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ADDIS ABABA UNIVERSITY
SCHOOL OF GRADUATE STUDIES
LLM PROGRAM IN BUSINESS LAW

**Business Income Taxation of Foreign Owned Construction
Entities in Ethiopia: Gaps in the International Tax Laws of
Ethiopia and their Enforcement in Practice**

A Thesis Submitted to the School of Law of Addis Ababa University in Partial
Fulfillment of the Requirement for the Master of Laws (LLM) Degree in Business Law

By: Tibebe Zewdu

Advisor: Tadesse Lencho (Phd)

February, 2017

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Examiners: 1. _____

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Declaration

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

Tibebe Zewdu Tegegn

Table of Contents

Contents	Page
Acknowledgments	i
Dedication	ii
Acronyms	iii
<i>Abstract</i>	iv
1. Chapter One: Introduction	
1.1. Background of the Research	1
1.2. Statement of the Problem.....	1
1.3. Research Questions	2
1.4. Research Objectives.....	3
1.5. Research Design and Methodology	3
1.6. Scope and Limitations of the Research.....	4
1.7. Significance of the Research.....	4
1.8. Organization of the Research Paper.....	4
2. Chapter Two: The Concept of International Taxation	
2.1. Meaning, Objectives and Problems of International Taxation	5
2.2. International Taxation Rules.....	8
2.2.1. Domestic Law	8
2.2.1.1. Residence Rules.....	8
2.2.1.2. Source Rules	9
2.2.1.3. Relief from Double Taxation.....	10
2.2.1.4. Anti-Avoidance Rules	11
2.2.1.5. Relationship with Tax Treaties.....	12
2.2.2. Tax Treaties	12
2.2.3. Model Tax Treaties	13
2.2.3.1. The OECD Model Tax Treaty	13
A. Scope.....	14
B. Permanent Establishment.....	14
C. Taxation of Income	16
i. Business Profits - through Permanent Establishment	16
ii. Associated Enterprises - Business Profits through Subsidiaries	17
2.2.3.2. The UN Model Tax Treaty	18
A. Permanent Establishment.....	19
B. Business Profits – through Permanent Establishment	20

C. Associated Enterprises - Business Profits through Subsidiaries	21
2.3.Determination of Profits in the Permanent Establishment Concept	21
2.3.1. Attribution of Income	21
2.3.1.1. Arm’s Length Principle	22
2.3.1.2. Transfer Pricing Methods	23
2.3.1.3. Formulary Apportionment	24
2.3.2. Net-Basis Taxation.....	24
3. Chapter Three: Ethiopian Rules of International Taxation and Deduction of Expenses	
3.1. Ethiopian International Taxation Rules	26
3.1.1. Domestic Tax Law	26
3.1.1.1. Permanent Establishment	26
3.1.1.2. Residence and Source Rules	29
3.1.1.3. Relief from Double Taxation.....	30
3.1.1.4. Anti-Avoidance Rules	31
3.1.1.5. Relationship with Tax Treaties	33
3.1.2. Tax Treaties	33
3.2. Ethiopian Rules on Deduction of Expenses for Business Profits	36
4. Chapter Four: The Practice in Business Income Taxation of Foreign Owned Construction Entities in Ethiopia	
4.1. Forms of Operation of Foreign Owned Construction Entities in Ethiopia	38
4.2. Attribution of Income	40
4.2.1. Income Subject to Tax in Ethiopia.....	40
4.2.2. The PE – Subsidiary Divide.....	45
4.2.3. Application of Tax Treaties	46
4.3. Allocation and Deduction of Expenses.....	48
4.3.1. Payments made by a PE to its Head-office.....	48
4.3.2. Depreciation.....	51
4.3.3. Head Office and Dual Purpose Expenses	52
4.3.4. Interaction of Deductions with Withholding Taxation	54
4.3.5. Transactions between Related Persons and Transfer Pricing	54
5. Chapter Five: Conclusion and Recommendations	
5.1. Conclusion	56
5.2. Recommendations.....	57

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To Christina

Acronyms

C+ or CP – Cost Plus Method

CUP – Comparable Uncontrolled Price Method

DTA – Double Taxation Agreement

EIC – Ethiopian Investment Commission

ERCA – Ethiopian Revenues and Customs Authority

FDRE – Federal Democratic Republic of Ethiopia

FITP – Federal Income Tax Proclamation

FTC – Foreign Tax Credit

HK – Hong Kong

LTO – Large Taxpayers Branch Office of the Ethiopian Revenues and Customs Authority

MoFEC – Ministry of Finance and Economic Cooperation

MoT – Ministry of Trade

OECD – Organization for Economic Cooperation and Development

PE – Permanent Establishment

PLC – Private Limited Company

PSM – Profit Split Method

RPM – Resale Price Method

TNMM – Transactional Net Margin Method

UK – The United Kingdom

UN – United Nations

US – The United States of America

Abstract

The taxation of income in a certain country possesses an international character when either the income subject to tax is derived from a foreign source or the person subject to income tax is a non-resident. The growing presence of multinational enterprises in different countries through their subsidiaries also brings up issues of international taxation. Such internationalization broadens the dimension of income taxation in significant ways making the concept of international taxation complex and subjecting it to profound study worldwide. It however has not received the attention it deserves in Ethiopian legal education and rather seemed ignored for so long by Ethiopian tax legislations and the tax administration.

This history however needs to change instantly for the better if Ethiopia is ever going to fulfill its growing need to attract foreign investment and build a modern and efficient tax administration capable of raising the revenues generated by the economy and preventing and fighting international tax avoidance. The recent introduction of the new Federal Income Tax Proclamation incorporating relatively extensive provisions on international taxation can be seen as one important leap in this regard.

To do its own humble part, this research paper attempts to bring the concept of international taxation to the spotlight by focusing on the issue of business income taxation of foreign owned construction companies in Ethiopia. It first depicts the global understanding of the important concepts present in international taxation and then reviews the rules of Ethiopia governing the matter together with their practical application on the ground. Since most foreign owned construction companies engage in various activities both in Ethiopia and other countries, the research specially focuses on issues surrounding the attribution of income from their activities occurring in different jurisdictions and the allocation of expenses to their Ethiopian businesses.

In so doing, the research shows the important areas where the Ethiopian international taxation rules and the practical determination of the taxable income of foreign owned construction companies fall short of. It then concludes that the gaps existing in the rules and the practice are too significant to be ignored and could lead to failure in realizing Ethiopian tax policy objectives. The research finally recommends some key solutions in order to fill the gaps already identified.

Chapter – One

Introduction

1.1. Background of the Research

In a country that employs both residence and source as a basis for taxation of income such as Ethiopia, residents pay income tax on their world wide income, and non-residents on their in-country income.¹ This brings the concept of international taxation which has its own sets of generally recognized norms such as the single tax (no double taxation), the benefits principle (that active business income should be taxed primarily at source, and passive investment income primarily at residence) and the principle of non discrimination.² A country's tax policy also has its own objectives, which in Ethiopia happen to be forging equity, raising revenue or economic development, attraction of foreign direct investment and modernization of the tax system.³

Taxation of the Ethiopian source income of non-resident businesses thus needs to be prudent enough to balance between such diverse norms and objectives. This is especially important nowadays where the country is on a vigorous growth and transformation path. The advent of membership to the World Trade Organization also opens up doors to foreign owned businesses requiring the existence of a modern and efficient tax system.

The government, cognizant of these facts, has recently revised the income tax laws of Ethiopia which necessitated this research as an attempt to see the gaps of the newly introduced income tax laws and the prevailing practices regarding the administration of international taxation.

1.2. Statement of the Problem

The existence of the delicate need to balance between the norms of international taxation and the general tax policy objectives of Ethiopia complicates the income taxation of foreign owned businesses, especially that of foreign construction companies, which are nowadays playing a significant role in Ethiopia's economy by engaging in large construction works.

¹ See Federal Income Tax Proclamation, 2016, Article 7, Proc. No. 979, *Neg. Gaz.*, year 22, no. 104 [hereinafter Federal Income Tax Proclamation no. 979/2016]

² Reuven S. Avi-Yonah, *International Tax As International Law: An Analysis Of The International Tax Regime* (Cambridge University Press 2007) 2

³ Taddese Lencho, 'Articulating Ethiopia's Current Tax Policy: Sources and Fundamental Objectives' (2014) in Taddese Lencho and Kyle Logue (eds), *The Ethiopian Tax System: Some Contemporary Issues and Problems*, Ethiopian Business Law Series 5, 14

Although the Federal Income Tax Proclamation has remedied some ills of the previous income tax law in treating their activities, there still lingers a significant difficulty in the identification of the taxable Ethiopian source income of these businesses and proper allocation of their expenses.⁴ This is because these companies derive income both from the export of construction materials by the main company abroad and from the provision of services in Ethiopia by the PE or subsidiary. They also incur expenses both in Ethiopia and in their main companies abroad which may both be related or unrelated to the operations in Ethiopia.

Besides these problems, tax treaties broadening the dimension of international taxation rules coupled with the complexity of anti-avoidance rules and the concomitant incapacity of Ethiopia's tax authorities for their proper application are posed as problems on which this research is based.

1.3. Research Questions

Accordingly, this research attempts to answer the following major research questions:

- What is the concept of international taxation in general, its rules in Ethiopian law and what are the loopholes therein?
- What are the globally accepted principles in attribution of income and deduction of expenses in international income taxation and under Ethiopian law?
- How is income being attributed and deduction of expenses being carried out in practice regarding foreign owned construction companies operating in Ethiopia?
- How far is the practice of attribution of income and deduction of expenses regarding foreign owned construction companies operating in Ethiopia in conformity with globally accepted principles and the Ethiopian Income Tax rules?
- What are the major gaps in the international tax laws of Ethiopia and the problems they pose in enforcement of the laws in practice? And finally
- What are the possible solutions towards filling the gaps existing in the Ethiopian international taxation rules and the practice in meeting the expected objectives of the rules?

⁴ See for example Income Tax Proclamation, 2002, Article 5(4), Proc. No. 286, Neg. Gaz., year 8, no. 34 [Now Repealed] [hereinafter, the previous Income Tax Proc. No. 286/2002] where a permanent establishment (PE) was wrongly depicted as a residence concept.

1.4. Research Objectives

The general objective of this research is to bring the issue of international taxation to the spotlight and show the shortcomings of its governing rules and the prevailing practices in Ethiopia. In so doing, it aims at assessing whether the Ethiopian tax authority is collecting the appropriate income tax from the activities of foreign owned construction companies operating in the country. Consequently, the specific objectives of the research are:

- Explaining the concept of international income taxation as it applies in Ethiopian law;
- Showing the accepted standards in determination of taxable income and deduction of expenses for foreign owned businesses operating in a country and probing their treatment in Ethiopian law;
- Showing how income is attributed and deduction of expenses is carried out in practice in the tax administration and weighing it against the law and international best practices; and finally
- Identifying the major gaps in the international tax laws of Ethiopia and their enforcement in practice, and pointing to possible ways of improvement.

1.5. Research Design and Methodology

This research has both doctrinal and non-doctrinal features. Doctrinally, a descriptive inference is made of the Ethiopian legal framework regarding international income taxation with a comparative analysis of global best practices. In the non-doctrinal path, an empirical endeavor is made to see how determination of taxable income is actually carried out in respect of foreign owned construction companies on the ground which is then weighed for conformity against the Ethiopian laws and global best practices.

Member countries of the OECD (Organization for Economic Cooperation and Development) are chosen for analyzing the global best practice for generally having the best experience in taxation. On the other hand, a couple of foreign owned construction companies operating in Ethiopia are chosen for analysis of the practice based on a purposive sampling from the Large Taxpayers Office (LTO) of the Ethiopian Revenues and Customs Authority (ERCA) for enabling to see the major problems in the area. The data collected and the practice reviewed as such are then qualitatively analyzed by accommodating the views of the tax authority and concerned

governmental organs, the perspectives of the relevant companies themselves and renowned audit and consultancy firms practicing in the country.

1.6.Scope and Limitations of the Research

Although the concept of international taxation involves a wide array of specific thematic areas, this research is only focused on the concept of source as a connecting factor for taxation, and at that, only the issue of business income taxation is treated in relation to the Ethiopian international taxation rules. The research is further narrowed down to a sector specific analysis from the perspective of foreign owned construction companies currently operating in Ethiopia in the form of permanent establishments and subsidiaries. The scope is thus narrowed for reasons of financial, time and mostly, space limitations. Absence of related domestic research on the subject was also another noteworthy constraint.

1.7.Significance of the Research

This research is believed to contribute to the effort of reaching at the much aspired knowledge based international tax administration in Ethiopia which undoubtedly will contribute to achievement of the tax policy objectives of the country. In addition to it serving as one of very few reading materials written on issues of international taxation in Ethiopia for anyone interested in the subject, its contribution to further research in such apparently overlooked area will also be paramount. But none of these are as important as the contribution it will make in informing officials of the tax authority and law makers to enable them ponder about the problems existing in their respective areas of expertise and induce them to come up with relevant solutions.

1.8.Organization of the Research Paper

This research paper is comprised of five Chapters. The first chapter introduces the research while the second chapter lays the conceptual foundation for the understanding of international taxation in general and the globally accepted principles in source country determination of taxable income. The third chapter analyzes the Ethiopian rules on taxation of the business income of foreign owned construction companies operating in Ethiopia followed by the fourth chapter in which the practice of determination of their taxable income is examined. The final chapter is where conclusions are made and relevant recommendations given.

Chapter – Two

The Concept of International Taxation

2.1. Meaning, Objectives and Problems of International Taxation

In this thesis, the term “international taxation” is used, for the sake of simplicity, to connote international income taxation and not the other aspects of indirect taxation. Although its name might suggest an international law of some sort, international taxation mainly results from domestic laws of a country dealing with the taxation of income that has an international character. It is well known that states have the sovereignty to tax income having a sufficient level of connection with them. Such connection is sufficiently created either on the relationship of the income (tax object) to the taxing state, commonly known as the source principle, or the relationship of the taxpayer (tax subject) to the taxing state based on residence or nationality.⁵

When subjects of a country (i.e. residents) enter into cross-border transactions with non-residents, or when non-residents enter into cross-border transactions involving that country, a foreign element exists and international taxation comes into the picture. International taxation can therefore be defined as the taxation of income arising from cross-border transactions by residents of a country (i.e. residence taxation) and of income of non-residents arising from cross-border transactions with a country (i.e. source taxation).⁶ It is thus simply the income taxation of cross-border transactions.

One important offshoot of such understanding is that international taxation is not only just the whim of one particular country, but also involves the influence of a plural of them through tax treaties. This is why one writer defined international taxation as that regime which comprises the interaction between the network of tax treaties and the domestic tax systems of countries in order to define “the appropriate level of taxation that should be levied on income from cross-border transactions” and “how the resulting revenues are to be divided among the taxing jurisdictions”.⁷

⁵ Committee of Experts on International Cooperation in Tax Matters, ‘Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties’ (2011) 9, para 1.1, available at <http://www.un.org/esa/ffd/tax/seventhsession/CRP11_Introduction2011.pdf> last accessed on April 13, 2016

⁶ Michael Kobetsky, *International Taxation Of Permanent Establishments: Principles And Policy* (Cambridge University Press 2011) 12

⁷ Avi-Yonah (n 2) 8

Besides the typically obvious justification of raising revenues, the tendency of states to engage in international taxation has other important objectives such as facilitation of international trade and investment and adherence to the principles of neutrality and inter-nation equity.

Neutrality is one objective that states aspire in their tax policies in order to render investment decisions made by residents and non-residents to be based on factors other than considerations of taxation. It takes either of the forms of capital export neutrality (CEN), requiring residents of a country to bear the same tax burden no matter where they choose to invest, or capital import neutrality (CIN) requiring all investments in a given country pay the same rate of tax regardless of the investor's residence.⁸ Although this objective guides international tax rules to some extent, it is too theoretical to be fully applicable by countries.⁹

The objective of inter-nation equity, on the other hand, is about the fair or "equitable sharing of the international tax revenue between two or more countries from cross-border transactions," whether they are developing or developed countries.¹⁰ It generally tries to answer the question of "how to allocate profits [and losses] among multiple states that might make a claim to tax the profits of a company resident in another jurisdiction".¹¹

In endeavoring to meet the above objectives however, international taxation is beset both by the problems of tax avoidance that are common to taxation of income in general and those that are special to its nature arising from the ability of international enterprises to avoid taxation through sophisticated tax planning techniques. In addition to tax planning, transfer-pricing and double taxation and double non-taxation are the major challenges of international taxation.

