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COLLEGE OF LAW AND GOVERNANCE STUDIES
SCHOOL OF LAW

MASTER OF LAW (LL. M) IN BUSINESS LAW

The Impact of VAT on Insurers' Subrogation Rights and Recovery
Mechanisms in Ethiopia: A Comparative Legal Analysis under the 2024
VAT Proclamation

A Thesis Submitted to Addis Ababa University College of Law and
Governance studies presented in Partial Fulfillment for the requirements
of the degree of Masters in Business Law (LL. M)

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Declaration

I Abreham Kalay, hereby affirm that the work entitled “The Impact of VAT on Insurers’ Subrogation Rights and Recovery Mechanisms in Ethiopia: A Comparative Legal Analysis under the 2024 VAT Proclamation” is the result of my work. All sources and references used in the study have been properly cited and acknowledged and the work has not been presented for any degree or examination in any other university.

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This is to certify that the thesis prepared by Abreham Kalay entitled: “The Impact of VAT on Insurers’ Subrogation Rights and Recovery Mechanisms in Ethiopia: A Comparative Legal Analysis under the 2024 VAT Proclamation”, in Partial Fulfillment for the requirements for the Degree of Masters in Business Law (LL. M) complies with regulation of the University and meets the accepted standards concerning originality and quality.

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Acronyms and Abbreviations

C.C.	Civil Code of the Empire of Ethiopia 1960 (Proc. No.165)
Com. Code	Commercial Code of the Empire of Ethiopia 1960 (Proc.No.166)
CoM	Council of Ministers
E.C.	Ethiopian Calendar
E.I.C.	Ethiopian Insurance Corporation
EU	European Union
EU VAT Directive	European Union Council Directive 2006/112
IMF	International Monetary Fund
NICE	National Insurance Corporation of Ethiopia
Fed. Neg. Ga	Federal Negarit Gazette
MoF	Ministry of Finance
New VATP	Value Added Tax Proclamation No. 1341/2024
New VATR	Value Added Tax Regulations No. 570/2025
Ny.I.C	Nyala Insurance Share Company
No.	Number
Proc. No.	Proclamation Number
SARS	South Africa Revenue System
VAT	Value Added Tax
WB	World Bank

Abstract

Subrogation allows the insurance company to recover money paid for settlements of claims from liable third party for that loss and maintain financial stability and long-term solvency. The importance of surrogation towards maintaining the efficiency of risk pooling process, controlling claims cost and affordability of premium price in the development of insurance markets like Ethiopia has essential. There are controversies after that the Ethiopian VAT Proclamation, No. 1341/2024 has made a new clause under Art 40(6) that totally incorporate surrogation recoveries in scope of taxable supply without clear legal rules that protect the representative capacity of insurers and addressing legal remedy nature of subrogation recoveries. This research has examined these controversies and analyzes the legal and practical implication of VAT on insurer's subrogation right. This research finds out the current legal framework of VAT creates ambiguity, administrative inconsistencies as well as practical challenges. Therefore, any legal reform should be made with clear legal framework, inclusive stakeholder engagement and effective strategies to protect a right balance between revenue collection and long-term development of insurance industry.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Ethiopia has recently replaced the 2002 VAT Proclamation with a new and more comprehensive law.¹ The change is part of the government's broader attempt to increase domestic revenue in light of growing fiscal pressures and its ongoing engagement with institutions such as the IMF and the World Bank.² The new proclamation comes up with several amendments intended to modernize the VAT regime and bring it in line with current economic and commercial realities.³

One of the major shifts under the revised law, particularly related to insurance service, is the charging of VAT on general insurance, ending more than twenty years of exemption.⁴ The reform also mischaracterizes subrogation and affects the way subrogation is treated for tax purposes. Under the new rule, all recoveries by insurers through subrogation are considered taxable supplies, regardless of the VAT status of the insured or beneficiary of the original claim.⁵ This marks a significant mischaracterization of the representative statutes of insurers in insurance surrogation recoveries, with potential implications for insurers' financial and legal obligations.

VAT is a broad-based consumption tax levied on the value added to goods and services at each stage of production and distribution.⁶ Its application in different countries has created many complex problems within the sphere of financial and insurance services. Basically, the intermediation nature of financial institutions in their services and technical difficulties in

¹ FDRE, Federal Neg. Gazz. No. 61, Value Added Tax Proclamation No. 1341/2024 (Addis Ababa, 2024). (Hereinafter New VAT Proc. No. 1341/2024)

² Eyasu Zekarias, New VAT on Insurance Premiums Sparks Concerns among Stakeholders (*Capital Newspaper*, 2024). <https://capitalethiopia.com/> accessed 19 January 2025. Such allegations have been raised repeatedly since the introduction of VAT in Ethiopia. See Misganaw Gashaw, Tax Reform Discourse and its Implication on Development: Evidence from the VAT Introduction in Ethiopia, *Mekelle University Law Journal*, Vol. 3, No. 1 (2015)

³ Carolyn Wright, Ethiopia Introduces New VAT Proclamation Introducing Raft of Changes, (2024) <https://globaltaxnews.ey.com> accessed 20 January 2025.

⁴ Mahider Belete, Ethiopia's Bold VAT Move: What It Means for Your Insurance Claims, (2025) <https://www.linkedin.com> accessed 24 January 2025.

⁵ New VAT Proc. No 1341/2024, Art 40(1).

⁶ Desalegn Mosissa, "The Value Added Tax and Sales Tax in Ethiopia: A Comparative Overview," (*European Journal of Business and Management*, Vol. 6 No. 23), (2014), P. 246.

identifying and isolating service charges within the service (e.g., insurance, loans, stock sales) have complicated the application or otherwise of VAT upon financial institutions.⁷ Financial institutions spread Value Added across various customers, making it difficult to calculate the exact value added for taxation.⁸ Insurance services, particularly claim settlements and subrogation recoveries, are not like normal goods and services supply transactions. As a result, there are considerable differences between countries. For example, most financial and insurance services are exempt under Article 135 of Directive 2006/112/EC in the EU,⁹ based on the principle of prioritizing administrative simplicity.¹⁰ Such, however, is not the case with countries such as South Africa, Australia, and New Zealand, which have enacted models that either tax certain financial services (e.g., fee-based ones) or allow input tax credit to prevent the cascading effect. Particularly, the different legal nature of subrogation recoveries, which arise when insurers pursue third parties in a representative capacity after indemnifying the policyholder by the name of the insured, should be considered in VAT treatment of subrogation recoveries, unlike Ethiopia's new VAT regime,¹¹ which cannot frame a rule to protect this nature under certain conditions.

Such international debates over VAT and insurance services are not only a policy matter, but they revolve around fairness, practical administration, and the need for clear legal rules. States like New Zealand frame an illustrative example, having taxed subrogation recoveries when input tax credits were previously claimed.¹² It is related to having considered the registration status of the original claim beneficiary. On the other hand, Ethiopia's current VAT law has not explicitly addressed the point at which subrogation recoveries trigger a VAT liability, the appropriate party

⁷ Taddese Lencho, To Tax or Not To Tax: Is That Really the Question? VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia, (5 Mizan Law Review, Vol. 5 No. 2), (2011), P 264.

⁸ *ibid.*

⁹ The basic regulation of the European VAT system is the so-called Value Added Tax System Directive (VATSD), Council Directive 2006/112/ EN of 28 November 2006 on the common system of VAT, [2006] OJL347/1. hereafter " EU VAT Directive". Since then, amended several times.

¹⁰ Exempted goods and services are exempt from the output VAT due on sales only; but are not entitled to a tax credit for the VAT paid on inputs, which means the exempted goods and services carry a hidden VAT, i.e., VAT paid on inputs; see Taddese (*Supra note 7*), Michael Keen and Stephen Smith (2007), VAT Fraud and Evasion: What Do We Know and What Can be Done? IMF Working Paper WP/07/31, International Monetary Fund.

¹¹ New VAT Proc. No 1341/2024, Article 40(6).

¹² New Zealand Goods and Services Tax Act 1985, Section 5(13B).

