capital city could be under the exclusive control of a Federal Government or it may enjoy self-governance right or it may be under the state government.¹²⁹ In Ethiopia, with the coming of the FDRE Constitution, every nation, nationality, and people of Ethiopia enjoy a right of self-determination including the right to unconditional secession.¹³⁰ Coming to Addis Ababa, the city is not established based on the concept of ethnic federalism. Hence, the self-governance right of the city is provided under a separate provision under article 49(2) of the

¹²⁵Gezachew Sileshi Chane, 'VAT and the FDRE Constitution: Is VAT Really an Undesigned Tax' (2015) 5 Bahir Dar U JL 354, P.362

¹²⁶Taddese Lencho, 'The Ethiopian Tax System: Excesses and Gaps, Michigan State International Law Review' (Vol. 20:2)334

¹²⁷ Alekaw Dargie (n 9) 3.

¹²⁸Yohanis Girma & Dr. Ümit Süleyman, 'A Review of Constitutional Principles Regarding Taxation: Ethiopian and Turkish Perspective,'(2017)

¹²⁹Donald C. Rowat, 'The Problems of Governing Federal Capitals,'(1968) P.345-346,

<<https://www.jstor.org/stable/3231296>> accessed 21 August 2021

¹³⁰FDRE Constitution (n 3)Art 39(1).

constitution. Unlike the rest Regional State of the Federation, the city administration is accountable for the Federal Government and the city is the seat of the Federal Government.¹³¹

As AAC is governed by a charter, for all legal and practical reasons the charter is the supreme law of the city.¹³²The detailed fiscal power of the city administration is illustrated under article 52 of the city charter. The city's fiscal power is almost similar to the fiscal power of the state government provided under article 97 of the FDRE Constitution.¹³³ Article 52(17) of the charter empowers the city administration to assess and collect CGT on property situated in the city.¹³⁴ Nevertheless, the charter does not illustrate which kind of capital asset is subject to CGT and the rate of CGT. It is up to the city council to determine the type of capital asset subject to CGT and the rate of CGT on the property situated in the city. In the absence of laws by the city council, it is difficult to determine which capital assets are subject to CGT in the city administration. In addition to this where the city administration uses the federal tax law, it is difficult to demarcate capital asset that is subject to taxation for AACA and the Federal Government. Currently, even if there is no legal ground the practice shows that AACA collects CGT over the transfer of building held by sole proprietorship while building held by a company, share, bond, transfer of mining and petroleum right or information is exercised by Federal government based on the federal laws.¹³⁵

The charter entitles the city government to determine and collect tax on that power specifically granted to it by the charter.¹³⁶ For the proper execution of its taxation powers, the city council has the mandate to enact a proclamation on taxation power reserved for the city under the charter.¹³⁷ So far, the city administration is receiving the fruits of CGT and other taxes based on

¹³¹Ibid, Art 49(2)(1).

¹³²Nuredin Kedir, 'Trends Eroding Taxation Power of Addis Ababa City Administration,' (LLM thesis, Addis Ababa University 2018)43

¹³³Jetu Edosa Chewaka, 'The de facto City State Status of Addis Ababa City Administration,' P.29
<<https://ssm.com/abstract=3460959>> accessed 12 August 2021

¹³⁴Addis Ababa City charter Government Revised Charter Proclamation (n 4)Art 52(17).

¹³⁵ Interview with Senayit Tsegaye, Tax Affairs Advisor at Head Office of Addis Ababa City Tax Authority, 6 September 2021

¹³⁶Addis Ababa City charter Government Revised Charter Proclamation (n 4) Art 11(2)(j).

¹³⁷Ibid,Art 14(1)(e).

Federal Government laws without enacting its proclamation. According to the principle of tax legality, taxation should emanate from the will of the resident of the city. The resident of AAC should give their consent for CGT through their representatives. CGT or other taxation levied using federal law does not show the residents are being taxed with their consent. This is because the federal law is enacted by HPR which is composed of 547 seats. Among these seats, the resident of Addis Ababa is represented only by 23 seats. So, the parliament by majority vote can easily ignore the 23 voices of the resident and enact a law against the will of the resident.¹³⁸

In the absence of clear law by the city government on the tax base and rate of CGT, the residents of the city may disagree to pay CGT based on federal law. Regarding this point, there was a practical case that happened in the Federal First Instance court between Ethiopia Revenues and Customs Authority V. Heyredin Hussein Mohammed.¹³⁹ In this case, the court refers to the case for the House of the Federation to assess the constitutionality of applying the then federal income tax proclamation no 286/1994 on individual trading within the city.¹⁴⁰ Then, the House rejects the case citing that the matter did not call for constitutional interpretation. However, the case should not be rejected. Because the city council has a mandated body to enact tax law. This is important to reflect the city's self-governing rights and the autonomy of residents of the city. Forcing the city taxpayer to pay tax based on federal law is contrary to the principle of tax legality, which dictates that the power to tax is inherent to the people, and the public should give their consent for the tax through their representative.¹⁴¹ Thus, receiving CGT from a city resident without enacting its law is against the city's autonomy and consent of the resident.

3.5- CGT Under the Federal Income Tax Proclamation

3.5.1. Assets Subject to CGT in Ethiopia

In Ethiopia, CGT will be imposed on gains derived from the disposal of an immovable asset, share, or bond.¹⁴² An immovable asset cannot be moved by humans or by itself without losing its

¹³⁸ Nuredin Kedir (n 132) 43.

¹³⁹ ERCA V, Hayredin Hussein, (Ethiopia Federal first Instance court, Addis Ababa, 14 November 2014), File No.203375 cited in Nuredin Kedir (n 131)55

¹⁴⁰ Nuredin Kedir (n 132) 55.

¹⁴¹ Alekaw Dargie (n 9) 3.