⁸ David A. Weisbach, 'The Use of Neutralities in International Tax Policy' (2014) Coase-Sandor Institute For Law and Economics Working Thesis No. 697, The University of Chicago 3 available at <<http://www.law.uchicago.edu/Lawecon/index.html>> last accessed on August 30, 2016. *See for a detailed analysis of these terms and other forms of neutralities.*

⁹ *See generally* Michael S. Knoll, 'Reconsidering International Tax Neutrality' (2011) University of Pennsylvania Law School Faculty Scholarship, Thesis 268 available at <http://scholarship.law.upenn.edu/faculty_scholarship/268> last accessed on August 30, 2016

¹⁰ Kobetsky (n 6) 17

¹¹ Kim Brooks, 'Inter-Nation Equity: The Development of an Important but Underappreciated International Tax Value' (2008) in R. Krever and J. Head, *Tax Reform in the 21st Century* (London: Kluwer Law International) 10 available at <<http://ssrn.com/abstract=1292370>> last accessed on September 07 2016

Tax planning is generally understood as the analysis of situations or planning of transactions or other activities in order to reduce tax liability as allowed by tax legislations.¹² International enterprises exploit tax benefits in different jurisdictions in any of the forms of transfer-pricing, thin capitalization, arranging payments to tax havens, double-dipping, or treaty shopping.¹³ When tax planning is made within the law, the effect is tax avoidance or tax minimization and does not constitute a criminal offense. But it would become criminal tax evasion when it goes against the provisions of the law, such as a taxpayer's failure to disclose income, falsely claiming deductions or fabricating accounts.¹⁴

Transfer-pricing, on the other hand, is normally the price at which "related parties" or "associated enterprises" transfer physical goods and intangible property or provide services among themselves.¹⁵ Therefore, it does not necessarily involve tax avoidance.¹⁶ The problem in taxation is when transfer-pricing turns to "transfer-pricing manipulation," which is the intentional setting of a transfer price for a transaction by related enterprises for the purpose of reducing the aggregate tax burden of the company/companies in question, and as such when the tax administration considers this to be "mis-pricing," "incorrect pricing," "unjustified pricing" or non-arm's length pricing.¹⁷

Besides the above problems, double taxation is posed as a problem for international taxation because of its effect in acting as a barrier to international trade by taking either of the forms of economic or juridical double taxation. Economic double taxation occurs when the same income is taxed twice in the hands of two different persons, while juridical double taxation is the situation where the same amount of income is taxed twice in the hands of the same person in two different jurisdictions.¹⁸ Economic double taxation may be caused by transfer-pricing

¹² Committee of Experts on International Cooperation in Tax Matters, 'Note on the Revision of the Manual for Negotiation of Bilateral Tax Treaties' (2011) para 74 <http://www.un.org/esa/ffd/tax/seventhsession/CRP11_Introduction2011.pdf> last accessed on April 13, 2016

¹³ For elaboration of each of these techniques, See Richard J. Vann., 'International Aspects of Income Tax' in Thuronyi, V. (ed.) *Tax Law Design and Drafting, Vol 2*, (International Monetary Fund, 1998) 60-80

¹⁴ Frans Vanistendael 'Legal Framework for Taxation' in Thuronyi, V. (ed.) *Tax Law Design and Drafting, Vol 1*, (International Monetary Fund 1996) 30; see also Kobetsky (n 6) 38-42 for definition of these terms.

¹⁵ OECD, Transfer-pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2010) 19, para 11

¹⁶ See United Nations, Practical Manual on Transfer-pricing for Developing Countries (United Nations 2013) 2 para 1.1.7

¹⁷ Ibid; Kobetsky (n 6) 71

¹⁸ For examples and situations in which each type of double taxation may arise, See Kobetsky (n 6) 44-45

adjustments, while juridical double taxation is caused by the conflicting operation of the diversified residence and source rules of countries.¹⁹ Conversely, double non-taxation often results from calculated tax planning by international enterprises or from pure misinformation on part of countries. There is also a legal and known instance for deliberate double non-taxation based on “tax sparing” agreements.²⁰

The problems of tax avoidance are tackled by anti-avoidance and transfer-pricing rules while double taxation and double non-taxation are usually tackled through the use of tax treaties by employing mechanisms such as mutual consultations and exchange of information between tax authorities of countries.²¹ The next section treats the different rules of international taxation through which its meaning, problems and objectives described above find their statement in law.

2.2.International Taxation Rules

2.2.1. Domestic Law

As international taxation basically emanates from the sovereignty of states to tax income under their jurisdiction, the important rules of the regime are mainly sourced from domestic (tax or non-tax) laws of countries. All nations of the world currently assert their jurisdiction to tax income that is sourced in their territories (territorial or source system) and most of them utilize both the residence and the source principle.²² For this reason, the first issue that any domestic tax law addresses in respect of international taxation is demarcating the reach of a state’s tax jurisdiction by defining the scope of the terms - residence and source.

2.2.1.1.Residence Rules

Whether a person is resident in a particular state is a question of domestic law. The “physical presence rule” (i.e. physical presence in a state for a certain period, usually 183 days of

¹⁹ Ibid

²⁰ See David Holland and Richard J. Vann ‘Income Tax Incentives for Investment’ in Thuronyi, V. (ed.) *Tax Law Design and Drafting, Vol 2*, (International Monetary Fund, 1998)

²¹ See for example Article 7(3) of the OECD Model Convention With Respect To Taxes On Income And On Capital (OECD 2014), where it calls for an appropriate adjustment to the amount of the tax charged on profits of a company by a resident country to the extent necessary to eliminate double taxation when the source country makes adjustments to the profits of the company based on the arm’s length principle.

²² United Nations, Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries (United Nations 2003) 10, para 5; Bolivia, Costa Rica, El Salvador, Guatemala, Hong Kong, Kenya, Malaysia, Nicaragua, Panama, Paraguay, Singapore and Uruguay are jurisdictions that tax on the basis of the source principle alone (i.e. territorial systems).

the year), the “facts-and-circumstances test” (i.e. use of indicators such as location of a person’s abode, fiscal interests, domicile, citizenship, etc) and some objective tests are used independently or together by most states to determine residency of individuals, while place of incorporation and place of effective management are used to determine residency of companies.²³

The United States for example uses the objective test of determining residency for tax purposes if an individual possesses the right to permanent entry to the US (i.e. a green card) alternative to the physical presence rule of staying 183 days or more during the taxable year.²⁴ In addition, the US stands as the only nation that asserts tax jurisdiction based on nationality.²⁵ Canada, Australia, the UK and France also use the physical presence test and require the staying of an individual for 183 days, and some for six months, together with case-by-case tests, while countries like the Netherlands, Sweden, Germany and Japan utilize unique facts and circumstances tests for the determination of residence of individuals.²⁶

With regard to corporations, Australia, Austria, Belgium, Denmark, France, Germany, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain and the UK use both tests of incorporation and place of management or principal head-office, while Finland, Greece, Sweden and the US, use the place of incorporation test as the sole determinant of the residence of a corporation.²⁷

2.2.1.2.Source Rules

Source of income is usually determined for tax purposes on factors such as the location of the assets and the activities that generated the income.²⁸ In determining source this way, business (active) income is usually differentiated from investment (passive) income and net basis taxation is applied to the former (i.e. deductions are allowed to be made to reach at taxable income) while gross basis taxation is applied to the latter by a withholding tax mechanism.²⁹

²³ Ibid

²⁴ Hugh J. Ault and Brian J. Arnold, *Comparative Income Taxation, A Structural Analysis* (Aspen Publishers 2010 3rd ed) 431

²⁵ In the past, a few other States, including Bulgaria, Mexico and the Philippines, have also used citizenship as a basis for taxation. See United Nations, *Manual for the Negotiation of Bilateral Tax Treaties* (n 22) 10, para 8

²⁶ See Ault and Arnold (n 24) 431-434

²⁷ Peter Harris and David Oliver, *International Commercial Tax* (Cambridge University Press 2010) 59

²⁸ United Nations, *Manual for the Negotiation of Bilateral Tax Treaties* (n 22) 9, para 2

²⁹ Ault and Arnold (n 24) 495; In this sense, investment (passive) income is that which is derived from the use of assets, and hence highly mobile, and include capital gains, interest, dividends, rents and royalties, whereas income

In applying net basis taxation to active or business income, some countries usually wait until the activity has a relative permanency (as in having a “permanent establishment”) before taxation, while others simply tax any activity occurring in their jurisdiction. When employing the permanent establishment concept therefore, by definition, a fixed period of time indicating the relative permanency of the activity is usually provided to avoid taxation of intermittent or discontinuous activities.³⁰ As such, domestic law usually provides the conditions for the existence of permanent establishment although this mostly appears in treaties.

Accordingly, the US, Canada and France treat business activities occurring in their jurisdictions with a net basis taxation with their respective case law defining what constitutes a business, while the existence of a permanent establishment is the important factor in the UK (for non-resident corporations), Japan, Netherlands, Sweden and German.³¹ Again, whether only the income derived through that business or also other income derived from other undertakings of the company is to be attributable to it (i.e., a force of attraction rule) is another matter governed by source rules.³²

2.2.1.3. Relief from Double Taxation

Domestic law also provides the method and manner of relief from double taxation if there is any. Such relief is usually granted by a residence country for taxes paid abroad in a source country through methods like a foreign tax credit, an exemption or a deduction system.³³ A deduction system proceeds by treating a paid amount of foreign tax as an expense and as such giving a taxpayer a deduction for the tax paid abroad in the source country in calculating its worldwide income in the residence country. An exemption system simply excludes foreign source income (or of a listed type) from the tax base in the residence country, similar to territorial systems of taxation.³⁴

from the provision of labor or business (i.e. activities) is referred to as active. *See* Harris and Oliver (n 27) 73 & Kobetsky (n 6) 22

³⁰ See the discussion below at section 2.2.3 about conditions of permanent establishment under the OECD and UN Model Tax Conventions.

³¹ Ault and Arnold (n 24) 497-498

³² *Ibid*

³³ Kobetsky (n 6) 43

³⁴ However, an exemption system of relief from double taxation needs to be distinguished from territorial systems of taxation as it is conditional on the fulfillment of certain factors, unlike the latter, and also affects the taxation of other income in terms of progressive rates in the residence country. *See* Vann (n 13) 38

However, since the deduction method only mitigates but does not relieve double taxation (and so, it is against capital export neutrality), and the exemption method clearly affects the revenue of the residence country, the third method of crediting foreign taxes is usually preferred. In the simplest of scenarios, the foreign tax credit system (FTC) first includes the source and the residence country income of the taxpayer in the tax calculation (referred to as “gross-up”) and then subtracts the tax paid in the source country from the tax that would have been paid for the overall income in the residence country.³⁵

Most countries of the world currently employ the above methods together, with varying degrees of the mix. The US mostly employs the FTC with a limited use of the exemption method and gives the taxpayer a choice between crediting and deducting foreign taxes, Japan and Sweden also accord such choice to the taxpayer and use the FTC, the UK predominantly uses FTC with an exemption for foreign dividends, Canada and Germany use a balanced combination of the FTC and the exemption method, the Netherlands primarily uses the exemption method in addition to the FTC, Australia uses FTC for passive income and the exemption method for active foreign income through PEs and France uniquely only allows foreign taxes to be deductible from the tax base.³⁶

2.2.1.4. Anti-Avoidance Rules

As noted above, international taxation tends to increase the possibility of tax avoidance by broadening the dimension for taxation. In response, domestic laws usually provide rules that aim at restricting the ability of international enterprises to avoid tax. Such anti-avoidance rules may be either “specific” that provide a list of prohibited techniques, such as transfer-pricing rules and thin capitalization rules or “general”, that deny taxpayers any tax benefits from illegitimate tax avoidance schemes (i.e. “substance over form” prohibition).³⁷

Most countries with developed tax systems have general and specific anti-avoidance provisions in their domestic laws that apply both domestically and to international transactions. The US has a general substance over form principle that allows the tax authority to re-characterize certain transactions when they are motivated by tax minimization together with developed special

³⁵ See Harris and Oliver (n 27) 266-275 for a detailed analysis of the three methods with examples.

³⁶ See Ault and Arnold (n 24) 446-452

³⁷ Kobetsky (n 6) 40

transfer-pricing rules.³⁸ France employs general anti-avoidance theories and specifically shifts the burden of proof to the taxpayer to prove that payments made to persons in low-tax jurisdictions are not exaggerated and are bona fide.³⁹ Japan and Sweden are unique in this area in not having special anti-avoidance rules in the international area apart from those employed in domestic transactions.⁴⁰

2.2.1.5. Relationship with Tax Treaties

Although it is a matter of constitutional law of countries to determine the hierarchy of domestic law and treaties, it is a common practice to insert a provision granting precedence to tax treaties over inconsistent domestic law into the domestic tax law itself.⁴¹ While France, Canada, Sweden, Australia, the Netherlands and Japan generally give precedence to treaty obligations over domestic tax law with some exceptions, the US, Germany and the UK somewhat place statutory law and treaties on equal status and open the possibility for treaty override by domestic law.⁴²

2.2.2. Tax Treaties

Beside domestic law, tax treaties govern matters of international taxation to a very important degree. The Vienna Convention on the Law of Treaties defines a treaty as “an international agreement concluded between states in written form and governed by international law...whatever its particular designation”.⁴³ Accordingly, tax treaties, are essentially bilateral⁴⁴ international agreements between countries signed to allocate or divide taxing rights over taxpayers and items of income (i.e. cross-border dealings) between them.⁴⁵

The main purpose of tax treaties, as seen from their nickname – “double tax treaties,” “double taxation conventions” or “double taxation agreements” is to prevent double taxation. Secondly, they serve the important purpose of prevention of tax avoidance and evasion through mutual exchange of information. Additionally, tax treaties are important (especially for developing countries with

³⁸ Ault and Arnold (n 24) 527-535, see for similar experiences of Canada, Germany, UK, Australia and Netherlands.

³⁹ Ibid

⁴⁰ Ibid

⁴¹ Vann (n 13) 10

⁴² See Ault and Arnold (n 24) 540-542

⁴³ Vienna Convention on the Law of Treaties of 23 May 1969, United Nations, *Treaty Series*, vol. 1155, art 2(1)(a)

⁴⁴ It is submitted that the Nordic agreement involving Denmark, Finland, Iceland, Norway, Sweden and the Faeroe Islands is the only successful multilateral tax treaty. See United Nations, Manual for the Negotiation of Bilateral Tax Treaties (n 22) 3, para 10

⁴⁵ Kobetsky (n 6) 44

nascent tax systems) to attract foreign investment by showing investors that the country subscribes to international norms in taxation, such as non-discrimination.⁴⁶

The General Rule of Interpretation of treaties in Article 31 of the Vienna Convention that requires the literal terms of a treaty to be interpreted in the context of its purpose, and Article 32 allowing the use of Supplementary means of Interpretation are very relevant in tax treaty interpretation in opening the door for the use of Model Tax Treaties and their accompanying commentaries in tax treaty interpretation.⁴⁷

2.2.3. Model Tax Treaties

There are currently thousands of tax treaties around the world, whose structure, with even the numbering of the articles, is largely said to be similar mainly because of being based on certain “models.”⁴⁸ These are model treaties which are not binding but are meant to serve as general guidelines for countries in negotiating tax treaties and facilitating their interpretation and practical application.⁴⁹ They were first developed by the efforts of the League of Nations in 1928 and pursued in the Organization for European Economic Co-operation (OEEC), and subsequently developed by the OECD and the UN.⁵⁰ Some developed countries such as the US, Sweden and the Netherlands also have their own model treaty, while countries like the UK, Japan, France, Canada and Australia do not have a published model treaty and generally follow the OECD model with the exception of the last two countries whose treaty policy differ from the OECD model convention.⁵¹ This thesis will deal with the OECD and UN Model Tax Treaties.

2.2.3.1. The OECD Model Tax Treaty

The OECD is an international organization composed of 35 developed nations of the world established in 1961 “in order to contribute to the development of the world economy.”⁵² It developed a draft double tax convention in 1963 and kept on publishing updates of a model tax

⁴⁶ Vann (n 13) 8

⁴⁷ Harris and Oliver (n 27) 34; *See also* Ault and Arnold (n 24) 543-545 for the practice of tax treaty interpretation among selected countries.