(insurer or third-party payer) responsible for such VAT, or the possible distinction between claim settled out of court (Voluntary settlement) and those resolved through litigation in terms of VAT applicability. Ethiopia's stance on the application of VAT on subrogation borrows elements from New Zealand's logic, particularly in its attempt to link subrogation recoveries with input tax credit. The lack of a clear and detailed legal framework in Ethiopia has created a mischaracterize of the insurer's legal status in subrogation recoveries, inconsistent practices among insurers, and confusion regarding the extent of their obligations. This gap has also contributed to an increase of court litigation, even by avoidable disputes by framing clear law, showing that the current approach leaves both insurers and third parties without reliable guidance.

Looking at how other jurisdictions, particularly New Zealand, Australia, and South Africa, approach demonstrates that Ethiopia would benefit from adopting a more coherent and predictable statutory legal system for treating subrogation under VAT. A well-designed legal and administrative structure is not only necessary for regulatory compliance but also plays a major role in fostering financial stability, certainty, and trust within the insurance industry. A clear understanding of how tax rules interact with insurance principles is crucial for addressing existing challenges and supporting the long-term growth of the sector.

1.2 Statement of the Problem and Research Question

Ethiopia's new VAT Proc classifies payments under a general insurance contract received by a registered person for a loss incurred in the course of a taxable activity as a taxable supply. It doesn't matter whether the recipient is directly a party to the contract or not.¹³ Particularly, Art 40(6) goes a further step by treating subrogation recoveries by insurers as taxable supplies, with certain conditions stipulated under Art 40(4) of the VAT proclamation. However, an unclear legal framework and inconsistency between the VATP and VATR led to a wrong VAT treatment of subrogation recoveries, which cannot consider the legal nature of subrogation and the representative capacity of insurers when exercising their right of subrogation. While the recent VAT amendments intended to widen the VAT base and strengthen compliance, they bring with them legal and administrative challenges for insurers and third-party payers.

Subrogation is a fundamental legal principle of insurance law that allows insurers to step into the insured's shoes or act as the insured's legal representative and recover losses from third parties

¹³ New VAT Proc. No 1341/2024, Article 40(1).

responsible for the insured's damage. However, charging VAT on subrogation recoveries in Ethiopia with an unclear legal framework introduces a layer of complexity and leads to uncertainties, disputes, court litigation, and potentially conflicts with the principle of indemnity, which ensures that neither the insured nor the insurer profits or suffers additional losses beyond actual damage.

Requiring insurers to charge VAT on amounts recovered through subrogation without clearly detecting who received the original claim payment and their tax status has led to ignoring the representative capacity of the insurer and adding another layer of administrative challenges and cost. Managing these obligations without a clear legal framework can be burdensome and may even discourage insurers from pursuing recoveries altogether.

The challenge is more serious because Ethiopia's insurance industry is still in an early stage of development, with a low participation rate. Imposing VAT on subrogation recoveries without legal consideration of their parties' nature has made their impact on slowing this progress by encouraging disputes and unnecessary litigation, both of which strain insurers' resources and complicate legitimate recovery efforts. The ambiguity and uncertainty surrounding Article 40(4) and 40(6) of the new VAT Proclamation add to these pressures. The insurers, taxpayers, and third parties are often unsure about the conditions under which VAT applies, when input credits can be claimed, and whether recovered amounts are consistently treated as taxable in every circumstance, regardless of the registration status of the insured or beneficiary of the original claim compensation.

Even if a few scholars have written about the broader VAT treatment of financial services, the specific issue of subrogation recoveries in Ethiopia has not been studied. One important work in this area is Dr. Tadese Lencho's study, *"To Tax or Not to Tax: Is That Really the Question? VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia."* His work offers a detailed look at how VAT applies to financial activities, particularly foreclosure sales and the collection of debts by banks.¹⁴ Dr. Tadese clearly illustrates how gaps in the law, unclear administrative practices, and misunderstandings about the nature of financial services often lead to compliance problems and legal conflicts. He also highlights the challenges created

¹⁴ Taddese Lencho (*Supra* note 7).

by VAT exemptions for financial institutions and the cascading effect of unrecoverable input VAT on the sector.

While Dr. Tadese's work offers an important starting point for understanding the broader relationship between VAT and financial services, it does not extend to the specific challenges created when VAT intersects with insurance subrogation recoveries. Likewise, the existing work of literature is silent on whether subrogation recoveries are to be taxed, the proper method of taxation, how input tax credits should operate in such contexts, or whether Ethiopia's new VAT rules align with long-standing insurance principles. As a result, a noticeable gap remains in both academic and regulatory discussions.

This research seeks to address that gap by examining how the New VAT Proclamation treats insurers' subrogation rights in practice. It evaluates the consistency of the new VAT regime with core doctrines of insurance law, highlights the legal and practical uncertainties arising from Articles 40(4) and 40(6), and examines Ethiopia's approach within the experiences of other jurisdictions like New Zealand, Australia, South Africa, and the European Union. In doing so, the study aims to propose reforms that would strengthen both the legal framework and its administrative application.

Accordingly, the research is guided by the following questions: -

1. How does the unappropriated application of VAT affect insurers' Subrogation rights under the Ethiopian law?
2. In what specific ways does VAT impact the legal and financial **position** of insurers in Ethiopia?
3. What are legal and practical difficulties arise for insurers when subrogation recoveries are subjected to VAT?

1.3 Objective of the Study

1.3.1 General Objective

The main aim of this research is to examine how the 2024 VAT Proclamation affects insurers' rights in Ethiopia, with a particular emphasis on the treatment of subrogation.

1.3.2 Specific Objective

- To explore the legal, conceptual, and theoretical issues surrounding the VAT treatment of insurance services in general and subrogation recoveries in particular.

- To analyze the legal framework governing VAT on subrogation recoveries and compare it with the approaches adopted in selected jurisdictions.
- To evaluate the administrative and legal challenges insurers encounter when implementing VAT obligations under subrogation recoveries.

1.4 Significance of the Study

This research aims to identify both legal and practical controversies by examining how the Ethiopian New VAT Proclamation treats insurers' subrogation rights. It elaborates on the legal, financial, and administrative challenges created by the new framework. In a practical sense, the study is highly relevant to the Ethiopian insurance market, which continues to face inconsistent practices, disputes, and litigation over the VAT treatment of subrogated recoveries. This research helps to frame a well-structured legal and policy framework to protect the legal nature of subrogation and promote administrative clarity, minimize disagreements among insurers, and support organizing a better tax compliance landscape.

1.5 Scope of the Study

The scope of this thesis is limited to evaluating the legal, financial, and administrative implications of the current VAT rules on insurers' subrogation rights under Ethiopia's New VAT Proclamation. It gives special emphasis on identifying the drawbacks related to the treatment of subrogation recoveries under the VAT regime. To identify a better practice, a comparative analysis was also conducted. It is important to note that the scope of the research is limited to VAT issues arising from subrogation recoveries and does not extend to the wider taxation of insurance services.

1.6 Methodology of the Study

The research basically examines the VAT treatment of subrogation recoveries under the New VAT rule. It also demonstrates the legal and practical impact of the New VATP on insurance companies' ability to recover payments by using their subrogation right. So, a doctrinal method is used to examine, interpret, and analyze the relevant legal rule under the new VAT framework concerning about subrogation right. A non-doctrinal method is also applied to analyze the practical realities and challenges related to the implication of VAT on the Subrogation right of the Ethiopian insurer. To achieve such a specified objective and able to gather a stakeholder perspective, a qualitative research approach of data collection has been conducted.

for the purpose of identifying a better experience and lessons they have given the legal framework of some selected countries has been used. Their experiences are relevant to give a valuable insight to guide coherent legal and policy reform in Ethiopia.

Regarding the source of data, both primary and secondary sources of data are used. As a primary source of data, Ethiopian VAT Proclamations and regulations, other relevant Ethiopian laws, court cases, VAT Acts, and guidelines from comparative jurisdictions are used. In addition to this, for the sake of exploring complex legal and practical challenges in a flexible and in-depth way, the researcher conducted semi-structured interviews. The interviews were conducted with three insurance company legal directors and three finance department heads.

Participants of the interviews are selected by a purposive sampling method taking into account their direct involvement in the drafting, discussion, and implementation of the VAT Proclamation. Specifically, the three legal department directors of different insurance companies were selected due to their active membership in the Ethiopian Insurance Association and their participation in commenting on both the draft and final version of the proclamation. And three finance department heads are active in their collaborative discussions with the legal directors during the policy development process, and they are interpreting and disseminating internal circulars within their respective institutions.