¹⁴² Federal Income tax proclamation (n 11) Article 59(1)

character.¹⁴³ In our country, the civil code does not define immovable assets. Rather it enumerates land and building as immovable property.¹⁴⁴The tax proclamation also extends immovable assets to mining and petroleum rights or information.¹⁴⁵ Hence, the proclamation suggests that land, building, and mining and petroleum right or information are considered immovable assets. Under the FDRE Constitution land is a common property of the nation, nationality, and people of Ethiopia and it is not subject to the transaction.¹⁴⁶

A share is a shareholder's stake in a corporation expressed as a monetary value that indicates the property relationship between the company and the shareholder.¹⁴⁷A bond is a document demonstrating indebtedness that entitles the bearer to a specified amount of interest and principal payments at maturity.¹⁴⁸Legal speaking the reference to share and bond extends to “any interest in shares or bonds, such as, in the case of shares, a right or option to acquire shares.”¹⁴⁹

The other immovable asset in the tax law is the disposal of mining and petroleum rights or information. Mining is any activity directed at extracting minerals on the earth or in water that has economic value.¹⁵⁰ Any right connected with a reconnaissance license, exploration license, retention license, or mining license granted under a mining operation proclamation is referred to as a mining right.¹⁵¹ Information relating to mining operations is mining information.¹⁵²on the other hand, petroleum includes ‘crude oil, any liquid or gas made from crude oil, coal, schist, shale, pea or any product of crude oil and condensate.’¹⁵³ Information relating to authorized

¹⁴³ Fassil Alemayehu, *Law of Property Teaching Material*,(2009) 26

¹⁴⁴Civil Code of the Empire of Ethiopia, 1960, Art. 1130, Proc. No. 165, Neg. Gaz., 19th year No.3,

¹⁴⁵Federal Income tax proclamation (n 11)Article 59(1) & 2(13).

¹⁴⁶FDRE Constitution (n 3)Art 40(3).

¹⁴⁷ Alemayehu Fentaw & Kefene Gurm, *Law of Traders and Business Organizations Teaching Material*(2009) 111

¹⁴⁸Workneh Alemnew, ‘Debenture and Bonds Under Ethiopia Law’(2017) P.12

¹⁴⁹ Council of Ministers Federal Income Tax Regulation, 2017, Art 6(1), Regulation No. 410, Neg.Gaz., 23rd Year, No.82

¹⁵⁰Mining Operations Proclamation (n 116) Art 2(18).

¹⁵¹Ibid, Art 2(22).

¹⁵²Federal Income Tax Proclamation(n 11)Art 36(13).

¹⁵³Petroleum and petroleum product supply operation Proclamation, 2013, Art 2(1), Proclamation No. 838, Neg. Gaz. 20th Year No.64

petroleum operations is petroleum information.¹⁵⁴ Those mining and petroleum rights or information are subject to transaction and trigger CGT where disposed. In Addis Ababa, the practice of transferring those rights and information is minimal compared to other capital assets.¹⁵⁵ So, I will focus on those capital assets that are being disposed of in the city.

3.5.1.1- Transfer of Building

One of the prominent immovable assets subject to CGT is building. A building is defined in Ethiopian law as "a permanent or temporary structure used for living, office, manufacturing, or any other function."¹⁵⁶ A building could be either a commercial or residential building. In the income tax proclamation, "a building held and wholly used for private residence for two years before its disposal is not subject to CGT."¹⁵⁷ This implies that any building other than a residential building used above two years will be subject to CGT. Hence, a private building held for less than two years or a building that has a commercial purpose is subject to CGT. Even though our law does not define a commercial building, it might be said that a commercial building is a building built to carry on one of the business activities listed in the commercial code.¹⁵⁸

Concerning CGT collected in the event of a transfer of building, the AAC tax authority delegated its power to collect tax to the AAC land tenure registration and information agency.¹⁵⁹ Delegation is done for convenience taxpayers so that they can pay the tax where they transfer the title deed of the building. However, there are contradictions between the directive enacted by the AAC cabinet to administer land service and the tax laws.

To begin with, a directive issued by the Minister of Finance under Article 10(1) provides that disposal of building under the construction stage is subject to CGT.¹⁶⁰ A given construction may have either a commercial purpose or residential purpose. The tax law seems that whatever the

¹⁵⁴ Federal Income Tax Proclamation (n 11)Art 2(17).

¹⁵⁵ Interview with Henok Kebede, Senior Legal Officer at AACA Tax Authority, 15 April 2021

¹⁵⁶ Ethiopian Building Proclamation (n 120).

¹⁵⁷ Federal income tax proclamation (n 11)Art 59(7)(a).

¹⁵⁸ Ethiopian's Commercial Code Proclamation No1243/2021, Art 5

¹⁵⁹ Delegation letter written by Addis Ababa city Tax Authority on 27/04/2008 E.C

¹⁶⁰ CGT Implementation Directive (n 10)Art. 10(1).

purpose of the building is where a building is under construction its disposal will trigger CGT. On the other hand, directives enacted by the AAC cabinet to administer land impose CGT based on the level and type of construction. It provides that where the building is under construction for residential purposes whatever the level of construction is it will not be subject to CGT.¹⁶¹ But if the building has commercial purposes and the level of construction is above 50% its disposal will be subject to CGT.¹⁶² If the level of construction is below 50% it will not be subject to CGT. The land tenure administration office is delegated by the city tax authority for the collection of CGT over the transfer of the building. However, the delegation is limited to collecting tax it does not extend to exempt some types of building. A given delegated organ should act within a power given to it from the delegator. Otherwise, any act beyond delegation is ultra-virus. The power to determine which building will be subject to CGT should be reserved to the concerned tax authority.

A given city master plan may classify the land usage of the city to commercial or residential purposes. As per the income tax proclamation whatever the city plan may show, a building wholly used for residential purposes two years before its disposal is exempted from CGT. This means, even though, under the city plan a given building fall under the category of a commercial building, so long as the owner uses the building for residential purpose and he did not issue business license using the building there is no reason why he is required to pay CGT. In contradiction to this, a directive enacted on land tenure administration service provides that, where a title deed shows the land usage plan is for commercial purpose or it has mixed usage, irrespective of the purpose of the building the seller is required to pay CGT at the time of disposal.¹⁶³ The practice in the city also shows that, even if the trade and industry bureau of the city proves that the building was not used for commercial purposes, so long as the title deed shows that the land location is planned for the commercial purpose it will be subject to CGT.¹⁶⁴

¹⁶¹AACA Land Holding Administration Service Directive (n 13) Art 30.4

¹⁶²Ibid

¹⁶³Ibid, Art 29(4)(3).

