ADDIS ABABA UNIVERSITY

COLLEGE OF LAW AND GOVERNANCE STUDIES

SCHOOL OF LAW

BUSINESS LAW STREAM

Critical Analysis of the Regulatory Framework Governing Corporate Income Tax Planning in Ethiopia

A Thesis Submitted in Partial Fulfilment of the Requirement for the Award of a Master of Laws (LLM Degree) in Business Law

By: Hirko Alemu

Advisor: Aschalew Ashagre (Assistant Professor)

Dec. 2020

Addis Ababa, Ethiopia

Thesis Approval page

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Declaration

I, Hirko Alemu Misraneh, hereby declare that the work presented herein is original work done by me and has not been published or submitted for publication elsewhere for the requirement of degree program.

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List of Abbreviations

BEPS	Base Erosion and Profit Shifting
DTT	Double Tax Treaty
EU	European Union
FDI	Foreign Direct Investment
FDRE	Federal Democratic Republic of Ethiopia
FITP	Federal Income Tax Proclamation
G20	Group of Twenty Countries
GAAR	General Anti-Avoidance Rules
IMF	International Monetary Fund
MLI	Multilateral Convention to Implement Tax Treaty Related Measures (MLI) to Prevent BEPS signed on 7th July 2017
MNCs	Multinational Companies
MOFEC:	Ministry of Finance and Economic Cooperation
OECD	Organization for Economic Cooperation and Development
TIWB	Tax Inspectors without Borders
UNDP	United Nations Development Program
UNCTAD	United Nations Conference on Trade and Development
US/USD	United States/United States Dollar

Abstract

The integrity of international taxation has been seriously marred due to tax planning techniques employed by multinational companies (MNCs) resulting in profit shifting from where they have real economic activities to no or low tax jurisdictions. Generally, this paper has tried to examine the depth and breadth of this corporate income tax planning by MNCs, across the globe, in Africa, and Ethiopia. It explored the prototypes of such techniques, how it works, and how it has been/could be/countered. As such, despite the incongruity among the figures reported, this paper has uncovered that a huge amount of revenue is being sheltered from tax authorities. Within this widespread nature of the problem, this paper has also tried to evaluate the existing rules set under the Ethiopian income tax regime to counter corporate income tax planning in light of international standards.

The author concludes that although there is an attempt to align these rules with OECD and UN Model Tax Conventions, they did not benefit from the subsequent amendments made by these institutions to their original instruments. The paper also found that the Avoidance of Double Taxation Treaties (DTTs) Ethiopia has signed with different countries as well as fiscal investment incentives granted to investors under investment regime are serving as tools for profit shifting. The paper found that lack of capacity, resources, know-how and information technology to implement the existing rules on corporate tax avoidance have exacerbated the already existing loopholes. Finally, tax planning by MNCs being an international problem, Ethiopia's failure to be part of critical international and continental initiatives and tax instruments have denied it any cooperation and mutual assistance which could have been of paramount importance to tackle tax planning by MNCs.

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Chapter One

Introduction

'The world is in turmoil and international taxation is exactly in the eye of the storm. Taxation has taken centre stage in the ongoing political and economic crisis where states are struggling to make ends meet. Any source of tax revenue is badly needed and therefore there is no shortage of new initiatives to improve the collection of taxes… attempting to deal with "aggressive" tax planning of multinational companies'[1]

1.1. Background of the study

Tax has been and remains to be a single most important sources of revenue, and Vito Tanzi and Howell Zee wrote that "until someone comes up with a better idea, taxation is the only practical means of raising the revenue to finance government spending on the goods and services that most of us demand".[2] Unfortunately, the integrity of this crucial source of revenue has been seriously compromised through tax planning, avoidance and evasion.[3]

The tax planning aspect of corporate taxation has recently come to prominence because of its resultant economic and social repercussions. Although the issue (as a matter of fact) is not new as such and has been practiced, the attention it is gaining from policymakers and the international community has made corporate tax planning a forefront and 'next to none' agenda in international taxation. There is a growing detection that governments are losing substantial corporate revenue as a result of tax planning aimed at shifting profits in ways that erode taxable base to the jurisdictions with more favorable tax treatment.[4]

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[1] Cees Peters, The Faltering Legitimacy of International Tax Law, Centre for Economic Research, (2013), p. 1

[2] Vito Tanzi and Howell Zee, "Fiscal Policy and Long-run Growth", International Monetary Fund, Vol. 44, No. 2 (1997), p. 1

[3] Hans Gribnau, "The Integrity of the Tax System after BEPS: A shared Responsibility", Erasmus Law Review, Vol. 1, No. 1, (2017), p. 1

[4] OECD, Addressing Base Erosion and Profit Shifting, (2013) (hereinafter *OECD 2013*), p. 13. It is also mentioned that tax planning has attracted the attention of mainstream media and the Bloomberg's "*The Great Corporate Tax Dodge*", The New York Times, "*But Nobody Pays That*", The Times, *Secrets of Tax Avoiders*, and the Guardians', "*Tax Gap*" are only some of them.

At the global level, robust empirical evidence evinces that multinational companies (MNCs) engage in tax planning.[5] Through this instrumentality of tax planning, these companies exploit the differences in tax jurisdictions in which they operate. They, for instance, use holding companies or conduit companies to take advantage of a country's tax treaty network or to take advantage of low tax jurisdictions to reduce their tax liability. They also exploit the differences in the tax treatment of certain entities, instruments, or even transaction, and preferential tax treatment for certain activities or incomes to reduce their tax burden.[6] Transfer pricing manipulation, strategic allocation of intangible assets and other intellectual property rights, and manipulation of internal and external debt levels are also among important profit shifting channels that MNCs utilize.[7]

The problem is such an acute that it has attained the attention of international community including "Group of Twenty" (G20), and the Organization of Economic Cooperation and Development (hereinafter, OECD). Being commissioned by the G20, the OECD came up with a codified Action Plan in 2013 on Base Erosion and Profit Shifting (BEPS) to eradicate opportunities for tax planning by multinationals.[8]

In a study conducted ten years ago, over the 39-years, Africa lost an astonishingly huge amount of about US$854 billion in cumulative capital flight, of which tax

[5] Asa Johansson and et al, "Tax Planning by Multinational Firms: Firm-level Evidence from Cross Country Database", OECD Economics Department Working Papers N. 1355, (2017), p. 6. There are also country-based reports on how the tax planning has affected their economy and even let to political discontent. For instance, in 2012/13, Starbucks had sales of 400 Million Euros but paid NO tax! It transferred some of its money to its sister company in Dutch and with the remaining, it bought coffee beans from Switzerland and paid high interest on money it borrowed. Amazon too, had sales of 3.35 billion Euros in 2011 but reported only tax expense of 1.8 million Euros. The same goes for the major companies in the world. Vanessa Barford and Gerry Holt, "Google, Amazon, Starbucks: The rise of 'tax shaming'," at: https://www.bbc.com/news/magazine-20560359, accessed on 9th August 2020. Please see also Eric Sherman, "How These Fortune 500 Companies (Legally) Paid $0 In Taxes Last Year" (April 2019) at: https://fortune.com/2019/04/11/amazon-starbucks-corporate-tax-avoidance/, last accessed on 9th August 2020

[6] Ibid

[7] ibid

[8] Ernesto Crivelli, et al, "Base Erosion, Profit Shifting, and Developing Countries", IMF Working Paper, WP/15/118, p. 3

planning was the major one.[9] Regrettably, this amount of revenue would have essentially wiped-out the continent's total external debt outstanding of around US$250 billion (at end of December 2008) and also potentially leave US$600 billion for poverty alleviation and economic growth.[10] The matter is even more pressing as the continental revenue loss kept increasing from about US$57 billion in the decade of the 1970s to US$437 billion over the nine years 2000-2008[11]

The situation in Africa got worsened due to fragile legal and institutional frameworks to contain such harmful tax practices. A study conducted on the revenue loss in Africa as a result of illicit capital flight including tax planning in 2019 indicated that the continent loses 80 billion USD annually.[12] This essentially means almost three times the money the continent receives in the form of aid.

The revenue losses as a result of corporate tax planning are increasing with the reports that are made successively. For example, in September 2020 Financial Accountability, Transparency and Integrity report states that the annual revenue loss as a result of tax planning by MNCs over the globe is between 500-600 Billion USD.[13] This posed a serious headache to governments since the problem is not only the money squandered but that which is not even collected in the first place.

To counter this undesirable phenomenon in the international taxation, there have been several efforts to tackle tax planning by MNCs. Generally, attitudes towards tax avoidance and tax planning are becoming increasingly negative.[14] Countries have provided for rules requiring intragroup trade to take place at market price (arm's length principle), rules restricting interest deductibility based on debt to equity ratio (thin capitalization rules) or interest to earning rations to limit the scope for the strategic allocation of debt, General Anti-Avoidance Rules (GAARs), and Controlled Foreign

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[9] Fakile Adeniran, and Uwuigbe Olubukunola, "Effects of Strategic Tax Behaviors on Corporate Governance", International Journal of Finance and Accounting, Vol. 2, No. 6, (2013), p. 3

[10] Ibid

[11] Ibid

[12] Africa Initiative Progress Report, Tax Transparency in Africa, Global Forum on Transparency and Exchange of Information for Tax Purposes, (February 2019), p.8

[13] Financial Accountability, Transparency and Integrity (FACTI) Report, (2020),

[14] Jodi J Schwartz and Swift S O Edgar (eds), Corporate Tax Planning Law Review, (2nd ed 2020), p. 72

Company Rules (CFCR).[15] It is said that withholding taxes on interest, royalty, and dividends, although strictly speaking are not rules of anti-avoidance, can influence tax planning.[16] The whole point is that the countermeasures adopted by countries as well as international institutions are as many as the means the MNCs use to reduce (or even escape) their tax liability.

Although the exact figure on revenue lost as a result of tax planning in Ethiopia is not clearly known, there are reports that due to corporate income tax planning the country is losing enormous amount of revenue. There are also reports indicating that Ethiopia has the highest illicit financial outflow from East African counties.[17] Moreover, IMF reported that tax contribution to GDP of Ethiopia is around 11.47 percent which is even below the Sub-Saharan average of 16 percent and East African standard (19%).[18] IMF also reported that Ethiopia lost 1.28 Billion USD in 2013 due to tax planning.[19] Similarly, in 2017, Tax Justice Network reported that Ethiopia lost 1.1084 Billion USD through profit shifting by MNCs which used different avoidance tricks.[20] A report by United Nations Economic Commission in 2018 estimated the country's revenue loss to be 10 percent of the economy.[21]

Ethiopia has amended its Income Tax Proclamation in 2016. It has also come up with Tax Administration Proclamation which is a new introduction in the country's tax regime. One of the defining features of those amendments made in the 2016 tax legislation was that there is a better articulated rules purported to curb tax planning and avoidance. It has already issued a transfer pricing Directive in 2015 with similar

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[15] AIrma Mosquera et al, Tools Used by Countries to Counteract Aggressive Tax Planning in Light of Transparency, (2nd ed. 2018), Vol. 46, p. 143

[16] Gribnau, cited above at note 3, p. 21

[17] United Nations Economic Commission for Africa, Base Erosion and Profit Shifting in Africa: Reforms to Facilitate Improved Taxation of Multinational Enterprises, (2018), p. 33

[18] International Monetary Fund, "Executive Board Consultation with the Federal Democratic Republic of Ethiopia", Press Release No. 16/443 (2016).

[19] Alex Cobham and Petr Jansky, "Global Distribution of Revenue Loss from Corporate Tax Avoidance: Re-estimation and Country Results", Journal of International Development, (2018), p. 230

[20] New Business Ethiopia, Profit Shifting Companies Steal 1.1 Billion annually -report, available at https://newbusinessethiopia.com/finance/profit-shifting-companies-steal-1-1-billion-annualy-ethiopia-report/, last accessed on Dec. 8, 2020

[21] United Nations Economic Commission for Africa, cited above at note 17, p. 33

purpose. However, the gist of those rules has not been evaluated particularly in-light with international standards to curtail tax planning. In the existence of these tax instruments, there are reports that the country is losing significant amount of revenue as a result of tax planning by corporate entities. There are further reports that avoidance of double tax treaty that Ethiopia has signed with different countries[22] as well as fiscal investment regime provided to attract foreign direct investments[23] have been an instrument of exploitation of by MNCs operating in Ethiopia as they have been elsewhere.

1.2. Statement of the problem

Several indicators at the global level have shown that corporate tax planning has become more and more aggressive positing serious economic, political as well as fairness issues. This has led to the perception that the existing tax rules are broken so much so that it (the existing tax rules) failed to curtail these massive tax planning and induced many to conclude that taxes are only being paid by naive. The problem of tax planning is bumping off the revenue capacity of African countries which is essential to foster their economic endeavors by denying them the 'fair slice' they deserve in international trade and investment from MNCs. Many MNCs command the kind of resources that enable them to plan and determine their tax liabilities in a very sophisticated and successful way. These MNCs hardly pay income taxes thereby shifting the tax burden to less expert taxpayers[24] and hence it is being argued that MNCs are "threat to the nation and its economy".[25] The tax rules put in place by states are found to be unable to prevent this behavior, and the fundamental principles of the

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[22] UNCTAD, Tackling Illicit Financial Flows for Sustainable Development in Africa, Economic Development in Africa (2020), p. 83

[23] Atakilti and Yohannes in Laura Abramovsky and et al, "Review of Corporate Tax Incentives for Investment in Low- and Middle-Income Countries", Institute for Fiscal Studies, IFS Briefing BN 299, (2018), p. 8

[24] Gribnau, cited above at note 3, p. 2

[25] Joseph J. Thorndike, "The Unfair Advantage of the Few: The New Deal Origins of "Soak the Rich Taxation" in Isaac William (ed), The New Fiscal Sociology: Taxation in Comparative and Historical Perspective, Cambridge University Press (2009), p. 33

tax system which is distributive justice[26] which sees member of society as responsible its possible share of burden is impaired.[27]

Corporate taxation is badly needed to foster the economy in Ethiopia.[28] However, OECD reports that sub-Saharan countries including Ethiopia are not collecting taxes as they raise less than 15% of their tax revenue.[29] Domestic revenue mobilization, against which tax planning is working, is not only the most important vehicle but also a reliable source of revenue for the development endeavors of developing countries like Ethiopia. Domestic revenue mobilization is a key means to reduce poverty and reliance on foreign aid. Africa Progress Report Panel has reported that most countries, Ethiopia inclusive, have not come up with robust rules which can counter tax planning by MNCs.[30] It further noted that where they have provided for rules, these countries immensely lack the capacity to properly implement the rules.[31]

There are rules adopted and found in the tax legislation and tax treaties that the country has signed with many countries. However, the sufficiency of those rules contained in the tax instruments to curtail tax planning has not been evaluated so far while there are reports indicating how the economy is being risked as a result of tax planning. This study has therefore tried to unpack what is lacking about those tax anti-avoidance rules Ethiopia has adopted that they failed to meet their intended purpose.

1.3. The Objective of the study

1.3.1. Main Objective

The main objective of this study is to closely examine Ethiopian tax rules crafted to regulate corporate income tax planning and their tenacity to curb tax planning by MNCs. It will assess the rules instilled under relevant Ethiopian tax instruments which have bearing (direct or otherwise) on corporate income tax planning and evaluate them against international standards.

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[26] ibid

[27] ibid

[28] Giulia Mascagni and Andualem Mengistu, "The Corporate Tax Burden in Ethiopia: Evidence from Anonymized Tax Returns", ICTD Working Paper 48, (March 2016), p. 3

[29] OECD, 'Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries' OECD Legal Department (2014), p. 10

[30] Alexandra Readhead, "Preventing Tax Base Erosion in Africa, a Regional Study of Transfer Pricing Challenges in Mining Sector", Natural Resource Institute, July 2016, p. 2

[31] ibid

1.3.2. Specific Objectives

In an endeavor to achieve aforementioned general objective, the paper aspires to accomplish the following specific objectives:

- The study will illuminate on the concept of corporate income tax planning within a general purview of international taxation. It will define and explore its gist.
- It will examine the building blocks of such tax planning, international standards, and best practices in tackling it and try to extrapolate to our context.
- The study will identify loopholes under tax instruments that pave for corporate income tax planning in Ethiopia.
- It will be an input for a further study on similar issues in the future.