⁴⁸ Vann (n 13) 7

⁴⁹ United Nations, *United Nations Model Tax Convention Between Developed and Developing Countries* (United Nations 2011) ix, para 12

⁵⁰ Timothy J. Goodspeed and Ann Dryden Witte, ‘International Taxation’ (1999), 261 available at <<http://encyclo.findlaw.com/6080book.pdf>> last accessed on August 30, 2016

⁵¹ *See* Ault and Arnold (n 24) 550-552

⁵² *See* <<http://www.oecd.org/about/membersandpartners/#d.en.194378>> last accessed on November 14, 2016

treaty for more than ten times until the present.⁵³ The latest version is the 2014 “OECD Model Tax Convention on Income and on Capital.”⁵⁴ This model has an accompanying detailed commentary for each article which is an important interpretation material although it is not a legally binding instrument.⁵⁵

The OECD model has 31 articles that describe its scope on persons and taxes covered, define important terms, set rules to what extent each of the two contracting states may tax income and capital and how international juridical double taxation is to be eliminated, with special provisions on mutual arrangements and final provisions on entry into force and termination. This thesis only treats provisions having direct link with business income taxation of foreign owned businesses.

A. Scope

The OECD model restricts its application only to “persons who are residents of one or both of the Contracting States” by defining the term “Resident” in Article 4.⁵⁶ Here, as residence is primarily to be defined by domestic law, a person might end up having double or no residence because most countries adopt different and multiple tests of residence.⁵⁷ For the problem of dual residency, the OECD model provides for “tiebreaker rules” in Article 4(2) (for individuals) and 4(3) (for companies). For individuals, the series of the tests of permanent home, the individual’s vital interests, habitual abode, nationality and finally mutual agreement of the competent authorities of the treaty countries are used sequentially in a progressive manner if any of the previous tests does not resolve the issue. The place of effective management is used as a tiebreaker for companies where there is residence in both contracting states.

B. Permanent Establishment

Permanent Establishment (PE) is defined in tax treaties for determining if a source country has taxing rights over business profits derived by activities in the source state of an enterprise

⁵³ See Kobetsky (n 6) 154-159 for a complete history of the OECD model.

⁵⁴ OECD, *Model Tax Convention on Income and on Capital 2014 (Full Version)*, (OECD Publishing 2015) available at <<http://dx.doi.org/10.1787/9789264239081-en>> last accessed on September 18, 2016 [hereinafter OECD, Model Tax Convention of 2014]

⁵⁵ OECD, Model Tax Convention of 2014, Introduction, para 29; Ault and Arnold (n 24) 543; Kobetsky (n 6) 162-168

⁵⁶ OECD, Model Tax Convention of 2014, Article 1 and 4

⁵⁷ See Harris and Oliver (n 27) 65 for a rare example of a case where an entity ends up with no country of residence

resident in another country.⁵⁸ The OECD model defines PE under Article 5 as “a fixed place of business through which the business of an enterprise is wholly or partly carried on” and specifically lists some activities as examples constituting a PE and some that do not constitute a PE (also known as preparatory and auxiliary activities).⁵⁹

The phrase “a fixed place of business...” in the above general definition is the first test for the existence of a PE which requires there being a facility such as premises, machinery, equipment or simply a space at a distinct place with a certain degree of permanence.⁶⁰ However, clear cut time duration is not set by the commentary. It only states the practice of many countries where a PE is normally deemed to exist only where a business had been carried on in a country through a place of business that was maintained for at least 6 months.⁶¹

Here, since “a place of business” is understood as any space for the carrying out of activities, a question may be raised as to whether a subsidiary would constitute a PE of its parent. Article 5(7) of the OECD Model provides in this regard that a parent-subsidary relationship in itself does not constitute a PE, even if the business of the subsidiary is managed by the parent.⁶² However, a subsidiary may become a PE of the parent in two situations.⁶³ One is under Article 5(1), if a subsidiary provides a space constituting a “fixed place of business” for the parent and second is under Article 5(5), if the subsidiary has, and habitually exercises, an authority to conclude contracts in the name of the parent (unless in the ordinary course of its business as an independent agent).

A “building site or construction or installation project” is the only activity in the definition where duration of time, of 12 months, is mentioned for the existence of a PE. Here, the 12 months period is counted from the date on which any preparatory work is begun, such as “installing a planning office for the construction,” until the work is completed or permanently abandoned with “seasonal or other temporary interruptions” included.⁶⁴ Continuous relocation of the activities of a construction or installation project as the project progresses, which is inherent in such

⁵⁸ Kobetsky (n 6) 182

⁵⁹ OECD, Model Tax Convention of 2014, Article 5

⁶⁰ OECD, Model Tax Convention of 2014, Commentary on Article 5, para 2

⁶¹ OECD, Model Tax Convention of 2014, Commentary on Article 5, para 6

⁶² See OECD, Model Tax Convention of 2014, Commentary on Article 5, para 40

⁶³ See OECD, Model Tax Convention of 2014, Commentary on Article 5, paras 4, 5, 6, 32, 33, 34 and especially 41

⁶⁴ OECD, Model Tax Convention of 2014, Commentary on Article 5, para 19; Here, bad weather and shortage of materials are respectively cited as examples for seasonal and temporary interruptions.

activities, as for example when constructing long distance roads, is immaterial regarding the PE being a single project as far as the project as a whole lasts for 12 months.⁶⁵

C. Taxation of Income

The OECD model follows a schedular approach in classifying the types of income that are subject to taxation in the source country. It has thus different rules for allocation of taxing rights between the treaty countries for income derived from several categories such as business profits, dividends, interest, royalties, etc. in its Articles 6 to 21. Apart from these specific categories of income, the OECD Model generally allocates taxing rights to the country of residence.⁶⁶ This emphasis to residence jurisdiction is there because OECD countries are developed countries which are net exporters of capital.⁶⁷ This thesis only considers the categories of income regulated by Articles 7 and 9 of the OECD model which respectively regulate business income derived by a non-resident person directly in the source country (i.e. through a PE), and business income derived through a subsidiary resident in the source country that is owned by a non-resident.⁶⁸

i. Business Profits – through Permanent Establishment

It is submitted that Article 7 of the OECD model on business profits is one of the most controversial provisions there in for several reasons.⁶⁹ Its sub-article 1 reads:

Profits of an enterprise of a Contracting State shall be taxable only in that State unless the enterprise carries on business in the other Contracting State through a permanent establishment situated therein. If the enterprise carries on business as aforesaid, the profits that are attributable to the permanent establishment in accordance with the provisions of paragraph 2 may be taxed in that other State.

In this provision, the phrase “enterprise of a Contracting State” is defined in Article 3 of the OECD Model as “an enterprise carried on by a resident of a Contracting State,” and the term “enterprise” applies to “the carrying on of any business” which makes “enterprise of a Contracting State” the same with a business carried on by a resident.⁷⁰ This shows the inclination of the OECD Model in giving exclusive taxation right to the residence country for a business

⁶⁵ OECD, Model Tax Convention of 2014, Commentary on Article 5, para 20

⁶⁶ See *particularly*, OECD, Model Tax Convention of 2014, Article 21 (1) on ‘Other Income’

⁶⁷ Kobetsky (n 6) 51

⁶⁸ Harris and Oliver (n 27) 120-121

⁶⁹ See OECD, Model Tax Convention of 2014, Commentary on Article 7, paras 3-7

⁷⁰ See OECD, Model Tax Convention of 2014, Article 3 (1) (c) & (d)

carried on by a resident. This exclusive taxation is however limited when such business constitutes a PE as understood in the above discussion. In this case, the Model gives in to a shared taxation right and permits the source country also to tax the profits attributable to the PE based on the “separate enterprise approach” enshrined in Article 7(2). These profits are the “profits that [the PE] might be expected to make...if it were a separate and independent enterprise engaged in the same or similar activities under the same or similar conditions...”⁷¹

Correspondingly, the separate and independent enterprise fiction also applies to deductions for expenses that the PE is expected to have incurred had it been a separate and independent enterprise. In this regard, the OECD Model had a provision (now deleted Article 7(3)) in its previous versions before 2010 with a general deductibility test that used to mandatorily allow the deduction of expenses incurred anywhere “for the purposes of the PE.”⁷² However, this test was abandoned for the difficulties it entailed in the 2010 update of the Model but is still found in tax treaties of countries based on the earlier model.⁷³

Deductibility of expenses is now solely a matter to be determined by domestic law as far as there is no discrimination based on residence, as enshrined under the non-discrimination rule of Article 24(3) of the Model.⁷⁴ Absence of discrimination means that a PE deserves a deduction in its own right for the notional expenses it makes to the head-office for use of the latter’s goods and services just as any other independent company of a state get a deduction for the payments it makes to get the same goods and services in an arm’s length transaction.⁷⁵

ii. Associated Enterprises – Business Profits through Subsidiaries

It goes without saying that a source country has the exclusive right to tax the profits of a resident business that wholly operates in the country based on both the residency and source jurisdictions. Though obvious, this is also provided in the first line of Article 7(1) of the OECD Model as quoted above. A resident business in the source country that is owned or largely controlled by a non-resident, i.e. a subsidiary, is a subject of international taxation for the foreign element it

⁷¹ OECD, Model Tax Convention of 2014, Article 7 (2)

⁷² OECD, Model Tax Convention of 2014, History on Article 7, para 3

⁷³ See OECD, Model Tax Convention of 2014, Commentary on Article 7, para 38 & 40; See also Harris and Oliver (n 27) 159-162 for an analysis of the difficulties this provision entailed including dual purpose expenditures.

⁷⁴ OECD, Model Tax Convention of 2014, Commentary on Article 7, para 30

⁷⁵ See OECD, Model Tax Convention of 2014, Commentary on Article 7, paras 31, 33, 34 & 40

holds (i.e. its non-resident parent). In this regard, Article 9 of the OECD Model treaty entitled “Associated Enterprises” becomes relevant as it applies where “an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State,” i.e., where there is a parent-subsidiary relationship.⁷⁶

This provision allows the source country to adjust the profits of a subsidiary where the latter has entered into a transaction with its non-resident parent “on other than arm’s length terms” (i.e. when the relations are not what would have occurred between “independent enterprises”) and hence its accounts do not show the true taxable profits arising in that state.⁷⁷ Here, the source country is not allowed to adjust the profits of the subsidiary every time there is a transaction with an associated enterprise, but only when “special conditions have been made or imposed between the two enterprises.”⁷⁸ In other words, no adjustment is allowed where the transactions are normal or on arm’s length basis. In short, what Article 9(1) allows is a “transfer-pricing” adjustment as will be discussed in section 2.3.1 below.

The effect of such adjustment may cause economic double taxation (i.e. taxation of the same income in the hands of different persons) to the associated parent and subsidiary enterprises in the subsidiary’s country of residence. This happens when the profits of the subsidiary are revised upwards by the residence country and tax is imposed on an income over which the parent has already paid tax in its own country of residence.⁷⁹ When this happens, Article 9(2) of the OECD Model provides that the other country shall make an appropriate adjustment so as to relieve the double taxation after ascertaining that “the figure of adjusted profits correctly reflects what the profits would have been if the transactions had been at arm’s length.”⁸⁰

2.2.3.2. The UN Model Tax Treaty

The United Nations Model Double Taxation Convention between Developed and Developing Countries⁸¹ (the UN Model) was developed in 1980 to facilitate conclusion of tax treaties between developing countries and between developed and developing countries, as the OECD

⁷⁶ OECD, Model Tax Convention of 2014, Article 9(1)

⁷⁷ OECD, Model Tax Convention of 2014, Commentary on Article 9, para 1

⁷⁸ OECD, Model Tax Convention of 2014, Article 9(1)

⁷⁹ OECD, Model Tax Convention of 2014, Commentary on Article 9, para 5

⁸⁰ OECD, Model Tax Convention of 2014, Commentary on Article 9, para 6

⁸¹ United Nations, *United Nations Model Tax Convention Between Developed and Developing Countries* (United Nations 2011) [hereinafter UN, Model Tax Convention of 2011]

Model represents only the position of developed countries.⁸² The UN Model has gone through several updates since then with the most recent version published in 2011.

The UN Model is substantially similar to the OECD Model, and is in fact based on the latter, with most of the provisions of the OECD Model also reproduced in the UN Model with their accompanying commentaries.⁸³ But there are also some divergences between the two models that make the UN Model of special interest to developing countries. Case in point is the fact that the UN Model generally favors greater source country taxing rights as compared to residence country taxation, unlike the OECD Model as discussed above.⁸⁴ Thus, this section will only treat such divergences of the UN Model as they relate to the major issues of the study through comparison with the corresponding provisions of the OECD Model, because the similar issues are extensively dealt in relation to the OECD Model in the previous section.

A. Permanent Establishment

Article 5 of the UN Model defines a PE similarly with Article 5 of the OECD Model but contains several significant differences. Among these, relevant to this study are:

- i. There being a 6-month test for a building or construction site constituting a PE, rather than the 12-month test under the OECD Model, and expressly extending to “assembly projects”, and “supervisory activities” in connection with building sites, construction, assembly or installation projects.⁸⁵ Regarding the time limit, the Commentary to the UN Model further allows that “in special cases, the 6-month period could be reduced in bilateral negotiations to not less than 3 months”.⁸⁶
- ii. Secondly, a PE results in the UN Model from the furnishing of services by an enterprise through employees or other personnel where such activities continue for a total of more than 183 days in any 12-month period commencing or ending in the fiscal year

⁸² UN, Model Tax Convention of 2011, vii para 8; *See also* Harris and Oliver (n 27) 17

⁸³ *See* UN, Model Tax Convention of 2011, x para 9

⁸⁴ UN, Model Tax Convention of 2011, vi para 3 & ix para 12. Also compare, for example, Article 21 of the UN Model on ‘Other Income’ with its OECD counterpart, where the former has an additional sub-article 3 allowing source country taxation unlike the OECD Model where strict residence taxation is adhered for income not specifically covered by the preceding provisions of the convention.

⁸⁵ UN, Model Tax Convention of 2011, Article 5(3)(a)

⁸⁶ UN, Model Tax Convention of 2011, Commentary on Article 5, 107 para 7

concerned.⁸⁷ This rule does not exist in the OECD Model. It favors developing countries as the provision of services like management and consultancy in developing countries by enterprises of industrialized countries can generate large profits.⁸⁸

- iii. Third, a delivery activity also results in a PE under the UN Model, unlike the OECD Model which includes it in the list of activities not deemed to constitute a PE, while it is not similarly mentioned in the UN Model.⁸⁹ One result of this inclusion is such that a “warehouse” used for any purpose, as far as it fulfills the other requirements of Article 5(1) of for example being a fixed place of business, etc, is a PE.⁹⁰ This is one manifestation of the UN Model being of special importance to developing countries which often wish to broaden the scope of the PE concept to enable them to tax its income.

B. Business Profits – through Permanent Establishment

Article 7 of the UN Model consists of several provisions of Article 7 of the OECD Model with some additional new provisions. One major departure of the UN Model with that of the OECD in relation to business profits is its incorporation of what is called a “Limited Force of Attraction rule” in its Article 7(1). Under the OECD Model, a state may tax profits only from business activities carried on “through” the PE, once a PE is established. But under the UN Model, a PE state is also allowed to tax profits attributable to sales in the PE state of “goods or merchandise of the same or similar kind as those sold through the PE” as well as “other business activities carried on in the PE state of the same or similar kind as those effected through” the PE.⁹¹ This is suitable for developing countries both for broadening the tax base and avoiding administrative problems involved in delineating the activities of a PE.

As explained in the corresponding section above, the OECD Model has deleted its Article 7(3) in relation to deductions, in effect making every notional payment of a PE to its head-office deductible for the PE by extending the arm’s length principle. This is the UN Model’s another

⁸⁷ UN, Model Tax Convention of 2011, Article 5(3)(b)

⁸⁸ UN, Model Tax Convention of 2011, Commentary on Article 5, 108 para 9

⁸⁹ Compare UN, Model Tax Convention of 2011, Article 5(4)(a) and OECD, Model Tax Convention of 2014, Article 5(4)(a) where delivery is included in the latter, as not constituting a PE, but not in the former.