¹⁶⁴ Interview with Biniam Shiferaw, AACA land tenure administration services team leader at head office, 27

August 2021

Where a building is built for residential purposes, the owner may use the building for commercial purposes. Regarding this point, the directive enacted by a Minister of Finance provides that, even though, a building is built for residential purposes, if a business license is issued and the building is used for commercial purposes its disposal will trigger CGT.¹⁶⁵ The tax law seems to impose CGT in case of disposal of a residential building that has mixed usage for commerce and residential purpose.¹⁶⁶ On the other hand, the directive issued by the AAC cabinet provides that in case of mixed-use of a given building it will trigger CGT where above 30% of the disposed of a building is used for commercial purposes.¹⁶⁷ The practice in the city also proves this fact and 30% is calculated not from total land coverage rather it is calculated from the total built-up area.¹⁶⁸

3.5.1.2- Transfer of Share and Bond

A share is a personal property capable of being transferred in the manner laid down in commercial code and articles of association. Compared to share companies, transfer of share in private limited company and partnership has stringent requirements. Transfer of share in private limited company and partnership more or less require a unanimous decision of shareholder or majority shareholder decision.¹⁶⁹ However, in Share Company unless otherwise restricted by the memorandum of association or extraordinary general meeting of shareholders there shall be no restriction on the transfer of the share.¹⁷⁰ Whatever the restriction is, where one disposes his share and obtains gain from disposal of share, he is required to pay CGT.

In practice, the problem with a share transfer is that, because there is no controlling mechanism in place from the tax authority, parties to the contract purposefully conceal the exact transfer value.¹⁷¹ Most of the time the parties agree at the par value of the share.¹⁷² Lack of forum in

¹⁶⁵CGT Implementation Directive (n 10) Art.10(2).

¹⁶⁶ Federal Income Tax Proclamation (n 11) Art 59(7)(a).

¹⁶⁷ AACA Land Holding Administration Service Directive (n 13) Art 29(4)(2) & 29(4)(4).

¹⁶⁸ Interview with Nardos Niguse, Senior Technical Officer in Bole Sub City Land Tenure administration Office, 18 August 2021

¹⁶⁹ Ethiopian's Commercial Code Proclamation No 1243/2021, Art 509(1)

¹⁷⁰ Ibid, Art 276(1).

¹⁷¹ Interview with Arba Beyene, Senior Legal Officer at Minister of Revenue, 19 August 2021

¹⁷² Interview with Mulune Beyabile, Senior Legal officer at Habesha Beverage share company, 31 August 2021

which share is disposed of opens the way for a party to avoid tax. In addition to this in the transfer of shares by shareholders, the law provides that it is the shareholder who acquired gain that is required to pay CGT.¹⁷³ The practice in the federal tax authority shows that it is a company that makes the payment of CGT.¹⁷⁴ The authority imposes CGT on the company because they believe that the company is easily available. Nevertheless, the company reimburses the tax paid from the shareholder who transfers his share.¹⁷⁵

A bond is a negotiable instrument that can be readily traded before its maturity date.¹⁷⁶ It could be transferred to legal heirs of the bondholder, transferred to a third party upon sale, or by donation.¹⁷⁷ Where a bond is transferred it could be transferred above par value. So, where ever there is gain from transfer of bond one is required to pay CGT. However, in Ethiopia, there is no form on which bond market will be transacted and there is no comprehensive bond law. This will hurt the bond market and tax obtained from its transfer.

3.5.2. Rate of CGT in Ethiopia

Rate is a percentage at which a given taxpayer is taxed. In Ethiopia, a person who derived income on disposal of an immovable asset is required to pay tax at a flat rate of 15 percent, and one who derives income on disposal of share or bond is required to pay tax at a flat rate of 30 percent.¹⁷⁸ The rate is a flat rate that is equally applicable irrespective of the amount of income generated. The rate of a capital asset on disposal of an immovable asset is preferentially treated compared to share and bond.

The rate of CGT on shares and bonds is too high compared with the practice of other countries. The practice in Australia, Canada, and the USA shows that they offer a preferential rate treatment for personal capital gains.¹⁷⁹ Reduction of the CGT rate encourages investors to dispose of their

¹⁷³ Federal Income Tax Proclamation (n 11) Art 59(1).

¹⁷⁴ Interview with Baye Abathun, Service tax Audit Team Coordinator at Minister of Revenue central district, 6 September 2021

¹⁷⁵ Interview with Mulune Beyabile (n 172).

¹⁷⁶ Workneh Alemnew (n 148) 12.

¹⁷⁷ Ibid 32.

¹⁷⁸ Federal Income Tax Proclamation (n 11) Art 59(1)(2).

¹⁷⁹ John Minas and Youngdeok Lim, (n 55) 191.

assets and engage in productive investment that is useful for the country. Since CGT will come into effect upon realization unless the tax rate is reduced it will bring a lock-in effect.¹⁸⁰ If one who disposes of his security is required to pay half of the benefit for tax purposes, he will not have the desire to sell the security; rather he will defer disposing of its share.¹⁸¹ The Ethiopian tax system does not target only to generate revenue, it also has the aim of encouraging investment.¹⁸² Thus, to bring an effective realization of capital gain and encourage investors to engage in a productive area it is better to reduce the rate of CGT.

3.5.3. Computation of CGT

The amount of gain on the disposal of a capital asset is obtained by deducting the total costs incurred for the asset and inflation adjustment from consideration obtained on the disposal of a capital asset.¹⁸³ Consideration for the disposal of a capital asset is the total amount of money received by a person at the time of disposal of the asset.¹⁸⁴ It also includes the fair market value of consideration made in kind at the time of disposal of the asset.¹⁸⁵

On the other hand, the cost of an asset includes the total consideration given by a person for an asset at the time the asset is acquired; any incidental expenditure and if the asset is constructed or developed the cost of construction or development is considered as a cost of an asset.¹⁸⁶ The detail of deductible costs will be discussed in the following section.

3.5.3.1- Deductions, Exemption, and Rollover Relief in the Computation of CGT

A- Deductions

Deductions are the sum of money that the taxpayer incurred to generate income and are reduced from the total income. A tax deduction is distinct from the exemption in that deduction is a portion of taxable income that may be excluded from taxation when certain conditions are

¹⁸⁰ Lawrence Lindsey (n 49) 18.

¹⁸¹ Peter Miller, 'The Capital Asset Concept: A Critique of Capital Gains Taxation:' The Yale Law Journal, Vol. 59, 1069

¹⁸² Taddese Lencho, 'Articulating Ethiopia's Current Tax Policy: Sources and Fundamental Objectives,' 17

¹⁸³ CGT Tax Implementation Directive (n 10) Art 6(3).