As a secondary source of data, this research reviewed academic books, journal articles, case commentaries, and research papers. Those secondary source materials are used to organize a theoretical and contextual foundation for the paper, to understand the intersection of taxation and insurance law, subrogation right, the principle of indemnity, and the controversy of applying VAT to subrogation recoveries.

The researcher uses the thematic content analysis method to identify key patterns, legal uncertainties, and proposed solutions by critically examining the data gathered from both primary and secondary sources.

1.7 Limitations of the Study

The absence of doctrinal or empirical studies on this topic, both locally and globally, limits the availability of reference materials and precedents. As a result, the researcher was often required to rely on primary legal texts, foreign VAT systems, and conducts interviews to develop original insight.

Secondly, practical constraints such as limited time and the inability to access the key policymakers and judicial decision-makers have affected the depth of the research. Although the comparative perspective conducted by referencing other countries' jurisdictions does not provide an exhaustive analysis of VAT implications on insurance services. So, future researchers are encouraged to explore the quantitative effect of VAT on premium pricing, claim recoveries, and administrative costs, or to conduct studies assessing the post-implementation impact of the Ethiopian 2024 VAT Proclamation on the insurance market.

1.8 Literature Review

Since charging insurance sector services, particularly subrogation recoveries, by VAT regulation is a recent development, there is currently no scholarly literature directly analyzing its legal, economic, and administrative implications. In particular, there is no research done to address the treatment of VAT on insurers' subrogation rights under the New VATP. However, some Ethiopian and international works provide foundational insights into the broader conceptual and policy debates surrounding VAT, taxable supplies, and financial services.¹⁵

One of a significant work that give an essential lens for understanding the limitations of Ethiopian VAT design in taxing complex financial transactions is Dr. Taddese Lencho's article.¹⁶ The work critically analyzes the legal and policy implications of the Ethiopian VAT regime by giving special concern for the ambiguity surrounding financial service exemptions and the controversies of applying VAT to bank foreclosure sales.

His work showed how VAT exemption without precise legal definitions can create interpretive uncertainty, regulatory disputes, and litigation. But the article can't address the VAT implications on subrogation recoveries in the insurance industry. The same issues are seen in the insurance sector after the introduction of Article 40(6) of the New VATP, which subjects subrogation recoveries to the taxable supply regime without a clear enforcement framework that protects the representative status of the insurer during subrogation recoveries. So, this research critically explored insurance and subrogation, examining whether similar structural issues persist and how they are addressed through legal reform.

¹⁵ Maya Misikir, Ethiopia's Attempt to Broaden Tax Base through VAT Law Faces Pushback, (*The Africa Report.com*, (2024) <https://www.theafricareport.com/> accessed 20 January 2025.

¹⁶ Taddese (*Supra note 7*) 256.

While international literature also does not directly address or intend to consider the specific problems this thesis aims to investigate, it provides valuable insights into the broader conceptual and policy issues surrounding VAT on insurance services. Richard Kreyer and Jonathan Teoh, in *GST and Insurance: Australia*, in a specific part, examine the policy rationale for exempting subrogation recoveries under Australia's GST system.¹⁷ They argue that subrogation is a compensatory nature and is subject to VAT undermines its nature and adds unnecessary complexity. Similarly, the EU scholars Otto A. Altenburger, Rudolf Diewald, and Max Göttsche¹⁸ explore the technical and conceptual difficulties of applying VAT to insurance services, particularly under the EU's exemption-based model. Further, Harry Grubert and James Mackie's¹⁹ research on VAT and financial intermediation argues that insurance, investment, and loan services do not align with traditional consumption tax principles, but rather mechanisms for smoothing consumption over time. Their work explains why many jurisdictions struggle to classify such services as either taxable or exempt, and how these choices affect VAT neutrality and financial sector efficiency.²⁰ To find an efficient way for incorporating financial services within a VAT framework, different approaches have been tried but haven't able to find an adequate alternative.²¹ The treatment of financial services under a VAT system is only clear in a theoretical model, such practical implementation faces several challenges more than other industries.²²

Specific VAT guidelines for insurance services, like the South African experience, have the capacity to avoid legal and practical disputes between insurers and tax authorities by developing a clear statutory rule. The guideline also provides valuable insight into how subrogation is

¹⁷ Richard Kreyer and Jonathan Teoh, *GST and Insurance: Australia*; Chapter 17 in R. van Brederode and R. Kreyer (eds), *VAT and Financial Services: Comparative Law and Economic Perspectives*. (Singapore: Springer), (2017), P. 319-335.

¹⁸ Otto A. Altenburger, Rudolf Diewald, and Max Göttsche, "The Inclusion of Insurance Services in the European VAT System—a Problem That Cannot Be Solved?" (*ZVers Wiss* 111), No. 3), (2022), P. 339-352.

¹⁹ Harry Grubert and James Mackie, 'Must Financial Services Be Taxed Under a Consumption Tax?' (2000) (*National Tax Journal*), (2000) P. 23.

²⁰ Otto A Altenburger, 'Applying VAT to Financial Services: Is the New "Mobile-Ratio Method" Adequate for Insurance?' (2022) P. 353.

²¹ *ibid.*

²² Alan J Auerbach and Roger H Gordon, *Taxation of Financial Services under a VAT*, (92 *The American Economic Review*), (2002), p. 411.

addressed either through explicit exemptions or gross-up mechanisms and issues regarding taxable supplies and input VAT credits.

After the conclusive understanding of the above domestic and international literature, it's necessary to clearly define and frame each taxable supply under a VAT framework. especially like insurance service where contractual indemnity, compensation, and third-party recoveries are related to each other. So, this research tries to address the current gap and contribute to clarifying the discourse related to VAT treatment of subrogation recoveries and propose legal recommendations.

1.9 Organization of the Paper

The research has five chapters. The first chapter is an introductory chapter consisting of the background of the study, statement of the problem, research question, research objectives, significance of the study, scope of the study, research methodology, limitations, and literature review. The second chapter deals with the conceptual and legal framework of the study. Under this chapter, the core concepts such as VAT, Insurance, and Subrogation are defined and explored in their theoretical and legal intersection. The third chapter examines different approaches to explore how VAT can be treated for financial and insurance services, including subrogation in selected jurisdictions. The fourth chapter focused on the Ethiopian context and analyzed how the New VATP treats insurers' subrogation rights and recovery mechanisms, and also identified legal ambiguities, administrative, and practical challenges. Lastly, chapter five presents the conclusion and recommendations of the study for legal and policy reforms that could improve the VAT treatment of subrogation in the Ethiopian insurance sector.

CHAPTER TWO

CONCEPTUAL AND LEGAL FRAMEWORK OF VAT AND SUBROGATION IN INSURANCE

2.1 Introduction

2.2 Overview of the Value Added Tax System

The idea of VAT was first proposed by a German businessman, “*Wilhelm Von Siemens*”, in the 1920s.²³ But the first country that formally implemented VAT into its tax system is France in 1954.²⁴ Since then, due to different countries have adopted and implement VAT in their own ways there is a debate about whether a particular tax can be considered as a true VAT system. Nonetheless, the core characteristics of VAT are generally agreed upon.²⁵

VAT/GST is a broad consumption tax levied on consumption and applied to the Value of imports and the added value of goods and services exchanged between businesses.²⁶ Despite its name, VAT is not primarily designed to tax the value added at each production stage, but it serves as a tax on final consumption.²⁷ This system permits businesses to deduct taxes paid on input using a credit mechanism. Although VAT is widely acknowledged as a comprehensive and broad-based form of general sales taxation.

VAT has become one of the most widely adopted forms of indirect tax at the international level. The first reason is its strong revenue-generating potential with its economic and administrative efficiencies when effectively designed and implemented.²⁸ The second one is its ability to avoid the cascading effects of general sales tax system, where taxes are levied repeatedly at each stage of production and distribution. Although, under a general sales tax businesses are unable to recover input taxes paid on goods and services, which leads to increase costs in capital-intensive sectors.²⁹

²³ Ebrill ML, Keen MM, & Perry MV, *The Modern VAT*, (Washington: International Monetary Fund). (2001), p. 4.