⁹⁰ UN, Model Tax Convention of 2011, Commentary on Article 5, 105 para 4 & 124 para 20-21

⁹¹ UN, Model Tax Convention of 2011, Article 7(3); UN, Model Tax Convention of 2011, Commentary on Article 7, 141 para 4 & 142-143 paras 6-7; See also Harris and Oliver (n 27) 157 & Kobetsky (n 6) 197; Also refer Federal Income Tax Proclamation no. 979/2016, Article 6 (3)(b & C) to see the inclusion of such a rule in attributing profits to a PE.

major departure as it incorporates an Article 7(3) which in principle allows deductions for ordinary executive and general administrative expenses incurred anywhere for the purposes of the PE but goes further and disallows deductions for amounts such as interest and royalties “paid” (other than toward reimbursement of actual expenses) by a PE to its head-office.⁹²

The UN Model also has a room for the use of a Formulary Apportionment in determining the profits attributable to a PE in difference from the 2014 OECD Model which is solely restricted to using the arm’s length principle.⁹³ Such a method differs from an attribution of profits based on the separate enterprise principle under Article 7(2), but this is allowed only in exceptional circumstances where it has been customary in the past in the country concerned to do so and also results “figures of taxable profit that approximate as closely as possible to the figures that would have been produced on a separate accounts basis”.⁹⁴

C. Associated Enterprises – Business Profits through Subsidiaries

Article 9 of the UN Model on Associated enterprises fully reproduces Article 9 of the OECD Model as discussed above, except for adding a third paragraph which restricts the application of Article 9(2) (i.e. which requires a country to make an appropriate adjustment to reflect a change in the transfer price made by a country under Article 9(1)) in cases where there is a final judicial, administrative or other legal ruling that puts one of the enterprises concerned liable to penalty with respect to fraud, gross negligence or willful default in relation to the adjustment of profits under Article 9(1).⁹⁵ In this circumstance, there would be no obligation on the other country to make the correlative adjustment under Article 9(2).⁹⁶

2.3.Determination of Profits in the Permanent Establishment Concept

2.3.1. Attribution of Income

Articles 7 and 9 of both the OECD and UN Model tax treaties provide how income is attributed to a PE and a foreign controlled subsidiary for source country taxation purposes. In this regard,

⁹² UN, Model Tax Convention of 2011, Article 7(3); UN, Model Tax Convention of 2011, Commentary on Article 7, 140-141 para 3

⁹³ UN, Model Tax Convention of 2011, Article 7(4)

⁹⁴ See UN, Model Tax Convention of 2011, Commentary on Article 7, 158-160 para 19

⁹⁵ UN, Model Tax Convention of 2011, Article 9(3)

⁹⁶ UN, Model Tax Convention of 2011, Commentary on Article 9, 175 para 8

the issue of construction works carried on by a PE in a source country is acknowledged as entailing special problems in attribution of profits resulting from the fact that materials and technical services are usually provided to the PE from other parts of the enterprise abroad. In this case, the OECD Model advises one to stick to the principle of Article 7(1) that “profits are attributable to a PE only with respect to activities carried on by the enterprise through that PE” and gives, as an example, the situation where goods are supplied by other parts of the enterprise to the PE. In this case, the profits arising from that supply do not result from the activities carried on through the PE and, therefore, are not attributable to it.⁹⁷

In relation to a foreign controlled subsidiary too, the profits subject to tax are similar to those of normal resident companies with the caveat that the source country is allowed to adjust the profits into such normality where the subsidiary transacted with its non-resident parent on other than arm’s length terms. This leads us to the arm’s length principle.

2.3.1.1. Arm’s Length Principle

Both the OECD and UN Models employ the arm’s length principle for allocating profits to a PE. This involves treating the PE as a separate entity with the rest of the enterprise. A foreign owned subsidiary is also supposed to make arm’s length dealings with its parent. The major aim of the arm’s length principle is seeking to make pricing of transactions between related parties to depend on market forces as it does between independent parties. Its main import is, therefore, its allowance for adjustment of the reported profits of a PE and a foreign owned subsidiary into the profits that they are expected to make had they been separate and independent enterprises transacting with their head-office/parent as independent enterprises.

In this regard, one can notice that there are two steps a source country must pass in order to determine and tax the profits of a PE based on the arm’s length principle. First is identifying the activities of the PE and the transactions carried on through it in order to treat a PE and the rest of the enterprise as if they were separate but associated enterprises (i.e. delineating the activities) and second is determining the arm’s length profits of the PE by quantifying the payments resulting from such transactions using transfer-pricing rules, if necessary.⁹⁸ If the dealings of the

⁹⁷ OECD, Model Tax Convention of 2014, Commentary on Article 7, paras 36 & 37

⁹⁸ Kobetsky (n 6) 287-288; Harris and Oliver (n 27) 153-154; OECD, Model Tax Convention of 2014, Commentary on Article 7, paras 20-22

PE are with complete outsiders, with which no association exists, only the terms of those dealings are considered for profit calculation. Transfer-pricing rules are employed only when the dealings of the PE are either with parts of the same enterprise or with other associated persons.⁹⁹

This is where the Transfer-pricing Guidelines of the OECD¹⁰⁰ and the Practical Manual on Transfer-pricing of the UN¹⁰¹ come in handy although “transfer-pricing regimes are creatures of domestic law”.¹⁰² Once a tax administration recognizes that a taxpayer’s pricing is not arm’s length, it moves to correct this mispricing by comparing the price in such controlled transaction between the associated parties with an uncontrolled transaction between independent parties. This comparison is “at the heart of the application of the arm’s length principle” and is known as a “comparability analysis.”¹⁰³ Rooted in this, the OECD and the UN Transfer-pricing Guidelines similarly authorize the following methods for establishing an arm’s length price.

2.3.1.2. Transfer-pricing Methods

The UN Practical Manual on Transfer-pricing of 2013 focuses on the problems and needs of developing countries and is developed seeking consistency with the 2010 Transfer-pricing Guidelines of the OECD.¹⁰⁴ For this reason, both the UN and OECD transfer-pricing guidelines similarly authorize 5 methods for establishing an arm’s length price which are divided into two categories. The first three, i.e. the comparable uncontrolled price method (CUP), the resale price method (RPM), and the cost plus method (C+ or CP) are called traditional transaction methods, while the other two, i.e. transactional net margin method (TNMM) and profit split method (PSM) are called transactional profit methods or profit-based methods.¹⁰⁵ Each of these methods has its own strengths and weaknesses and the choice of a particular method solely depends on the circumstances of each case.¹⁰⁶

⁹⁹ See OECD, Model Tax Convention of 2014, Commentary on Article 7, para 24

¹⁰⁰ OECD, Transfer-pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2010) [hereinafter OECD, Transfer-pricing Guidelines of 2010]

¹⁰¹ United Nations, Practical Manual on Transfer-pricing for Developing Countries (United Nations 2013) [hereinafter UN, Transfer-pricing Manual of 2013]

¹⁰² UN, Transfer-pricing Manual of 2013, 21, para 1.7.2

¹⁰³ OECD, Transfer-pricing Guidelines of 2010, 33, para 1.6

¹⁰⁴ See UN, Transfer-pricing Manual of 2013, vii

¹⁰⁵ UN, Transfer-pricing Manual of 2013, 195, para 6.1.3

¹⁰⁶ Since the space limitation does not allow such discussion, one is advised to consult UN, Transfer-pricing Manual of 2013, pages 191–257 to fully understand when a particular transfer-pricing method is appropriate and how it is used together with its strengths and weakness with detailed case examples of use for each method.

2.3.1.3. Formulary Apportionment

Formulary apportionment is the other alternative to the arm's length principle for allocating profits from international transactions in which an international enterprise is treated as a unitary and integrated business and its net profit is allocated to each jurisdiction it operates in based on a certain formulary criteria like relative assets or revenues.¹⁰⁷ In the arm's length principle, a PE might turn out to make a profit while the overall enterprise is at a loss, or vice versa, which would not happen in the formulary apportionment approach.¹⁰⁸

As noted above, currently only the UN Model has a room for formulary apportionment, and even that is full of exceptions.¹⁰⁹ However, there is a pervasive argument that the two transactional profit methods noted above (i.e. TNMM and PSM) are a form of formulary apportionment.¹¹⁰ Formulary apportionment is praised for avoiding the problems of transfer-pricing and the separate enterprise fiction, and hence there is a growing academic push towards international tax reform for its inclusion although it has not yet been tested at an international level.¹¹¹

2.3.2. Net Basis Taxation

After attribution of income is completed for tax purposes, deductions for expenses are generally allowed based on the economic connection between the attributed income and the expenditures. As noted above, the UN and the OECD Model tax treaties had similar rules with regard to allocation of expenses until they departed in 2010 when the OECD abandoned its former Article 7(3) and adopted a new Article 7 in which it relied solely on the general separate enterprise approach enshrined in Article 7(2) for allocation of deductions based on domestic law and the principle of non-discrimination (Article 24(3)).¹¹²

Therefore, in the OECD Model, deduction of expenses now rests on the principle that the PE is separate with its owner and any transfer of assets or provision of services by the owner to the PE

¹⁰⁷ Vann (n 13) 61

¹⁰⁸ Harris and Oliver (n 27) 153-154

¹⁰⁹ See Section 2.2.3.2 (B) above.

¹¹⁰ See Kobetsky (n 6) 89-93 and the citations there in for the argument that the two transactional profit methods are in effect formulary apportionment methods in treating associated companies as a unitary business.

¹¹¹ Kobetsky (n 6) 393; See also Commission of the European Communities, *Company Taxation in the Internal Market* (2001) 271 available at <<http://ec.europa.eu/transparency/regdoc/rep/2/2001/EN/2-2001-1681-EN-1-0.Pdf>> last accessed on September 4, 2016

¹¹² See generally Kobetsky (n 6) 179-237 for comparison of former and new Articles 7 of the OECD Model

involving certain expenses would be seen as if the PE is being notionally charged for them in an arm's length relation and therefore treated as the expense of the PE for which it is entitled to get deductions.¹¹³ Accordingly, a notional rent is for example expected to be paid by the PE to its owner where the PE uses the latter's materials (as is done if the dealing was between two arm's length entities), or a notional interest is expected to be paid by the PE to a sum of money injected by the owner, that ought to be characterized as a loan.¹¹⁴ The OECD illustrates this point in light of construction works by a PE in a source country where "overhead expenses related to administrative functions performed by the head-office for the benefit of the PE" will be deducted as notional charges of the PE.¹¹⁵

The UN Model also allows a deduction for expenses made anywhere for the purposes of the PE including executive and general administrative expenses but specifically prohibits a deduction for notional payments by the PE to the head-office by way of royalties, commission or interest, and also conversely does not attribute such payments as income to the PE if they are made by the head-office to the PE.¹¹⁶

However, allowing deductions for expenses made by the head-office for the purposes of the PE is sometimes seen as theoretically inconsistent with the separate enterprise approach, with the question that "if the PE and the head-office are truly treated as separate taxpayers, why should the PE be entitled to deduct such an expense?"¹¹⁷ Also in reality some countries like the UK deny a deduction for dual-purpose expenditures.¹¹⁸ But generally, following treaty practices, the trend in most countries is that all expenses effectively connected with and borne by a PE, whether incurred by it or the head-office abroad on its behalf are deductible except for those notional or "self-charged" expenses for internal payments or transfers by the PE to the head-office such as royalty and interest payments for assets of the head-office used by the PE, and not actually paid or accrued to third parties.¹¹⁹

¹¹³ See OECD, Model Tax Convention of 2014, Commentary on Article 7, paras 31, 33, 34 & 40

¹¹⁴ See OECD, Model Tax Convention of 2014, Commentary on Article 7, para 28

¹¹⁵ OECD, Model Tax Convention of 2014, Commentary on Article 7, para 34

¹¹⁶ UN, Model Tax Convention of 2011, Article 7(3); UN, Model Tax Convention of 2011, Commentary on Article 7, 140-141 para 3

¹¹⁷ Harris and Oliver (n 27) 160

¹¹⁸ Harris and Oliver (n 27) 161

¹¹⁹ See Ault and Arnold (n 24) 502-505. When the expenses are dual purpose (i.e. both for the purposes of the head-office and the PE), they are allocated on a formulary basis based on the appropriate documentation held.

Chapter – Three

Ethiopian Rules of International Taxation and Deduction of Expenses

Based on the foundations laid by the previous chapter for understanding the concept of international income taxation, this chapter explores the domestic and treaty rules of Ethiopia governing the matter with a specific focus on the aspect of determination of the profit of foreign owned construction companies subject to tax in the country. In so doing, it seeks to show the gaps in the laws and their interpretation by the relevant authorities.

3.1.Ethiopian International Taxation Rules

3.1.1. Domestic Law

At the time of conducting this study, the income tax law that is in force in Ethiopia is the Federal Income Tax Proclamation no. 979/2016 (FITP) made effective since July 8, 2016.¹²⁰ This proclamation comprises of rules relevant to international taxation better than all its predecessors both in terms of quality and quantity with inclusion of a separate chapter dedicated for “International Tax” (Chapter 5 of Part 4).¹²¹ This section treats the rules in this proclamation and other domestic laws that are specifically relevant for the study.

3.1.1.1.Permanent Establishment

The first rule relevant to international taxation in the FITP is found at the beginning of the Proclamation where a Permanent Establishment (PE) is defined in Article 4 in a similar way as Article 5 of the UN Model Tax Convention.¹²² Witnessing such similarities tempts one to conclude that the definition of a PE in the Proclamation mirrors the definition given to it in the UN Model. This is true especially when noticing the inclusion of some features that are unique to the UN Model Convention (as opposed to the OECD Model). Such features are: first, “services” constituting a PE when run for a period of 183 days in any one year period (including when

¹²⁰ Federal Income Tax Proclamation, 2016, Proc. No. 979, Neg. Gaz., year 22, No. 104

¹²¹ Although it may be difficult to weigh the quality of one rule over another, comparing accuracy of some concepts could be a starting point for that purpose. See for example, Chapter 1 above for instances where the predecessor of the new income tax proclamation falls short of in this regard, the most manifest being the misunderstanding of Permanent Establishment as a residence concept.

¹²² Compare Federal Income Tax Proclamation No. 979/2016, Article 4 and UN, Model Tax Convention of 2011, Article 5

provided by employees of an enterprise (i.e. an extended-arm rule)).¹²³ Second, there being a more than 183 days test for a building or a construction site (including assembly, installation project and supervisory activities) for constituting a PE.¹²⁴ Third is the inclusion of “warehouse” in the list of activities specifically mentioned as constituting a PE.¹²⁵ Fourthly, the inclusion of a limited force of attraction rule is another one of such features as is discussed in the next subsection.

Notwithstanding such a striking similarity, the FITP does not incorporate certain important sub-articles in the provision defining a PE as a distinguishing feature from both the UN and OECD Model Treaties. The first absentee is a provision that would specifically list those activities not deemed to constitute a PE (i.e. auxiliary activities).¹²⁶ This could have been helpful for avoiding unnecessary quarrel between taxpayers and the tax authority over the treatment of some activities as PEs. The reason why the proclamation avoided such a provision is not clear especially when witnessing that it used to appear in its predecessor, the repealed Income Tax Proclamation.¹²⁷

The legal experts at the Ministry of Finance and Economic Cooperation (MoFEC) who participated in the drafting of the FITP have disclosed that this was made deliberately to broaden the number and type of activities deemed as PEs in Ethiopia.¹²⁸ Ato Birhanu said that as a developing country, it is in Ethiopia’s best interest to broaden the scope of the term PE.¹²⁹ It was also the view of the legal department of the Ethiopian Revenues and Customs Authority (ERCA) that even though auxiliary activities are not listed in the FITP, it is not that much difficult to differentiate activities not constituting a PE by exclusion from the definition.¹³⁰ Ato Belete specifically raised an example of a foreign company who solely uses its facilities in Ethiopia for purposes of display of merchandize, as in exhibitions. He rightly indicated that such activity was

¹²³ Federal Income Tax Proclamation No. 979/2016, Article 4(2)(c); *See also* UN, Model Tax Convention of 2011, Article 5(3)(b) for an almost verbatim provision.

¹²⁴ Federal Income Tax Proclamation No. 979/2016, Article 4(3); *See* UN, Model Tax Convention of 2011, Article 5(3)(a) for an almost verbatim provision except for the time duration being 6-months rather than 183 days.