¹⁸⁴ Federal Income Tax Proclamation (n 11) Art 70(1).

¹⁸⁵ Ibid, Art 70(1).

¹⁸⁶ Ibid, Art 68(1)(a).

satisfied, while tax exemption constitutes income that is not subject to taxation in the first place.¹⁸⁷ In Ethiopia, deductions for purpose of CGT are costs incurred to buy the asset including any other cost for the asset, inflation adjustment, and previous loss concerning the disposal of a capital asset.¹⁸⁸

The cost of an asset among others includes the total cost incurred either in terms of money or in-kind for an asset at the time the asset is acquired and if the asset is constructed, improved, or developed the cost of construction, improvement, or development.¹⁸⁹ Any incidental expenditure to acquire or dispose of the asset is also considered a cost.¹⁹⁰ This cost could be cost incurred for a broker, government fee, and tax to acquire the asset. Furthermore, any expenditure to install, alter, renew, improve, reconstruct the asset is considered as a cost of an asset.¹⁹¹ In the case where a person acquires an asset by way of gift, the fair market value of an asset at the time of acquisition of gift is considered as a cost of the asset.¹⁹²

In addition to costs, the law recognizes previous losses concerning the disposal of a capital asset. Where the cost of an asset at the time of disposal exceeds the consideration for disposal there will be a loss on disposal of a taxable asset. If there is a loss on disposal of a capital asset, the loss shall be recognized and offset a gain on disposal of the same class of capital asset indefinitely.¹⁹³ However, this deduction will not apply where the transfer of the capital asset is made between related persons.¹⁹⁴ The law prohibits a deduction for a related person because the buyer and seller will not act independently. Hence, they may intentionally evade the payment of tax and increase their deductible costs. To get a deduction of loss and costs the person should

¹⁸⁷ <<https://www.bankrate.com/glossary/t/tax-deduction/>> accessed at 11 August 2021

¹⁸⁸ CGT Implementation Directive (n 10) Art 6(3).

¹⁸⁹ Federal Income Tax Proclamation (n 11) Art 68(1)(a).

¹⁹⁰ Ibid, Art 68(2).

¹⁹¹ Ibid, Art 68(1)(b)(c).

¹⁹² Ibid, Art 68(3).

¹⁹³ Ibid, Art 59(4)(a)(b).

¹⁹⁴ Ibid, Art 59(4)(c) – The Federal Tax Administration Proclamation under Art. 4 it defines related person broadly so that it includes persons that has affinal and consanguineal relation and related person that is expected to act in accordance with the directions, requests, suggestions, or wishes of the other person.

substantiate the amount of loss and costs to the tax authority.¹⁹⁵ This means the taxpayer should produce evidence to support the loss and costs incurred on the asset. Unless the taxpayer convinces the tax authority by the production of evidence the loss and costs will not be considered.¹⁹⁶

The practice in AAC shows that save for the acquisition costs, any incidental and other expenditure to acquire or dispose of the asset and previous loss will not be deducted.¹⁹⁷ In addition, the practice in AACA also shows that there is no deductible cost for donation.¹⁹⁸ The thought is, the donee who is required to pay tax has got the capital asset without incurring a cost.¹⁹⁹ Those problem has become serious in the city because the land tenure administration office is delegated to collect CGT without adequate awareness of the tax. Most of the time they use as a reference only the land administration service directive which does not incorporate the detail about deductions and recognizing loss. In addition, the computer system in which most sub-city operate itself does not have space to recognize other costs, expenditures, and losses.²⁰⁰ Furthermore, the taxpayers do not make a complaint because they avoid CGT by reducing the disposal value of the asset and they do not have a practice of recording documents for their costs. But, the practice in the Minister of Revenue shows that, so long as the company proves the costs with a document and there is no intention to avoid tax the authority will consider any costs related to the building and previous loss.²⁰¹

B- Exemption

¹⁹⁵Federal Income Tax Proclamation (n 11)Art 59(4)(d).

¹⁹⁶CGT Implementation Directive (n 10)Art 8(4).

¹⁹⁷ Interview with Tewdiros Begashaw, Land Tenure Administration Team leader at AAC Land Tenure Administration head office, 27 August 2021

¹⁹⁸Interview with Mulat Ayalew, Land Tenure Administration Officer in Arada Sub City Land Tenure administration Office of AAC, 24 August 2021

¹⁹⁹ Ibid

²⁰⁰ Interview With Tewdiros Shiferaw, Information and digitalization officer in Bole Land Tenure Administration, 18 August 2021

²⁰¹ Interview with Baye Abathun, (n 174).

- Where the transfer is made between husband and wife as means of a divorce settlement.²⁰⁷ This is because the husband and wife do not encounter any gain or loss. Rather they divided their common property for purpose of a divorce settlement.
- Transfer of property from the deceased person to his beneficiary or executor.²⁰⁸ If the beneficiary later sells the asset, he will be subject to CGT.
- Where again is obtained as a result of loss or destruction or expropriation and the consideration is reinvested by a recipient in an asset of like kind within one year of the disposal.²⁰⁹ Here the deferral is made to encourage reinvestment.
- Where there is corporate reorganization, the transfer is not considered as the disposal of a capital asset.²¹⁰ The reorganization of a company can be in the form of a merger, acquisition, or takeover of a share of another company, division of the resident company, or spin-off.²¹¹ The corporate reorganization will be deferred of payment of CGT only where there is no intent of tax avoidance.²¹² Taxing corporate capital gains can impede asset sales and reorganization that reallocate capital between firms.²¹³

Concerning rollover relief, the practice in AACA also shows that there is no payment of CGT in case of transfer is made for divorce settlement and where the transfer is made from the deceased to beneficiary or executor.²¹⁴ Also, there is no payment of CGT in case damage is compensated whether it is reinvested within one year or not.²¹⁵ Concerning corporate reorganization, there was a practice of collecting CGT. But currently, since a direction is given for sub-city not to collect CGT in case of company reorganization there is no collection of CGT.²¹⁶

²⁰⁷ Federal Income Tax Proclamation (n 11) Art 71(1)(a).

²⁰⁸ Ibid, Art 71(1)(b).

²⁰⁹ Ibid, Art 71(1)(c).

²¹⁰ Ibid, Art 35(1)(a).

²¹¹ Ibid, Art 35(3).