²⁴ *Ibid.*

²⁵ *Ibid.*

²⁶ Desalegn Mosissa Jalata, *The Value Added Tax and Sales Tax in Ethiopia: A Comparative Overview*, (*Europea Journal of Business and Management*), (2014), P. 246.

²⁷ Ebrill, Keen and Perry (*Supra note 23*) 4.

²⁸ NT Azaria and Z Robinson, *The Revenue Raising Capabilities of a VAT System in Developing Countries: Economics*, (*8 South African Journal of Economic and Management Sciences*), (2005), P. 63.

²⁹ Charles E, McLure, *The Tax Assignment Problem: Conceptual and Administrative Consideration in*

Under the VAT system the final burden of tax is ultimately covered by the final consumer. based on input tax credit mechanism businesses can able be deduct the VAT they are paid on inputs from VAT they are collect on sales. This can avoid the accumulation of tax across the supply chain. This feature promotes economic neutrality, supports more efficient resource allocation, and encourages investment, which in turn stimulates economic growth.³⁰ For these reasons, VAT is often preferred over general sales tax systems in modern tax policy frameworks.

2.3 Overview of VAT in Ethiopia

In Ethiopia VAT was first introduced in 2002. It replaced the general sales tax law (in force since 1993), a single-stage sales tax whose application was limited to manufacturers, producers, and/or importers.³¹ The introduction of VAT was not aimed only to broaden the tax base and improve revenue generation but also to align the country's tax policy with anticipated trade commitments under the World Trade Organization (WTO) and to meet policy direction set by the International Monetary Fund (IMF).

Since then, the VAT proclamation has been amended twice in 2008 and 2019 by Proclamation No. 609/2008, and Proclamation No. 1157/2019, respectively. The 2008 Amendments were mainly focused on VAT registration requirements and criminal liabilities associated with VAT.³² On the other hand, the 2019 Amendments were mainly on reducing the tax reporting burden for a certain category of taxpayers, withholding of VAT by taxpayers, and VAT refund.³³ Consequently, a new VATP was introduced in 2024 that replaced the previous VAT proclamation.

The recently enacted VATP has one of its primary objectives to narrow the gap between potential and actual tax collection by addressing previous inefficiencies and updating the legal framework.

Achieving Subnational Fiscal Autonomy, (National Economics and social Development Board of the Royal Government and World BANK), (1999), P. 29.

³⁰ Dasalegn (*Supra note 26*), P. 246

³¹ As of the mid-20th century, most countries of the world have moved to VAT by replacing their general sales tax and its varieties. VAT is now the most important form of general sales tax in use. Sales tax was formally introduced in Ethiopia in 1993 by Proclamation No 68/1993 and it passes through several amendments within the operated period of more than four decades.

³²Mahder Amachew, A Brief on the Draft VAT Proclamation; The Changes Introduced, (2022) <<https://renewcapital.com>> accessed 14 March 2025.

³³ *Ibid.*

VAT is widely regarded as a crucial tool for promoting macroeconomic stability and fostering economic growth by strengthening the foundation for domestic revenue generation.³⁴

Under the new VAT Proclamation, the registration threshold increased to two million birr.³⁵ For deciding whether a taxpayer reaches this amount, the tax authority also looks at the taxable transactions of related persons, which can help to prevent the splitting of businesses to avoid registration.³⁶ Although VAT is designed to apply throughout the entire chain of economic activity, but its reach in Ethiopia has been relatively limited. This is because on one hand, the VAT system itself is still developing, and in the other hand, due to administrative and structural challenges that have made its full implementation difficult.³⁷

2.4 VAT and Financial Services: Theoretical Intersection

The intermediate nature of financial services especially in activities such as lending, insurance, and securities transactions, makes it difficult to determine the exact value added at each stage of the process. Because of this technical difficulty, applying VAT consistently and accurately becomes challenging, and many jurisdictions choose to exempt financial services altogether.

The justified reason behind the exemption of financial services mainly rounded on social policy objectives and administrative feasibility. Exemption for social policy primarily focused on wide accessibility of essential services such as health and education. But the main reason behind exemption of financial services is the practical challenges during identifying and taxing the real value added.

Financial institutions give a mix of intermediation and non-intermediation services. Intermediation service includes activities such as mobilizing funds and linking savers with borrowers or policyholders with beneficiaries. In contrast, non-intermediation services are basically provided by explicit fees, such as the service of custody, consultancy, and advisory services. The main reasons behind the complications in the application of VAT are a challenge to clearly separate a

³⁴ Ebrill, Keen and Perry (*Supra note 23*) 8.

³⁵ New VAT Proc. No 1341/2024, Article 12(2).

³⁶ New VAT Proc. No 1341/2024, Article 12(3).

³⁷ Taddese Lencho (*Supra note 7*) 265.

line between these two types of services, because Intermediation service is often priced through margins rather than explicit fees, which makes it difficult to identify the actual value added.³⁸

Value Added Tax (VAT) has become one of the most commonly used tax systems worldwide. Because when it is designed well, it can generate substantial revenue and is relatively manageable to administer.³⁹ But the application of VAT to financial services is difficult due to different legal and economic reasons. There is no adequate and clear practical method to tax financial services, so they are exempted in many countries.⁴⁰ Financial institutions often profit from intermediation services by distributing service charges among many customers. This makes it difficult to identify the exact added value and, in turn, keeps it out of the reach of VAT.⁴¹ Administrative challenges are also a reason that constrained the reach of VAT in financial services.

Another argument suggests that taxing financial institutions could distort consumer decisions, as a consumption-based tax, VAT, should ideally apply only to actual consumption. For instance, insurance services are not considered direct consumption goods; rather, they serve as a tool for managing and spreading financial risks over time.⁴² These services help individuals and businesses allocate resources towards future consumption, typically involving goods that are already subject to VAT. Therefore, applying VAT to such services is seen as inconsistent with the core principle of taxing only final consumption and supports the case for exempting them.⁴³

Harry Huizinga explains that, unlike most sectors where value added is easily calculated, financial services pose a challenge due to the difficulty in valuing financial capital, one of their main inputs. This makes it hard to determine the actual value added, complicating the application of VAT to the sector.⁴⁴ While the other reason for exempting financial services from VAT is the technical difficulty in taxing them, some scholars say financial services have a unique nature, including their role in capital allocation, liquidity management, and risk distribution. This makes it reasonable to

³⁸ *ibid* 172

³⁹ Charles E, McLure (*Supra note 29*) 5.

⁴⁰ Otto A. Altenburger (*Supra note 20*) 354.

⁴¹ Taddese (*Supra note 7*) 265.

⁴² Grubert and Mackie (*Supra note 19*) 25.

⁴³ *ibid*.

⁴⁴ Harry Huizinga, A European VAT on Financial Services? (*Economic Policy*, Vol. 17, No. 35), (2002), P. 500.

treat them differently and keep out of VAT, both for practical challenges and complexity to tax effectively under the conventional VAT system.⁴⁵

2.5 VAT Treatment of Financial and Insurance Services in Ethiopia

Ethiopia's treatment of financial services under VAT has evolved significantly over time. The first Value Added Tax Proclamation No. 285/2002 adopted the conventional model followed by many jurisdictions, broadly exempting financial services from VAT. However, this exemption was not absolute. Certain service was explicitly classified as taxable under Ethiopian VAT laws, even when they are provided by a financial institution, and whether or not they are rendered in connection with an exempt financial service.⁴⁶ The law gives minimal detail about the scope and types of services that are qualified for exemptions. Relatively, the VAT Regulation tries to fill this gap by listing the types of financial services that were either exempt or taxable,⁴⁷ irrespective of whether they were offered by financial institutions or other providers.⁴⁸ In this framework, all insurance services, whether life, health, or general insurance, were considered exempt from VAT, alongside a wide range of financial services.⁴⁹

Importantly, the exemptions under this regime were not based on the identity of the service provider, such as banks or insurers, but rather on the nature of the service itself. This approach clarified that the VAT exemption was not a special privilege granted to the financial industry but a policy decision tied to the characteristics of certain services, particularly those with technical or conceptual challenges in VAT application.⁵⁰ A policy shift occurred with the enactment of VAT Proclamation No. 1341/2024, which restructured the VAT framework with the goals of broadening the tax base, enhancing revenue collection, and improving alignment with international tax standards. One of the major changes introduced was the partial removal of the VAT exemption for insurance services. Under the revised VAT regime, only life and health insurance are exempted.