¹²⁵ Federal Income Tax Proclamation No. 979/2016, Article 4(2)(a); although ‘warehouse’ does not appear in the same list in the UN Model, a delivery activity resulting in a PE for not being mentioned in the list of activities not deemed to constitute a PE in Article 5(4)(a) of the model warrants the inclusion of a ‘warehouse’ as an activity constituting a PE in the UN Model. *See* the discussion in Section 2.2.3.2(A) under Chapter 2 above.

¹²⁶ *See* UN, Model Tax Convention of 2011, Article 5(4)(a) and OECD, Model Tax Convention of 2014, Article 5(4)(a)

¹²⁷ *See* the previous Income Tax Proc. No. 286/2002, Article 2(9)(b)

¹²⁸ Interview with Ato Birhanu Taddese, Senior Legal Expert at MoFEC (MoFEC, December 13, 2016)

¹²⁹ *Ibid*

¹³⁰ Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

one of the auxiliary activities in the previous income tax proclamation¹³¹, and held that the same activity would not attract a PE in the FITP as far as there is no sale by the company of the items displayed at the exhibition. He added that a sale in exhibitions is prohibited by Customs law because goods brought for this purpose are imported only temporarily, but if there is still a sale, that a PE would be attracted and tax will be paid. However, he admitted that without the withholding tax scheme incorporating these activities, it would be unfeasible to tax them as they are not registered as taxpayers and would be very difficult to identify their income for taxation.¹³²

But what the law and the authorities seem to overlook in this regard is the fact that it is specifically because it is impracticable, and more importantly undesirable, to tax such intermittent activities that the concept of a PE has been developed in the first place for source country taxation purposes, as noted in chapter 2 above.

Secondly, it would have been better if there was a sub-article in Article 4 of the FITP providing that a parent-subsidiary relationship does not constitute a PE in itself, as the UN and OECD Models do and as used to appear in the FITP's predecessor.¹³³ In the absence of such a provision, there remains a chance for a subsidiary to be mistakenly taken as a PE of its parent without it engaging in activities that would make it fall in the normal definition given for a PE.

In this regard, the view of legal experts at MoFEC is that the avoidance of such a provision might be a drafting problem, but held that it is not that much relevant whether such sub-article is included or not because first, it is more of theoretical and a very rare instance that a subsidiary becomes a PE, and second, it is easy to differentiate between a subsidiary and a PE as a subsidiary is independent and always an Ethiopian resident.¹³⁴ However, differentiating between a subsidiary and a PE is not as easy as suggested and the problem has also actually happened in practice as will be discussed in the next chapter.¹³⁵

¹³¹ See Article 2(9)(b)(i) of the previous Income Tax Proc. No. 286/2002

¹³² Ibid

¹³³ See UN, Model Tax Convention of 2011, Article 5(8); OECD, Model Tax Convention of 2014, Article 5(7); and Article 2(9)(e) of the previous Income Tax Proc. No. 286/2002

¹³⁴ Interview with Ato Bochu Sintayehu and Ato Birhanu Taddese, Senior Legal Experts at MoFEC (MoFEC, December 13, 2016)

¹³⁵ See the discussion under section 2.2.3.1(B) in Chapter 2 above and section 4.2.2 in Chapter 4 below.

Furthermore, such differentiation is crucial because the effects in taxation of income derived from the two entities are very much different. One consequence is the fact that a limited force of attraction rule is applied when a foreign enterprise engages in a business activity through a PE in Ethiopia, while that does not apply in case of a subsidiary. This brings a more burdensome tax liability to a foreign enterprise engaged in a business through a PE as the income from the provision of the same or similar goods and services by it will be attributed to the PE even if not directly made by the latter.

3.1.1.2. Residence and Source Rules

The other important rules of international taxation found in the FITP are the Residence and Source rules.¹³⁶ An individual is Ethiopian resident when he “has a domicile in Ethiopia,” or “is a citizen of Ethiopia who is a consular, diplomatic, or similar official posted abroad,” or “is present in Ethiopia, continuously or intermittently, for more than 183 days in a one-year period,” while incorporation or being formed in Ethiopia or having a place of effective management in Ethiopia makes a “body” an Ethiopian resident.¹³⁷

Because the tax laws do not afford their own definition of “domicile”, consulting the Civil Code is important in which domicile is understood as “the place where [a] person has established the principal seat of his business and of his interests, with the intention of living there permanently.”¹³⁸ So it can be said that both the physical presence rule and the facts-and-circumstances test for the determination of residence are employed in Ethiopian law.

With regard to source, the FITP in principle makes all business income derived by a resident an Ethiopian source income.¹³⁹ For a non-resident, the business income derived by its PE in Ethiopia is an Ethiopian source income in addition to the income derived from the same or similar activities as those engaged by such PE even if not made directly by the PE (i.e. a limited force of attraction rule).¹⁴⁰ Legal experts at MoFEC expressed that it is difficult to put the determination of what is meant by “same or similar” in the Proclamation because it needs to be

¹³⁶ Federal Income Tax Proclamation No. 979/2016, Articles 5 and 6

¹³⁷ See Federal Income Tax Proclamation No. 979/2016, Article 5

¹³⁸ See Civil Code of the Empire of Ethiopia, 1960, Article 183 - ff, Proclamation No. 165, Neg. Gaz., Year 19, No. 2

¹³⁹ See Federal Income Tax Proclamation No. 979/2016, Article 6(2)

¹⁴⁰ See Federal Income Tax Proclamation No. 979/2016, Article 6(3); A limited force of attraction rule is also a feature similar to the UN Model Tax Convention. See the discussion in Section 2.2.3.2(A) under Chapter 2 above.

determined on a case by case basis, or employing the advance ruling mechanism newly incorporated in Part 11 of the Tax Administration Proclamation when appropriate.¹⁴¹

3.1.1.3. Relief from Double Taxation

Among the three methods of relieving double taxation noted above, the Ethiopian law recognizes the foreign tax credit (FTC) method as provided under Article 45 of the FITP. Unlike other jurisdictions, it is not clear whether the deduction and exemption methods are given a residual place in Ethiopian law for relieving other types of foreign taxes paid which are not deemed “income tax” under the provision, as the FTC applies only for “income taxes” paid abroad.¹⁴²

In addition, the FTC rule in the FITP does not have a provision covering the issue of multiple foreign taxes paid in different countries, unlike its predecessor, which used to incorporate a “per-country limitation” rule.¹⁴³ The absence of such rule may defeat the limited crediting rule in Article 45(1) by enabling taxpayers to credit excess foreign taxes (i.e. greater than the Ethiopian tax payable on the foreign income) by averaging them with another foreign tax which is lesser than the Ethiopian tax payable in respect of the foreign income. Or it may at least create a ground for disagreement between taxpayers and the tax authority.

Business losses incurred in a foreign country are also allowed to be deductible in the FITP, but only against foreign income, by carrying the losses forward up to 5 years.¹⁴⁴ Here too, there is no provision, unlike the FITP’s predecessor,¹⁴⁵ that makes it clear as to whether such foreign loss is to be treated with a “per country limitation” rule. That is, the prohibition placed by Article 46(1) (especially the Amharic version) is only against deducting foreign losses against Ethiopian source income, and not against foreign income from another, third, foreign country. This is another gap in the FITP which might breed uncertainty in the tax administration and become a source for disagreement between the tax authority and taxpayers.

¹⁴¹ Interview with Ato Birhanu Taddese, Senior Legal Expert at MoFEC (MoFEC, December 13, 2016)

¹⁴² See the definition given for “foreign income tax” in Federal Income Tax Proclamation No. 979/2016, Article 45(6)(b). But it should be noted that the payment of taxes other than income tax or recoverable value added tax in a foreign country is not listed as a non-deductible expense unlike the latter two in Article 27(1)(h) of the FITP, thus leaving the door open for its deductibility.

¹⁴³ See Article 7(4) of the previous Income Tax Proc. No. 286/2002

¹⁴⁴ Federal Income Tax Proclamation No. 979/2016, Article 46(1 - 3)

¹⁴⁵ See Article 7(3) of the previous Income Tax Proc. No. 286/2002

As regards the absence of a per-country limitation rule in Articles 45 and 46, both experts interviewed at MoFEC simply admitted that it is probably an overlooked issue and nothing other than a drafting problem.¹⁴⁶ However, the head of ERCA’s legal services department opined that the absence of such a rule is not that much of a headache for Ethiopia mainly because the tax-rate in Ethiopia is less than most other countries and it is currently rare that an Ethiopian resident invests in a foreign country let alone in a plural of them.¹⁴⁷

3.1.1.4. Anti-Avoidance Rules

The first anti-avoidance rule provided in the FITP is the Thin Capitalization rule of Article 47. This rule denies the deductibility of an interest payment by a non-financial subsidiary or PE in Ethiopia having in excess of a 2 to 1 average debt to average equity ratio in a tax year as far as its debt exceeds an arm’s length amount.¹⁴⁸ This is to prohibit the paying out of what is actually a non-deductible dividend payment in a disguise of a deductible interest.

The other anti-avoidance rules in the FITP appear in Articles 78, 79 and 80. Article 78 prohibits the splitting of income between related parties made in view of lowering the total tax payable by either party, with related parties as defined in the Tax Administration Proclamation.¹⁴⁹

The transfer-pricing rule appearing in Article 79 allows the tax authority to adjust any non-arm’s length transaction between two parties into market-like conditions. There is also an obligation laid on taxpayers to report details of transactions made with related persons during a tax year with their tax declaration, at the pain of a Birr 100,000 administrative penalty.¹⁵⁰ This provision together with “a Directive issued by the Minister” applies both for domestic and international transactions.¹⁵¹

However, the provision not being restricted only to transactions made between related persons is confusing, not only because transfer-pricing is an issue innately linked with related parties, but

¹⁴⁶ Interview with Ato Bochu Sintayehu and Ato Birhanu Taddese, Senior Legal Experts at MoFEC (MoFEC, December 13, 2016)

¹⁴⁷ Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

¹⁴⁸ See Federal Income Tax Proclamation No. 979/2016, Article 46(1- 3)

¹⁴⁹ See Federal Income Tax Proclamation No. 979/2016, Article 2 *cumulatively with* Federal Tax Administration Proclamation, 2016, Article 4, Proc. No. 983, Neg. Gaz., year 22, No. 103 [hereinafter Federal Tax Administration Proclamation No. 983/2016]

¹⁵⁰ Federal Tax Administration Proclamation No. 983/2016, Article 114(6)

¹⁵¹ See Federal Income Tax Proclamation No. 979/2016, Articles 79(2- 4)

also “when independent parties transact with each other, their commercial and financial relations are ordinarily determined by market forces.”¹⁵² This can be seen where both the UN and OECD Model Tax Conventions and even the predecessor of the FITP allow transfer-pricing adjustments only for transactions made between related parties.¹⁵³

In this regard, one legal expert at MoFEC admitted that the transfer-pricing issue is indeed linked with related persons and said that any indication otherwise in Article 79 (1) is a drafting problem by pointing out those provisions like Article 79(3) and (5) where related parties are specifically mentioned as indications of that fact.¹⁵⁴

However, the head of ERCA’s legal services department had a different opinion.¹⁵⁵ For him, Article 79 deliberately avoided the application of the transfer-pricing provision only for related persons because the problem of transfer mispricing could also happen between purely unrelated persons for other motivations such as avoiding withholding taxation duties by splitting certain transactions in to amounts not subject to withholding taxation.¹⁵⁶ This is why, according to Ato Belete, that the Tax Administration Proclamation included a rule for “fair market value,” for the purposes of the transfer-pricing rule of the FITP, in which fair market value was defined primarily not in relation to a comparable transaction between unrelated persons, but in relation to an ordinary open market value at the time and place in question.¹⁵⁷

But subjecting unrelated persons to transfer-pricing rules as suggested does not seem to be the spirit of the FITP. This is because of the inherent understanding of the transfer-pricing concept as discussed in chapter 2 above and as incorporated in the transfer-pricing directive mentioned by Article 79 of the FITP. This directive was issued by MoFEC and came into force since October 12, 2015, as per Article 29 of the previous Income Tax Proclamation.¹⁵⁸ The scope of this

¹⁵² OECD, Transfer-pricing Guidelines for Multinational Enterprises and Tax Administrations (OECD 2010) 19, para 1.2

¹⁵³ See UN, Model Tax Convention of 2011, Article 9; OECD, Model Tax Convention of 2014, Article 9; and the previous Income Tax Proc. No. 286/2002, Article 29

¹⁵⁴ Interview with Ato Birhanu Taddese, Senior Legal Expert at MoFEC (MoFEC, December 13, 2016)

¹⁵⁵ Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

¹⁵⁶ Only the supply, in one transaction, of goods involving more than 10,000 Birr, and services involving more than 3,000 Birr are subject to withholding taxation in Ethiopia. See Federal Income Tax Proclamation No. 979/2016, Article 92(1)

¹⁵⁷ See Federal Tax Administration Proclamation No. 983/2016, Article 3

¹⁵⁸ የገንዘብና ኢኮኖሚ ልማት ሚኒስትር ‘በማስተላለፊያ ዋጋ የሚደረግ ግብይትን ለመከላከል የወጣ መመሪያ ቁጥር 43/2007’ (unpublished) (in Amharic) [hereinafter Transfer-pricing Directive No. 43/2007]

directive is set to be applicable for the pricing of international and domestic transactions between “related” persons (and not any two (independent) parties).¹⁵⁹ Again, since the directive indicates that it highly relied on the OECD Transfer-pricing Guidelines and even accepts it as a relevant source of interpretation,¹⁶⁰ it is highly tempting to conclude that the transfer-pricing rule in the FITP is intended to be applicable only for transactions between related persons. For determining arm’s length prices, the directive uses the 5 transfer-pricing methods mentioned in chapter 2.¹⁶¹

Other than the above “specific” anti-avoidance rules, the FITP also incorporates a “general” anti-avoidance rule in Article 80 where the tax authority is allowed to conduct a substance-over-form analysis and reverse any tax-avoidance scheme.

3.1.1.5. Relationship with Tax Treaties

Even though the Ethiopian Constitution equates the status of treaties with proclamations¹⁶², Article 48 of the FITP makes tax treaties to prevail over the domestic tax law whenever there is conflict.¹⁶³ This is in accordance with international practices as noted in Chapter 2 above.

3.1.2. Tax Treaties

Besides the above domestic rules for the governance of matters of international taxation, Ethiopia has signed and is currently negotiating quite a number of tax treaties, also known as double taxation agreements (DTAs). Based on the data from MoFEC, as of 21, January, 2016, Ethiopia has signed and ratified tax treaties with 18 countries, signed but not yet ratified tax treaties with another 10 countries, completed negotiation with 7 other countries, is under negotiation with other 15 countries, and has exchanged interest for negotiation with 8 other countries.¹⁶⁴ But this data of the MoFEC is not up to date and only shows the status of Ethiopian DTAs until 21, January, 2016. Those DTAs listed in the following table from No. 19 up to 24 are ratified after such date. At the time of writing up this research therefore, countries having a

¹⁵⁹ Transfer-pricing Directive No. 43/2007, Article 3

¹⁶⁰ See Transfer-pricing Directive No. 43/2007, Preamble and Article 18

¹⁶¹ See Transfer-pricing Directive No. 43/2007, Article 6 and the discussion in Chapter two under section 2.3.1.2

¹⁶² The Constitution of the Federal Democratic Republic of Ethiopia, 1995, Article 9(4), Proc. No. 1, Neg. Gaz., year 1, No. 1 [hereinafter FDRE Constitution]

¹⁶³ Federal Income Tax Proclamation No. 979/2016, Article 48(2)

¹⁶⁴ Ministry of Finance and Economic Cooperation, DTAA Status Table, last updated on 21 Jan, 2016 (unpublished)

signed and ratified DTA with Ethiopia are 24 as depicted in the following table with their ratification proclamations.