1.4. Significance of the study

It is increasingly clear that tax planning and tax avoidance strategies are at least as important as statutory parameters in explaining corporate taxation.[32] Although we find modest scholarly writings on conceptually related topics, the Ethiopian taxation rules on tax planning (their gist as well as versatility) have not been examined so far. Although tax planning is not tabled as major tax agenda in academia so far in Ethiopia, there is ample evidence that the country is losing an insurmountable amount of revenue through tax planning some of which are presented above. Therefore, apart from examining the rules in our tax instruments to regulate tax planning and identify any gaps in them, the current study will ignite academic discourse on tax planning and its effects in Ethiopia.

This is study will also be an important input for legal reform in general and tax reform in particular. The findings of the study may aid the government intent on tax reform through legislation or tax policy (if it wants to come up with one).

1.5. Research Questions

The central question that this paper tried to answer is "whether Ethiopian income tax regime has contained an enduring and efficacious tax planning rules in light with the dynamic tax planning practices by MNCs and global experiences".

This study has also tried to answer the following derivative questions:

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[32] Mascagni and Mengistu, cited above at note 28, p.8

1. In the context of international taxation, what does tax planning mean and how does it affect revenue collection?
2. Are our income tax laws sufficiently informed by rules which aid abating income tax planning by MNCs?
3. To what extent the Ethiopian corporate income taxation framework has kept pace with changes in global business practices leading to tax planning?
4. Is there a need for reform in our income tax laws and procedures to curb the effects of tax planning?
5. What should be the role of the tax authority to achieve efficient tax enforcement and curb aggressive corporate income tax planning?

1.6. Scope of the study

The concept of tax planning by MNCs is so broad that it will take from pages to catalog. The focus of the current study is, therefore, limited to the analysis of the theoretical understanding as well as the normative framework pertaining to corporate income tax planning in Ethiopia. It has not indulged into the case studies of instances of tax planning so far unless incidentally. The study is also limited to the analysis of corporate income tax planning by MNCs operating in Ethiopia and all other taxpayers are excluded from the study. The study will examine profit shifting techniques which MNCs operating in Ethiopia are using in avoiding paying taxes on profits they generate.

1.7. Limitation of the study

The research is limited due to a lack of secondary data to develop a theoretical foundation on tax planning and its effect within the Ethiopian context. Nor are there precise and official empirical data of the revenue loss quantum as a result of tax planning in Ethiopia from which theoretical ratiocination would have been inferred.

The research is also trammeled of sufficient information that could have been gathered from the stock market if Ethiopia had one. Currently, there is no operating stock market in Ethiopia to get more reliable financial information.[33] The study is further constrained due to the covid-19 pandemic during which this research is conducted. It has, particularly, hindered in-person communication of some relevant government

[33] The Council of Ministers of the Federal Democratic Republic of Ethiopia has announced on Dec. 22, 2020 (the time when this research was being wrapped up) that it has approved a bill establishing stock market in Ethiopia. However, its full implementation requires further process.

officials and stakeholders for further data. Utmost effort is, however, made to maintain the merit of this study even if these limitations have indeed happened.

1.8. Research Methodology

This research is essentially doctrinal. As the title of this research tells, the author set-off the work with discussion of conceptual underpinnings of international taxation and tax planning. The paper then evaluated the existing Ethiopia's income tax instruments which have relevance to the topic. Double taxation treaties that Ethiopia has signed with different countries have also been consulted. Investment proclamation and regulations giving fiscal incentives have been examined. Policy documents, Minutes, as well as Explanatory Notes of operating income tax proclamation are closely scrutinized. Books, journal articles, commentaries, and other scholarly writings has been utilized too. The efforts by some international institutions such as OECD, EU, UNDP, UNCTAD to fight corporate tax planning have been elaborated. Finally, the experiences of some countries have been tried to be extrapolated to benefit from comparative analysis and take lessons thereof.

1.9. Organization of the study

The study is clustered and presented in four chapters. The first chapter of this study pertains to the Background of the Study, Statement of the Problem, the Objective of the Study, the Significance of the Study, Research Questions, Scope of the Study, its Limitation, and the Methodology that is to be followed in doing this research.

Then, Chapter two comes where the important concepts relating to tax planning is dealt with. The question of what tax planning is within a wider overview of illicit financial flows, international taxation ,and its ramifications, its meaning, its chronicles, its relationship with other common concepts such as tax avoidance and tax evasion, etc. have been dealt with. This Chapter is followed by a brief overview of the global efforts and lessons from a few countries in dealing with tax planning.

Chapter three of this paper pertains to analysis of Ethiopian rules to counter income tax planning by MNCs. It evaluated the pertinent rules in our tax system (income tax to be particular) which are of relevance in tax planning and corresponding countermeasures. It weighs them against international standards, identifies its gaps, and debunks what it feels is lacking. Finally, Chapter four of the paper summarizes the work and gives recommendations.

Chapter Two

General Overview of Corporate Income Tax Planning

2.1. Introduction

In the notorious case between Grogory vs. Helvering, Judge Learned Hand said, 'anyone may so arrange his affairs that his taxes shall be as low as possible; he is not bound to choose that pattern which will best pay the treasury; there is not even a patriotic duty to increase one's taxes'.[34] Since taxes are compulsory exactions which the sovereign claims from corporate taxpayers so designated by law the latter are left alone to arrange their tax affairs by themselves within the bounds of the law. However, that freedom led to the loss of an enormous amount of revenue as some MNCs effectively reduced and even at times escaped their tax liabilities taking advantage of the mismatches between the tax jurisdictions within which they operate. This resulted from the artificial shifting of profits to low or no-tax jurisdictions.[35] This fact has forced countries and international institutions to come up with a new way of dealing with the taxation of MNCs.

Historically, tax planning and avoidance in general were open to different views. One of those views is, and this is what was once taken by the British courts in the 1980s as well, that 'as long as what the taxpayer does is within the terms of the tax law, there is nothing wrong with it, even if the taxpayer manages to find a clever and artificial way of reducing tax'.[36] This reasoning has reinforced the corporate leaders to justify their effort to avoid taxes taking advantage of the loopholes in the tax laws.

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[34] It was once stated that "no man in this country is under the smallest obligation, moral or other, so to arrange his legal relations to his business or his property as to enable the Inland Revenue to put the largest possible shovel into his stores. The Inland Revenue is not slow -and quite rightly - to take every advantage which is open to it under the taxing statutes depleting the taxpayer's pocket. And the taxpayer is, in like manner, entitled to astute to prevent, so far as he honestly can, the depletion of his means by the Revenue. Joan Riddle, "Tax Evasion vs. Tax Avoidance", Resource News, Vol. 6, No. 12 (1982), p. 13

[35] Martin Hearson and et al, "The Appropriateness of International Tax Norms to Developing Country Contexts", Financial Accountability, Transparency and Integrity, (July 2020), pp. 1-2

[36] Victor Thurnoni, Comparative Tax Law, Kluwer Law International (2003), p. 176

Some argued that corporations cannot be expected to voluntarily pay more than that is legally required.[37] According to them, as long as there is no clear violation of a provision of relevant tax instrument, there is no reason to blame corporate entities for the mere fact that they have paid less tax than the government wanted them to pay. Some even take the argument further and hold that in the case of share companies, managers are under a fiduciary duty to engage in tax planning and make sure that the corporation pays the least tax possible.[38] Many others have, however, challenged this assertion.[39] They vehemently argued that, left uncontrolled, the tax planning by corporate entities will leave the public purse empty and bring about a race to the bottom.[40] Few even argued that there is nothing legal in corporate tax planning[41] stating that to hold tax planning legal is simply a misconception.

2.2. Corporate income taxation: Focus on MNCs

The power to tax is one of the attributes of sovereignty 'without which no sovereignty can be described as such'.[42] MNCs are established to engage in business activities thereby generating income (profit) which is subject to tax unless relieved otherwise. With the advent of globalization and the flourishment of commercial ventures, corporations started to expand their business overseas outside of their place of incorporation. Century ago, commerce and investments were predominantly territorial. Corporations were incorporated and did their businesses within the national jurisdiction of registration. In those days, corporate taxation did not have many challenges as these companies were subject to one jurisdiction where income was generated, declared, and taxed. However, since the last decades, companies have become more and more

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[37] Heidi Zummo et al, "Addressing Aggressive Tax Planning through Corporate Tax Disclosures: An Explanatory Case Study", E-Journal of Tax Research, Vol. 15, no. 2, (2017), p. 2

[38] It was once argued that the executives who run America's corporations have a fiduciary duty to maximize profit for their shareholders. One way to maximize profits is to minimize taxes .... the main thing you learn is that tax avoidance is everybody. ... duty. You're supposed to try to avoid. Omri Marian, "Is all corporate tax planning good for shareholders", University of California, Davis Law Review Vol. 905 *(2018)*. P. 2

[39] ibid

[40] ibid

[41] https://www.taxjustice.net/2019/05/28/new-ranking-reveals-corporate-tax-havens-behind-breakdown-of-global-corporate-tax-system-toll-of-uks-tax-war-exposed/ last accessed on November 10, 2020

[42] Stpejan Gadzo, "Nexus Requirements for Taxation of Non-Residents' Business Income, A Normative Evaluation in the Context of Global Economy", IBFD Doctoral Series, Vol 41, (2018), p. 44

multinational with head office in one jurisdiction while having subsidiaries, associates, or branches in other parts of the world. The anomaly is that our international corporate taxation regime has not been improved accordingly. It is regrettable, says Elias Agbo, that "the international tax laws have not kept pace with the changes in the global business environment".[43]

There is a desire on the part of developing countries to have these MNCs invest within their territories mainly for economic reasons. Countries have put in place several fiscal and non-fiscal incentives to make the business environment for these MNCs more attractive and conducive. Numerous double taxation avoidance treaties have also been signed between the countries of these corporations and host countries to make sure that incomes generated by those companies are not subjected to tax twice. However, such tax treaties, themselves, have become a mechanism for corporate tax dodging- through what is called treaty-shopping. These days, some argued that developing countries are not getting much benefit from FDIs due to offshore financial centres.[44] As profits generated by these MNCs are ultimately shifted to tax havens or jurisdictions with low tax rates, developing countries are denied a fair share of the investments and commerce through tax.

MNCs could shift the profits from where they are doing businesses to another place through different arrangements with the sole reason of reducing or evading taxes. For that purpose, there are known tax havens and low tax jurisdictions which grant corporations preferential tax treatment. Some jurisdictions do not even tax corporate incomes at all in North America, Asia, Europe, and Oceania.[45] Moreover, some jurisdictions do tax corporate incomes as low as 5.5% of their income.[46] Therefore, corporates do their businesses overseas and shift their profits through different means to those jurisdictions with no tax or low tax rates. This has effectively left many countries in a position that they failed to meet their social and economic objectives as corporate tax income forms a significant part of their revenue. The problem is

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[43] Elias Igwebuike Agbo, “Aggressive Tax Planning in Africa”, International Research Journal of Human Resource and Social Sciences, Vol. 7, No. 8, (2020), p. 49

[44] Niels Johannesen, "Are less developed countries more exposed to multinational tax avoidance?" United Nations University, (May 2017), p.5

[45]AlkeAsen, "Corporate Tax Rates around the World", Fiscal Fact, No. 679 (2019), p. 5

[46] ibid

particularly severe in developing countries like Ethiopia where revenue is already scarce to meet developmental objectives that will improve the lives of many.

2.3. Corporate income tax planning defined and explored

In the literature of corporate taxation, the terms tax avoidance, tax planning, and tax dodging are being used interchangeably. These terms generally refer to a situation where MNCs avoid paying taxes by using legal loopholes and mismatches. What is particularly relevant in the case of tax planning (sometimes referred to as tax dodging) is that it often happens in the multinational setting. In that case, corporations shift their profits to other jurisdictions than where they do their business for tax purposes.

The OECD glossary of terms defines tax planning as 'an arrangement of a person's business and/or private affairs to minimize liability'.[47] For the OECD, the term is generally used to describe the exercise by the taxpayer of his affairs whose main purpose is to reduce tax liability and in that sense; although the exercise may be strictly legal, it is repugnant to the intent it purports to achieve.[48]

The other definition we have is from the European Commission. The European Commission has defined tax planning as 'taking advantage of the technicalities of a tax system or of mismatch between two or more tax systems to reduce tax liability'.[49] Of course, it is submitted that the borderline between acceptable and unacceptable tax planning is said to be a blurred one.[50] Elias Agbo already argued that the difference between acceptable and aggressive tax planning is merely theoretical and it is unclear in practical terms, while Denis Healey even said, 'the difference between tax avoidance and tax evasion is the thickness of a prison wall'.[51]

Victor Thuronyi admits that the terms tax planning, tax evasion, and tax avoidance are related tax terminologies with their distinctive features but are used imprecisely in

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[47] Glossary of Tax terms, OECD, https://www.oecd.org/ctp/glossaryoftaxterms.htm, last visited on 1st October 1, 2020

[48] ibid

[49] Paolo Piantavigna, "Tax Abuse and Aggressive Tax Planning in the BEPS Era: How EU Law and the OECD are Establishing a Unifying Conceptual Framework in International Tax Law Despite Linguistic Discrepancies" World Tax Journal, (2017), p. 47

[50] European Commission, "Aggressive Tax Planning Indicators Final report, Taxation Working Paper (2017), p. 23

[51] Elias Igwebuike Agbo, cited above at note 43, p. 52, Denis Healey, Former UK Chancellor of the Exchequer, The Economist, Vol. 354, Issues 8152-8163(2000), p. 186

taxation.[52]. Tax evasion is outrageously illegal and usually a criminal offense leading to punishment. Tax avoidance, on the other hand, involves structuring or restructuring one's affair so that he/she/it pays less than what he/she/it would have otherwise paid and it might include taking advantage of the tax laws which contain inadvertent errors.

Tax planning, somehow, sharing the features of the two seems to lie somewhere in between. Pieces of literature on tax planning do not regard it as a justified and purely legal exercise as such. The guiding motto for MNCs in engaging in aggressive tax planning is that 'everything not forbidden by law is allowed'.[53] Specially, aggressive tax planning by MNCs which operate in inter-state setting has been censured for jeopardizing legitimate taxing right of countries where they generated their profits. It is very difficult to establish conceptual precision between these notions in taxation. Some, for instance, have argued that tax avoidance includes tax planning itself.[54] For instance, Kutera on his part argues that tax evasion is a different story and stands to be separate from those other two.[55]

The tax planning by MNCs has become, as Oxfam International calls it, an 'epidemic' seriously threatening the capacity of developing countries to meet the basic needs of their citizens who lack education and health services.[56] Robert Bird and Karie Davis opined that corporate tax planning has multifaceted ramifications. They argued that this act 'is not just a financial problem for tax authorities, but one that erodes critical

[52] Thuronyi, cited above at note 36, pp. 154-156. Thuronyi also appeals to an attempt made once in the USA to provide for some litmus tests to clarify conceptual ambiguity between avoidance and evasion of tax. There, it was said, "Tax avoidance is doing what you can within the law. Avoidance of tax is not a criminal offense. All taxpayers have the right to reduce, avoid, or minimize their taxes by legitimate means. The distinction between avoidance and evasion is fine, yet definitive. One who avoids tax does not conceal or misrepresent, but shapes and pre-plans events to reduce or eliminate tax liability, then reports the transactions. Evasion, on the other hand, involves deceit, subterfuge, camouflage, concealment, some attempt to colour or obscure events, or making things seem other than what they are"

[53] Małgorzata Kutera, "A Model of Aggressive Tax Optimization with the Use of Royalties", Journal of Economics and Management, Vol. 30, No. 4 (2017), p. 4

[54] Mahfoudh Hussein and Ku Nor Ismail, "Corporate Tax Planning Activities: Overview of Concepts, Theories, Restrictions, Motivations, and Approaches", Mediterranean Journal of Social Sciences, p. 1

[55] Malgorzata Kutera, cited above at note 53, p. 4

[56] Oxfam International, Inequality and Poverty, the Hidden costs of tax dodging, https://www.oxfam.org/en/inequality-and-poverty-hidden-costs-tax-dodging, last visited on 7th November 2020

common spaces necessary for the smooth functioning of regulatory compliance, organizational integrity, and society'.[57]

2.4. Nexus Requirement for taxation of MNCs

We have already said that taxation is a sovereign right. However, it must be underscored that tax sovereignty (or sovereignty as it is under international law) is not unlimited. For a taxing state to assert its power of taxation over the taxpayer, it has to establish the legal relationship between itself and the taxpayer which could be personal or objective.[58] This question of the nexus between taxing state and taxpayer is particularly relevant in the context of international taxation which could, potentially, bring two or more states on board. Thus, the sovereign right to taxation by states is limited by the nexus requirement between the taxer and taxed. Therefore, there has to be a genuine link between the two to exercise taxing right. Thus, there are connecting factors developed for a given state to exercise its taxing power over a taxpayer. The most widely known connecting factors for the state to exercise its taxing power are residence and source principles.