⁴⁵ Conventional VAT systems refer to the standard or traditional models of VAT that follow the invoice-credit mechanism. These systems are widely used in most economies and taxing consumptions at each stage of production and distribution; see Taddese (n 7). p. 274.

⁴⁶ Council of Ministers Value Added Tax Regulations No. 79/2002, Federal Negarit Gazeta, 9th year, No. 19, Article 20(6) (Hereinafter VAT Regulation 2002).

⁴⁷ VAT Regulations 2002, Article 8(2)(b).

⁴⁸ VAT Regulations 2002, Article 20 (1), (2).

⁴⁹ VAT Regulations 2002, Article 20 (2) (d).

⁵⁰ Taddese (*Supra note 7*) P. 278.

All other categories of general insurance, covering around 90 % of policies in Ethiopia, are subject to the VAT.⁵¹

According to Schedule 2 of the new VATP, financial services provided by licensed banks, other financial institutions, or even non-institutional actors remain exempted, like the treatment under the 2002 VAT proclamation.⁵² However, the New VATP includes a more specific list of exempt financial services within the proclamation itself, rather than being listed out in regulations.

Another change introduced by the New VAT Proclamation is the institutional reassignment of the power to grant exemptions from the MoF to the CoM. The aim is to create a more coordinated and transparent system for administering VAT exemptions. In line with this change, the CoM issued Directive No. 1006/2024, which updates and formalizes the list of VAT-exempt goods and services. This directive nullified previous exemptions granted by various MoF decisions or directives and subjected many formerly exempt items to the standard VAT rate of 15%.⁵³

Moreover, the new VAT framework emphasizes limiting exemptions only to final consumption products. In the case of financial institutions, services offered for a fee, such as commissions, advisory charges, or transaction-based service fees, are now considered taxable. This targeted approach aims to distinguish between core intermediation services, which remain exempt due to technical difficulties in VAT application, and fee-based services, which are easier to tax and more aligned with consumption principles.

In General, even if the exemption of main financial services activities continues to be exempt from VAT, the decision to tax general insurance and other fee-based financial services reflects a policy change to broaden the VAT base and modernize the overall tax administration system of the country.

⁵¹ Maya (*Supra note 15*).

⁵² New VAT Proc. No 1341/2024, Schedule 2 Article 1(c), 2(18).

⁵³ New VAT Proc. No 1341/2024, Article 73(1) (2), The Ministry of Finance (MOF) has issued a new directive No. 1006/2024 with the list of exempt goods in addition to the lists on VAT proclamation No. 285/2002 (as amended) and VAT regulation NO. 79/1995. The new directive also excluded all goods and services that have previously been exempt through various directives issued or decisions made by the MOF. Such goods will now be subject to VAT at the standard rate of 15%.

2.6 Possible Approaches for VAT Treatment of Insurance Services

2.6.1 Full Taxation with Input Tax Credits

This model has been proposed by the government's Advisory Panel on GST in New Zealand as a way to enhance revenue and preserve the neutrality of the VAT system.⁵⁴ Full taxation of insurance services refers to a VAT regime in which insurance premiums are subject to VAT, while insurers are permitted to claim input tax credits for the VAT paid on goods and services purchased in the course of providing insurance coverage.⁵⁵ A full taxation approach is relatively more compatible with the neutrality principle of VAT. Under this VAT system, the tax obligations fall on the final consumer, and businesses are not affected by the cascading effects of taxes.⁵⁶ In contrast, a full taxation approach has a high capacity of generating revenues and avoiding the ambiguity created by exemptions.⁵⁷

But there are both practical and administrative challenges of applying a full taxation approach, such as the difficulty of identifying the exact value of services provided and determining which services are actually a consumption.⁵⁸

2.6.2 Exemption, with No Credits

Most of the time, exempting financial services from VAT is considered as doing a good thing for the financial industry. But the effect is the reverse of what was presumed. Under this exemption approach, insurance services are not subject to VAT at the point of sale; however, insurance companies remain liable for paying VAT on their purchases of goods and services used in the course of their business operations, which cannot be recovered as input tax credits.⁵⁹ One of the central administrative issues associated with exemption is the difficulty of differentiating input VAT. Insurance companies typically provide both taxable and exempt services, such as when certain fee-based services are taxed while others remain exempt. In these situations, separating the

⁵⁴ Second Report, of the Advisory Panel on Goods and Service Tax, (1984), p. 6-9.

⁵⁵ Huizinga (Supra note 44), p. 31.

⁵⁶ *ibid.*

⁵⁷ *ibid.*

⁵⁸ *id.*, P. 32.

⁵⁹ *id.*, P. 499.

input VAT that applies to taxable activities from that connected to exempt ones becomes very difficult. This increases the compliance burden for both the taxpayers and the authorities.⁶⁰

Furthermore, financial institutions have chosen to provide some services like IT services, legal consultancy, and document management by their own rather than outsourcing such services. Outsourcing services are subject to VAT, and institutions cannot claim input credits on those payments. As a result, insurers may consider that performing such activities in-house is more economically efficient.⁶¹

Because of the discourse related to identifying what exemption actually means, financial products are becoming diversified, and service delivery becomes more sophisticated, it is difficult to exactly identify which transaction falls under the scope of exemption.⁶² In addition, the exemption of financial services might seem like to be simple for administration, but over time, exemptions tend to reduce efficiency, create fairness concerns, and increase compliance burdens. So, for countries that want to build a broad-based VAT system, exemption of financial services is not the most effective approach.⁶³

2.6.3 Zero-rating (exemption with full credits)

As the name indicates, Zero-rating means applying 0% of VAT on the supply of certain goods or services. Which differs Zero-rating from exemption is the entitlement to claim input tax credit. Under this approach, businesses do not have a burden to bear the tax burden on their inputs. Therefore, applying zero-rating is more effective than exemption because of its ability to preserve VAT neutrality and reduce the cascading effect of tax.

As a drawback raised related to the zero-rating approach is the tendency to slightly decline government revenue. This approach also may require administrative work, such as handling the process of refunds or rebates for the insurer, but both the above impacts are usually manageable in a still-developing insurance sector and a limited number of insurance providers, like Ethiopia.⁶⁴

⁶⁰ *ibid.*

⁶¹ Taddese (Supra note 7), P. 308.

⁶² De La Fera, Rita, 'The EU VAT Treatment of Insurance and Financial Services (Again) under Review.' (EC Tax Review, Vol. 16, No. 2), P. 74-89.

⁶³ Otto A. Altenburger · Rudolf Diewald · Max Götttsche (n 18).

⁶⁴ Malcolm Gillis, The VAT and Financial Services, (World Bank, DRD220), (1987), P. 33.

moreover, zero-rating insurance service can be an effective way to attract consumers and encourage greater use of insurance and support broader financial inclusion.⁶⁵

Sometimes, there are policy considerations, such as protecting legal rights, strengthening the financial sector, and encouraging the use of insurance as a risk-management tool, which need to be considered in the government's tax design procedure.⁶⁶ From both an efficiency and policy standpoint, zero-rating appears to be a more viable option than complete exemption, which often leads to hidden tax burdens.⁶⁷

2.7 The Doctrine of Subrogation in Insurance

2.7.1 Meaning, Nature, and Advantage of Subrogation

The origin of the doctrine of subrogation can be traced back to Roman law,⁶⁸ where the Latin term “surrogare” meaning “to substitute” or “to put in the place of another,” laid the conceptual groundwork for what is now recognized in insurance law.

In the context of insurance, the Subrogation right is one of the most important doctrines and a fundamental legal principle of insurance law that substitutes the insurer in place of the insured to claim reimbursement of what it had paid to the insured, from a liable third party for a loss covered by the insurance”.⁶⁹ The insured gives to the insurer any legal rights to collect damages from the liable third party to the extent that a loss payment is made.⁷⁰ If the insured has acted in a way that precludes a lawsuit by the insurer against the third-party liable, the insurer can raise this as a defense and will be properly excused from payment of the policy proceeds.⁷¹ If an insurer has fulfilled its obligation by compensating the insured under the terms of the contract, and if its

⁶⁵ *ibid.*

⁶⁶ *id.*, at 11.