²¹² Ibid, Art 35(4).

²¹³ Mihir A. Desai & William M. Gentry, *The Character and Determinants of Corporate Capital Gains*, (2004)P. 2

²¹⁴ Interview with Tewdiros Begashaw, (n 196)

²¹⁵ Interview with Gizachew Mulugeta, Land Tenure Administration Service Team Leader at AACA Land Administration Head Office. 16 April 2021

²¹⁶ Interview with Endale Haile, Land Tenure Adjustment and certification Team Leader at AACA land Administration Head Office, 27 August 2021

3.5.3.2- Valuation of Capital Assets

To determine the appropriate amount of CGT the taxpayer should honestly declare the amount of disposal to the tax authority. However, the problem in our country is that parties involved in the capital asset transfer falsely under-value the actual disposal price. So, there should be a mechanism for controlling this kind of valuation by implementing a property valuation mechanism. However, real property valuation is not an uneasy task as it needs professionally skilled valuation staff and finance.

In Ethiopia, where the tax authority rejects documents that show costs and consideration obtained at the disposal of the asset produced by the taxpayer, the amount of gain on the disposal of a capital asset will be assessed based on fair market value.²¹⁷ The Cassation Division of the Federal Supreme Court also decided that valuation of immovable property should take into consideration book value and fair market value of the asset at the time of disposal.²¹⁸ Fair market value is supported because it promotes equity and it takes into consideration taxpayer capacity to pay. The Ethiopian federal tax administration proclamation state that a fair market value of goods and assets at a particular time and place is the ordinary open market value of the goods and assets at that time and place.²¹⁹ Open market value is not addressed in the proclamation. However, it is defined as a price at which similar assets of comparable quality and quantity are sold by an owner to an unrelated person in an arms-length transaction.²²⁰

Where it is not possible to determine fair market value based on open market value, fair market value is determined by taking into consideration any similar goods and assets would ordinarily fetch in the open market at that time and place, adjusted to take account of the differences between the similar goods and asset and the actual goods and asset.²²¹ This method follows a comparison of the value of a property under the same quantity, quality, and location. The economic rationale for the comparison method is that a prudent person would not pay more for a property than other persons have recently paid for comparable properties given that the general

²¹⁷Capital Gains Implementation Directive (n 10), Art 8(3).

²¹⁸Ashanaifi Abdulqadir and Shito Ibrahima, (Ethiopia Federal Supreme Court Decision, 9 November 2001 E.C), File No. 35003, Volume 9, Page 29-30

²¹⁹Federal Tax Administration Proclamation, 2016, Art 3(1), Proclamation No. 983, Neg. Gaz., 22nd year No. 103

²²⁰<<https://www.lawinsider.com/dictionary/open-market-value>> accessed 11 August 2021

²²¹ Federal Tax Administration Proclamation (n 218) Art 3(2).

market conditions are the same.²²² Where it is difficult to determine fair market value based on the above ground, it is determined by the tax authority in a manner it is consistent with generally accepted principles of valuation.²²³ This generally accepted principle of valuation is based on the principle of comparison that it consists of sales comparison; income capitalization; and replacement cost.²²⁴

The practice in AAC reveals that there are two types of valuation mechanisms to know the value of the building. These are valuation mechanisms based on the computer database and valuation mechanisms based on estimated value or in Amharic 'ye kurit waga gimit' mechanisms.²²⁵ For a building built before 1988 E.C value of the building will be assessed based on computer database collected in 1988 E.C.²²⁶ This data shows the value of property used to build the house based on the price of the property that was in 1988 E.C.²²⁷ To make a valuation based on this system an officer will feed the computer the materials used to build the building then the computer will make a valuation of the building. This valuation shows the 1988 E.C book value of properties used to build the house.

For buildings built post-1988 E.C the value of the building will be assessed based on the price estimated by the Addis Ababa Construction Bureau.²²⁸ The price is allocated per meter square for each type of building.²²⁹ For instance, currently, the value of G + 0 up to G+1 building per meter square is 4000 (four thousand) Birr. And the value of the building will increase as the building floor increase. According to this assessment method, the value of a commercial building located in a 100m² built-up area will cost 100*4000=400,000 (four hundred thousand) birr. But in the real market one cannot imagine building on 100m² with 400,000 (four hundred thousand) birrs. The fundamental problem concerning this valuation mechanism is it does not take into

²²²Ermiyas Teshome, 'Practice of Real Property Valuation for Collateral: Case Study on Selected Banks,' (MSc Thesis, Addis Ababa University 2020)P.35

²²³ Federal Tax Administration Proclamation (n 218)Art 3(4).

²²⁴ Ermiyas Teshome, (n 222) 33.

²²⁵ Interview with Endale Haile (n 216).

²²⁶Ibid

²²⁷Ibid

²²⁸ Ibid

²²⁹ Ibid

consideration the location of the building and the material used to build the building. So, it shows neither the market value nor the book value of the building.

Compared to the computer database valuation, the estimation valuation system is said to be to some extent closer to market value. However, in both cases, the valuation mechanism is too much far from market value. Surprisingly, even in a case where the parties intentionally reduce the amount of transaction to avoid tax, most of the time the amount valued by the city administration will be less than the price fixed by the parties.²³⁰ In a case where the valuation made by the officer is less than the price agreed by the parties, the officer takes the bigger value as a market value of the building.

One of the major tax policies of Ethiopia is to modernize its tax system.²³¹ But, due to outdated practices mentioned above, the city administration is losing much amount of money. In Ethiopia's market economy the value of capital assets is too dynamic. So, the city administration should develop a fair market valuation mechanism. However, fair market valuation requires a periodic valuation to reflect the change in the value of the asset.²³² Frequent valuation is important to achieve the goal of fair market valuation, maintain the legitimacy of the tax, reduce the burden of large increases in assessed values which could provoke protests, mitigate unending litigations and non-compliance²³³

The practice with regards to share also shows that there is no valuation mechanism developed by the tax authority.²³⁴ Hence, contracting parties to avoid payment of CGT agree up on par value of a share and the consideration of disposal of a share will be the price agreed by the parties.²³⁵ The tax authority has no option other than accepting the price fixed by the parties. This problem happens because the transfer of shares is made on an unregulated market and there is no forum

²³⁰Interview with Dagnachew Yibelital, Document certifying officer in Yeka Land Tenure Administration office, 1 September 2021

²³¹ Taddese Lencho, (n 182) 14.