2.4.1. Residence Principle

The concept of residence as a nexus for taxation originated in the context of natural person *vis-a-vis* state and its application in the context of MNCs could lead to some difficulties. However, it is ascertained that almost all states in the world use the residence nexus to tax juridical persons too, and hence MNCs.[59] Determining the residence of a given company is not as easy as it appears from the start. Generally, two approaches are employed to determine the tax residence of companies. One of these approaches is the formal approach in which the place of incorporation test or place of the registered legal seat is taken as a tax residence of a company. The corollary is that as nationality nexus is for taxing natural persons, so is the place of incorporation for corporate entities in general- essentially the place of birth approach. But the equation will lead to some absurdities as they lack physical attributes, and it will be meaningless to insist on their presence as such. McIntyre eloquently stated "a corporation does not live, does not have a home, and is not located anywhere. It can have a residence,

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[57] Robert Bird and Karie Davis, "Tax Avoidance as a Sustainability Problem", Journal of Business Ethics, Vol. 1, No, 1, (2016) p. 1010

[58] Gadzo, cited above at note 42, p. 75

[59] Id, p. 77

therefore only if the law assigns to it one".[60] Under the factual approach on the other, the residence of a company is determined by analyzing the facts revealing the place of effective management. This can lead to what is called dual residence when all of those factors are not fulfilled in a single country.

2.4.2. Source Principle

The other major nexus for exercising taxing right is the source of income. Unlike the residence nexus that somehow establishes personal attachment, the source principle establishes economic attachment. It deals with where certain taxable income is generated rather than where the taxpayer resides. Generally, source-based taxation is justified because the state has invested in creating economic opportunities for these MNCs for them to make those profits. Therefore, it is fair for the source state to exercise a taxing right over the income generated by such company using the resources availed to it. However, source-based taxation of MNCs has its challenge as well. The major flaw in this source-based approach is that there are ample situations where it could be difficult, if not impossible, to trace where the source of certain income is.[61]
These traditional tax arrangements on the basis of residence of taxpayer and source of income are said to be outdated as a result of globalization. IMF reported 'the current international tax arrangements rest on concepts of companies' 'residence' and the 'source' of their income, both of which globalization has made increasingly fragile'.[62]

2.4.3 Avoidance of Double Taxation

MNCs do their business in a cross-border setting while the power to tax is essentially bound to one's territory. This territoriality is compounded by the notion of sovereign right of taxation. Halliday already argued that "tax sovereignty is a case for international double taxation, because it empowers national governments to decide independently whether and to what extent cross-border activities are subject to domestic tax".[63] This will, at least, lead to the conflict on the taxing power of the source

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[60] Id, 78

[61] Committee of Experts on International Cooperation in Tax Matters, "Introduction to International Double Taxation and Tax evasion and Advocacy" in Ayene Mengesha, the Challenges of Taxing Multinational Enterprises in Ethiopia: A Developing Country Perspective, (LLM Thesis, Bahir Dar University School, 2017) p. 17

[62] IMF, "Spillovers in International Corporate Taxation", IMF Policy Paper (2014), p. 8

[63] Terence C. Halliday, (ed) Transnational Legal Orders, Cambridge University Press, (2015), p. 157

country and the resident country. Due to the different results these principles entail, and further, due to the fact that countries in the world do not have similar application of these principles, the possibility that companies would be exposed to double taxation by two or even more states has led to the development of certain relief. These double taxation concerns have been addressed at the national level by each state (unilateral measures) through bilateral treaty means, as well as multilateral measures. At an international level, these double taxation concern is attempted to be addressed through the OECD Model Tax Convention and United Nations Model Double Taxation Convention both of which include the same compromise between the country of source and country of residence.[64] In effect, they allocated that the country of the source has the right to tax active income while the country of residence has the right to tax passive investment.

The double tax avoidance regime could, therefore, be unilateral, bilateral, or multilateral. One of the most common unilateral double taxation avoidance mechanism is through a foreign tax credit.[65] This emanates from the fact that states normally tax their residents on their worldwide income. Hence, a resident taxpayer will be credited to the extent that he can prove that he has paid for foreign governments on his foreign source.[66] The other unilateral means to avoid double taxation is the exemption rule. In this case, the residence country excludes income derived in another state from the taxable base which essentially means that its taxing right will be limited to source only.[67] Then, its taxing right will be limited to its sources originating from its boundaries and then it has exclusive right over that source.[68] Bilateral and multilateral measures are executed through avoidance of double taxation treaties and conventions respectively.

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[64] UNCTAD 2020 Report, cited above at note 22, p. 82

[65] Yan Xu, "Foreign Tax Credits and the Complexity of Tax Law: China as a Case Study", AT Review Vol 46, (2017), p. 1

[66] Andrew Lymer (ed) The International Taxation System, Kluwer Academic Publishers, (2002), p. 10

[67] Michael Langa, Introduction to the Law of Double Taxation Conventions, Linde Publishing, (2nd ed. 2013), pp 1-2

[68] Ayene Mengesh, cited above at note 61, p. 21

2.5. Major Tax planning Mechanisms Employed by MNCs

2.5.1. Sham Transactions and abuse of tax laws by MNCs

Generally speaking, 'sham transactions' are those conducted with the sole or main purpose of tax benefit and which do not have economic substance. Thus, MNCs enter into different kinds of dealings and make some transactions merely to get a tax advantage from the tax authority. There have been different tests employed and been utilized by courts of different jurisdictions to hold those transactions made with the objective of tax benefit alone to disallow them of the tax benefit they sought. Much ink has also been spilled on the need to separate such sham transactions from the genuine ones. One of the doctrines developed to test and identify these sham transactions from those genuine ones is the 'economic substance doctrine'.

Economic substance doctrine states that if a given transaction does not have economic motive or substance, then all tax results of that transaction including the claimed tax benefit, income, deductions should be disregarded as if the transaction had never occurred [69] Proponents of this doctrine argued that "transactions that claim inappropriate tax benefits are a perennial problem and hold that if a given transaction does not pass the economic substance test, then the taxpayer should not be allowed to benefit from the tax advantage he purported to take through that transaction".[70]

There are on the other side, writers, who oppose the application of this economic substance doctrine. They hold that this doctrine is too good to be an appropriate test to identify sham transactions from others. For example, Lederman states:

> Unfortunately, the economic substance doctrine is a terrible tool for that endeavour… the doctrine is so disconnected from the inquiry of whether a transaction was abusive that one judge has called it a 'smell testy'. Moreover, given the doctrine's focus on the taxpayer's purpose and whether there was a prospect of pre-tax profit, taxpayers can easily manipulate it.[71]

Indeed, it also not clear whether the tax authority has to verify whether the specific taxpayer claiming tax advantage of such sham transaction had economic motive, or

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[69] Rebecca Rosenberg, "Codification of the Economic Substance Doctrine: Agency Response and Certain Other Unforeseen Consequences", William & Mary Business Law Review Vol.10, No. 1(Nov. 2018), p. 4

[70] Leandra Lederman, "W(h)ither Economic Substance?" Maurer School of Law: Indiana University, (2020), p. 392

[71] Id, pp. 391-392

whether, in disregard of such motive, the tax authority has to assess objectively whether such transaction will be acceptable for tax benefits sought in general. In this sense, the USA Court in *ACM Partnership case,* in declaring the transaction as sham stated: "...the inquiry into whether the taxpayer's transactions had sufficient economic substance to be respected for tax purposes turns on both the 'objective economic substance of the transactions' and the 'subjective business motivation' behind them..."[72] However, this subjective assessment of the taxpayer's expected pre-tax profit can be arbitrary and in practice has led to confusion. For instance, another court has decided, in a case similar as ACM case above, that the taxpayer's transaction had economic substance because he anticipated profit.[73]

2.5.2. Transfer [Mis]pricing and Arm's Length Principle

In a globalized economy, MNCs operate their cross-border investments through the most tax-efficient corporate structures[74] spreading their functions, assets, and risks across multiple related entities located in different jurisdictions.[75] In the case of developing countries, such as African countries, this practice has resulted in value-adding activities being transferred away from where the initial economic activity took place.[76] These cross-border movements of goods and services require transfer pricing, a standard practice within MNCs that was not originally meant to be illegal.

For taxation of their incomes, these MNCs are not considered as one and single taxpayer. This is because a company incorporated and established in one country may have different subsidiaries or branches in different countries. Moreover, companies want to deal with those related entities when that is possible if the nature of the transaction, they desired is possible through related entities. Because of the suspicious nature of such transactions between related entities, the rules of arm’s length principle are developed to scrutinize the transaction.

The UN Practical Manual on Transfer Pricing for Developing Countries defines transfer pricing as the pricing of cross-border, intragroup transactions in goods,

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[72] ACM Partnership v. Commissioner. 157 F.3d 231 (3rd Cor. 1998), in Thuronyi, cited above at note 36, p. 165

[73] Id, 166

[74] United Nations Conference on Trade and Development, World Investment Report, Reforming International Investment Governance, 2015, p. 188

[75] UNCTAD 2020 Report, cited at above note 22, p. 83

[76] ibid

intangibles, or services.[77] The OECD has also come up with the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations in 2017 which is an amendment to the one it fathered in 2010. These Guidelines are meant to serve as supportive of individual state's efforts to come up with their own national transfer pricing rules. Studies reveal that transfer pricing remains central to MNCs' tax strategy in intra-group transactions[78] and a serious headache to states in exercising their taxing right.

The rules of arm's length principles are developed to deal with the transactions between such related entities. This principle dictates that transactions between related parties shall be at the price that would have been had the same transaction taken place between independent parties. The United Nations Conference on Trade and Development (UNCTAD) reported in 2020 that, in practice, the application of the principle requires the ability to identify a comparable product and price. While for standardized products this is relatively easy, it is difficult, if not impossible, for highly complex products and intangibles such as intellectual properties as one may not easily find the market price for these properties. As markets are thinner in developing countries, there is consensus that even with the best intentions, the arm's length principle is difficult to implement there than it is in developed countries.[79]

A related but distinct issue here is the issue of secrecy in international taxation. The profits are in one way or the other shifted to tax haven which is sometimes called secrecy jurisdiction. It provides facilities that enable corporates to escape liability. A study by Tax Justice Network on the largest quoted companies in the Netherlands, France, and the UK, revealed that 99 percent of those for which information was uncovered operate through secrecy jurisdictions.[80] The shifting profits to these secret jurisdictions got momentum since the leakage of Panama papers.[81]

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[77] United Nations Practical Manual on Transfer Pricing for Developing Countries, Department of Economic & Social Affairs, (2017)

[78] Khadija Sharife, "Tax Us If You Can: Why Africa Should Stand for Tax Justice", Tax Justice Network-Africa, (2011), p. 12

[79] UNCTAD 2020 Report, cited above at note 22, p. 83

[80] ibid

[81] The 'Panama Papers', or as they are commonly referred to as 'the Panama Leaks', are around 12 million documents that contain vastly discrete financial and they contain clandestine financial information. *See* Syed Haider Ali Zaidi et al, “Panama Papers and the dilemma of global financial

From an operational perspective, abusive transfer pricing, a form of trade mispricing, is abated through the application of the arm's length principle. The practice is based on the excessive manipulation by MNCs of prices of cross-border transactions between related parties. The result of abusive transfer pricing is to artificially shift profits from high-tax jurisdictions to low- or no-tax jurisdictions through the following three key channels: First, through trade mispricing by manipulating intragroup import and export prices whereby affiliates in high-tax countries import goods and services at high prices from firms in low-tax countries. In such case, since an affiliate has to pay much high prices than that would have otherwise been paid by independent company, its tax base will be eroded.

Secondly through debt shifting in intragroup financing, whereby an affiliate in a high-tax jurisdiction borrows from an affiliate in a low-tax jurisdiction and pays an artificially high-interest rate to reduce its profits and tax burden. Finally, location of intangibles and intellectual property (for example, brands, research and development, and algorithms, other intangibles) whereby an entity holds its intangible assets and intellectual property in a tax haven and charges its affiliates service fees for using these assets.[82] We will discuss in a greater detail the second channer (excessive interest payment) and third channel (royalty payment) latter.

Generally speaking, through these techniques of abusive transfer pricing, it will then be the MNCs themselves that will be the ultimate decision-makers regarding the question of how much and to which authority they should pay tax, which is strictly against the fiscal sovereignty of national governments.[83] They decide how much should be artificially shifted to elsewhere, and how much shall remain for the source state, where they (MNCs) generated income, as an income tax revenue.

Article 9 of the OECD Model Tax Convention better explains this. It reads ‘where conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those conditions, have accrued to one

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transparency”, International Journal of Modern Research in Management, Volume 1, Issue 2 (December 2017), p. 1

[82] UNCTAD 2020 Report, cited above at note 22, p. 84

[83] Ayene Mengesha, cited above at note 61, p. 38

of the enterprises, but, because of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly'.[84]

It must be recognized that the arm's length principle has drawbacks too. To apply this principle, there has to be a comparable transaction against which the transaction between related parties is to be evaluated. In this sense, it is very difficult to find comparable transactions for every transaction that undertakes. It is particularly difficult to determine the arm's length price for intangible properties such as intellectual properties. This is simply an extension to the fact that implementing transfer pricing rules is tedious by itself as, Edward Klein bard, Chief of staff of the US Congress on the Committee of Taxation once said 'transfer pricing enforcement is dead. Despite everyone's efforts we're not collecting tax. It's a global problem'.[85]

One alternative proposed in this regard is the 'presumptive taxation' approach. This approach is provided under the income tax laws of some countries, such as Japan, to give the tax authorities 'the power to 'presume' an arm's length price based on information gathered by the authorities, and to reassess the taxpayer's taxable income on that basis'.[86] Well, this approach is open to abuse by the authority if left unlimited and hence it is only applicable, as a last resort, in case the taxpayer fails to provide documentation in support of arm's length price within a reasonable time and even then, its application is restricted to domestic taxation as it could, otherwise, result in double taxation.[87]

The Global Formulary Apportionment is the other alternative tabled by tax scholars. This approach tries to allocate a global profit generated by the MNCs group on a consolidated basis among the associated enterprises found in different jurisdictions based on a predetermined and mechanistic formula.[88] According to OECD, although this approach has never been tried between countries so far, it is in use by some local taxing jurisdictions[89]. OECD reasoned that this approach is extremely difficult to

[84] OECD, Model Tax Convention on Income and Capital: (OECD Publishing, 2010) Art 9

[85] Jamie Morgan, "Corporation tax as a problem of MNC organisational circuits: The case for unitary taxation", The British Journal of Politics and International Relations, Vol. 18, No. 2, (2016), p. 466

[86] United Nations Practical Manual on Transfer Pricing, cited above at note 77, p. 369

[87] ibid

[88] OECD, Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, 2017), p. 39

[89] ibid

implement, time-consuming, and all in all unrealistic in tackling double taxation and hence rejected it. This alternative is suggested along with the application of 'unitary taxation' in recent tax literature which is being considered for application by the European Union.[90] There are also other recently emerging alternatives but details of them are not required here.

2.5.3. Royalty payment

The increasing trend in the use of capital enhancing technologies and various intellectual property rights have brought about major concerns in international taxation. Corporate taxation becomes particularly pressing because of the difficulty to subject the payment of royalties for the use of these intellectual properties to the arm's length principle.[91] There is no consensus both among policymakers and academia on how best to approach royalties that are extensively used to avoid the payment of taxes by MNCs. In this regard, Steffen suggested 'we show that it is optimal to set a withholding tax on (intra-firm) royalty payments equal to the corporate tax rate and deny any deductibility of royalty payments.[92]

As far as the deductibility of royalty payments is concerned, there is disparity among jurisdictions which was tried to be balanced by the UN Tax Model Convention.[93] For MNCs, royalty payment has been one of the most effective instruments in shifting their profits from the place where they do their businesses. It can shift its profits in the name of payment of royalty for the use of an intellectual property as per the license agreement. These MNCs pay excessive amount of royalty for the 'use' of intellectual property belonging to the other, thereby eroding its tax base. The concern here can be seen in light with the discussion we had in relation to transfer pricing too.