No.	Country Having a signed and ratified DTA with Ethiopia	Ethiopian DTA Ratification Proclamation Number
1	Kuwait	92/1997
2	Italy	95/1998
3	Russian Federation	223/2000
4	Yemen	296/2002
5	South Africa	479/2005
6	Turkey	480/2005
7	Romania	486/2006
8	Israel	505/2006
9	Algeria	507/2006
10	Tunisia	508/2006
11	French Republic	584/2008
12	Czech Republic	585/2008
13	Sudan	747/2012
14	India	748/2012
15	China	749/2012
16	Egypt	750/2012
17	Seychelles	773/2012
18	The United Kingdom of Great Britain and Northern Ireland	774/2012
19	Kingdom of Saudi Arabia	947/2016
20	Portuguese Republic	948/2016
21	People's Republic of Korea	949/2016
22	Ireland	950/2016
23	United Arab Emirates	951/2016
24	Kingdom of Netherlands	952/2016

Table 1: Countries that Ethiopia has signed and ratified tax treaties with up to Jan, 2017

However, ratification of a treaty in the parliament does not in itself make a tax treaty effective according to a legal expert in MoFEC.¹⁶⁵ He said that practically, it is only when the instrument of ratification is exchanged with the treaty partner that the treaty is fully effective in both countries.¹⁶⁶ Accordingly, it is only the tax treaty of Ethiopia with 8 countries, i.e. Italy, Egypt, India, Sudan, China, French Republic, Turkey and The United Kingdom of Great Britain and

¹⁶⁵ Interview with Ato Birhanu Taddese, Senior Legal Expert at MoFEC (MoFEC, December 13, 2016)

¹⁶⁶ Ibid

Northern Ireland, that is effective in Ethiopia as of 21 January 2016, because exchange of the ratification instrument is made only with such countries.¹⁶⁷

According to the legal expert in charge of treaty negotiation in the MoFEC, these tax treaties are not signed based on a uniform model tax treaty.¹⁶⁸ Ato Bochu said that one cannot find a tax treaty signed purely based on one model. Rather, the OECD model, the UN model, and the South-African-Development-Community (SADC) and East-African-Economic-Community (EAEC) Model Tax Treaties are all used as inputs for the negotiation. He disclosed that the Ethiopian tax treaty negotiation team always prepares a model representing Ethiopia's primary interests by updating new principles from all available model tax treaties, and therefore, it cannot be said that Ethiopia subscribes to a particular model for negotiating its tax treaties.¹⁶⁹

However, getting access to the texts of these treaties for treatment in this study has proved to be a difficult task to the researcher. For one, the ratification proclamations in Ethiopia themselves do not incorporate the text of the treaties. Second, MoFEC as the organ empowered to implement the treaties by the ratification proclamations is not ready to grant official access to them for an unofficially stated reason of confidentiality.¹⁷⁰ The researcher has however managed, with a great difficulty, to access copies of Article 7 of the Ethio-Turkish and Ethio-Chinese DTAs from an anonymous source and confirmed that both DTAs are modeled after an earlier version of the OECD Model Tax Treaty which is largely similar to the version discussed above.

But one could not pass without noting that confidentiality is a seriously questionable ground for denial of access to DTAs considering that tax treaties ought to have been public documents once they are ratified by parliament as a manifestation of the constitutional rule of transparency. This is one gap in Ethiopian tax administration that may preclude officers of the tax authority from fair assessment of the tax liability of taxpayers and incapacitates taxpayers from asserting their legal rights incorporated in tax treaties. This is because the international tax rules found in the domestic tax laws are themselves overwhelmed by significant gaps and problems which could really use supplementation by tax treaties.

¹⁶⁷ Ministry of Finance and Economic Cooperation, DTAA Status Table, last updated on 21 Jan, 2016 (unpublished)

¹⁶⁸ Interview with Ato Bochu Sintayehu, Senior Legal Expert at MoFEC (MoFEC, December 13, 2016)

¹⁶⁹ Ibid

¹⁷⁰ The double taxation agreement between Ethiopia and China is found at the official website of ERCA, but only the draft version is uploaded.

3.2.Ethiopian Rules on Deduction of Expenses for Business Profits

The FITP generally allows deductions for any expenditure “necessarily incurred by the taxpayer during the year in deriving, securing, and maintaining amounts included in business income.”¹⁷¹ The term “necessarily” in this provision is a new addition to the FITP which did not exist in its predecessor.¹⁷² Legal experts at MoFEC expressed that this inclusion was necessitated because of past experiences where there used to be cases of claiming deductions for expenses not having a “*sine qua non*” connection with the business.¹⁷³ The head of the legal services department at ERCA also supported this view by saying that the term “necessarily” is a deliberate inclusion made to enable the tax authority weigh the “relevance” and the “actual incurrence” of a particular expense claimed for deduction by a taxpayer.¹⁷⁴

Apart from the above general rule, there are also other expenditures specifically allowed as deductions by the FITP including interest payments for a loan, donations, depreciation allowance and business losses subject to specific procedures and limitations.¹⁷⁵ For long term contracts, in which most construction contracts fall in, the FITP allows taxpayers to claim deductions for their expenditures based on the percentage of the contract completed during the year, and in some cases to carry their losses backward to a previous tax year.¹⁷⁶

However, the FITP does not put any clear limits to deductions for certain payments made by PEs or subsidiaries to their foreign affiliates or to expenses incurred by the head office for the purposes of the PE. One might be disappointed for expecting to find such a limitation in Article 27 of the FITP that provides for non-deductible expenses when noticing that most of the international tax rules in the FITP are similar with those of the UN Model Convention which denies deductions for notional payments made by a PE by way of interests, royalties and other payments such as management or commission fees in its Article 7(3).¹⁷⁷

¹⁷¹ Federal Income Tax Proclamation No. 979/2016, Article 22(1)(a)

¹⁷² See Article 20 of the previous Income Tax Proc. No. 286/2002

¹⁷³ Interview with Ato Bochu Sintayehu and Ato Birhanu Taddese, Senior Legal Experts at MoFEC (MoFEC, December 13, 2016)

¹⁷⁴ Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

¹⁷⁵ See Federal Income Tax Proclamation No. 979/2016, Articles 22(1)(b - d) & 23 - 26

¹⁷⁶ Federal Income Tax Proclamation No. 979/2016, Article 32

¹⁷⁷ See section 2.3.2 in chapter 2 above.

In this regard Ato Birhanu is of the view that the general rule of deduction in Article 22(1)(a) is limitation enough to disallow deductions to expenses made by the head office or other notional payments made by the PE to its head-office because this provision only allows deductions for actual expenses made by the PE or subsidiary itself.¹⁷⁸ The anti-avoidance rules such as the thin-capitalization rule discussed above are also limitations to deductibility of expenses. With these rules in mind, the next chapter assesses their practical implementation on the ground.

¹⁷⁸ Interview with Ato Birhanu Taddese, Senior Legal Expert at MoFEC (MoFEC, December 13, 2016)

Chapter – Four

The Practice in Business Income Taxation of Foreign Owned Construction Entities in Ethiopia

The FITP is a newly enacted income tax law with significant changes from its predecessor especially in the international tax regime.¹⁷⁹ For this reason, this chapter examines the practical application of the regime before the coming in to effect of the FITP for putting the application of the FITP in to perspective. Since the study focuses on taxation of the business profits of foreign owned construction entities in Ethiopia, the chapter begins by inspecting the major business forms in which these companies currently operate in the country, for this has its own bearing in their taxation.

4.1. Forms of Operation of Foreign Owned Construction Entities in Ethiopia

The Ethiopian investment law provides that any foreigner needs to obtain an investment permit before carrying out business activities in the country.¹⁸⁰ Such investment may be carried out in any of the forms including a sole proprietorship or a business organization incorporated in Ethiopia or abroad.¹⁸¹ According to a Senior Information Analyst in the Ethiopian Investment Commission (EIC), foreign owned construction entities registered for a permit at the Commission are only Grade-1 contractors and the rest are registered in the respective regional states they carry out their business in.¹⁸² But since all foreign owned construction companies meet the capital ceiling limitation for a Grade-1 contractor status, they are all registered at the EIC.¹⁸³

¹⁷⁹ See Staff Reporter, Interview with, Wollela Abehodie, 'Getting Acquainted with the New Tax Law' *The Reporter* (Addis Ababa, June 18, 2016) <<http://archiveenglish.thereporterethiopia.com/tags/interview?page=10>> last accessed on December 6, 2016

¹⁸⁰ Investment Proclamation, 2012, Article 12(1), Proc. No. 769, *Neg. Gaz.*, year 18, No. 63 [hereinafter Investment Proclamation No. 769/2012]

¹⁸¹ Investment Proclamation No. 769/2012, Article 10(1)

¹⁸² Interview with Ato Samuel Abebe, Senior Information Analyst at EIC (EIC, December 9, 2016)

¹⁸³ Ibid; a foreign investor needs to allocate a minimum capital of 200,000 USD or 150,000 USD (for investing jointly with a domestic investor) for a single investment project. See Investment Proclamation No. 769/2012, Article 10(1)

In this domain, based on the data organized by the EIC, there are in total 401 licensed foreign construction company investments in Ethiopia since March 05, 1993 to October 26, 2016.¹⁸⁴ Among these, 298 are established in the form of private limited companies (PLCs), while 6 are in the form of share companies (SCs) and the remaining 97 are in the form of sole proprietorships.¹⁸⁵ With such business forms, 108 of the investments are branches of foreign companies incorporated in different countries abroad, while the other 293 are incorporated in Ethiopia.¹⁸⁶ The effort made by the researcher to differentiate subsidiaries of foreign parent companies from among these 293 resident construction companies was not fruitful for there was no data organized in this manner at the EIC.¹⁸⁷

Unlike the above construction businesses operating in Ethiopia with a relative permanency, there are foreign construction companies that engage in particular construction projects in the country after winning international bids. These companies are not required to obtain investment permits for that specific project which they carry out through establishing project offices by registering in the Ministry of Trade (MoT), and not at the EIC.¹⁸⁸ However, the data from MoT is general and only shows all foreign companies winning international bids without sector-wise categorization, which made it difficult to determine the number of construction companies having PEs in Ethiopia.¹⁸⁹ But it suffices for the present purpose just to know that foreign owned construction companies also operate via project offices in Ethiopia.

In the context of this study therefore, one can conclude that foreign owned construction companies operate in Ethiopia in various business forms including project offices, branches and subsidiaries. The first two are PEs as per the latter's legal definition. With this in mind, the next section treats the practical assessment of the income of these companies for taxation purposes.

¹⁸⁴ EIC, 'List of Licensed Foreign Construction Company Investment Projects Since March 05, 1993 - October 26, 2016 G.C' (unpublished), available from the information desk at EIC, last accessed on December 9, 2016

¹⁸⁵ Ibid

¹⁸⁶ Ibid

¹⁸⁷ Interview with Ato Samuel Abebe, Senior Information Analyst at EIC (EIC, December 9, 2016)

¹⁸⁸ Interview with Ato Abraham Lemma, Service Sector Projects Facilitation and After Care Team Leader at EIC (EIC, December 12, 2016)

¹⁸⁹ Interview with Ato Mengistu Mergia, Trade Information Collection and Organization Expert at MoT (MoT, December 9, 2016)

4.2. Attribution of Income

Determination of the profits of any company for tax purposes begins by appraising the total income of the business subject to tax in Ethiopia. The next sub-sections treat the issues involved in this process from the practical point of view.

4.2.1. Income Subject to Tax in Ethiopia

Identification of income subject to tax in Ethiopia is the first task the tax authority does in attributing income to a PE because the principle of territorial taxation demands it. According to tax auditors in the tax authority, allocating the income of a PE engaged in construction works has dual faces which may be seen as simple and complicated. The first simpler scenario exists when there is a construction project that only carries out the technical part of the construction in Ethiopia without engaging in the supply of goods used as inputs in the project. In this case, identification of the Ethiopian source income is not a difficult job because the construction companies mostly carry out their works for known clients such as the government or one of its organs like the Ethiopian Roads Authority.¹⁹⁰ An auditor will then simply send a letter to the owner of the project in request of what they have paid to the construction company as a cost for the project and this will constitute the total income of the PE subject to tax in Ethiopia.¹⁹¹

Other than this direct payment received for the construction services carried out by a PE, however, the existence of a supply (export) of goods that will serve as inputs to the construction in Ethiopia by the head office of the PE complicates the process of identification of income.¹⁹² According to Ato Zeleke, most high profile construction projects carried out in Ethiopia involve both the supply (export) of the materials used as inputs in the project from the PE's country of origin and the performance of the actual construction services in Ethiopia, which he called "offshore supply of goods" and "onshore provision of services," respectively.¹⁹³ According to him, the income from both activities is currently attributed to the PE over which tax is to be paid.

¹⁹⁰ Interview with Ato Nebiyu Gedle, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 15, 2016)

¹⁹¹ Ibid

¹⁹² Interview with Ato Zeleke Jambo, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 16, 2016)

¹⁹³ Ibid

For clear understanding of the issue, the income tax assessment of ZTE (H.K) Limited Ethiopian Branch, which is a Chinese company, engaged in “construction of telecommunication sites & production of telecommunication equipments” obtaining an investment license from the EIC in 2009 in the form of a PLC was selected from among the taxpayers at LTO – ERCA.¹⁹⁴

Ato Zeleke, as one of the auditors who participated in the tax assessment of the company, elaborated the process of identification of income in ZTE’s case as follows.¹⁹⁵ The initial agreement that gave rise to the issue was the contractual agreement concluded between Ethio-Telecom and ZTE Corporation (head quartered in Shenzhen, China and specialized in manufacturing of telecom equipments) both for the provision of telecom equipments and installation of telecommunications infrastructure in Ethiopia. On the other hand, the company called ZTE - H.K, a subsidiary of ZTE Corporation based in Honk-Kong and specialized in telecom installation services, was the one that obtained an investment permit in Ethiopia and was found actually carrying out the installation services through its branch.

When it came to the income tax assessment, ERCA required 920 million birr in tax from the company in Ethiopia, as well as interest and penalties for both the offshore supply of goods and the onshore provision of services.¹⁹⁶ According to the auditor in the case, it is the “stand” of the LTO branch office and ERCA as a whole that any construction deal involves the supply of materials plus the provision of services and there is no way for a PE in Ethiopia to be treated as separate from its head-office only for the offshore supply of goods and relieved from paying tax on the income from such activity.¹⁹⁷ He said, however, that had there been no relation between the importer and exporter of the goods, i.e., if the one supplying the goods and the one carrying out the construction were purely separate entities, the income from the export of the goods would not have been taxed in Ethiopia.¹⁹⁸

¹⁹⁴ See EIC, ‘List of Licensed Foreign Construction Company Investment Projects Since March 05, 1993 - October 26, 2016 G.C’ (unpublished), available from the information desk at EIC, last accessed on December 9, 2016

¹⁹⁵ Interview with Ato Zeleke Jambo, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 16, 2016)

¹⁹⁶ Fasika Tadesse, ‘Gov’t Considering to Pull ZTE Off Ethio-telecom Deal’ *Addis Fortune*, Vol 15 No 760 (Addis Ababa, November 23, 2014) < <http://addisfortune.net/articles/govt-considering-to-pull-zte-off-ethio-telecom-deal/>> last accessed on December 16, 2016

¹⁹⁷ Interview with Ato Zeleke Jambo, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 16, 2016)

¹⁹⁸ *Ibid*

Ato Zeleke further disclosed that the tax thus assessed was taken by the taxpayer to the tax review committee and beyond to the ERCA's head office, but the assessment was not reversed. However, after the case was further taken to a ministerial level, he said that a decision was finally given, to the particular case of ZTE and to all similar others in the future, not to include the income from the offshore supply of goods in tax-auditing a PE in Ethiopia, only when the construction contract is a "vendor financing agreement." Ato Zeleke elaborated that a vendor financing agreement is a construction contract in which the head-office of the construction company itself facilitates access to funding from foreign sources. Such was the type of the contract in ZTE's case in which ZTE Corporation facilitated funding for the telecom project from the National Development Bank of China in a loan agreement.¹⁹⁹ ZTE's tax case was then finalized by "administrative measures which reduced the tax by nearly half."²⁰⁰

Only part of this story was however confirmed by the MoFEC's Legal Service Director. According to Ato Wasihun, it was indeed the case that ZTE's tax assessment was reduced due to a decision by the Council of Ministers after involvement by the Chinese Ambassador of the time.²⁰¹ But he said that there was no decision, or any law for that matter, that allowed the differential treatment of "vendor-financing agreements" as such.²⁰² He said that the decision was limited for ZTE's specific case and was made only once, not because the assessment was wrong but, due to an administrative decision which was made in accordance with the power vested to the government by the Income Tax Proclamation to relieve any income from payment of tax.²⁰³