²³²Melkam Ayalew, 'Real Property Valuation for Taxation in Ethiopia: Customizing Mass Appraisal System A Case of Bahir Dar City,' (MSc Thesis, Bahir Dar University 2020)18

²³³ Ibid

²³⁴Interview with Arba Beyene, (n 171).

²³⁵ Ibid

on which share is sold.²³⁶ In addition to this, there is no valuation mechanism developed for the transfer of the share. However, where a company disposes its share, there is a practice of calculating CGT from retained earnings of the company.²³⁷

3.5.3.3- Inflation Adjustment

Inflation is a rise in the price value of goods and services in the overall economy. Inflation affects the purchasing power of money. As the price of goods and services increases, a given amount of money will purchase fewer goods and services. Payment of tax without adjusting inflation is not payment of tax on gain rather it is a payment of tax on economic loss.²³⁸ In an inflationary economy like Ethiopia unless there is inflation adjustment again will be paper gain and illusory. In Ethiopia, the income tax proclamation does not deal with an inflation adjustment for CGT. However, the income tax regulation provides that immovable assets shall be adjusted for inflation as determined under a directive issued by the Minister of Finance.²³⁹

Under the regulation, inflation adjustment is made only for an immovable asset; it does not extend to shares and bonds. The directive enacted by the Minister of Finance also prohibits inflation adjustment for the disposal of shares and bonds.²⁴⁰ As the effect of inflation on the purchasing power of money is similar in both commercial activities the law is not clear why it prohibits inflation adjustment for disposal of shares or bonds. A good tax system should be neutral. But the directive unfairly discriminates against the disposal of shares and bonds. To rectify this problem, currently, the Minister of Finance has come up with a circular that allow inflation adjustment for the transfer of a share.²⁴¹ Though the circular brings fairness among taxpayers engaged in different business activities, it is not in line with its directive and Council of Minister regulation. Even hierarchically circular cannot override the directive of the Minister.

²³⁶ Taddese Lencho (n 16) 507.

²³⁷ Ibid, 505

²³⁸ Noel B Cunningham and Deborah H Schenk (n 32)324.

²³⁹ Council of Ministers Federal Income Tax Regulation (n 148)Art 56(1).

²⁴⁰ CGT Implementation Directive (n 10) Art 6(5).

²⁴¹ FDRE Minister of Finance Circular Ref no ሞግአ,ገ 0/7749 date 22/10/2013 E.C

Regarding building the directive made inflation adjustments based on the Minister of Finance's annual average inflation rate determination.²⁴² But, the Minister of Finance is not a proper organ to determine the inflation rate. The proper organ to determine the inflation rate is the Ethiopian central statistics agency. Inflation adjustments made by improper organs could be made at a disadvantageous position either the taxpayer or government.²⁴³ Considering this problem the Minister of Finance currently come up with a circular that gave the power to determine inflation adjustment to the Ethiopian central statistics agency.²⁴⁴ However, the circular is not in line with the directive issued by itself.

Practically, while data collection all interviewees in the land administration office respond that there is no inflation adjustment to calculate CGT.²⁴⁵ This is due to a lack of awareness on the part of the officers. In an inflationary economy like Ethiopia, disregarding inflation adjustment is harmful to the taxpayer. The tax is not collected from real gain rather it is taxing paper gain. However, the practice in the Federal Government Minister of Revenue shows that there is inflation adjustment for buildings.²⁴⁶

3.5.3.4- Methods of Taxing CGT

There are accrual and realization methods for taxing CGT. Of the two options of taxation, the Ethiopian Income Tax Proclamation has preferred realization means of taxation. Article 59(1) of the income tax proclamation provides that a person who derives gain from the disposal of a capital asset will be subject to CGT.²⁴⁷ According to this provision, for CGT to come into effect there must be a disposal of capital assets. Disposal is defined as a transfer of a capital asset by sale, exchange, substitution, or gift and when an asset is canceled, redeemed, relinquished, destroyed, lost, expire, or surrendered.²⁴⁸ In addition to this, the term derive requires receipt of gain generated from the disposal of a capital asset.²⁴⁹ Taxpayers under schedule D should declare

²⁴²CGT Implementation Directive (n 10) Art 6(5)(6).

²⁴³ Serkalem Eshetie (n 106) 86.

²⁴⁴ FDRE Minister of Finance Circular Ref no ማኢን 0/7749 date 22/10/2013 E.C

²⁴⁵ Interview with Gizachew Mulugeta, (n 215).

²⁴⁶ Interview with Melese Fanuel, Tax auditing officer in minister of Revenue east district, 24 August 2021

²⁴⁷ Federal Income tax proclamation (n 11) Art 59(1).

²⁴⁸ Ibid, Art 67(1)(2).

²⁴⁹ Ibid, Art 2(5)(b).

their income within two months after the date of the transaction giving rise to the income.²⁵⁰ From the reading of the above provisions, we can conclude that CGT will come into effect where there is a realization of capital gain. This option is preferred over accrual means of calculating CGT, because, it is in line with the canon of the economy of taxation and it does not require the government to frequently incur unnecessary costs on the valuation of the property.

3.6- Recordkeeping for CGT Purpose

To determine a proceed of disposal of a capital asset it is necessary to establish initial value, different costs incurred for the asset, and disposal value of the capital asset. In Ethiopia, category A and B taxpayers must keep a book of account while it is optional for category C taxpayers.²⁵¹ With regards to CGT taxpayers, the income tax proclamation requires that those taxpayers should keep a record of the acquisition date and any cost related to building and consideration obtained on disposal of the building.²⁵² Where a taxpayer fails to produce a document that shows all its costs and expenditure, the tax authority may disallow the deduction of costs.²⁵³ The directive on CGT also provides that taxpayers who are obliged by law to hold a book of account are required to produce documentary evidence that shows all costs incurred for capital assets and consideration received on disposal of a capital asset.²⁵⁴ Where the produced document is accepted by the tax authority, valuation of a capital asset is not required as the value of disposal and cost of a capital asset could be easily ascertained from the document. However, where a taxpayer does not produce a document or the taxpayer is not obliged to hold a book of account, they are required to make a valuation of the cost of their asset by an appropriate body.²⁵⁵ Where the taxpayers fail to make a valuation by the appropriate body, the tax authority considers as if there is no cost for the asset.²⁵⁶ But, considering as if there is no cost while there is building seems unfair. Rather the law should set an option of assessing by the government at the expense of the taxpayers.