[90] Matti Ylonen, "Back from Oblivion? The Rise and Fall of Early Initiatives Against Corporate Tax avoidance from the 1960s to the 1980s", Transnational Corporations, Vol. 23, No. 3, (2017), p. 50

[91] Steffen Juranek and et al, "Royalty Taxation under Tax Competition and Profit Shifting", Public Finance, (2018), p. 2

[92] ibid

[93] Certain countries do not allow royalties paid to be deducted for the payer's tax unless the recipient also resides in the same State or is taxable in that State. Otherwise, they forbid the deduction, See OECD, Commentaries of the Articles of Model tax Convention, (2010), p. 206

2.5.4. Debt- Equity financing (Thin Capitalization)

Debt and equity are taxed differently in most states. The basic difference underlying the two is that while interest on the debt is generally a deductible expense of the taxpayer and taxed at ordinary rates in the hands of the payee, dividend is not deductible and is typically subject to some kind of tax relief (an exemption, exclusion, credit) in the hands of the payee.[94] This is manageable in domestic context as these differences in treatment may result in debt and equity being subject to a similar overall tax burden. But such difference in treatment of debt and equity creates a tax-induced bias when it comes to the cross-border investments by MNCs.[95]

In the cross-border context, the main tax policy concerns surrounding interest deductions relate to the debt funding of outbound and inbound investment by MNCs.[96] These MNCs are typically able to claim relief for their interest expense while the return on equity holdings is taxed on a preferential basis, benefiting from a participation exemption, preferential tax rate, or taxation only on distribution.[97] On the other hand, subsidiary entities may be heavily debt-financed, using excessive deductions on intragroup loans which leads to base erosion on the income of the subsidiary and lifts the local profits from being taxed.[98] Taken together, these opportunities surrounding inbound and outbound investment potentially create competitive distortions between groups operating internationally and those operating in the domestic market.[99]

This situation is referred to us, in tax scholarship, as "thin capitalization" to indicate that the entity is 'thinly capitalized' with equity while it is funded with a substantial amount of debt. To avoid such abuse by MNCs of the interest deductibility that results in base erosion, countries usually stipulate some sort of restrictions on the amount of

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[94] OECD, "Base Erosion and Profit Shifting Project: Limiting Base Erosion Involving Interest Deductions and Other Financial Payments Action 4", Update Inclusive Framework on BEPS, (2016), p. 19. It should however be recognized that some jurisdictions do not allow interest paid to be deducted unless the recipient also resides in the same jurisdiction. According to them, where a resident taxpayer has paid interest to a taxpayer in another state, the former may not claim a deduction as far as the amount of interest he has paid to the latter. See. Commentary on Tax Convention mentioned above as well, p. 206

[95] ibid

[96] ibid

[97] ibid

[98] OECD, BEPS Action 4: Interest Deductions and Other Financial Payments, (2015), p. 6

[99] ibid

interest deductibility. They have implemented rules to curb tax-driven debt financing that leads to interest deductions being excessive from point of view of tax authorities and to protect their corporate tax bases.

Action 4 of the Action Plan on Base Erosion and Profit Shifting developed by the OECD pertains to limiting base erosion through interest deductions and other financial payments.[100] In its 2015 Final Report, the OECD recommended the so-called fixed ratio approach. This approach limits an entity's net deductions for interest to the percentage of its earnings before interest, taxes, depreciation and amortisation (EBITDA).[101] The OECD suggested this approach should at least be applicable to MNCs to avoid base erosion.[102] The OECD recommended a ratio of between 10%-30% of the entire earnings to be allowed as a deductible expense for taxpayer but stressed that it should be as low as possible.[103]

2.5.5. Special Purpose Entities (SPE)

MNCs can gain tax advantages through SPEs or regular operating units and this often involves shifting profits to a low-tax jurisdiction through debt allocation, transfer pricing, or corporate inversions.[104] Tax scholars have estimated that 40 percent of global FDI is routed through special purpose entities which are often set up solely for tax avoidance purpose-with 85 percent of that in just eight jurisdictions.[105] In other words, 40 percent of global investments are phantom investments whose money passes from one to the other through empty corporate shells named as 'special purpose entities'.[106] These shells, otherwise called 'special purpose entities', do not have

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[100] OECD 2013, cited above at note 4

[101] OECD BEPS, Limiting Base Erosion Involving Interest Deductions and Other Financial Payments, Action No. 5 (2015), p. 11

[102] ibid

[103] ibid

[104] Jannick Damgaard and Thomas Elkjaer, "The Global FDI Network: Searching for Ultimate Investors", International Monetary Fund, WP/17/258, (2017), p. 9

[105] ibid

[106] Jannick Damgaard et al, "The Rise of Phantom Investments, Empty Corporate Shells in Tax Havens Undermine Tax Collection in Advanced, Emerging, and Developing Economies", Finance and Development, (September 2019), pp. 12-13. These authors mentioned an example of "double Irish with a Dutch sandwich," which involves transfers of profits between subsidiaries in Ireland and the Netherlands with tax havens in the Caribbean as the typical final destination. These tactics achieve even lower tax rates or avoid taxes altogether"

business activities as such apart from carrying-out holding activities, conducting intrafirm financing, and management of intangible assets which simply aim at minimization of the MNCs' global tax liability.[107] As this income is reported neither at the domicile of the parent company nor at the place of production, tax scholars referred to such income as 'stateless income'.[108] This has already blurred traditional FDI statics and made it quite impossible to understand genuine economic integration.[109]

2.5.6. Tax Treaty abuse (Treaty-shopping)

Double tax treaties (DTTs) are an instrument with the main purpose of facilitating cross-border trade and investment essentially by 'demarcating the taxing rights of countries.[110] However, it has been found that treaty-shopping is pervasive in countries that have signed DTTs with investment hubs[111]. DTTs are agreements between states that divide up the right to tax cross-border economic activity.[112] These bilateral DTTs generally have the principal aim of reducing double taxation and thus encouraging cross-border investments.[113] Accordingly, there are now over 3,000 DTTs in force worldwide, covering 96 percent of foreign direct investment.[114] Treaty-shopping is one of the techniques employed by MNCs to shift their profits from where they do their economic activity. By misusing and abusing DTTs, enormous amount pf revenue has been evaded to tax havens or low tax jurisdictions by these MNCs.

It is reported that, currently, there exists more than 500 DTTs which are in force in Africa.[115] The UNCTAD reported that the revenue costs to African countries from tax treaty-shopping are estimated to have amounted to $3.4 billion in 2015.[116] Researchers from the IMF and the World Bank further estimate the cost of treaty-shopping in Africa

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[107] ibid

[108] Edward D. Kleinbard, "Through a Latte, Darkly: Starbucks's Stateless Income Planning", Legal Studies Research Paper Series, (2013), p. 1518

[109] ibid

[110] Sebastian Beer and Jan Loeprick, "The Cost and Benefits of Tax Treaties with Investment Hubs: Findings from Sub-Saharan Africa", IMF Working Paper WP/18/227, P. 4

[111]. ibid

[112] FACTI 2020 Report, cited above at note 13, p. 38

[113] ibid

[114] ibid

[115] UNCTAD, cited above at note 22, p. 84

[116] Id, p. 86

to be about 20 to 26 percent of corporate income tax revenue from each treaty with an investment hub.[117]

Therefore, it has been evidenced that DTTs whose primary purpose was, as UN Model Tax Treaty states, to promote, by eliminating international double taxation, exchanges of goods and services, and the movement of capital and persons have become an important instrument of corporate tax planning by MNCs.[118] As a result, some even challenge the significance of tax treaties for developing countries.

Treaty-shopping can also occur when an investor from one country invests in another country but does so through country C merely because he can profit his taxes to the latter where profits are untaxed. This occurs when a company tries to take advantage of DTTs between A and B using a shell company based in jurisdiction C.

Several efforts have been made to counter this. One such effort is the actions of the BEPS project which have pinpointed unilateral measures to be taken by jurisdictions both individually and multilaterally such measures requiring amendment of bilateral (and multilateral) tax treaties. In this regard, a Multilateral Convention to Implement Tax Treaty Related Measures (MLI) to Prevent BEPS signed on 7th July 2017 can be taken as one of the outcomes of the OECD/G20 Project to tackle BEPS and aimed at translating multilateral measures through modification of tax treaties.[119] MLI can be taken as a 'successor' to DTTs bringing 3000 DTTs available so far in the world. However, MLI does not automatically replace the already existing DTTs between countries.

2.5.7. Hybrid Mismatch Arrangements

Hybrid Mismatch Arrangement is a technique utilized by MNCs, generally speaking, to take advantage of the difference of tax laws of different jurisdictions *vis-à-vis* a given instrument or entity. A payment made by a Chinese company from Beijing may be considered as debt for Chinese income tax law while it could be considered as equity for Australian income tax law. Then, in that case, a payer company in Beijing can

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[117] Ibid

[118] ibid

[119] OECD, 'Explanatory Statement to the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting' OECD Publishing, Paris (2016). See also Birhanu Tadesse Daba, Should Ethiopia Sign the MLI?? Prospects and Challenges with a spotlight on treaty abuse and PE, (LLM Thesis, University of Amsterdam, July 2018), p. 2

benefit from Chinese deduction on interest and exemption on Dividend from Australian income tax law- which leads to double non-taxation as well. This hybrid mismatch arrangement has been keen for MNCs such as Apple Inc as well for avoiding billions of dollar profit tax.[120]

Action 2 of BEBS calls for the development of instruments to put an end to or neutralize the effects of hybrid mismatch arrangements and arbitrage.[121] Hybrid mismatch arrangements can be used to achieve unintended double non-taxation or long-term tax deferral by, for instance, creating two deductions for one borrowing, generating deductions without corresponding income inclusions, or misusing foreign tax credit and participation exemption regimes.[122] Indeed, at times, it might be difficult to outrightly determine which country has lost revenue as a result of this mismatch since the laws of both country are involved. But no doubt that the overall tax due by MNCs engaging in such harmful tax practice will unduly minimized.

2.6. Effects of Corporate Tax planning in Revenue Collection

In 2015, the OECD estimated the global corporate income tax revenue losses arising from base erosion and profit shifting (a phrase coined by OECD to refer to corporate tax planning) to be between 4 percent and 10 percent of global corporate income tax revenues (between US$100 billion and US$240 billion based on 2014 figures).[123] In 2019, Tax Justice Network reported that an estimate of 500 billion dollars is dodged as a result of tax planning each year from the tax authorities.[124] The revenue losses as a

[120] This is so due to the difference in the characterization of Apple Inc in the USA and Ireland. According to Ireland law, a company is a resident where its place of management is situated. For the USA law, however, a company is resident where it is registered. Since the company is registered in Ireland, USA authorities may not tax it. At the same time, Ireland only applied place of management rule and Apple Inc has its place of management is in the USA as the company does not even have employees in Ireland, it couldn't exercise taxing right over it.

[121] OECD 2013, cited above at note 4

[122] ibid

[123] OECD, Base Erosion and Profit Shifting, (2015), (hereinafter *OECD 2015*), Action 11. See also David Bradbury et al, "Estimating the fiscal effects of Base Erosion and Profit Shifting Data Availability and Analytical Issues", Transnational Corporations, Vol. 25, No. 2 (2018), p. 1

[124] Rachel EtterPhoya, "How can Africa take action against Corporate tax Henry, Solutions from Corporate Tax Index", Tax Justice Network, (June 18, 2019)

result of corporate tax planning are increasing with the reports that are made successively. For example, in September 2020 Financial Accountability, Transparency and Integrity (FACTI) reported the annual revenue loss as a result of tax planning by MNCs over the globe to be between 500-600 Billion USD.[125] Reports released by *AllAfrica* as well as *The East African* on December 7, 2020, even indicated that:

> 'Multinational corporations paid billions less in tax than they should have by shifting 1.38 trillion USD worth of profit out of the countries where they were generated and into tax havens, where corporate taxes are extremely low or non-existent'.[126]

Africa is more affected by this harmful tax practice than the rest in terms of the economic situation of the continent although not so in terms of the figure of revenue lost. United Nations reported in September 2020 that African countries lose 80 billion dollars annually due to tricks by MNCs which is three times the amount they receive as an aid. This simply means that for every dollar in the form of aid it received, Africa lost three dollars in the form of tax planning by MNCs. Moreover, it is further stated that across the African continent, MNCs are extracting resources, selling products, and using labor, but they are paying far too little tax than they have to.[127]

It is said that developing economies, like Africa, have faced problems on two fronts when it comes to the taxation of businesses. On the one hand, many, particularly small, domestic businesses are unregistered with the tax authorities and operate in the shadow economy, otherwise referred to as 'hard-to-tax-group'. For this reason, corporate income tax is assumed to be a significant source of revenue for the governments to undertake their duties towards the citizens. However, MNCs engage in tax dodging and have either been paying far less than they have to or even have avoided paying at all.[128]

There is ample evidence that the world is indeed less effective in preventing sophisticated aggressive tax planning activities by MNCs in comparison with

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[125]FACTI, cited above at note 13, p. 8.

[126] Kennedy Senelwa and Mohamed Issa, Africa Losing 25.7 Billion to fraudsters using tax havens, The East-African, Dec7, 2020, https://www.theeastafrican.co.ke/tea/business/east-africa-fraudsters-using-tax-havens-3220952

[127] ibid

[128] Clemens Fuest, "International Profit Shifting and Multinational Firms in developing countries"), International Growth Center, (2008) Working paper, p. 2

evasion-related activities carried out by individuals in tax havens.[129] Tax evasion by individuals seems to be easily detectable than the tax planning made by MNCs.[130]

2.7. Taxation of MNCs and Developing Countries Challenge

More often than not, developing countries are importers of FDIs most of which are conducted through MNCs. These developing countries provide different fiscal and non-fiscal incentives so that MNCs invest in their territories. However, the challenge arises when it comes to taxation of the profits of these MNCs. The complexity of the corporate tax planning techniques compounded by multinational nature of the companies, as well as the weakness of these developing countries tax regime have led to the result that they failed to effectively exercise their taxing right with regards to MNCs which would have contributed much to their revenue. The central challenge posed against the developing countries is how to exercise legitimate taxing right over these companies while maintaining an investment-friendly environment which would attract more investors.[131]

International Monetary Fund (IMF) has already stated that developing countries are more exposed to tax planning by companies than developed ones and are losing a significant share of the revenue.[132] Because of these, in developing countries, losses due to global corporate taxation are estimated to range from 6 to 13 percent of total tax revenue which is far more prodigious amount when compared with 2 to 3 percent in OECD countries.[133]

Fighting corporate tax planning demands various contributions. There have to be effective avoidance rules and appropriate income tax laws in place that are crafted carefully which do not leave loopholes for MNCs. It is not just enough, for instance, to have few provisions in the primary income tax legislation on the arm's length principle to fight transfer pricing. It requires detailed transfer pricing regulations, including guidance notes, specific documentation, and annual transfer pricing disclosure requirement, to least few. Then, it requires a strong tax authority staffed with equipped

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[129] Dr. Irma Johanna, "Tools Used by Developing Countries to Counteract Aggressive Tax Planning in the Light of Transparency" Leiden University Vol. 46, No. 2, (2018) p. 18

[130] ibid

[131] Ayene Mangesha, cited above at note 61, p. 14

[132] International Monetary Fund, "Corporate taxation in Global Economy", IMF Policy Paper, (2019)

[133] UNCTAD 2020, cited above at note 22, p. 21

manpower. MNCs have all the resources in place to hire tax advisors, lawyers, and accountants to find for them these loopholes and help them in avoiding taxes. Unfortunately, developing, especially African countries, are not blessed with this. These countries neither have strong tax institution and trained professionals that can properly deal with this corporate tax planning nor they have the required resources for doing so.[134]

2.8. Major Efforts in Dealing with Tax Planning at the International Level

2.8.1. Convention on Mutual Administrative Assistance in Tax Matters

The Convention[135] is the most comprehensive instrument that is meant to tackle corporate tax dodging across the world through cooperation between states. This convention was developed by OECD in collaboration with the Council of Europe in 1988 and was amended by Protocol in 2010. By September 2020, more than 141 countries have already signed the Convention. It strives to coordinate countries to assist each other in various means to make sure that due taxes are collected properly. The preamble of the Convention indicated its purpose and as such, it is written that the aim was "to facilitate administrative cooperation among member countries so that they could effectively counter international tax evasion and other forms of non-compliance".[136]

One of the primary tax areas to which the application of the Convention extends is, as provided for under Article 2, the profit/income tax. Therefore, the Convention undoubtedly plays a pivotal role in assisting member states to collect taxes they have to and tackle international tax planning by MNCs. Regrettably, Ethiopia is not a signatory to this Convention yet. It, therefore, cannot benefit from the benefit of mutual assistance encapsulated by the Convention. Mutual administrative assistance between states is critical in international taxation as we have seen before.