Such an approach is however unacceptable for the finance personnel at the Ethiopian branch of ZTE H.K Limited. According to its local finance manager, there were two agreements that Ethio-telecom made, one a framework agreement with ZTE Corporation incorporating both the equipment and service aspects, and two with ZTE H.K only for the installation services.²⁰⁴ Ato Habtamu said that what ERCA attributed as income to the PE in Ethiopia from the import of the equipments is not right because the Ethiopian branch does not have a license to import goods and

¹⁹⁹ See Brigitte Read, 'The Chinese telecommunications war in Africa' (March 7, 2013) <<http://china-africa-reporting.co.za/2013/03/the-chinese-telecommunications-war-in-africa-2/>> last accessed on December 16, 2016

²⁰⁰ See Fasika Tadesse, Addis Fortune (n 196)

²⁰¹ Interview with Ato Wasihun Abate, Legal Service Directorate Director at MoFEC (MoFEC, January 25, 2017)

²⁰² Ibid

²⁰³ Ibid

²⁰⁴ Interview with Ato Habtamu Abdisa, Local Finance Manager at ZTE H.K Limited Ethiopian Branch (Addis Ababa, December 20, 2016)

even storage space to keep stock. He said that the importer of all the equipments was Ethio-telecom and the Ethiopian branch of ZTE just took the equipments from Ethio-telecom's storage and provided the installation service. He said that to make matters worse, deduction for expenses of the equipments was not even allowed for the Ethiopian branch because the cost of the equipments was not shown in the branch's accounts as its accountants believed that the equipments had nothing to do with the branch based on the second contract made with Ethio-telecom which only involved installation services. What caused this problem, according to Ato Habtamu, is ERCA's tax auditors going to the client, Ethio-telecom, to find out the income of the taxpayer rather than going directly to the taxpayer to determine the actual income it had made through its activities, which was really only the income from the installation services.²⁰⁵

For the external audit firm involved in ZTE's case also, the cause for the problem was the Ethiopian branch of ZTE not writing in its accounts the cost of the equipments as its expenses for the installation service it provided for deduction purposes.²⁰⁶ He said that in the case of Yapi Merkezi PLC Ethiopian branch for instance (which is also his firm's client and the other construction company selected for analysis in this study), the income from both the offshore supply of equipments and the onshore provision of services is aggregated as income of the PE in Ethiopia in the branch's accounts and the cost of the equipments is then fully written as the expense of the branch. This, according to Ato Tibebe, has a net effect of attribution to the Ethiopian branch of the income only from the onshore provision of services because the deduction of the cost of the equipments nullifies the attributed income from their import.²⁰⁷ This was also confirmed by the chief accountant of Yapi Merkezi PLC Ethiopian branch.²⁰⁸

However, the former tax audit directorate director of ERCA believes that this net zeroing effect ultimately hurts the tax revenue of Ethiopia because of the inefficiency of Ethiopia's customs valuation.²⁰⁹ According to Ato Mengistu, without the actual customs value being determined for the imported equipments, the attribution to the PE of the income from both the supply of

²⁰⁵ Ibid

²⁰⁶ Interview with Ato Tibebe Mengistu, Manager at Tibebe Mengistu & Co., Chartered Certified Accountants (UK) and Authorized Auditors (Eth) (Addis Ababa, December 19, 2016)

²⁰⁷ Ibid

²⁰⁸ Interview with Ato Henock Tibebe, Chief Accountant at Yapi Merkezi PLC Ethiopian Branch (Addis Ababa, December 19, 2016)

²⁰⁹ Interview with Ato Mengistu Balcha, Former Tax Audit Directorate Director at ERCA and a current private tax consultant (Addis Ababa, December 21, 2016)

equipments and provision of services (which he believes is right) and then allowing deduction for the cost of the equipments will end up enabling the company to avoid tax by inflating the value of the imported equipment and thus the tax deductions allowed for the PE.

An anonymous consultant at Deloitte Consulting PLC also disclosed that they advise their foreign clients wishing to come to Ethiopia for construction works that it is the stand of Ethiopia's tax authority to attribute the income from both the offshore supply of goods and the onshore provision of services to the PE in Ethiopia.²¹⁰

Ato Habtamu, the local finance manager of ZTE Ethiopian branch, also disclosed that this is the accounting system that his company currently exercises after the tax row with ERCA (discussed above) was concluded.²¹¹ They now write the cost of the imported equipments as expenses of the branch in Ethiopia. But regarding the documentation necessary for expensing the cost of the equipments, he said that they use the copies of the import documents of Ethio-telecom because this is the only alternative as the equipments are not imported in the branch's name.

Therefore, the practice currently standing in Ethiopia shows that the tax authority deems the income from an offshore supply of equipments in construction contracts as a profit derived through a PE in Ethiopia and thus, as an Ethiopian source income. However, this is inconsistent with the separate enterprise approach as discussed in chapter 2 above unless it is argued that the attribution was based on a certain version of a limited force of attraction rule. This is because the separate enterprise approach included in Article 7 of tax treaties (including the Ethio-Chinese DTA which is based on the OECD Model) provides that a country can only tax the income of an enterprise derived through, and attributable to, a PE in that country and that profits made by the head-office from export to its PE cannot be included as profits of the PE. But what is surprising is that even a limited force of attraction rule has only appeared in the Ethiopian income tax regime through the recently enacted FITP which was not in existence during the tax assessment of the above case of ZTE and again, the OECD modeled Ethio-Chinese DTA does not incorporate any force of attraction rule.

²¹⁰ Interview with an anonymous tax consultant at Deloitte Consulting PLC (Addis Ababa, December 21, 2016)

²¹¹ Interview with Ato Habtamu Abdisa, Local Finance Manager at ZTE H.K Limited Ethiopian Branch (Addis Ababa, December 20, 2016)

As noted above, the tax authority relied for its assessment only on the contractual agreement ZTE Corporation had with Ethio-telecom for provision of both the offshore and onshore equipments and services. But such reliance solely on contractual agreements for tax assessment purposes without basing on any legal authority, domestic or treaty-based, can be seen as one hazardous gap in the practice as it is against the tax principle of legality and may also open the door very wide for a trouble-free scheme of tax avoidance by taxpayers through easy manipulation of the terms of their contract.

Besides, the practice of differentially treating only certain construction contracts based on special administrative decisions could collide head-on with the principle of non-discrimination in international tax law and may also put the certainty of the tax system in jeopardy.

4.2.2. The PE – Subsidiary Divide

It was noted in the discussions above that although a PE and a subsidiary are legally distinct forms of businesses, there are situations where subsidiaries of foreign companies become so much dependent on their parent companies to the extent that they serve as PEs by which the parent company directly engages in a business through them in source countries. In this regard, a question was posed by the researcher to the head of the legal department of ERCA for any experience in which a subsidiary was found to be a PE of its parent company.

Ato Belete has disclosed one notable case to the researcher in which a certain anonymous Canadian company had opened an Ethiopian subsidiary in Afar region by investing less than a 5 million birr capital.²¹² He said that this subsidiary company carried out its activities by securing all the finance needed for its up-running from the Canadian parent company. As an instance, it carried out its works by employing up to 16 contractors for whom the parent company made all the payments outside Ethiopia. The subsidiary was then offered for sale at the price of 163 million dollars for an Israeli company. When the case came to ERCA to finalize the sale, it caused a suspicion as to how a company established with less than a 5 million birr capital could be sold in such amount while not making any tax declarations to ERCA. Based on the investigation carried out, it was later decided by ERCA that the Ethiopian company was a PE

²¹² Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

through which the Canadian company was directly conducting its business and that having no financial independence from its parent was the primary indication of this.

Finally, Ato Belete said that a total of 1.14 billion birr was required in tax from the company because the activities of the Canadian company were deemed as a scheme to avoid withholding and other taxes in Ethiopia. With this, he concluded that the primary factor for differentiating a subsidiary from a PE practically in ERCA is the financial interdependence existing between the “subsidiary” and the parent companies, and the tax authority will always deem a subsidiary as a PE whenever there are facts pointing to this direction as described in the above case although there are no clear and objective rules in the tax laws.²¹³

However, knowing that the primary purpose of establishing whether or not there is a PE of a foreign enterprise in a source country is for the taxation of the profits of the entity, it makes one wonder if it was really necessary in the above case to deem the existence of a PE. The issue of withholding taxation has arisen in the case in respect of the expenses incurred by the head-office and not the profits. For this reason, the case could have been settled only through the application of rules of withholding tax and the concept of PE should have been left alone because the issue was not even about taxing the profits of the Ethiopian company.

4.2.3. Application of Tax Treaties

As has already been noted, issues of international taxation are governed both by domestic tax laws and tax treaties. But both tax auditors²¹⁴ and the head of the tax audit department at LTO²¹⁵ interviewed for this study have informed the researcher that they have worked as auditors for more than 8 years in the tax authority, but had never consulted a tax treaty for determination of the taxable income of a foreign owned company. Concerning the question whether they are provided with the texts of tax treaties that Ethiopia had signed and ratified, they answered that they understand such issues as “only matters of the finance and economy ministry” and said that they never had access to a tax treaty because treaty texts are not sent to them as are tax related directives issued by MoFEC. Furthermore, the tax auditors disclosed that they had never come

²¹³ Ibid

²¹⁴ Interview with Ato Nebiyu Gedle and Ato Zeleke Jambo, Tax Audit Team Leaders at LTO branch of ERCA (LTO, December 15 and 16, 2016)

²¹⁵ Interview with Ato Birhanu Sisay, Tax Audit Work Process Coordinator at LTO branch of ERCA (LTO, December 16, 2016)

across a taxpayer that requested for a treaty privilege while being audited, even in the auditing of ZTE's case discussed above.

Regarding taxpayers, the financial manager of ZTE H.K Limited Ethiopian branch has said that they have not ever asserted a claim for a privilege based on the Ethio-China tax treaty for the business income tax payable in Ethiopia because for one their tax consultant did not provide them with the necessary knowledge, and second because of the pre-conception that ERCA would not accept it even if they did.²¹⁶

In contrast, the chief accountant of Yapi Merkezi PLC Ethiopian branch has disclosed that the company is currently not withholding tax from the payments it makes to foreign technical service providers based on the privilege provided in the Ethio-Turkish double taxation agreement.²¹⁷ The external audit firm working with the company also disclosed that Yapi Merkezi has secured a letter from MoFEC stating that the Ethiopian branch need not withhold tax for the payments it makes to foreign technical service providers based on the tax treaty Ethiopia signed with Turkey.²¹⁸ An anonymous tax consultant at Deloitte Consulting PLC also said that tax treaties are one part of the request that their clients abroad present for consultation before coming to Ethiopia and that they provide their consultancy by referring to the relevant tax treaty Ethiopia signed and ratified.²¹⁹

The Ethiopian tax authority not having a single clue over tax treaties is thus another huge gap witnessed in practice. A taxpayer not knowing whether it has a tax-treaty privilege and not asserting such to the tax authority should not even have been a pretext for not basing a tax assessment on a ratified and effective tax treaty by ERCA because such treaties are in effect parts of the law of the land. Such practice might even pose political and diplomatic risk to the Ethiopian government as dishonoring a treaty duly entered in to. It might even bring international arbitral suits to the government by aggrieved investors besides its probable effect of repelling foreign investment.

²¹⁶ Interview with Ato Habtamu Abdisa, Local Finance Manager at ZTE H.K Limited Ethiopian Branch (Addis Ababa, December 20, 2016)

²¹⁷ Interview with Ato Henock Tibebe, Chief Accountant at Yapi Merkezi PLC Ethiopian Branch (Addis Ababa, December 19, 2016)

²¹⁸ Interview with Ato Tibebe Mengistu, Manager at Tibebe Mengistu & Co., Chartered Certified Accountants (UK) and Authorized Auditors (Eth) (Addis Ababa, December 19, 2016)

²¹⁹ Interview with an anonymous tax consultant at Deloitte Consulting PLC (Addis Ababa, December 21, 2016)

4.3. Allocation and Deduction of Expenses

After the gross income is attributed to a PE, the taxable business income is determined by the tax authority by identifying the expenses incurred in furtherance of the business and allocating them to parts of the business deserving deductions. However, there are some thorny issues relating to the question of allocating such expenses either to the PE or the head-office and allowing deductions for the PE as discussed in chapter 2 above. The practical occurrence of such issues in Ethiopia is discussed in this section.

4.3.1. Payments made by a PE to its Head-office

The first set of expenses claimed by any business for deduction is the cost it directly incurred through payment for goods and services used for running the business. The payments thus made to unrelated persons do not pose special problems as to their deduction.²²⁰ In this case, what an auditor in ERCA ordinarily does is look at the relevance and the actual incurrence of the expense, as in checking the legality of the receipts presented for the costs, and then directly apply the deduction.²²¹

According to Ato Nebiyu, it is the payments directly made by a PE to its head-office that present special problems in the process of deduction. He said that PEs in Ethiopia mostly bring in technical personnel from their head-offices to perform certain activities. In this case, the PE in Ethiopia does not usually make the payments to such persons. Rather, the head-office makes the payment by issuing what he called “inter-company invoices” that say “cost receivable from the Ethiopian branch” and the PE in Ethiopia writes this cost in its accounts as “cost payable to the head-office”. Ato Nebiyu said that such inter-company invoices for which no actual payment is made by the PE are not acceptable by ERCA and the deductions claimed for the expenses will be rejected. This also relates to the treatment of head-office expenses as will be discussed next.

He said that for like payments made by the PE to be deductible, there has to be a contractual agreement between the PE and the technical service provider approved by the relevant authority and the National Bank for payments made in foreign currencies. Furthermore, there must be

²²⁰ Interview with Ato Nebiyu Gedle, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 15, 2016)

²²¹ Ibid

actual payment and it is again checked whether the service was actually given, together with an assessment of whether the payment is not excessively inflated and whether or not the service was not available locally.²²² If these requirements are not fulfilled, the claim for deductions is rejected or adjusted accordingly.²²³

One mechanism of checking whether the payment was actually paid is seeing if withholding tax was withheld by the PE from the payment it made, according to the tax auditors interviewed.²²⁴ However, they admitted that the evaluation for the non-inflation of the payments is made subjectively by an auditor taking his own experience of other cases into account, for there are no objective comparable prices to judge them against (especially for services). They said that it is to cure such problems that a transfer-pricing team is established at LTO, as will be discussed later.

In this regard, the local finance manager of ZTE H.K Limited Ethiopian branch said that the branch is currently deducting as expenses the payments it directly makes to the head-office for the provision of training services by the latter to Employees of the PE.²²⁵ He said that while doing this, the branch is withholding the necessary withholding tax from the payments.

On the other hand, regarding the use by a PE of construction machineries provided by the head-office, a tax auditor at ERCA said that no deduction is allowed for notional lease payments claimed as being made by the PE to the head-office.²²⁶ He said that the construction machineries are deemed as properties of the PE and thus only depreciation is calculated.