²⁵⁰Ibid, Art 83(7).

²⁵¹Ibid, Art 82(1)(2)(3).

²⁵²Ibid, Art 82(5).

²⁵³Ibid, Art 82(6).

²⁵⁴CGT Implementation Directive (n 10)Art 8(1) (2).

²⁵⁵Ibid, Art 8(4).

²⁵⁶Ibid

CHAPTER FOUR

CONCLUSION AND RECOMMENDATION

4.1- Conclusion

Capital gain is an income realized on the disposal of capital assets like that of a commercial building, share, bond, mining, and minerals right or information. Capital gain is the difference between the money received from selling the asset and the costs incurred for the capital asset, inflation adjustment, and previous loss if any. The value of a capital asset may increase as a result of different reasons that may be attributed to the owner's effort or without the effort of the owner. Whatever the cause for an increment is, CGT is due so long as there is an increase in the value of the capital asset realized.

Due to its special nature, there is no unanimous agreement on the taxation of CGT. There are arguments for and against CGT. Those who argue for CGT support their allegation arguing that the existence of CGT broadens the tax basis, brings vertical and horizontal equity, and protects the integrity of the tax system. On the other hand, those who argue against CGT raise that it brings a lock-in effect that discourages realization of a capital asset; its difficulty for administration; inflation. To compromise the two extremes there is an argument that supports the preferential treatment of CGT by reducing the tax rate.

In Ethiopia, the FDRE Constitution has detailed and specific rules on the division of taxation power to the federal and Regional Governments. The Constitution illustrates exclusive taxation powers of the Regional and Federal Governments, their concurrent power and paves the way how to deal with undesignated taxation power. Nonetheless, CGT is not expressly given either to the Regional or to the Federal Government. As undesignated taxation, the joint houses of HPR and HoF do not provide a solution for it. But, the Federal Government and AACA are exercising taxation power over CGT. The Federal Government is exercising CGT taxation power over the transfer of immovable assets, shares, and bonds held by the company; while AACA is exercising CGT over the transfer of building held by a sole proprietorship.

The power of AACA to impose CGT emanates from the city charter which is thought to be the supreme law of the city. The charter also grants the power to enact a proclamation for AACA on taxation power exclusively granted to them. This was important to reflect the self-governing

right of the resident of the city and to give their consent for the taxation. In addition to this, according to the tax legality principle in a democratic state tax should emanate from the will of the governed. But the city administration is collecting CGT based on the income tax law enacted by the Federal Government. In the absence of the city government law, it is difficult to determine the capital assets subject to CGT in the city. It is also tough to demarcate the taxation power of the city from the Federal Government and the resident of the city can challenge to pay CGT to the city administration based on federal law.

In Ethiopia, CGT is imposed on again acquired from the disposal of a building, mining, and petroleum right or information, share, and bond. Concerning CGT paid in case of transfer of building, the AAC tax authority gives the power to collect CGT to the land tenure administration office of the city. This is important for convince of the taxpayer as they could make payment of CGT while they transfer the title deed. But there are some contradictions between the tax laws and the directives enacted for administering the land service. The contradiction come in the case of disposal of building under construction, residential building, and a commercial building used for residence. While the tax law imposes CGT on the disposal of residential buildings used for less than two years and buildings under construction, the land administration service directive exempts disposal of residential buildings. It also exempts the disposal of buildings under construction based on the level and purpose of the building. Accordingly, where the level of an under-construction building that has commercial purpose is above 50% it will call for CGT, while the level of construction is less than 50% or in a case where the building is built for residential purposes whatever the level of the building is, it will not be subject to CGT.

In calculating CGT, the whole money acquired from the disposal of a capital asset is not subject to tax. There are deductions, exemptions, and rollover relief. In Ethiopia, the deduction allowed for CGT purposes includes all costs incurred to acquire the asset, inflation adjustment, and the previous loss incurred on the disposal of capital assets. The costs could be acquisition costs and any other costs related to the capital assets. To enjoy deductions of costs and loss one should convince the tax authority by producing a document that shows his costs and loss. The practice in the AACCA shows that costs incurred to acquire the asset will be taken into account while the other costs and previous losses will not be considered. This is due to a lack of awareness on the part of the tax-collecting officer and the taxpayers also do not claim their rights.

The income tax regulation and directive made inflation adjustments for an immovable asset. The adjustment is made based on the Minister of Finance annual average inflation rate determination. But the Minister is not a proper organ to determine inflation adjustment. The proper organ to make inflation adjustments is the Ethiopian central statistics agency. Inflation adjustments made by improper organs could affect the benefit of the taxpayer and government. In the law inflation adjustment is made only for immovable assets and it does not extend to share and bonds. But, the effect of inflation on the purchasing power of money is similar in both cases. To rectify this problem the Minister of Finance comes up with a circular that extends inflation adjustment for disposal of the share though the circular is not compatible with the Income Tax Regulation and the CGT directive. This circular is subject to challenge until the tax law extends inflation adjustment for disposal of shares and bonds. However, the practice in AACCA shows that there is no inflation adjustment for the disposal of a building. This is because of a lack of awareness on the part of the delegated organ to collect CGT.

In Ethiopia, CGT is paid upon the realization of a capital asset. So, it is said that CGT is a voluntary tax that needs the disposal of capital assets. The preferential rate of CGT is thought to be one means of encouraging the realization of capital assets. In Ethiopia, the CGT rate on the transfer of immovable property is minimal compared to shares and bonds. The rate of CGT on the transfer of shares and bonds is too high that it could discourage the disposal of the capital asset.

In determining the value of a property, the tax law comes up with a fair market valuation mechanism. Accordingly, fair market value will be determined based on open market value or by comparing the value of a similar capital asset, or by taking into consideration the generally accepted principles of valuation. But the law other than providing the general principle there is no specific and detailed rule on how to determine come up with fair market value.