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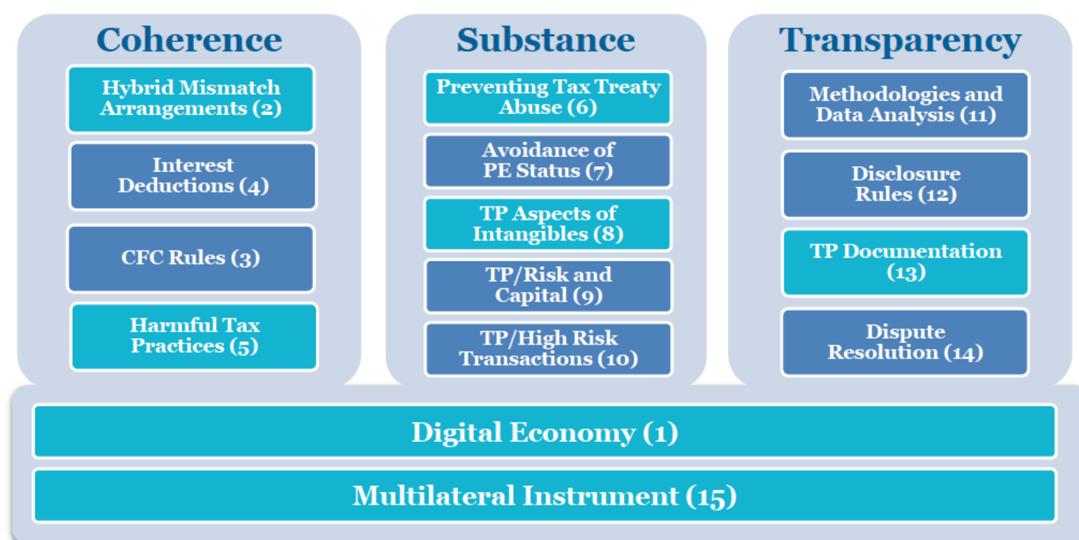
[134] Agbo, cited above at note 43, p. 55, see also Ayene Mengesha, cited above at note 61, pp. 39-40.

[135] OECD/Council of Europe, The Multilateral Convention on Mutual Administrative Assistance in Tax Matters: Amended by the 2010 Protocol, OECD Publishing, Paris, https://doi.org/10.1787/9789264115606-en.

[136] Preamble of the Convention

2.8.2. OECD and G20 Developments

A well-coordinated fight against corporate tax planning was started with a landmarking project set in 2013 when the G20 countries mandated the OECD to launch and come up with reports on the Action plans on aggressive tax planning by MNCs. It, therefore, came up with a report which is coined as a Base Erosion and Profit Shifting (BEPS) basically which is 15 Action Plans categorized under 3 major pillars as depicted below.[137]



After two years, OECD came up with a Final Action Plans in 2015 that needs to be considered to effectively fight base erosion and profit shifting. OECD and G20 then continued to work on equal footing in 2015, they came up with a more comprehensive framework package of the project. In fact, this BEPS comprehensive package represents the greatest renovation to international tax rules and the OECD itself praised this work as "first substantial renovation of the international tax rules in almost a century".[138] This BEPS project concluded that 'fundamental changes are needed to effectively prevent double non-taxation, as well as cases of no or low taxation associated with practices that artificially segregate taxable income from the activities that generate it'[139]

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[137] OECD 2013, cited above at note 4, pp, 7- 8

[138] OECD/G20, Preventing the Artificial Avoidance of Permanent Establishment Status, Base Erosion and Profit Shifting Final Report, 2015, p. 3

[139] Id, Action Plan 3

The OECD/G20 have also fathered an BEPS Inclusive Framework in 2016 so that more countries (outside of OECD and G20 member states) can join the initiative and work together.[140] Currently, more than 128 countries are working together to tackle corporate tax planning by MNCs following the Base Erosion and Profit Shifting report provided by the OECD.[141] It is believed that this will ensure inclusivity and also set a very good level-playing field for all concerned (developed, developing as well as emerging economies). Before OECD launched this Inclusive Framework, which invited developing countries as well, it has been highly criticised as being only an advocate of developed countries.[142]

2.8.3. European Union Commission

Following the works by OECD the European Union has also started dealing with the matter at the continental level. As such, following the BEPS Action plans as adopted by the OECD, in 2016, European Union Commission Council came up with Directive no. 1164/2016 laying down rules against tax dodging by companies across the continent. As far as the purpose of the Directive is concerned, the recitals provided that 'it is necessary to lay down to strengthen the average level of protection against aggressive tax planning in the internal market'. Apart from the detailed explanations of the situation that necessitated its issuance and the approach to be followed to curtail tax planning, the Directive has also contained provisions on specific measures that must be adopted across the continent to abate the problem. These are interest limitation rules (Article 4), exit taxation (Article 5), General anti-abuse rules (Article 6), controlled foreign company rules (Article 7), and Hybrid mismatches (Article 9). The European Commission has revised this Directive in May 2017 through Directive 952/2017.

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[140] OECD, About the Inclusive Framework on BEPS, **https://www.oecd.org/tax/beps/beps-about.htm/** last visited on Dec 23, 2020

[141] ibid

[142] Joseph Stiglitz, Corporate tax avoidance, It is No Longer Enough to take half measures, The Guardian,https://www.theguardian.com/business/2019/oct/07/corporate-tax-avoidance-climate-crisis-in equality accessed on November 12, 2020

2.8.4. United Nations Development Program (UNDP)

As one can see here, although the efforts by OECD (and G20) and the European Commission are paramount, it (this effort) is very much limited. It is limited in terms of the number of countries involved as well as the economies it purported to save. The developing countries, which are said to be major victims of corporate tax dodging, were never consulted nor became beneficiaries as such. Hence, the OECD launched a joint program called Tax Inspectors Without Borders (TIWB) with UNDP in 2015 to 'strengthen developing countries' auditing capacity and multinationals' compliance worldwide'.[143] Since its establishment, it has assisted several developing countries to develop their skill in tackling corporate tax planning. The importance of TIWB was summarized by the Secretary-General of OECD as:

> The concept of TIWB is simple: expert tax auditors are sent to help interested tax administrations in developing countries, where they work side-by-side with local auditors to strengthen their capacity…tax officials around the globe are gaining the knowledge they need to identify when their big taxpayers are not paying the correct amount, as well as the confidence and skills to engage with them to ensure correct taxes are collected…TIWB is filling an important skills gap, helping address Base Erosion and Profit Shifting (BEPS) and abusive tax avoidance by multinational enterprises.[144]

TIWB announced in 2019 that since initiated, with the joint efforts of OECD and UNDP, it has brought significant changes in boosting the capacity of developing countries, especially from sub-Saharan countries.[145] In 2019 it reported that for every 1-dollar cost that it spent on TIWB for its work, these developing countries are collecting 1000-dollars more from tax revenue with its assistance.[146]

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[143]UNDP, Four years on and half a billion dollars later - Tax Inspectors Without Borders, (2019), https://www.undp.org/content/undp/en/home/news-centre/news/2019/Four_years_on_and_half_a_billion_dollars_later_Tax_Inspectors_Without_Borders.html, last visited Nov. 11, 2020

[144] ibid

[145] Tax Inspectors Without Borders (TIWB), Newsletter Vol. 3 (2019), p. 2

[146] Ibid

2.8.5 Tax Justice Network

The Tax Justice Network is an independent international network established in 2003 with the specific mission to "change the weather on a wide range of issues related to tax, the tax havens, and financial globalization".[147] It is an institution that does not have political affiliation with any of the countries in the world. Since its establishment in 2003, the Network has coordinated plenty of works in tackling corporate tax dodging by MNCs companies. The Chief Executive of the Network regretfully stated the following concerning the vast revenue being forgone by MNCs through different tricks at 2019 Press:

> the hypocrisy revealed by the corporate tax index is sickening. A handful of richest countries have waged a world tax war so corrosive; they have broken the global tax system beyond repair. The ability of governments across the world to tax multinational corporations to pay teachers wages, build hospitals, and ensure a level playing field for local businesses has been deliberately and ruthlessly undermined**.** When our laws for taxing global corporations stop working, the global economy stops working for the vast majority of us. To curtail the corporate tax avoidance that costs hundreds of billion dollars every year, governments must finally deliver international rules that ensure profits are declared, and tax paid, in the places where real economic activity takes place. Corporations should be taxed where their employees work, not where their ledgers hide.[148]

2.8.6 Africa Initiative

Coming to Africa, substantial amount of the continent's government revenue source comes from corporate taxation which is said to be close to $67 billion in 2015.[149] Corporate taxation forms by far more significant share of government revenue in African countries than in developed countries such as OECD countries, mainly because these African countries are unable to raise as much revenue from payroll taxes.[150]

Although the joint UNDP-OECD efforts we have seen above also concerns Africa, there is a need to have a special effort at the continent level to tackle corporate tax

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[147] https://www.tax justice.net/ last visited on Nov. 10, 2020

[148] Tax Justice Network https://www.taxjustice.net/press/new-ranking-reveals-corporate-tax-havens-behind-breakdown-of-global-corporate-tax-system-toll-of-uks-tax-war-exposed/, last visited on Nov. 23, 2020

[149] UNCTAD 2020, cited above at note 22, p. 21

[150] Ibid

planning. Therefore, the African members of the Global forum in 2014 decided to create an African focused program to deal with corporate tax planning and referred to it as 'Africa Initiative'.[151] The main objective of the Africa Initiative was to unlock the potential of tax transparency and exchange of information for Africa and help Africa tackle tax avoidance and evasion. By June 2020, it was reported that the Initiative is working across 33 African Union member states and 3 other non-member states. However, Ethiopia is not a party to this Initiative as well. On June 25, 2020, Tax Transparency in Africa 2020 was established as part of the Africa Initiative to foster its mission to deal with corporate tax dodging. Tax Transparency Africa has come up with a report on tax avoidance by MNCs and its estimated revenue loss across the member states.[152]

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[151] http://www.oecd.org/tax/significant-progress-made-in-fighting-tax-evasion-and-illicit-financial-flows-in-africa-but-further-efforts-needed-to-support-domestic-revenue-mobilisation.htm last accessed on November 11, 2020

[152] Africa Initiative Progress, Global Forum on Transparency and Exchange of Information for Tax Purposes, Tax Transparency in Africa, (2020)

Chapter Three

Regulatory Framework against Corporate Income Tax Planning in Ethiopia

3.1. Introduction and Context

Ethiopia is the major investment destination for the last decade in East Africa with the ever-increasing surge of foreign direct investment (FDI) and commerce.[153] Ethiopia is recorded as the biggest FDI recipient among East African countries for 2020 as well.[154] The economic liberalization, which is being undertaken in the country, its accession to the World Trade Organization (WTO) which is on the finalization stage, as well as the establishment of the Continental Free Trade Area (CFTA) will make Ethiopia in a fitting position to continue to be one of the investment hubs of Africa.

FDI and revenue mobilization are interrelated. There is no doubt that increased investment by MNCs into a country leads to increased revenue mobilizations as these companies will have to pay taxes, among other things, on the profits that they have generated. It has been revealed that "corporate tax revenue and Foreign Direct Investment (FDI) are two important development finance sources, which are closely linked to the taxation of MNCs".[155] One of the major issues that member states of the Addis Ababa Action Agenda (AAAA) agreed up on was also 'to make sure that all companies, including MNCs, pay taxes to the government of countries where economic activity occurs, and value is created'.[156]

This is mainly so because the biggest public challenge that hinges upon the governments of developing countries is not the money squandered or stolen, but that which is never collected in the first place.[157] Due to the lack of capacity to put in place

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[153] UNCTAD 2020 Report, cited above at note 22

[154] Id, p. 34

[155] Sabine Laudage, "Corporate Tax Revenue, and Foreign Direct Investment: Potential Trade-Offs and How to Address Them", German Development Institute, Working Paper 17/2020, p. 1

[156] Hearson and et al, cited above at note 35, pp. 1-2

[157] The Economist, Taxing times African governments are trying to collect more tax, https://www.economist.com/middle-east-and-africa/2020/01/11/african-governments-are-trying-to-collect-more-tax accessed on November 14020

a strong corporate tax regime and effectively implement the anti-avoidance rules, these developing countries could not collect the taxes due to them by MNCs. Tax planning by MNCs deprive developing countries like Ethiopia of a resource required to combat poverty. It weakens the capacity of the country in addressing the basic needs of its citizens.

As we have seen under chapter two this thesis, corporate tax planning is a global threat, and it is not peculiar to developing countries alone. It is an "epidemic" to use Oxfam's expression,[158] that the world is dealing with. However, although the amount of revenue lost could even be higher in developed countries as a result of these MNCs tax planning, on utility terms, it is developing countries that suffer most as they already have poor capacity on provisions of necessary social services and tax planning by MNCs will simply exacerbate the problem. In this regard, it has become evident that the

> International corporate tax system is outdated, unfair, and will continue to cost developing countries tens of billions of dollars in lost revenue each year unless it is completely overhauled. Tax abuse by multinational corporations increases the tax burden on other taxpayers, violates the corporations' civic obligations, robs developed and developing countries of critical resources to fight poverty and fund public services exacerbates income inequality and increases developing country reliance on foreign assistance.[159]

Therefore, despite an increase in FDI, the sufficiency of correspondingly effective corporate taxation rules which is capable of curtailing tax planning by MNCs in developing countries such as Ethiopia is a pressing issue.[160] In the absence of such safeguarding anti-abuse rules to exercise their legitimate taxing right over these MNCs, the development agenda they have will not be realized. It resulted in MNCs getting undue in jeopardy of the legitimate taxing right of these countries.

In this chapter, we will examine the rules set by Ethiopia to counter corporate income tax planning by MNCs. We shall see the rules under income tax legislations, double tax treaty regime, as well as fiscal incentive regime. Before that however, we will briefly

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[158] Oxfam International, cited above at note 56

[159] Independent Commission for Reforms in International Corporate Taxation (ICRICT), Illicit Financial Flows and Development Financing, (2015), p. 3

[160] Yosef Alemu Gebreegziabher, “Ethiopia Law on Transfer Pricing: A Critical Examination”, Jimma University Journal of Law, Vol. 5 (2013), p. 218

see the share of MNCs in Ethiopia's FDI and the level of corporate income tax dodging in Ethiopia.

3.2. The Share of MNCs in Ethiopia's FDI

MNCs are the major and indeed indispensable facilitators of FDI. MNCs are incorporated or unincorporated enterprises comprising parent enterprises and their foreign affiliates. These affiliates could take the form of subsidiaries, branches, or associates. Foreign direct investment (FDI), on the other hand, is defined as "an investment involving a long-term relationship and reflecting a lasting interest and control by a resident entity in one economy (foreign direct investor or parent enterprise) in an enterprise resident in an economy other than that of the foreign direct investor (FDI enterprise or affiliate enterprise or foreign affiliate".[161] It is clear that the two are interrelated, intertwined, and in an actual sense, they go hand in hand.[162] In other words, there exists an umbilical cord relationship between MNCs and FDI simply because in specific and numeric terms, MNCs account for 95% of total FDI.[163]

There has been a constant increase in MNCs in Ethiopia for the last decades. As the date received from the Ethiopian Investment Commission (EIC) indicated, only from 2014 to 2019, more than 1598 projects were given license out of which 739 are already operational, 558 at the pre-implementation phase and 301 of them are at implementation phase.[164] In doing this research, I have tried to verify the extent of investments made by MNCs from all those investing in Ethiopia, but such data does not exist. The data I managed to secure from the EIC is the extent of general FDIs in Ethiopia by sector and year.[165] Therefore, the writer assumed that given the ample report that more than 95% of the total investments in the world are being undertaken by

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[161] This is a general definition provided by the OECD, Detailed Benchmark Definition of Foreign Direct Investment, third Edition (OECD, 1996), and International Monetary Fund, Balance of Payments Manual, fifth edition (IMF, 1993)

[162] Mohammed Dass and Abdulmajid Jamal, "Multinational Corporation and Foreign Direct Investment: An Implication for the Third World States", Arts, and Social Science Journal, Vol. 9 (5), 2018, pp. 1-2

[163] ibid

[164] Date from Investment Commission obtained on Dec 2020. I am grateful to Eyuel Zelalem, an Investment Expert at EIC for availing me such data.

[165] Interview through phone and email correspondences on 23rd Dec. 2020

MNCs as reported above, the fact could be similar in Ethiopia too. There is also lack of exact data on the share of corporate income tax in revenue of the government.[166]

A given MNC operating in Ethiopia in a certain sector could have its head office, place of effective management, subsidiaries, branches, or offices in other countries. This invites the shifting of profits from Ethiopia, where this company is having real economic activity, to elsewhere for taxation through one of the means we have seen under chapter two of this paper. It can shift its taxable income(profit) from Ethiopia through different tricks. These tricks could steam from the double taxation treaty that the country has signed with countries of investors or from national rules in the income tax proclamation. Tax planning by MNCs, thus, results in a race to the bottom for countries like Ethiopia that has put in place several measures to attract FDI only to have its taxing right infringed and undermined.