For a clear understanding of such claim by a PE and ERCA's stand, the case of Yapi Merkezi PLC Ethiopian branch, a PE of a Turkish company engaged in general construction in Ethiopia,

²²² Interview with Ato Birhanu Sisay, Tax Audit Work Process Coordinator at LTO branch of ERCA (LTO, December 16, 2016) and Ato Nebiyu Gedle, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 15, 2016)

²²³ Ibid

²²⁴ Ibid

²²⁵ Interview with Ato Habtamu Abdisa, Local Finance Manager at ZTE H.K Limited Ethiopian Branch (Addis Ababa, December 20, 2016)

²²⁶ Interview with Ato Nebiyu Gedle, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 15, 2016)

is selected.²²⁷ This company entered in to a contract with Ethiopian Railways Corporation (ERC) for the construction of the Awash-Woldiya to Hara Gebeya Railway Project.²²⁸

According to the head of the legal services department of ERCA, this company established a plant for the manufacturing of the steel bars forming the railway track by importing the machine from its head-office abroad.²²⁹ The PE then claimed a deduction for lease payment to the head-office for the use of such machine by saying that the machine is the property of the head-office for the use of which lease is normally expected to be paid. However, ERCA refused to acknowledge such claim of the PE by saying that the PE cannot claim to make notional lease payments to what is in effect a company of which it is one part and finally decided only for the calculation of depreciation for the machine but no deduction for the notional (i.e. not actually paid) lease payment.²³⁰

The external auditor for Yapi Merkezi PLC Ethiopian branch, however, said that the one that claimed for the deduction of the lease payment for the railway machine was a sister company of Yapi Merkezi, known as Yapiray, and that the request was later accepted by MoFEC as a valid request subject to the two conditions that the machine should not be available in Ethiopia and the lease payment should be an arm's length amount.²³¹

Such subjective stand held by ERCA is thus another gap one can observe in the practice since it is not backed by any legal authority. Theoretically, there should be no ground to deny any PE the right to lease equipments from its head-office as long as the royalty to be paid for the lease is an arm's-length amount. This is because, for one, the PE and the head-office are treated as separate entities for tax purposes in both models of tax treaties discussed above and second, there is a chance for a PE to substitute the head-office by another company as the lessor in order to easily bypass such unnecessary hurdle. The spirit of the rule of "taxation of recharged technical fees

²²⁷ See EIC, 'List of Licensed Foreign Construction Company Investment Projects Since March 05, 1993 - October 26, 2016 G.C' (unpublished), available from the information desk at EIC, last accessed on December 9, 2016

²²⁸ Daniel Berhane, 'Turkish, Chinese sign up for Mekele – Awash new Rail route' *Horn Affairs English* (Addis Ababa, June 29, 2012) < <http://hornaffairs.com/en/2012/06/29/turkish-chinese-sign-up-for-mekele-awash-new-rail-route-ethiopia/>> last accessed on December 17, 2016

²²⁹ Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

²³⁰ Ibid

²³¹ Interview with Ato Tibebe Mengistu, Manager at Tibebe Mengistu & Co., Chartered Certified Accountants (UK) and Authorized Auditors (Eth) (Addis Ababa, December 19, 2016)

and royalties” provided in Article 52 of the FITP is also in favour of allowing the lease of equipment by a PE as clearly indicated in the provision.²³²

Regarding other types of payments that PEs and subsidiaries make to their head-offices or parents, such as interest payments for loans, Ato Nebiyu, one of the tax auditors interviewed, said that he has not come across any PE in Ethiopia that borrowed from its head-office in his 8 years experience in ERCA and indicated that the law only allows a company to borrow from its shareholders.²³³ He said however that the thin capitalization rule for a subsidiary and the ten percent tax for repatriated profit by a PE newly incorporated in the FITP Articles 47 and 62 respectively will serve in the future to control payments made by PEs and subsidiaries to their head-offices or parents abroad.

The financial heads of the Ethiopian branches of both ZTE H.K Limited and Yapi Merkezi PLC also disclosed that they have not ever received interest bearing loans from their head-offices or share-holders.²³⁴

4.3.2. Depreciation

Probably due to the above stand by the Ethiopian tax authority in refusing deduction for lease payments in favor of depreciation, the calculation of depreciation for the determination of a PE’s taxable income is in itself beset with significant problems posed by tax avoidance schemes designed by taxpayers. Ato Nebiyu disclosed that the construction machineries imported by most PEs for construction works in Ethiopia are deteriorated second hand machineries but with declared customs values of very high prices.²³⁵ They do this in order to inflate the book value of the asset and then claim deduction of high amounts in form of depreciation every year. He said that since construction materials are mostly imported duty free as investment incentive, the PE would not lose anything for declaring huge amounts as prices of the machines for customs purposes.

²³² See Article 52 of the FITP where payment for leased equipment by a PE to its head-office is clearly allowed.

²³³ Interview with Ato Nebiyu Gedle, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 15, 2016)

²³⁴ Interview with Ato Habtamu Abdisa, Local Finance Manager at ZTE H.K Limited Ethiopian Branch (Addis Ababa, December 20, 2016) and Ato Henock Tibebe, Chief Accountant at Yapi Merkezi PLC Ethiopian Branch (Addis Ababa, December 19, 2016)

²³⁵ Interview with Ato Nebiyu Gedle, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 15, 2016)

He said that the Ethiopian authorities also lack the necessary capacity to check the quality of such machineries and there is no way to check for their actual value as they are mostly re-exported back when the work in Ethiopia is completed. Ato Nebiyu said that these machineries are imported only for the purpose of deducting depreciation from the PEs total income. In order to carry out the actual construction work, the PE usually leases other machineries locally and yet again claims a deduction for the cost, and ERCA would not have a legal ground to deny deduction for such costs, according to Ato Nebiyu.²³⁶

To add insult to injury, it is not only these costs that are being claimed for deduction by construction PEs in Ethiopia, but also very high expenses for costs of maintenance and spare-parts for the deteriorated machineries.²³⁷ For Ato Mengistu, this is a terrible gap in the practice and second hand machineries that had been used elsewhere for more than two years should not even be allowed to be imported for the works of a PE because most times PEs in Ethiopia import a construction machinery that is fully depreciated in a project at another country as a scheme to erode their tax base in Ethiopia. For him, the book value of such machinery should be zero and depreciation disallowed because most project offices of foreign construction companies in Ethiopia declare losses for most tax years and the above problem is probably the primary cause responsible for this.²³⁸

4.3.3. Head Office and Dual Purpose Expenses

The other set of expenses that raise problems in the process of deduction of expenses for a PE are those expenses the head-office makes for the purposes of the PE or both for itself and the PE. All of the tax-auditors and legal professionals interviewed in this study from ERCA and the MoFEC simply disclosed that expenses incurred by the head-office are not in any way deductible for the PE in Ethiopia in practice.

The important reason given for this practice is the provision of the FITP and its predecessor allowing deductions only for those expenses incurred by the “taxpayer” itself. Any receipt

²³⁶ Ibid

²³⁷ Interview with Ato Mengistu Balcha, Former Tax Audit Directorate Director at ERCA and a current private tax consultant (Addis Ababa, December 21, 2016)

²³⁸ Ibid

presented by the PE issued in the name of the head-office abroad, therefore, would not fulfill this criterion, according to all the mentioned interviewees working in the tax authority and MoFEC.

For the former tax audit directorate director of ERCA however, the major cause for the rejection of head-office expenses by the authority is absence of the relevant documentation by the head office showing the allocation base used for allocating its expenses to the different parts of the company, for what purpose the expenses were incurred and whether the said service was actually given for the PE.²³⁹ He said that most PEs of foreign companies are unable or not willing to present such documentation of the head office for unknown reasons.

However, the taxpayers interviewed opined that the expenses incurred for the PE, wherever incurred, need to be deductible expenses for the PE and that they are in practice writing such costs incurred by the head-office as expenses of the PE in their accounts but admitted that they expect a challenge from ERCA in the future.²⁴⁰

But it is important to remember here that the rule of “taxation of recharged technical fees and royalties” provided in Article 52 of the FITP shows that the new tax law accepts the possibility for a head-office to incur certain expenses for the purposes of the PE and that there is a prospect for the deduction of such cost to the PE.²⁴¹ With the application of this provision therefore, it could be difficult for ERCA to deny deductions for expenses incurred by a head-office for the purposes of its PE in the future as the provision squarely allows the head-office to recharge such expenses to the PE. Article 7(3) of the tax treaties signed by Ethiopia based on the OECD Model also mandatorily allows for the deduction of expenses incurred anywhere for the purposes of a PE. This is the case with the Ethio-Turkish and Ethio-Chinese DTAs. One can therefore see the outright denial for deduction of head-office expenses for the purposes of a PE by ERCA as another significant gap in the practice.

²³⁹ Ibid

²⁴⁰ Interview with Ato Henock Tibebe, Chief Accountant at Yapi Merkezi PLC Ethiopian Branch (Addis Ababa, December 19, 2016)

²⁴¹ See Federal Income Tax Proclamation No. 979/2016, Article 52

4.3.4. Interaction of Deductions with Withholding Taxation

The FITP imposes a 15 percent tax on a non-resident for income from rendering of technical services and lays a duty on the person making the payment to withhold the tax on behalf of the tax authority.²⁴² Although such tax is outside the scope of this study, the withholding duty of the payer has a bearing in deduction of the costs it incurred. This is because, one of the preconditions for deduction of expenses incurred by a PE or a subsidiary engaged in a construction business in Ethiopia is fulfilling of this withholding duty for payments made for technical services rendered by non-residents.²⁴³ Ato Belete said that denying a deduction for such an expense is the only mechanism for securing payment of the withholding tax.

But regarding its enforcement in practice, the tax auditors at LTO said that the payment is not demanded from the withholding agent separately from the claim for deductions. Rather, an auditor automatically calculates the withholding tax that ought to have been withheld from the payment in addition to penalty and interest for not doing so in time.²⁴⁴ It is after doing this that whether the expense is eligible for deduction or not is determined and the deduction is allowed if the requirements discussed above in relation to payments made by PEs are fulfilled.

4.3.5. Transactions between Related Persons and Transfer-pricing

As noted above, the major distinguishing feature of international taxation from other aspects of income taxation is the existence of dealings between related persons. It is actually for this reason that a subsidiary is treated differently from other resident businesses in the country by application of transfer-pricing rules. Although it is shown in the above headings that Ethiopia also has transfer-pricing rules, the tax auditors in LTO of ERCA disclosed that the transfer-pricing directive issued by MoFEC was not even once applied in the determination of income of foreign owned construction companies in their branch office.²⁴⁵

²⁴² Federal Income Tax Proclamation No. 979/2016, Articles 51(2)(c) & 89(1); *See* Article 32(1) of the previous Income Tax Proc. No. 286/2002 where the same withholding duty existed except for the rate of the tax being 10%.

²⁴³ Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

²⁴⁴ Interview with Ato Nebiyu Gedle and Ato Zeleke Jambo, Tax Audit Team Leaders at LTO branch of ERCA (LTO, December 15 and 16, 2016)

²⁴⁵ Interview with Ato Birhanu Sisay, Tax Audit Work Process Coordinator at LTO branch of ERCA (LTO, December 16, 2016) and Ato Nebiyu Gedle, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 15, 2016)

The head of the legal department of ERCA reiterated this fact.²⁴⁶ The reason for this, according to Ato Belete, is the complicatedness of the transfer-pricing directive and the transfer-pricing methods there in, in addition to the difficulty of identifying transactions made with related parties. However, he disclosed that not even a single request for legal advice on the directive was made by auditors of the tax authority to the department he leads.²⁴⁷

Presently, the tax authority has officially established a “transfer-pricing audit team” since June 2016 only in its LTO branch, in which most international companies with annual turnovers of more than 27 million birr pay their taxes.²⁴⁸ According to the leader of this team, Ato Animut Biyalfew, the name of the team is now changed to “International Taxation Unit” and is composed of five auditors including him as its leader.²⁴⁹ The head of the tax audit department at LTO disclosed that this team has begun its work in 2009 E.C budget year by identifying those international companies having frequent dealings with related persons and making them fill out formats prepared for this purpose.²⁵⁰ He said that the team is currently auditing two international companies suspected of engaging in transfer mis-pricing.²⁵¹

²⁴⁶ Interview with Ato Belete Ahmed, Legal Services Directorate Director at ERCA (ERCA, December 14, 2016)

²⁴⁷ Ibid

²⁴⁸ Interview with Ato Animut Biyalfew, Tax Audit Team Leader at LTO branch of ERCA (LTO, December 16, 2016)

²⁴⁹ Ibid

²⁵⁰ Interview with Ato Birhanu Sisay, Tax Audit Work Process Coordinator at LTO branch of ERCA (LTO, December 16, 2016)

²⁵¹ Ibid

Chapter – Five

Conclusion and Recommendations

5.1. Conclusion

This research studied the global understanding of the issue of international income taxation and explored the current Ethiopian rules applicable in business income taxation of foreign owned construction entities and their enforcement in practice. In so doing, it showed the gaps existing in the Ethiopian rules and the practice as seen from international and practical points of view.

From an international tax law perspective, some major gaps were identified while the law and the practice were tested against the UN and OECD Model Tax Treaties and domestic best practices of developed countries. Among these, significant are:

- The non-inclusion of certain important provisions that could have clarified certain concepts and avoided possible tax disputes in the future;
- The utter lack of knowledge on the understanding and even existence of tax-treaties by auditors of the tax authority, and tax treaties not being given a single place in tax assessments;
- The determination of the existence of a PE and attribution to a PE of income from offshore supply of equipments [and deduction of their cost as expenses] not being based on a clearly written law and sometimes even being contrary to some accepted principles in international taxation such as non-discrimination, double taxation and double non-taxation;
- The outright denial of deductibility for head-office expenses with no sound justification; and
- The door being open for tax avoidance by subsidiaries through transfer-pricing manipulations for lack of understanding and application of the transfer pricing rules by the tax authority.

From a practical point of view, on the other hand, some problems were identified in the drafting and application of some provisions in the tax laws that may have an effect of reversing the basic principle the law itself had set out to uphold and causing a diversified understanding of the same concept among different parts of the tax administration (i.e. MoFEC plus the tax authority) and between the tax administration and taxpayers. The major gaps identified in this regard are:

- Participants in the drafting of the FITP having polarized views over the reason for existence or absence of certain provisions and thus difficulty in finding the true intention of the drafter for interpretation of tax laws;
- Widespread subjectivism being witnessed in income tax assessment by tax auditors for not completely relying on legal authority in their decisions or for lack of tools such as appropriate comparable prices in testing the value of some transactions;
- Some administrative decisions for tax relief being given by channels other than the established tax dispute settlement machinery causing disorganized practices not envisaged by the tax law and thus having its own toll on the certainty of the tax system; and
- There being no filter at customs point for determining the actual value and appropriate useful life of deteriorated construction machineries causing erosion of large tax bases through undue calculation of depreciation expenses.

The net effect of these problems will cast its own dark cloud on Ethiopia's efforts in meeting its tax policy objectives by leading to loss of revenues and creating hindrance for foreign trade and investment. Besides, efforts at bringing equity and modernizing the tax system would be unlikely to be successful with such problems existing. This is of course in addition to the improbability of meeting the basic objectives behind taxing international income like avoiding discrimination and double taxation and adhering to the benefits principle, unless the problems are controlled in due time. The following recommendations are forwarded in view of contributing towards such goal.

5.2. Recommendations

In order to embark on an efficient, fair, predictable and legal administration of the international tax regime in Ethiopia and fulfill the policy objectives of taxation in general, the most important recommendations that the researcher forwards after conducting this study are:

- For MoFEC to deploy the advance ruling and other mechanisms envisaged by law aimed at creating a uniform, harmonized and policy oriented interpretation and application of the tax laws among itself, ERCA and the latter's internal legal and audit directorates and branches;
- For the texts of tax treaties ratified by the Ethiopian parliament to be published officially and in the meantime, for MoFEC to allow access to these treaties for tax-auditors and the general public through different means including its website or its archives;

- For tax-auditors and legal personnel of ERCA and MoFEC to be given continuous trainings on the concept of international taxation in general and of ratified tax treaties in particular and for tax-treaty privileges to be accorded to relevant taxpayers even if not claimed by them;
- For the issuance of clear rules in subsequent legislations by the government clarifying the problems identified in this research such as the exclusion of some provisions and the non-deductibility of some expenses currently being applied practically without a clear legal authority, in order to adhere to the principle of legality in taxation;
- For every tax assessment notification by tax auditors of ERCA to be justified by a legal authority such as clearly justifying the attribution of income to a PE from offshore supply of equipments either on a limited force of attraction rule or other principles provided in domestic tax law or tax-treaties because Ethiopia's source based jurisdiction should not be left at the mercy of a contractual agreement between persons;
- For administrative tax reliefs given to selected taxpayers by parts of the government other than the tax-review and the tax-appeal-commission in the aftermath of a duly served tax assessment notification be avoided as much as possible for maintaining predictability of the tax system and preventing defiance to the international tax principle of non-discrimination;
- For ERCA to strengthen its international-taxation unit for effective application of the transfer-pricing and the other anti-avoidance rules;
- For ERCA to strengthen the customs valuation of construction machineries and other goods imported for construction works in Ethiopia to filter away deteriorated equipments and prevent the loss of tax revenues through unnecessary depreciation allowances;
- For MoFEC and ERCA to reconsider their stand against deductibility of head-office expenses incurred for purposes of the PE in situations where the appropriate documentation is presented as an adherence to fairness in taxation, relevant rules in tax-treaties and the country's general tax policy objective of attracting foreign investment; and finally
- For ERCA and MoFEC to apply the principle of correlative adjustment provided in tax-treaties and mutually consult with the residence countries of PEs in Ethiopia when transfer-pricing adjustments are made or income is attributed from the offshore supply of equipments in order to avoid double taxation and double non-taxation by preventing the residence country from imposing tax on the same income or writing the same cost as expenses.

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