⁶⁷ *ibid.*

⁶⁸ Ronald Horn, *Subrogation in Insurance Theory and Practice*, (S.S. Huebner Foundation, Homewood), (1964), p. 15.

⁶⁹ George E Rejda and Namara Michael, *Principles of Risk Management and Insurance*, (12th Pearson Education, Boston), (2014), p. 184-192.

⁷⁰ *ibid.*

⁷¹ Jeffrey A Greenblatt, *Insurance and Subrogation: When the Pie Isn't Big Enough, Who Eats Last?* (The University of Chicago Law Review), (1997), p. 137.

subrogation right has been prejudiced by the insured's settlement with the at-fault third party (tortfeasor), the insurer is entitled to seek reimbursement from the insured.⁷²

The doctrine of subrogation not only facilitates equitable recovery but also reinforces the principle of indemnity, which is the foundation of insurance law by ensuring that neither the insured nor the insurer profits from the occurrence of a loss. In practice the insurer is entitled to recover from third parties responsible for the damage, but only to the extent of the compensation paid to the insured. But there are contractual features that may reduce the reimbursement amount of covered loss, such as deductibles and other contractual provisions.

Since the concept of subrogation is not confined to a single discipline, its meaning may vary across different areas of study. It is recognized and applied within several branches of obligation law.⁷³ Therefore, it is essential to clarify the specific legal context in which the term is used when defining it. In this regard, Subrogation is most commonly associated with the law of contracts, particularly within the realm of insurance.⁷⁴ Now it's necessary to examine the types of subrogation right that are recognized under insurance law.

2.7.2 Type of Subrogation

Subrogation may take different forms depending on the framework within which it is applied. In the context of insurance law, two primary categories of subrogation are recognized: legal (equitable) subrogation and conventional subrogation.⁷⁵ Legal subrogation arises by operation of law,⁷⁶ and does not require an express provision in the insurance contract.⁷⁷ This form of subrogation ensures that once an insurer indemnifies the insured, the insurer is automatically entitled to a right to recover from a third party responsible for the loss, regardless of whether the policy explicitly mentions such a right.

⁷² *ibid.*

⁷³ Mawcha Geremedhn, *The Doctrine of Subrogation in Ethiopian Insurance Regime: Its Significance and Applicability to Liability Insurance*, (LLM Thesis), (2020), p. 20.

⁷⁴ *ibid.*

⁷⁵ Spencer L Kimball and Don A Davis, *Extension of Insurance Subrogation*, (Mich. L. Rev), (1961), p. 841.

⁷⁶ Horn (Supra note 68) P. 15.

⁷⁷ Mawcha (Supra note 73). p. 22.

On the other hand, conventional subrogation stems from an express agreement between the insurer and the insured.⁷⁸ Usually incorporated into the terms of the insurance policy. In such cases, the subrogation right is contractually created and governed by the general principle of contract law.⁷⁹ This type of subrogation becomes particularly important when insurance policies are not regulated by law.⁸⁰ The distinction between legal and conventional subrogation highlights the dual sources, law and contract, through which insurers may acquire the right to step into the shoes of the insured to pursue recovery from a third party.

2.8 The Economic and Legal Significance of Subrogation for Insurer and the Ethiopian Insurance Industry

The doctrine of subrogation plays a pivotal role in strengthening the financial sustainability and long-term development of insurance markets, especially in emerging economies such as Ethiopia, where the industry remains underdeveloped.⁸¹ After the Ethiopian insurance industry showed gradual improvement since 1994, when the financial sector was liberalized, it still remains one of the least developed in the region.⁸² In 2022, the sector contributed only 0.6% to the national GDP, and overall insurance penetration only estimated at well below one percent.⁸³ The gross written premiums amount is estimated at around 0.3 percent of GDP. In contrast, Kenya, which has a similar economic profile, has reported an insurance contribution of about 1.5 percent of GDP and generates 2 billion USD in annual premiums, which is almost six times that of Ethiopia's total contribution.⁸⁴ The Ethiopian insurance market is highly dominated by general (non-life) insurance, while life insurance products represent only a small share of overall business.⁸⁵

⁷⁸ Horn (Supra note 68) P. 16.

⁷⁹ *ibid.*

⁸⁰ Mawcha (Supra note 73) P. 22.

⁸¹ Hailu Zeleke, *Insurance in Ethiopia: Historical Development, Present Status and Future Challenges* (Master Printing Press), (2007), p. 91-98.

⁸² *ibid.*

⁸³ Doubell Chamberlain, 'Then and Now: Is Ethiopia at an Inflection Point after 15 Years of Insurance Underdevelopment?' (*Cenfri*, 22 February 2024) <<https://cenfri.org>> accessed 15 June 2025.

⁸⁴ Samson Berhane, *When Will Ethiopia's Insurance Industry Join the Economic High-Flyers?* <<https://www.linkedin.com>> accessed 15 June 2025.

⁸⁵ Kahase G/Michael, *Ethiopian Insurance Sector and Its Contribution to Economic Growth*, (Masters of Business Administration Thesis, AAU), (2018), P. 7.

The insurance sector can benefit when the doctrine of subrogation is given proper legal and practical protection. Through the subrogation right, an insurance company can recover the paid amount of money during a claim by representing and taking all rights of the insured from the legally responsible party for the loss.⁸⁶

The amounts recovered through subrogation can not only help the insurance company to restore its capital but also maintain liquidity and solvency, strengthen its profitability, and manage its operations more sustainably.⁸⁷ Finally, these financial benefits can be essential for improving insurance penetration and building public confidence in the sector.⁸⁸

Where there is limited capital and weak recovery systems in the insurance industry, like in Ethiopia, the net recovery amount from exercising the subrogation right plays a great role in the industry.⁸⁹ They can help insurers manage the risk pooling mechanism and invest in developing new products or expanding their services.⁹⁰ These improvements support wider national objectives such as deepening the financial sector, promoting economic stability, and ensuring that risks are transferred efficiently by an affordable premium. So, it's necessary to properly check that insurance companies are able to exercise their surrogation right within their representative capacity from the insureds, and there is no unreasonable burden from legal, regulatory, and tax frameworks, like VAT rules.

2.9 The Legal Basis of Subrogation in Ethiopia's Insurance and Civil Law Regimes

The effective application of the subrogation right depends on the existence of a clear and supportive legal framework. As an important legal principle, both insurance law and other civil law should provide well-defined and clear rules for subrogation that allow insurer to use their right as the law provides.

⁸⁶ Robert E Keeton, Basic Text on Insurance Law (West Pub Co., St. Paul Minn), (1971), P.2.

⁸⁷ George E. Rejda and Michael J. McNamara, Principles of Risk Management and Insurance, (12th Pearson Education Boston), (2014), P. 30.

⁸⁸ *ibid.*

⁸⁹ Mawcha (Supra note 73) 33.

⁹⁰ *ibid.*

In the Ethiopian context, the principal legal instruments addressing subrogation are the Commercial Code, the Civil Code, and sector-specific proclamations such as the Civil Servants Law and the Labour Proclamation.

2.9.1 The Commercial Code

The Ethiopian Commercial Code, in force since 1960, addresses insurance under Title III of Book III. It distinguishes between two broad categories of insurance into insurance against damages (indemnity insurance) and insurance of persons (non-indemnity insurance).⁹¹ The Code explicitly affirms the indemnity nature of property insurance, requiring full, but not excessive, compensation for loss.⁹² Certain legal provisions of the Code apply to all forms of insurance. Art. 658 can be mentioned as an example, and the most important provision that lists down the particulars required by any kind of valid insurance contract.

Article 683(1) of the Com. Code provides a clear statutory basis for legal subrogation in property insurance, establishing that once the insurer compensates the insured, it is legally subrogated to the rights of the insured against any third party responsible for the loss.⁹³ Similarly, Article 1971(c) of the Civil Code reinforces this right.⁹⁴ Conversely, Article 690 of the Com. Code emphatically prohibits subrogation, both legal and contractual, in the context of personal insurance. The rationale lies in the belief that no monetary recovery can truly compensate for personal loss such as death or bodily injury. Thus, allowing both compensation from the insurer and damages from a tortfeasor is not considered unjust enrichment.