3.3. Revenue Effect of Corporate Income Tax Planning in Ethiopia

Tax constitutes a lion's share in the revenue of Ethiopia.[167] Undeniably, Ethiopia has recorded a significant increase in the amount of tax revenues collected in recent years.[168] However, several reports are revealing that Ethiopia continues to lose an enormous amount of revenues due to corporate tax planning. This led to the fact that the country's tax contribution to GDP being around 11.47 percent which is even below the Sub-Saharan average of 16 percent and East African standard (19%) as per the 2016 IMF report.[169]

A report by United Nations Conference on Trade and Development (UNCTAD) in 2015 indicated that Ethiopia is among the victims of corporate tax planning in which it

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166 I have tried to see the revenue shares of MNCs in other African countries, as such, OECD recorded in 2014 that 70% of Rwanda tax base is from MNCs. In Burundi, one company contributes more than 20% of total tax collection. In Nigeria, MNCs represent 88 of total tax base. In Peru, related party's transaction accounts for more than 26% of the GDP. See OECD, Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries, cited above at note 29

167 Workineh Ayenew, "Determinants of Tax Revenue in Ethiopia (Johansen Co-integration Approach)", International Journal of Business, Economics, and Management, Vol.3, No. 6, (2016), pp. 70-72

168 For instance, Ethiopia collected 198.1 Billion Birr (5.5 Billion USD) in the 2018/2019 Fiscal Year, while it managed to collect 233.7 Billion Birr (6.5 Billion USD) in the 2019/2020 Fiscal Year according to a source from the Ministry of Revenue website.

169 International Monetary Fund, cited above at note 18

estimated the total amount avoided by MNCs from developing countries through tax planning to be 100 billion dollars a year.[170] In the same year, 2015, an IMF researcher disagreed with this amount and provided that an amount of close to 213 billion dollars is avoided every year from developing countries as a result of tax planning by multinationals.[171] As one of those developing countries, it seems reasonable that Ethiopia is exposed to corporate income tax abuses by MNCs. Indeed, Sara Dillion already argued that 'In no sense can widespread tax avoidance by corporations be a matter of indifference to the societies in which the corporations operate[172] which simply implies where MNCs are, there exists corporate tax avoidance.

A piece of closer information is disclosed by *The East African,* on December 7, 2020, in which it reported, referring to watchdog organizations such as Tax Justice Network, Public Services International, and Global Alliance for Tax Justice that Ethiopia , Kenya, Burundi, Tanzania, Uganda, South Sudan, and Rwanda together lose 1.2 Billion USD annually as a result of avoidance by MNCs.[173]

The Report estimated that Ethiopia lost 379.5 Million USD of which 362.6 Million USD goes to MNCs and 16.9 Million USD is lost to individuals' offshore tax evasion.[174] It is further noted that Ethiopia's vulnerability to such corporate abuse is linked to outward trade with China, accounting for 10.1 percent risk, Saudi Arabia (9.9 percent), and Kuwait (9.7 percent).[175]

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[170] World Investment Report, (2015), cited above at note 74, p. 200

[171] Ernesto Crivelli, Base Erosion, Profit Shifting, and Developing Countries, as cited by the Guardian, Tax Dodging by Big Firms "robs poor countries of billions of dollars a Year" at https://www.theguardian.com/global-development/2015/jun/02/tax-dodging-big-companies-costs-poor-countries-billions-dollars, visited on Dec 15, 2020

[172] Sara Dillion, "Tax Avoidance, Revenue Starvation and the Age of the Multinational Corporation", Legal Studies (2016), p. 6 Sara regretfully says "There can be no doubt about the fact that wealthy individuals and large corporations are feverishly, and routinely, engaged in an "offshore" quest to avoid the obligation to pay national taxes.1 An entire industry has grown up to serve this desire to avoid paying taxes.2 The fears of a suspicious global public have been confirmed by "LuxLeaks" and the Panama Papers, two contrasting but related windows on the elaborate devices whereby large corporations and wealthy individuals hide their assets and avoid the payment of taxes"

[173] Kennedy Senelwa and Mohamed Issa, Africa Losing 25.7 Billion to fraudsters using tax havens, The East African, December 7, 2020, at https://www.theeastafrican.co.ke/tea/business/east-africa-fraudsters-using-tax-havens-3220952

[174] ibid

[175] ibid

Although the fact that MNCs are taking advantage of the loopholes in Ethiopia's income tax regime is generally confirmed, the figures on amount of revenue lost is not clear. For instance, in sharp contrast to the *East African* Report above, the International Monetary Fund (IMF) reported that Ethiopia lost 1.28 Billion USD in 2013 due to a similar reason.[176] Similarly, in 2017, Tax Justice Network reported that Ethiopia lost 1.1084 Billion USD through profit shifting by MNCs which used different avoidance tricks.[177] The same confusions exist at the global level where the IMF reported the annual amount of revenue lost as a result of tax planning to be 600 Billion USD, while Tax Justice Network and reported the total amount of revenue lost to be 500 Billion USD.[178] The data concerning the revenue lost from Africa as a result of tax planning by MNCs is prone to similar challenges as well. But that Ethiopia is losing an enormous amount of revenue due to such tax planning exercises by MNCs is a matter of consensus.

3.4. Major Rules designed to Counter Corporate Income Tax Planning in Ethiopia

The rules on corporate income tax planning are primarily provided for under the Federal Income Tax Proclamation No. 979/2016. However, the treaty-shopping aspect of tax planning has also a treaty regime and to that extent, it is imperative to examine what the double taxation treaties that Ethiopia has signed with different countries so far have to say. There are also some shreds of evidence that indicate that fiscal incentives granted by the Ethiopian investment regime are serving as a pretext for MNCs for avoiding corporate income taxes. Thus, in this section, a detailed explanation of the two regimes (income tax legislation and double taxation treaty) and a synopsis of the fiscal incentive undeinvestment regime as a tool for tax planning in Ethiopia will be made.

3.4.1. The Federal Income Tax Proclamation

3.4.1.1. Transfer Pricing Rules

We have seen in Chapter two of this paper that transfer pricing is one of the most effective instruments employed by MNCs to avoid paying taxes. In fact, as the OECD deliverables are gradually increasing as far as other tax planning strategies are

[176] Cobham and Jansky, cited above at note 19, p. 230

[177] New Business Ethiopia, cited above at note 20

[178] FACTI, cited above at note 13

concerned, MNCs will perhaps be left with transfer pricing to avoid paying taxes. In an attempt to mitigate this, the income tax proclamation[179] has stated that in cases where the transaction between two related bodies do not reflect what would have been had the transaction taken place between independent entities, the tax authority may make necessary adjustments. Article 79 reads:

> The Authority may in respect of any transaction that is not an arm's length transaction, distribute, apportion, or allocate income, gains, deductions, losses, or tax credits between the parties to the transaction as is necessary to reflect the income, gains, deductions, losses, or credits that would have been realized in an arm's length transaction.

Transfer pricing may, in particular, be used by non-resident companies to reduce the tax due in Ethiopia by one of its subsidiaries or permanent establishment. For instance, a non-resident parent company may supply goods or services to its subsidiary in Ethiopia for a higher price than that would have been had it supplied for an independent company. As the Ethiopian subsidiary has to pay more costs for these goods and services, the tax liability of this subsidiary can be significantly reduced or even go into loss in which case loss carry forward may even be requested. A similar problem could happen concerning the head office of a non-resident taxpayer located outside of Ethiopia and a permanent establishment located in Ethiopia.

To abate this, Ethiopia has introduced the rules of the arm's length principle in 2002. Although the former tax proclamation, which was repealed in 2016,[180] had a provision requiring that transactions between related parties be at arm's length, there was no guidance on how that rule was to be implemented. However, the Ministry of Finance and Economic Cooperation (MOFEC) came up with a more comprehensive Transfer

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[179] Federal Income Tax Proclamation, *Federal Negarit Gazette* Extra-Ordinary Issue Proc. No.979/2016, 22nd Year, No. 104, (August 2016). I will simply refer to this instrument as 'Proclamation' because it called itself as such. Otherwise, it seems to me that the instrument could rather be called an "Income Tax Code" instead of a Proclamation. This is so because unlike its predecessor, which was limited to conventional areas of taxation for income tax purpose, this instrument is a consolidated one, repealing Income Tax Proclamation 286/2002 (along with its amendments), the Mining Income Tax Proclamation No. 53/1993 (along with its amendments), as well as Petroleum Operation Income Tax No. 296/1986 (along with its amendments)

[180] Federal Income Tax Proclamation, 2002, Proc. No. 286 *Federal Negarit Gazette*, 8th Year, No. 34

Pricing Directive in 2015.[181] Although Income Tax Proclamation no. 286/2002, based on which the Directive was issued, has already been repealed and replaced by Income Tax Proclamation No. 979/2016, the Directive is still applicable according to Article 101(6) of the latter proclamation.

Article 4 of this Directive stated 'where a taxpayer engages in a transaction with a related person, the taxpayer shall determine the amount of its taxable income in a manner that is consistent with the arm`s length principle'. It then goes on and states that this amount of taxable income shall align with the arm`s length principle if the conditions of those transactions do not differ from the 'conditions that would have applied between unrelated persons in comparable transactions carried out under comparable circumstances'.[182] Here, the comparability approach is to be employed and the comparison should be made between controlled and uncontrolled transactions.[183] The definition for related persons is already made by Article 4 of the Federal Tax Administration Proclamation.[184] This comparability could be internal (which means a given transaction between related persons will be compared with the transaction one of such parties had with independent party) or external (which means a given transaction will be compared with transaction between independent parties outside of such MNCs).[185] The Directive has borrowed five major actors that need to be taken into account in doing the comparison (entirely taken from OECD Guidelines).
The Directive has also provided for 'Approved Transfer Pricing Methods' and these methods are consistent with the OECD 2010 Guideline that we have seen above. The Directive itself refers to the Guideline under Article 18 when it stated the "OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations are a relevant source of interpretation for this Directive".[186]

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[181] MOFEC, *Transfer Pricing Directive* 43/2015

[182] Id, Article 4

[183] The Directive has defined 'controlled transaction' as a transaction between related parties while 'uncontrolled transaction' as a transaction between unrelated parties.

[184] Federal Tax Administration Proclamation, 2016, Proc. No. 983, *Federal Negarit Gazette*, Extra-Ordinary Issue, 22nd Year, No. 103,

[185] Transfer Pricing Directive, cited above at note 181, Article11

[186] Article 18 of the Directive. Of course, it has also provided that in case of discrepancy, the Directive shall prevail.

Hence, it has been tried to align the gist of this Transfer Pricing Directive with the principles enshrined under the OECD Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations of 2010 (OECD Guidelines). However, the OECD has substantially revised the content of these Guidelines in 2017 while the Directive remained the same and unrevised since issued.[187]

Moreover, the Directive does not contain administrative and/or penal clauses.[188] For instance, Article 15 of the Directive states that 'a taxpayer must have in place contemporaneous documentation that verifies that the conditions in its controlled transactions for the relevant tax year are consistent with the arm's length principle and provide the same to the tax authority within 45 days up on request duly issued onto him by the tax authority'. It is not clear what penalty will follow if he fails to do so. Nigeria also encountered a similar problem as it did not provide for penalty clause under its Transfer Pricing Regulation until it amended it in 2018 where it inserted a provision on penalty for failure to declare or notify.[189] The Nigerian Transfer Pricing Regulation states that 'a connected person shall declare its relationship with all connected persons whether such persons are resident in Nigeria or elsewhere'.[190] Therefore, MNCs operating in Nigeria are obliged to report to the Nigerian Federal Inland Revenue Service (FIRS) of their relationship with any of their related companies/counterparties. Ethiopian Transfer Pricing Directive does not have a similar provision.

Moreover, Article 14 of this Nigerian transfer pricing Directive stipulated that MNCs should, without notice or demand, disclose transactions that are subject to the Regulations which are controlled transactions.[191] However, the Ethiopian Transfer Pricing Directive article 15 states that such disclosure will only be made when the authority made such request in writing and even then, within 45 days of the date of request by the tax authority. This is indeed a serious flaw in the Directive.

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[187] OECD Revised Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (2017, infra-note 236

[188] Although Tax administration proclamation No 983/2016, art 111 has a general provision on tax avoidance penalty, it does not seem to have envisaged such matters.

[189] Public Notice, Income Tax (Transfer Pricing) Regulations, (2018)

[190] ibid

[191] Ibid. Article 13 of this Regulation has already provided that a company has to declare its relationship with any of its related parties within 18 months from the date of incorporation or within 6 months after the end of the Accounting Year.

Malawi also published its new Transfer Pricing Regulation in 2017 (which is exactly similar to ours) but it has inserted a penalty provision in it for failure related to documentation.[192] It is believed that such prudent provision alerts MNCs to make proper declaration and notification to the tax authority.

With all these imperfections, one can still hold that the Directive is still comprehensive enough (in relative terms) to deal with existing transfer pricing matters along with those essential provisions under the income tax proclamation. The problem related to transfer pricing in Ethiopia lies mostly in factors outside of normative issues and pertains to its technicality and lack of necessary infrastructure rather than having rules themselves. The headache is extra-legal, so to speak, factors that are hindering the implementation of them.

For instance, there is no a properly functioning Transfer Pricing Department or Unit at the Ministry of Revenues to properly handle the issue of transfer pricing, according to Mahider Tesfaye, an in-house counsellor at the Ministry of Revenues.[193] There has been an attempt to have such a Unit at the Ministry but has not yet succeeded. This Transfer Pricing Audit Process Unit has less than 6 persons unequipped with the necessary know-how on how transfer pricing even works. Mahider says that the Ministry is in full cognizance of the structural and personal inefficiency of the department as well as the massive revenue loss as a result of such lack of capacity. The Ministry also does not have a tax technology database to trace such matters.

Tariku Adugna also uncovered that this Unit, with the mandate to collect and organize information about MNCs incorporated in Ethiopia and analyse sources of information including from foreign source, has proven itself ineffective in doing so.[194] Since analysing, specifying, and supervising the level of risk involved in the controlled transaction as well as determining whether they align with the rules of arm's length principle require a well-coordinated work, it is hereby argued that Ethiopia is not in a position to effectively implement even the existing transfer pricing rules to the fullest.

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[192] Taxation (Transfer Pricing) Regulations 2017, Government Notice No. 37

[193] Interview on Dec 8, 2020, through email correspondence. I am grateful to Mahider Tesfaye for information.

[194] Tariku Adugna Raya, The Application of Ethiopian Transfer Pricing Rules on Multinational Enterprise: Consistency of the Practice with the Ethiopian Transfer Pricing Rules, (LLM thesis Addis Ababa University, Unpublished, 2019), p. 53

High-Level Panel on Illicit Financial Flows from Africa already reported in 2015 its concern on the absence of a special Unit on transfer pricing in most countries in Africa. It penned its concern as:

We are particularly concerned that only three African countries had transfer pricing units in their internal revenue services. Given the widespread nature of such activities even in developed countries involving well-known companies, we noted that African countries lacking any official monitoring capacity must be very vulnerable to IFFs stemming from transfer mispricing.[195]

3.4.1.2 General Anti Avoidance Rules (GAAR)

It may held that the General Anti Avoidance Rules (GAAR) is one of a newly embraced rule to the 2016 income tax proclamation although the Value Added Tax Proclamation had equivalent clause.[196] These rules are rules which enable the tax authority to scrutinize schemes that are entered into 'for the sole or dominant purpose of enabling tax benefit for one or all of the parties to the scheme'.[197] The requirements that trigger the action of a tax authority under Article 80 are provided under sub-article 1 of the Federal Income Tax Proclamation(FITP). Article 80 of the FITP provided for how the scheme whose main or sole purpose was to gain tax benefit has to be dealt with. The scheme, as per sub-article 4 of Article 80 of the FITP, is to be understood broadly and is not limited to a direct legally enforceable course of actions. It might even include actions that may not be enforceable by legal proceedings as well as a unilateral course of actions.

Second, a person must have obtained a tax benefit in connection to this scheme. Tax benefit for this anti-avoidance purpose is already listed under sub-article 4 of Article 80 and, as such, it includes a reduction in liability of a person to pay tax, a delay in the arising of a liability of a person to pay tax, and any other avoidance of a liability of a person to pay tax. The third requirement that article 80 of the FITP stipulated for, and which seems more subjective, is the 'purpose of the scheme' as can be established given

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[195] ICRICT, cited above at note 159, p. 3

[196] Initially, this rule was adopted by the Value Added Tax Proclamation No. 285/2002 (VATP) in Article 60 with the heading "Schemes for obtaining tax benefits. VAT Proclamation.