The practice of building valuation in AACCA is full of confusion. In the city administration, there are two valuation mechanisms. These are valuation mechanisms based on the computer database and valuation mechanisms based on estimated value. The valuation made using a computer database shows the book value of the building based on 1988 E.C data. The valuation made using the estimated value fixes the value of the building per meter square without taking into consideration the location of the building and the materials used to build the build. In both cases, the value of the building does not show the market value of the building. Even most of the time it

is less than the value agreed by the parties. Worse than this, there is no valuation mechanism for the transfer of the share. Due to this the party to contract intentionally agreed at par value to avoid tax. The tax authority does not have an option other than taking the price fixed by the parties. This mechanism may allow for the taxpayer to avoid tax and make the government lose much amount of CGT.

5.2- Recommendation

To mitigate the legal and practical problem concerning CGT, I recommend the following: -.

- The joint house of HPR and HoF which is entrusted to determine over undesignated tax should expressly designate CGT. Accordingly, as Regional Government is a basis for building the joint houses can assign CGT over the disposal of building for the Regional Government. On the other hand, since matters related to a transfer of a share of a company could have a nationwide effect on investment and economy it could be assigned for the Federal Government or concurrently to both levels of government.
- To properly realize its taxation power and determine the tax rate and capital assets subject to CGT in the city, the AAC council should come up with its tax law. This is important at least to reflect the consent of the resident in the law and exercise the constitutional self-governing rights of the resident.
- The land administration service directive should be consistent with the tax laws. AAC tax authority delegates the land administration office to collect tax in the transfer of buildings. The delegated body should collect CGT based on the law enacted by the tax authority. So, CGT in case of disposal of building under construction and residential building used for less than two years should be in line with CGT law directive.
- The rate of CGT on the transfer of shares and bonds should be reconsidered. A CGT is a voluntary tax that comes into effect where the owner disposes of the asset. Where the tax rate is too high the owner may defer payment of tax by holding the asset. So, to encourage disposal of a capital asset, increase investment, and bring more revenue for the government there should be preferential treatment. Otherwise, it may open the way for misrepresentation of a sale price and discourage investment.
- The tax law should come up with a proper valuation mechanism for building and share. Currently, the law provides that valuation of capital assets should be conducted taking

into account the market value of the asset. But it does not come up with proper means of implementing the law. So, there should be clear directives on how to make the market value of the capital assets.

- A building valuation mechanism of AACCA needs serious reconsideration. Currently, in the city administration, there are some independent private property valuers. So, the city administration could share the experience of this valuator with themselves. In a dynamic economy like Ethiopia, the value of building increases now and then. So, the valuation mechanism should be made frequently taking into account the market value of the asset.
- The provision of the tax law directives that recognize the rate of inflation determined by the Minister of Finance should be amended. The coming amendment should recognize inflation adjustment made by a proper organ which is the Ethiopian statistics agency. In addition to this, as the tax law needs to be neutral the inflation adjustment should extend to the disposal of shares and bonds.
- AAC should properly recognize all costs incurred to generate capital gains assets and previous losses as provided under the law.
- The tax authority should make awareness-creating activities for the Addis Ababa land administration office that is delegated to collect CGT on disposal of the building. Delegation of tax collecting power without creating awareness could put both government and taxpayer at a disadvantageous position. Most of the practical problem revealed in this thesis is due to lack of awareness of the officer. So, the authority is required to deliver training and different awareness creating mechanisms on deductions, inflation adjustment, consideration of loss, valuation of the building, and the like.
- The tax authority is required to develop voluntary compliance of taxpayers. Hence, the authority can develop low tax morale of the taxpayer by educating and giving free tax counseling services for the taxpayers. In addition to this, it is required to develop its service delivering mechanism, combat corruption, minimize the legal gap in the law and take a measure that could be a lesson against those taxpayers that avoid tax.

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- 3- Interview with Biniam Shiferaw, AACA land tenure administration services team leader at head office, August 27/2021
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- 15- Interview With Tewdiros Shiferaw, Information and digitalization officer in Bole Land Tenure Administration, 18 August 2021

Interview Questions

- 1- A building could be either a residential or commercial building. Which kind of disposal of a building is subject to CGT? Which building do you consider as a commercial building?
- 2- If you collect CGT from the disposal of a residential building, when do you impose CGT on the transfer of residential building?
- 3- A person may use a portion of its residential building for commercial purposes. How do you impose CGT in a case where this kind of building is disposed of? What is your legal basis?
- 4- A person may use its residential building for commerce for a long or short time. How long should a given residential building be used for commerce to be subject to CGT?
- 5- A building could be under construction for commercial purpose or residential purposes. On which under construction building do impose CGT?
- 6- To generate gain from disposal of a capital asset, one may incur costs, there may be previous loss and there may be inflation. What kind of deduction do you take into consideration in the computation of CGT? Is there a deduction of historical cost, improvement cost, expenditure to acquire and dispose of the asset? Do you make inflation adjustments? Is there loss carry forward? What should a taxpayer fulfill to benefit from deduction?
- 7- Do you impose CGT where transfer of the capital asset is made from the deceased person to his beneficiary or husband and wife as part of a divorce settlement? Is there a CGT collection where there is corporate reorganization? When do you grant roll-over relief? What do you exempt from CGT?
- 8- What could you do where the contracting parties under-value the amount of consideration obtained from the disposal of a building? If you made a valuation, how do you make a valuation of the value of the building? Do you make a valuation based on book value or market value? How do you get the historical value of the building?
- 9- Do you make an inflation adjustment in calculating CGT? How do you make an inflation adjustment?
- 10- Do you impose CGT where there is company reorganization?

- 11- What could you do if parties in transfer of share agree and under-declare the amount of transfer to evade tax?
- 12- What is considered as historical cost in case of transfer of share? Per value or all costs registered by the taxpayer?
- 13- Is there a payment of CGT where the company repurchases its share?
- 14- Who is required to pay CGT for sell of shares by shareholders?
- 15- How do you calculate the amount of CGT in case of donation? What is the cost of a person who acquires the asset by donation?
- 16- What is the legal source of AACAA to collect and impose CGT? Does the city have its CGT law? If not, can the city use the federal laws? Can the city claim CGT base and rate based on the federal income tax law?
- 17- What is the demarcation line between Addis Ababa city administration and Federal Government on the collection and imposing CGT? What is the base for this demarcation?
- 18- Is there a practice of transfer of rights and information over mining and petroleum in Addis Ababa? If yes, what practical problem do you encounter in collecting and assessing CGT?
- 19- Who is empowered to administer the transfer of buildings and shares held by a business organization like share companies and private limited companies in Addis Ababa? If it is the Federal Government what is its legal ground?

Annex

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