Liability insurance has existed in categories of "insurance against damages" under the commercial code, but there are no specific provisions under the code that deal with how subrogation is treated in liability insurance. One view suggests that because liability insurance often deals with

⁹¹ Commercial. Code, Proc.No.166, Neg. Gaz., 19th Year. No. 3, Art. 654(2) and (3). Four Chapters (Arts. 654-712) of the Code, with other laws, are devoted to regulate the legal framework of insurance in Ethiopia. Additionally, marine insurance is regulated by the marine code, Maritime Code of the Empire of Ethiopia 1960, Proc. No. 164, Neg. Gaz., 19th Year. No. 1, Art. 288-369.

⁹² *id.*, Art. 678.

⁹³ *id.*, Arts. 682 & 683. The Commercial Code uses the phrase 'insurance of object' to refer the class of insurance commonly called 'property insurance'.

⁹⁴ George Krzeczunowicz, *The Ethiopian Law of Compensation for Damage*, (Addis Ababa University, Faculty of Law), (1977), P. 86.

compensation for third-party property damage or bodily injury, and given its indemnity character, subrogation should logically be permitted, at least for property-related claims.⁹⁵ This argument is strengthened by the placement of liability insurance within the same chapter of the Commercial Code as property insurance, implying shared legal attributes.⁹⁶

Moreover, the draft Insurance Proclamation, expected to replace outdated parts of the Commercial Code, proposes clarifying the legal status of subrogation in liability insurance.⁹⁷ In practice, contractual subrogation clauses are increasingly used in liability policies to fill the legislative gap, relying on the general principle of freedom of contract.⁹⁸ Nevertheless, there are computing arguments against applying subrogation to liability insurance, particularly when the insured party is the injured person. Analogous to the reasoning in personal insurance, it is argued that allowing subrogation in such contexts could deny victims full recovery, undermining the humanitarian purpose of such coverage.⁹⁹

2.9.2 The Civil Code

The Ethiopian Civil Code addresses both legal and contractual subrogation.¹⁰⁰ Under Articles 1968 and 1969, contractual subrogation is putted which emanates from agreements either initiated by the creditor or debtor. Meanwhile, Article 2093(3) specifically recognizes subrogation within insurance contracts, providing that the insurer, upon compensating the insured, may be substituted into the rights of the insured and claim reimbursement from the third-party liable.¹⁰¹

⁹⁵ Tsegaye Demisse, *Introducing the Doctrine of Subrogation under the Ethiopian Personal Insurance Regime*, (LLM Thesis AAU), (2020) P. 27.

⁹⁶ Mawcha (Supra note 73) 36.

⁹⁷ Commercial. Code, Proc.No.166, Neg. Gaz., 19th Year. No. 3., The proposal also discussed on Private Sector Development Hub/Addis Ababa Chamber of Commerce and Sectorial Association, "Position of the Business Community on the Revision of the Commercial Code of Ethiopia" PSD Hub Publication No.8 (2009), P. 32.

⁹⁸ Chris Parsons, *Insurance Law* (CII, 2018/19) 12/2. It is usually the task of Civil Codes to regulate general obligation including contract and tort laws.

⁹⁹ Tsegaye (Supra note 95) 29.

¹⁰⁰ Jonathan Eddy, *Payment with Subrogation under the Ethiopian Civil Code*. (9 J. Eth.L.No.1), (1973), p. 106- 115.

¹⁰¹ The Civil Code of Ethiopia., Proc. No.165, Neg Gaz., 19th Year. No. 2, Art 2093.

This provision enables contractual subrogation even in personal insurance, as long as such a clause is expressly stipulated in the contract. For example, Tsegaye Demisse, in his master’s thesis, argues that Article 2093(1), read in conjunction with Article 2093(3), supports the enforceability of subrogation clauses in personal insurance to avoid double recovery and preserve equity between parties.¹⁰²

2.9.3 Other Legal Instrument

In addition to the commercial and civil codes, sectoral legislation also recognizes subrogation. The Civil Servants Proclamation provides that if a civil servant suffers a work-related injury due to a third party’s fault, the employer government institution, after paying compensation, has the right to recover that amount from the tortfeasor.¹⁰³

Similarly, the Labour Proclamation No. 1156/2011 imposes strict liability on employers for work-related injuries and details the scope of compensation, including medical costs, disability payments, and dependents' benefits in the event of death.¹⁰⁴

Notably, the Federal Supreme Court Cassation Bench, in the case of “*Ethiopian Insurance Corporation vs. Africa Beza College–Awassa Campus.*”¹⁰⁵, affirmed the legal subrogation right of an employer’s insurer to seek reimbursement from the third party liable for an employee’s injury. The Court reasoned that if an employer possesses the right to subrogation, then the employer’s insurer, after settling a claim, must equally inherit that right. This landmark ruling set a binding precedent, affirming that private employers, like government institutions, are entitled to subrogation under Ethiopian law.¹⁰⁶

¹⁰² Tsegaye (Supra note 95) 29.

¹⁰³ Federal civil servants Proc., No. 1353, Fed.Neg.Gaz.31th Year No 9, 10th December 2024, Arts. 85, 87.

¹⁰⁴ Labor Proc. No.1156 fed. Neg, Gaz 25th Year No. 89 5th September, 2019 Arts 96(1), 105, 107, 109.

¹⁰⁵ E.I.C. Vs Africa Beza College-Awassa Campus, Federal Supreme Court of Ethiopia, Cassation Division, File No. 99179, Unpublished Decided on September 25/2008 E.C.

¹⁰⁶ *ibid.*

2.10 Legal and Tax Implications of Subrogation under the New VAT Regime

2.10.1 The Nature of Insurer Subrogation Right

In insurance businesses, there are transactions where the insurer acts as a principal, and there are also instances where the insurer acts in a representative capacity for the insured. Through the subrogation right, an insurer can recover the paid amount of money during a claim by representing and taking all rights of the insured from the legally responsible party for the loss.¹⁰⁷ In this situation, an insurer has acted as the insured's legal representative, which means the insurer cannot have an obligation and right that does not actually belong to the insured. This implies that the VAT treatment of subrogation recoveries cannot be assessed separately from the first transaction that gave rise to the damage and occurred between the victim and the liable third party.

In subrogation, the recoveries may be taxable depending on whether the insured is a registered VAT payer or not, and the damage involves a taxable supply of goods or services. VAT is chargeable on the compensation payable by the liable third party. In such a case, the insurer exercises its subrogation right in a representative capacity and should effectively step into the legal and tax position of the insured. Consequently, the insurer takes an obligation to account for output VAT that would otherwise have been payable by the insured. On the other hand, where the insured is not VAT registered or where the original claim settlement does not constitute a taxable supply, subrogation recoveries should also remain outside the scope of VAT.

It is important to see the characteristics of the transaction in the application of VAT. The law considers subrogation as a right that is a legal and contractual source through which an insurer can reimburse a payment for the loss from the liable third party through its representative capacity. Both insurance practitioners and tax authorities considered subrogation recoveries exempted from VAT in practice before the enactment of the 2024 VAT Proclamation. This treatment was not the result of explicit legislative exemptions, but rather comes from the absence of clear statutory guidelines on the VAT implications of subrogation recoveries under the previous legal framework. As a policy shift to broaden the tax base, the New VATP legislatively subjects subrogation recoveries for VAT. Nevertheless, the lack of legal clarity under the current legal framework of VAT creates inconsistent application and mischaracterization of subrogation recoveries.

¹⁰⁷ Commercial Code (Supra note 91) Art 683.

To properly understand the policy rationale underlying the policy shift, and to assess whether subrogation recoveries fulfill the fundamental requirements of VAT liability, it is necessary to examine conceptual shifts from “taxable transactions” to “taxable supply” with the core elements that define a taxable supply under the current VAT framework. Accordingly, the following section analyzes the core elements of taxable supply and evaluates whether, and in what circumstances, insurer subrogation recoveries should be legally considered to fall within the VAT net.