[197] This is also including what is commonly called a 'sham transaction' or 'simulation transaction' where the taxpayer presents to the tax authorities a purported transaction, but the legal reality of the transaction is different and in which case the tax will be applied according to the actual legal reality, not the taxpayer's pretended reality. Thurnoni, cited above at note 36, p. 157

the facts. If given the substances of the scheme, 'it would be concluded that a person or one of the persons, who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the person to obtain the tax benefit', sub-article (2) empowers the Authority to determine the liability of such person or 'any other person related to the scheme as if the scheme had not been entered into or carried out'.[198]

In determining a person's tax liability as if the scheme had not been entered into or carried out, sub-article (2) enables the Authority to "rewrite" a transaction by treating particular events as if they did or did not happen at such time or involving such third-party deals. Sub-article (2) also empowers the Authority to make corresponding adjustments to the tax liability of any other person affected by the scheme. For a corresponding adjustment to be made with a person, the person need not be a party to the scheme, it is required only that he/she/it is affected by the scheme.

It has to be noted that unlike specific anti-avoidance rules, a GAAR is intended to apply to all types of transactions and arrangements, all types of taxpayers, all types of taxes including capital gains tax, and all types of payments and receipts. GAAR is a provision of last resort which Ethiopian Ministry of Revenue may claim to strike-down with aggressive tax planning by MNCs in case where the scheme is 'so blatant, artificial or contrived that it is only explicable by the desire to obtain a relevant tax benefit'.[199]

The problem with Ethiopia's GAAR is that the threshold is so high that it may not be able to catch those schemes which have, as one of their reasons, the purpose of obtaining a tax benefit. This is because it says the Authority may only intervene as per Article 80 of the proclamation where the scheme has been entered into for the sole or dominant purpose of enabling that person to obtain a tax benefit. The rules under the MLI for instance provide that such intervention is triggered even where one of the main purposes is to obtain a tax benefit and it does not have to be the sole or dominant reason as such.[200] The 'sole' or 'dominant purpose' tests under the income tax proclamation to deny tax benefit seems an unwarranted threshold.

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[198] Ibid

[199] Waerzeggers Christophe and Cory Hillier, "Introducing a general anti-avoidance rule (GAAR)—Ensuring that a GAAR achieves its purpose," Tax Law IMF Technical Note Legal Department, Vol. 1, No. 1 (2016), P. 1

[200] Article 7 of the Convention reads: Notwithstanding any provisions of a Covered Tax Agreement, a benefit under the Covered Tax Agreement shall not be granted in respect of an item of income or capital if it is reasonable to conclude having regard to all relevant facts and circumstances, that *obtaining that*

Ethiopian GAAR also failed to state the period within which the Ministry of Revenue has to notify the taxpayer of the new adjustment made. Can for example such assessment by the Ministry of Revenue be notified to the taxpayer after 10 years from the year to which the assessment relates? IMF in its sample GAAR, suggested such assessment shall be notified 'within 5 years from the last day of the tax year to which the determination or adjustment relates'.[201]

Finally, it has to be noted that GAAR is not a self-executing rule as many of the rules that we have seen in this paper. Far from that, this rule may only be properly implemented where the Ethiopian Ministry of Revenue is capable enough to decide to decide and make a valid determination. That is why GAAR is not a rule that every country in the world have accepted. IMF stated that the proper application of GAAR could be tedious in countries such as Ethiopia as it challenges 'the capacity of the tax authority to appropriately apply the GAAR in a measured, even handed and predictable way' adding that sme countries have formed a dedicated GAAR panels for this purpose.[202]

3.4.1.3. Thin Capitalization Rules

Thin capitalization is a common practice by the MNCs to avoid taxes.[203] It involves taking advantage of the mismatches between different tax systems about interest and dividends. Thin capitalization results, as we have discussed under chapter two, when a company is financed more by debt than by equity hence the company is 'thinly capitalized'. These MNCs also try to ensure the lender being in a very low tax rate (because they receive interest income) and the borrower in a country where interest cost can be deducted for income tax purposes.[204] Thus, using advantage of the choice

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benefit was one of the principal purposes of any arrangement or transaction that resulted directly or indirectly in that benefit unless it is established that granting that benefit in these circumstances would be per the object and purpose of the relevant provisions of the Covered Tax Agreement.

[201] Christophe, cited above at note 199, p. 10

[202] Id, p. 1

[203] As details explained under chapter two

[204] Prijohandojo Kristanto, New Capitalization Rules, Feb. 3, 2016, https://www.taxand.com/our-thinking/news/new-thin-capitalization-rules/#:~:text=Thin%20Capitalisation%20refers%20to%20a,_Indonesia's%20new%20Thin%20Capitalisation%20rules, last visited on November 22, 2020

between equity and debt financing as well as the location of debtor and borrower, MNCs shift profits.

Article 47 of the income tax proclamation provides that a foreign-controlled resident company other than a financial institution that has an average debt to equity ratio above 2 to 1 for a tax year is not allowed deduction as far as the excess interest it has paid is concerned. This provision should be understood in line with what has been provided for under Article 23 of the same proclamation which states that interest expenditure concerning loans used to generate business income is deductible. A debt-to-equity ratio of 2 to 1 means that the company uses 2 Birr/dollar debt for every 1 Birr/dollar equity. If a foreign-controlled company working in Ethiopia is financed through debt more than what is stipulated above, it may not be given a deduction benefit as far as that excess interest is concerned.

This Article applies to a foreign-controlled resident company. For that provision, a foreign resident company is defined as a resident company in which more "than 50% of the membership interests in the company are held by a non-resident either alone or together with a related person or persons".[205] An Explanatory note on the Final Draft of the Income-tax proclamation, while it was drafted, has made the following remarks concerning how MNCs take advantage of the thin capitalization in its Article 47 as:

> The advantage arises because interest expense is fully deductible to the subsidiary (the tax value of the deduction is 30%) and taxed at 10% to the non-resident parent under the non-resident tax in Article 51. Thus, the effective rate of the Ethiopian tax rate on the profits derived by the subsidiary and repatriated to the parent as interest is 10%. This can be compared to an equity investment where dividends are paid by the subsidiary out of profits that have been taxed at the corporate rate of 30% and, besides, non-resident tax at the rate of 10% applies to the dividends (i.e., the effective rate of tax on an equity investment is 37%). The differential in tax encourages non-residents to use excessive levels of debt to finance their Ethiopian operations to reduce the level of Ethiopian tax paid.[206]

This guides the non-resident taxpayers on how to finance their operations in Ethiopia. Parent companies tend more often to finance their operations in Ethiopia through debt

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[205] Income Tax Proclamation, cited above at note 179, Article 47(4h)

[206] An Explanatory note on the Final Draft of the Income-tax proclamation, 2016 (with Researcher)

than through equity financing. Therefore, the rule of thin capitalization is crafted to make sure that excessive debts are not employed to take advantage of the tax implications of debt and equity and escape profits untaxed through excessive debts. Hence, Article 47 of the income tax proclamation essentially limits the debt amount that a company may have since it is limited to 2 to 1 of its equity investments.

Finally, it is important to note that although Ethiopia has gone appreciable miles in crafting important rules on thin capitalization to tackle base erosion and profit shifting, these rules have their defects. First of all, we have said that thin capitalization rules determine maximum debt or interest on which deduction is allowed. In tax scholarship, the former is called thin capitalization or indirect interest deduction rule while the latter is called interest deduction rule or direct interest deduction or earning stripping approach.[207] The income tax proclamation provided for thin capitalization or indirect interest rules only and failed to provide for the direct interest deduction and some argued that it should have included that too."[208]

This author argues that Ethiopian thin-capitalization rules should be revised to reflect the amendments made by OECD in its 2015 Final Report. As we have seen in Chapter two of this paper, OECD recommended to limit the ratio of number of interests to be allowed as deductible in relation to the company's total earnings before interest, taxes, depreciation and amortisation. The author argues that recommended ratio by the OECD (which is a ratio of between 10%-30% of the entire earnings) seems reasonable to adopt as the practice of many countries shows as well.

Moreover, Ethiopia's thin capitalization rules have also failed to provide the debt-equity ratio as well as maximum deductible rate when it comes to financial institutions. However, since currently there is no foreign-controlled financial institution in the country, it might be argued that the above limitations are not pressing to render Ethiopia's thin capitalization rules overtly defective.

3.4.2. Ethiopia's DTTs Regime and Tax Planning by MNCs

We have seen under Chapter two of this paper that bilateral tax treaties signed between states have been [ab]used to jeopardize the taxing rights of source countries. Generally,

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[207] Desalegn Deresso Disassa, "Analysis of Interest Deduction Rules Under Ethiopian Corporate Tax System", International Journal of Science, Technology, and Society, Vol. 8. No. 6 (2020), p. 138

[208] Id, p. 147

these (DTTs) have three characteristics that are worth mentioning. First, they limit the rate at which the source state can impose withholding taxes. Second, they also limit what can be subjected to tax, for instance through the (re)definition of permanent establishment, which sets a minimum threshold of activity that must take place in a country before its government can levy a tax on the profits generated there by the taxpayer concerned. Third, tax treaties exempt some types of income earned in the source country from taxation in that country altogether, for example, taxes on capital gains in particular circumstances.[209] Therefore, all these three features of DTTs are a voluntary limit on the source country's taxing right.

Ethiopia's effort to attract FDI includes signing various bilateral DTTs with different countries.[210] So far, Ethiopia has signed these DTTs with different countries including Algeria, Czech Republic, France, India, Israel, Italy, Kuwait, Romania, Russia, South Africa, Tunisia, Turkey and Yemen, the Netherlands, and China. Although the existing literature on the cost of DTTs is very much limited and the estimates vary, it is a commonly shared view that a significant amount of revenue due by MNCs is not being paid due to the DTTs states sign.[211]

Taking after the UN and OECD Model Conventions,[212] most of the DTTs that Ethiopia has signed (which I have consulted) embodied preemptory provisions on treaty abuse such as Limitations on benefits (LOB), Capital Gains, and permanent establishment (PE) provisions. These DTTs are a verbatim copy of the UN Model Double Taxation Convention between Developed and Developing Countries[213]. In fact, in terms of the gist of these DTTs, they have similar content as well. For instance, if we consider the DTTs signed between Ethiopia and the Netherlands on the one hand, and Ethiopia and

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[209] UNCTAD 2020, cited above at note 22

[210] Aschalew Ashagre, "A Note on Resolution of Tax Disputes Arising from DTTs and Implications for Developing Countries", Mizan Law Review, Vol. 13, No. 3 (2019), p. 513

[211] Petr Jansky and Marek Sedivy, "Estimating the Revenue Costs of Tax Treaties in Developing Countries", The World Economy, Vol. 42, No. 6, (2019), p. 2. See also Oxfam Case Study, Cursed by Design: How the Uganda-Netherlands Tax Agreement is denying Uganda a fair share of oil revenues, (2020), pp.3-4

[212] The OECD has revised this Model Tax in 2017. OECD, "Update to the OECD Model Tax Convention", Fiscal Affairs, November 2017.

[213] United Nations Model Double Taxation Convention between Developed and Developing Countries, Department of Economic & Social Affairs, New York, (2001)

China on the other, we see that they both have 29 Articles which almost entirely correspond to each other with insignificant disparity.

Article 48 of the income tax proclamation also deals with the issues of DTTs. One of the questions answered by the proclamation is the status of such treaties *vis-à-vis* the proclamation itself. It sets the priority rule. As such, sub-article 2 provides that where conflict happens as to the applicability of the terms of the DTTs and the provisions of the proclamation, in principle, the treaty shall prevail.[214] However, is also stipulated that as far as part eight of the proclamation (those dealing with tax avoidance) are concerned, the proclamation prevails over the DTTs. [215]

Moreover, the provision on the priority of DTTs over the proclamation is also limited by conditions provided for under sub-article 3. Accordingly, it provides that any exemption, reduction of tax rates, or exclusion that is accorded according to DTTs may only be claimed by a resident of the other contracting state. Moreover, it even adds that to be qualified to be a resident of that contracting state, at least fifty percent of underlying ownership shall belong to the individual(s) who are residents of that other contracting state who shall be on doing active business there. This is a wise rule to avoid treaty-shopping as we have seen in the preceding Chapter. Had it not been for this rule, MNCs that do not have any business relationship in another contracting state with Ethiopia will simply do their business through that contracting states to benefit from the privileges that DTT might accord. These DTTs Ethiopia signed with different countries also provide for their definition of resident.

These DTTs signed between Ethiopia and different countries have their problem which will help MNCs in engaging in tax planning. The major drawback in these DTTs, however, is that they have excessively reduced the applicable rates on dividends, interests, as well as royalty payments. In most of the cases, the applicable tax rate for these passive income under these DTTs is a maximum of 5%. This seems disadvantageous to Ethiopia. It also goes counter to what is provided for in the UN Model Convention on Taxes on Income and Capital of 2017. This Model Convention

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[214] This also ignites the debate on the status of treaties generally under Ethiopia's hierarchy of laws. Article 9(4) of the FDRE Constitution states that "All international agreements ratified by Ethiopia are an integral part of the law of the land". The position of human rights treaties seems to be at least equal to the Constitution as has been enunciated under Article 13 (2). However, much debate is there when it comes to non-human rights treaties such as that of DTTs that we are considering.

[215] Income Tax Proclamation, cited above at note 179, Article 48(2)

suggested a 15% tax rate, (Article 10, save for special exception provided) on dividends, 10% tax rate on interest (Article 11) although it did not suggest any definitive tax rate applicable to royalties (Article 12).

Although empirical data is lacking, some studies revealed that Ethiopia and many other African countries are losing revenue due to the low tax rate applicable to dividends, interests, and royalties.[216] Some studies show DTTs do not benefit low-income countries like Ethiopia anyway.[217] These DTTs simply ensure that the income of investors is not opened to double taxation and also shield the MNCs from being taxed in the country where they have real economic activities.

The DTTs signed by Ethiopia with different countries have a defective provision with regards to the permanent establishment as well. MNCs do their businesses in Ethiopia through permanent establishment while they will be a resident elsewhere and it is crucial to carefully craft a permanent establishment clause. In this regard Action, 6 and 7 of the OECD 2015 Action Plan calls for a revision to the definition of permanent establishment to prevent abuses.[218] It also reminds countries to take care in replacing arrangements under which the local subsidiary traditionally acted as a distributor by "commissionaire arrangements" with a resulting shift of profits out of the country where they have real economic activities without significant substantive change in the functions performed. The basic reason of such commissionaire arrangement is to make sure that income of non-resident company is not subject to tax. Let us see this by example.

Suppose A is a company resident in the State X, and it specializes in the sale of medical equipment's and products. Suppose further that until 2020, these equipment's and products were sold to the State Y by another company called company B both of which belong to the same multinational group. As of 2021 however, the two companies (A and B) agreed to change the status of company B to commissioner following the conclusion of commissionaire contract. Hence, company B will transfer

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[216] Jansky and Sedivy cited above at note 211, p. 1. Petr states that Ethiopia is one of those "developing countries in the ActionAid tax treaty dataset where there is no available IMF CDIS data about stocks."

[217] A report to the G-20 Development Working Group by the IMF, OECD, UN and World Bank, Options for Low-Income Countries' Effective and Efficient Use of Tax Incentives for Investment, (2015), p. 1

[218]

all of its fixed assets and stocks to company A and agreed to sell these products in its own name but for the benefit and at the risk of company A. Then, in this situation, company A had a permanent establishment in Ethiopia before 2020 and therefore had taxable presence on its profits but because of such commissionaire arrangement, the only tax that company B would have to pay is tax on its commission fee.

Through this arrangement, MNCs shift their profits through commissioner arrangements which are not considered as a permanent establishment under these DTTs. A similar problem is reflected in the DTTs signed by Ethiopia with different countries. For instance, Article 5(6) of *Ethio-China* DTT states:

> 'Enterprise of a Contracting State shall not be deemed to have a permanent establishment in the other Contracting State merely because it carries on business in that other State through a broker, general commission agent or any other agent of an independent status, provided that such persons are acting in the ordinary course of their business'.[219]

Last, but not least, the way the title and preamble of those DTTs are crafted have their problem. The title of all DTTs that Ethiopia has signed says "…for the avoidance of double taxation and prevention of fiscal evasion". However, OECD in its amended Model Convention in 2017 suggested that this kind of conventional stipulation in the DTTs is defective. It suggested that it should clearly state that the purpose of DTTs is not only to avoid double taxation but also to avoid double non-taxation or reduced taxation.[220] This purpose of DTTs should have been clearly stated in the title and preambular provisions as they, under Article 31(2) of the Vienna Convention on the Law of Treaties, form part of the main context of the DTTs.

[219] Agreement between the Government of People's Republic of China and the Government of the Federal Democratic Republic of Ethiopia, Ethiopia-China Avoidance of Double Taxation and Prevention of Fiscal Evasion with Respects to Taxes on Income

[220] Article 6 of MLI states: a covered tax agreement shall be modified to include the following preamble text; "Intending to eliminate double taxation with respect to taxes covered by this agreement without creating opportunities for non-taxation or reduced taxation through tax evasion or avoidance (including through treaty-shopping arrangements aimed at obtaining reliefs provided in this agreement for the indirect benefit of residents of third jurisdictions".

3.4.3. Fiscal incentive scheme and tax planning by MNCs

Ethiopia's investment regime offers a generous and extended incentive for foreigners. The maximum 9 years exemption period provided for in Regulation No. 270/2012[221] was amended in 2014 to even increase the incentives to 15 years for some sectors.[222] The country has also come up with a new investment proclamation very recently, proclamation No. 1180/2020.[223] Although generally, section six of the proclamation provided for a general framework of available investment incentives, it stated under Article 17 that details of such investment incentives will be determined by regulation to be issued following the adoption of the proclamation. Accordingly, the Council of Ministers has adopted Regulation No. 474/2020.[224] However, article 20/21 of the regulation indicated that provisions of the old regulation on investment incentives shall remain in force until repealed by another law. Therefore, as far as the investment incentives are concerned, the income tax exemption package ranging up to 15 years is still applicable. Thus, MNCs investing in Ethiopia will be entitled to a tax holiday of up to 15 years depending on the sector in which and place where it is investing.

Although the core rationale behind granting such extended income tax holidays seems to attract FDI, studies show that there is no such positive correlation between investment incentives and an increase in FDI. Atakilti and Yohannes have argued, after examining existing literature on the matte declared that the existing literature shows inconclusive evidence between the two.[225]

They concluded that eevidence from cross-country studies using aggregate-level outcomes show that tax incentives may affect FDI levels but not necessarily a total investment, suggesting the possibility of crowding out effects".[226] Hence, the conception that an increase in fiscal incentives necessarily leads to increased FDI is misguided. Some hold that these tax-breaks and loans so far extended by the

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[221] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers Regulation, 2012, Reg. 270, *Federal Negarit Gazette* 19th Year, No. 4 (2012)

[222] Investment Incentives and Investment Areas Reserved for Domestic Investors Council of Ministers (Amendment) Regulation, 2014, Reg. No. 312, 20th Year, No. 62 (2014)

[223] Eric Neumayer, "Do Double Taxation Treaties Increase Foreign Direct Investment to Developing Countries?" The Journal of Developmental Studies, vol. 43, No. 8 (2007), p.

[224] Council of Ministers Investment Regulation, 2020, Reg. No. 474, *Federal Negarit Gazette* 26th Year, No. 71,

[225] Atakilti and Yohannes, cited above at note 23, p. 8

[226] Ibid

government in pursuit of encouraging investment were simply unproductive.[227] These incentives are, as major international institutions reported, "generally rank low in investment climate surveys in low-income countries, and there are many examples in which they are reported to be redundant; that is, the investment would have been undertaken even without them".[228] A survey made by OECD on whether investors would have invested had this fiscal incentives were not provided indicated that 'over 90 % of investors would have invested even if incentives were not provided'.[229]

These unwarranted tax incentives can create tax-planning opportunities resulting in revenue leakages. OECD reports that existing MNCs reconstitute themselves as "new" ones towards the end of their tax holiday periods so that they can continue to be tax-exempted.[230] They also attempt to re-characterise certain activities so that they fall within the boundaries of qualifying economic activities.[231] Similarly, tax incentives pave opportunities for profits and deductions to be artificially shifted across MNCs with different tax treatments either domestically or internationally.[232]

This is a dilemma that not only Ethiopia, but also similar developing countries are facing. They avail generous tax exemptions and hence forge their taxing right, but they sometimes turn out to be in vain. Tax incentives may be effective in attracting some efficiency-seeking FDIs which are motivated by lowering production costs than for other types of investment.[233] However, many developing countries, including Ethiopia, offer incentives to almost all investors, including those motivated by access to natural resources or the domestic market, who are less likely to respond to incentives. There are scuttlebutts that MNCs operating in Ethiopia are excessively manipulating and abusing these incentives.

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[227] Tewodros Makonnen and James Rockey, "The Effectiveness of Industrial Policy in Developing Countries: Causal Evidence from Ethiopian Manufacturing Firm", Leicester University Department of Economics, Working Paper No. 16/07, p. 1

[228] Report by IMF, OECD, UN and World Bank, cited above at note 217, p. 1

[229] OECD, Report to G20 Development Working Group on the Impact of BEPS in Low Income Countries, cited above at note 29, p. 21

[230] Id, p. 22

[231] ibid

[232] ibid

[233] Maria R. Andersen, "Corporate Tax Incentives and FDI in Developing Countries", Global Investment Competitiveness Report (2018), pp. 73 and 90

Ethiopia should also make sure that these incentives are not being nullified by the tax systems of those company's residence.[234] This is so because even if the host country, Ethiopia for instance, gives such holidays and incentives, but the country of residence of these MNCs apply taxes on worldwide income, and the entire income of Ethiopia's operation, which benefited from such tax holiday is going to be taxed by residence state, it will then nullify the incentives itself. To avoid this situation, there emerged a tax sparing mechanism included in many DTTs between residence and host countries. But study in 2016 disclosed that from OECD member states, Ethiopia only has such agreement only with one member.[235]

Therefore, it is imperative to re-examine to what extent these tax holidays granted are indeed meeting their objectives. Although this requires independent research of a higher scholarship than mine, the Ethiopian government should seriously consider limiting the extent of these tax holidays and work more on other critical concerns of investors including infrastructure, bureaucracy, as well as stability.

3.5. Major Challenges to counter Corporate Income Tax Planning in Ethiopia

The major rules under Ethiopia's income tax regime which are meant to curb corporate income tax planning and the resultant artificial profit shifting by MNCs. What can be transpired from this discussion is that the rules are crafted taking into account the norms in the OECD and United Nations instruments. For instance, the Ethiopian transfer pricing framework corresponds to the OECD 2010 Guidelines. Moreover, the DTTs that Ethiopia has signed with different countries have also been taken from UN and OECD Model Tax Conventions. The same goes for the majority of anti-avoidance rules in the income tax proclamation. However, OECD has made major amendments to its Model Tax Conventions on which those DTTs are based in 2017, and Ethiopian DTTs signed has not benefited from those major amendments made.[236] OECD has also amended its 2010 Transfer Pricing Guidelines while the Ethiopian Transfer Pricing Directive unaltered.

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[234] Dhammika Dharmapala and Céline Azémar, Tax Sparing, FDI, and Foreign aid: Evidence from Territorial Tax Reforms, University of Chicago, Working Paper No. 758 (2016), p. 47

[235] Id, p. 19

[236] Some of the major changes made to OECD Model Tax Conventions pertain to the Title and Preamble of the OECD Model, Article 1 (persons covered), Improper use of the Convention and new Article 29 on Entitlement to benefits, which includes the OECD Model a limitation of benefit (LoB) rule.

The challenges in Ethiopia effectively implement these rules are multiple. On the one hand, although these rules are fair enough, if properly implemented, to deal with tax avoidance, they have defects that will hinder them from bringing the desired result. These can be attributed to the DTTs that extremely limits the taxing power on dividends, interests, and royalty or that which grant unwarranted tax holidays. These can be taken as legal challenges.

Secondly, and most importantly, the techniques that are employed by MNCs in shifting their profits are highly technical and sophisticated. This requires corresponding trained professionals, well-equipped institutions, information technology, to mention only a few. Ethiopia lacks all of these, and in their absence, it is virtually impossible to implement those rules and curtail tax planning by MNCs.

Finally, tax planning is a matter of international taxation whereby cooperation and information exchanges between countries become vital. In this regard, Ethiopia is not a party to any significant international as well as continental initiatives. Ethiopia is not a signatory of the overwhelmingly important Convention on Mutual Administrative Assistance in Tax Matters as we have discussed in Chapter two. So far, more than 141 countries have already signed the Convention, but Ethiopia did not sign yet. The Convention is a major coordination vehicle between states in dealing with corporate tax dodging by MNCs. In this regard, Ethiopia is not a beneficiary as it is not a member state. Ethiopia is also not a participant in Africa Initiative.[237]. The main objective of the Africa Initiative was to unlock the potential of tax transparency and exchange of information for Africa and help Africa tackle tax avoidance and evasion.

[237] http://www.oecd.org/tax/significant-progress-made-in-fighting-tax-evasion-and-illicit-financial-flows-in-africa-but-further-efforts-needed-to-support-domestic-revenue-mobilisation.htm last visited on Nov11, 2020

Chapter Four

Conclusion and Recommendation

4.1. Conclusion

MNCs often use complex, interlocking, and usually very effective devices to shift their profits from where they have real economic activities. The paper has brought up an eye-catching statistic of revenue lost as a result of corporate tax planning globally, in Africa, as well as an overview of the Ethiopian situation.

The paper generally concludes that the international tax system as it stands is distorted and only a few are getting advantage of these distortions. If one closely looks at the matter, there is not even such thing as international tax law. It is simply a coalescence and patchworks of national tax laws supplemented by various bilateral as well as few multilateral tax treaties that we have onboard to regulate international taxation. There is no level-playing field in international taxation indeed. With these distortions among tax jurisdictions, the writer believes that such misery will continue to persist.

The writer argues that to abate such a flaw in international taxation, there has to be a comprehensive and binding (not just model) international tax instrument that is not based on separate entity philosophy for MNCs. This unitary taxation regime will have to consider MNCs as a single entity for tax purposes with one master tax account and answerable to one designated tax authority. Then, a system of profit apportionment between states where they operate has to be devised simultaneously on an agreed formula. The paper argued that this can be a better approach to follow although it might not be able to dispense all the problems.

Amidst these all, the main challenges that Ethiopia faces when it comes to corporate income tax planning is underscored in this paper. Accordingly, it has been found that the country has to react on three fronts. From the legal front, the existing rules inculcated under the Ethiopian income tax regime seems to be faulty. These, at least, include, income tax proclamation, Transfer Pricing Directive, an investment incentive regime, and (DTTs.) The other front is the capacity-building front. The third front is the international coordination and collaboration front.

As far as the first front is concerned, we have already pinpointed the major flaws in those instruments. We have particularly seen how defective the Transfer Pricing Directive 43/2015 is in dealing with corporate income tax planning. This Directive was issued largely in line with the OECD 2010 Guidelines. However, the OECD has substantially revised the content of these Guidelines in 2017 while the Directive remained the same and unrevised since issued. The Directive does not contain a penal provision as well. Moreover, the Directive stipulates that relation with related parties will be communicated to the tax authority upon the request by writing of the latter and even then, within 45 days of such request. In light of the practice in many countries (of which Nigeria and Malawi are mentioned in this paper), it is found that such delay of notification has its problem.

Ethiopia's DTTs regime has a drawback, too. We have particularly seen that the way these treaties define permanent establishment and commissionaire arrangements is faulty and does not benefit the host country Ethiopia. Clauses on commissionaire arrangement in these DTTs are largely taken from the OECD Model Tax Convention of 2010. However, since the definition of the permanent establishment by OECD was found to be faulty and circumvented by the MNCs to avoid paying taxes, the OECD has amended this in its 2017 Model Tax Convention. OECD has also dedicated Action 7 of its 2015 Action plans on Preventing Artificial Avoidance of Permanent Establishment Status. However, the DTTs signed by Ethiopia in line with the 2010 OECD Model Tax Convention is not revised yet.

Finally, from the legal front, fiscal incentives provided to attract FDI are said to be unwarranted and it is found that it is being abused by MNCs. This is a dilemma that not only Ethiopia, but also similar developing countries are facing. Such generous tax holidays provided by the Ethiopian investment regime are being nullified by the resident countries of these companies and a real investment return on those foregone revenues is not clear so far.

The second and perhaps the major front is the capacity-building front. It is found that MNCs often use a set of complex and interlocking mechanism to shift their profits from where they have real economic activities to low tax jurisdiction. Unless there is a corresponding institutional capacity to implement anti-avoidance rules to curb these tax planning practices by MNCs, it is quite impossible to achieve the desired objective. This research has shown how weak Ethiopia is on this front. The paper has taken an example of the fight against transfer (mis)pricing and found that the government is not

equipped well to win the fight. It is discovered that the Transfer Pricing Unit under the Ministry of Revenue is still dysfunctional. It is understaffed and does not have the necessary infrastructure required such as a Database to properly trace transactions.

Thirdly, Ethiopia is behind the international cooperation regime. In this regard, this paper found that Ethiopia has almost nothing to benefit from international cooperation in tackling corporate tax planning. Corporate income tax planning being an international problem, it can only be remedied through a consorted effort with a cooperative spirit to fight it. Therefore, cooperation and information exchanges among countries are vital. In this regard, Ethiopia is not a party to any significant international as well as continental initiatives. Ethiopia is not a signatory of the overwhelmingly important Convention on Mutual Administrative Assistance in Tax Matters. So far, more than 141 countries have already signed the Convention, but Ethiopia has not signed yet. The Convention is a major coordination vehicle among states in dealing with corporate tax dodging by MNCs.

Ethiopia has not ratified the Multilateral Convention to Implement Tax Treaty Related Measures (MLI) to Prevent BEPS as well. This instrument is keen on assisting the countries in amending their DTTs swiftly and add anti-avoidance provisions by MNCs. Ethiopia is also not a participant in continental initiatives such as the Africa Initiative whose main mission is to unlock the potential of tax transparency and exchange of information for Africa. On June 25, 2020, Tax Transparency in Africa 2020 was established as part of the Africa Initiative to foster its mission to deal with corporate tax dodging. Ethiopia is not part of this latter initiative as well.

4.2. Recommendations

Based on the findings of this research, the following are recommended:

- ❖ Generally, Ethiopia should undertake or commission to be undertaken further research of higher scholarship than the current author on the real effect of corporate income tax planning in the country. In doing this research, it has been found that there is no clear data in the country on the portfolio of such tricks employed by MNCs and the amount of revenue foregone.
- ❖ Ethiopia should rigorously boost the implementation capacity of the tax authority and persons working in it. It should in particular have a properly functioning Transfer Pricing Unit of its own that is well equipped with

infrastructure as well as knowhows of corporate tax planning techniques aimed at curbing this problem.

- Ethiopia needs to revise its Transfer Pricing Directive of 2015. This amendment should make it align with the OECD 2017 Transfer Pricing Guidelines. This amendment should also oblige MNCs to report any relation they have with related parties to the tax authority within a specific time by themselves without the need for issuance of a request by the authority. Moreover, this amendment should also have a penalty clause. Monitory mechanism should be included as well to ensure compliance.
- This paper recommends that Ethiopia's thin capitalization rules should be revised to reflect the amendments made by OECD in its 2015 Final Report. OECD recommended to limit the ratio of number of interests to be allowed as deductible in relation to the company's total earnings before interest, taxes, depreciation and amortisation (EBITDA). The author recommends ratio by the OECD (which is a ratio of between 10%-30% of the entire earnings) to be adopted.
- Ethiopia needs to reconsider the DTTs it signed with different countries so far. To facilitate easy renegotiation of DTTs it has signed so far, it needs to ratify the MLI. Ratification of this Convention will make such renegotiation easy. Preambles of these DTTs should be amended and include avoidance of double non-taxation as their objective as well. Provisions relating to tax rates for passive incomes, which in most cases is put a maximum of 5%, and provisions on the residence and permanent establishment should be revised.
- Ethiopia should commission a study on the effectiveness of investment fiscal incentives given by the investment regime so far. It should make sure whether tax holidays ranging up to 15 years granted is indeed paying off or it is simply abused by MNCs and avoid paying taxes.
- Ethiopia must consider signing an overwhelmingly important Convention on Mutual Administrative Assistance in Tax Matters which has been signed by more than 141 countries. This because the Convention is a major coordination vehicle between states in dealing with corporate tax dodging by MNCs.
- Ethiopia should also actively engage in regional, continental as well as international Forums and Initiatives working to fight corporate income tax planning by MNCs.

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