2.10.2 The Notion of ‘Taxable Supply’ and Its Application to Insurer Subrogation Recoveries

Under the new VATP, the legal basis for applying VAT to domestic transactions is grounded in the concept of a “taxable supply”. A taxable supply is defined as a supply of goods or services made in Ethiopia by a person in the course or furtherance of a taxable activity, excluding an exempt supply. In addition, the definition explicitly includes anything that is treated as a taxable supply under the provisions of the proclamation, regardless of whether it fits the standard definition.¹⁰⁸

The definition entails three core elements: (a) supply of goods or services; (b) that occurs in Ethiopia; and (c) that is made in the course or furtherance of a taxable activity. Alongside a broader inclusion clause that enables the law to treat certain supplies as taxable by express provision, the structure allows the proclamation to bring within the “VAT Net.”¹⁰⁹

To understand the role of subrogation in VAT, it's better to examine the taxable supply. The definition consists of three basic elements. A taxable supply is:

- a) a supply of goods or services;
- b) that occurs in Ethiopia;
- c) in the course or furtherance of a taxable activity.

The Subrogation right is exercised in all of Ethiopia, so it's more relevant to examine the first and third elements.

¹⁰⁸ New VAT Proc No 1341/2024, Article 2(47).

¹⁰⁹ The phrase "VAT Net" is a commonly used metaphor in VAT law, referring to the scope of activities or transactions subject to VAT. It is used to describe how certain transactions are, even if non-traditional supplies can be brought into the VAT system through legislative design that deems certain activities taxable for policy or administrative reasons.

2.10.3 Supply of Goods or Services

According to the proclamation, goods refer to all kinds of corporeal movable or immovable property, excluding money and intangible electronic transmissions.¹¹⁰ Services are defined as anything that is not goods or money.¹¹¹ The ‘supply of goods’ is described as the sale, exchange, or other transfer of the right to dispose of goods as an owner, or the lease or hire of goods under a hire-purchase or finance lease arrangement.¹¹²

On the other hand, ‘supply of service’ is defined as anything done that is not the supply of goods or money. More specifically, a supply of services includes a wide range of intangible transactions: the grant or surrender of rights, the provision of facilities or advantages, toleration of situations, refraining from acts, or even the transmission of products through electromagnetic systems.¹¹³ From this broad definitional framework, it is evident that the scope of “supply” under the new proclamation is expansive, capturing a variety of non-traditional, intangible, or non-physical exchanges.¹¹⁴

However, when examining the nature of subrogation, it does not involve transactions in which the insurer supplies goods or services to the third party. Rather, subrogation is a legal mechanism through which the insurer enforces the insured's pre-existing right of recovery against a liable third party after indemnifying the loss. The insurer neither creates new value nor provides a service to the tortfeasor it merely substitutes itself in the legal position of the insured.

Therefore, while the new VATP provides a deliberately broad definition of taxable supply, classifying subrogation recoveries as supply, particularly as a supply of service, it does not independently constitute a supply of goods or service. However, subrogation recoveries may be subject to VAT where the underlying original loss made to a VAT-registered insured constitutes a taxable supply. Which means VAT cannot arise from the act of subrogation recoveries itself.

¹¹⁰ New VAT Proc No 1341/2024, Art. 2 (20).

¹¹¹ New VAT Proc No 1341/2024, Art. 2(37).

¹¹² New VAT Proc No 1341/2024, Art. 2(40).

¹¹³ New VAT Proc No 1341/2024, Art. 2(41).

¹¹⁴ See Art. 2(41) of The New VAT Proc No 1341/2024. The expansion of “supply of services” to include toleration of a situation, refraining from acts, and electromagnetic transmissions reflects the legislature’s intent to align the VAT base with modern, non-traditional forms of economic activity.

2.10.4 That occurs in Ethiopia

The second element, “that occurs in Ethiopia,” is generally satisfied without legal ambiguity, as both the indemnification and recovery processes take place within Ethiopian jurisdiction. Subrogation claims are typically pursued through domestic legal mechanisms or informal negotiations and result in financial settlements within Ethiopia. Therefore, this element does not bar VAT application but merely reinforces territorial applicability.

2.10.5 In the course or furtherance of a taxable activity

This requirement consisted of two elements: ‘*taxable activity*’ and ‘*in the course or furtherance of*’-

A. Taxable Activity

Article 7(1) of the new VATP defines “taxable activity” as “any activity carried on continuously or regularly by a person that involves, or is intended to involve, in whole or part, the supply of goods or services to any other person for consideration.” From this definition, three cumulative elements can be identified: the activity must be continuous or regular, it must involve or be intended to involve the supply of goods or services, and such supply must be made to another person for consideration. Other countries use phrases like ‘economic activity’, ‘enterprise’, or ‘businesses’ to refer to what the Ethiopian VAT law calls ‘taxable activity’.¹¹⁵

The concept and applicability of supply of goods and services have examined in the above, so it is necessary only to examine the elements of continuous or regular supply for consideration.

B. For continuous or regular activity

A taxable activity must be a continuous or regular activity to be subject to the regime of VAT. VAT requires some regularity in the activity of the taxpayer. In the context of modern VAT systems, a transaction is considered a taxable supply if it takes place as part of a broader taxable activity. This means that the individual supply does not need to be frequent or ongoing to fall under

¹¹⁵ The Australian GST law, for example, uses the word ‘enterprise’ and European Union VAT Directive uses ‘economic activity’ to refer to the same thing; to refer to what is known in Ethiopia VAT legislation simply as ‘taxable activity’.

VAT, what matters is that it occurs within the framework of a continuous or regular business activity.¹¹⁶

The enforcement of the subrogation right does not automatically qualify as a taxable activity, but its replacement of a taxable transaction that would be undertaken by the insured original right implies its effect. In addition to this, the taxable supply of recoveries by exercising the subrogation right by the insurer is not expected to be continuous or regular for it to attract VAT as long as it occurs in the context of a continuous or regular activity of the insurer. The focus is more directly on the linkage between any given supply and the overarching taxable activity.

C. In the course of furtherance of...

VAT legislation does not offer a single definition of the phrase “in the course of furtherance of” a taxable activity. Instead, it outlines specific instances where the supply of goods or services may or may not fall within this scope. At first glance, the phrase may seem vague, but its purpose is to encompass the wide range of transactions that occur in connection with a taxable activity. Whether a particular supply qualifies depends on the specific facts and circumstances surrounding the transaction.

In the case of insurance companies, their operations are inherently continuous and regular, involving the provision of coverage in return for premiums, activities that clearly qualify as taxable under Article 2(50) of the New VAT Proclamation. As a result, any processes that are part of or related to this core business can be viewed as occurring in the course of a taxable activity and become vulnerable to VAT application.

2.11 Conceptual Shift from "Taxable Transaction" to "Taxable Supply" and Its Implications

One of the key amendments introduced by the New VAT Proclamation is the replacement of the term “taxable transaction” by “taxable supply.” The change cannot be merely a change of the term's name, but it also implies a conceptual and structural change towards the country's VAT design.

¹¹⁶ Taddese (Supra note 7) 291.

Under the repealed VAT Proclamation No. 285/2002 and Regulation No. 79/2002, VAT was triggered by a "taxable transaction," defined as a supply of goods or services made in Ethiopia in the course or furtherance of a taxable activity, excluding exempt supplies.¹¹⁷ This formulation explicitly separated the event that attracted VAT (the transaction) from the broader economic context in which it occurred (the taxable activity). A taxable activity, under Article 6 of the repealed proclamation, referred to any activity conducted regularly or continuously that involved or intended to involve the supply of goods or services for consideration.

In contrast, the new VAT Proclamation No. 1341/2024 does not define or use the term "taxable transaction." The new VAT proclamation uses the term "taxable supply" instead of "taxable transaction". According to Article 2(47) of the proclamation, "taxable supply" is a supply of goods or services made in Ethiopia by a person in the course or furtherance of a taxable activity, other than an exempt supply. Concerning "taxable activity," the definition is almost substantially the same as the amended law, which defines it as a regular or continuous activity carried out for consideration. So, the new VAT Proclamation by structurally removing the intermediate notion of a "taxable transaction" gives more place for the direct relationship between each supply of goods or services and the broader taxable activity to which it belongs to identify the tax liability.

As discussed in detail in Chapter Four, the change raises conceptual challenges about what subrogation should be treated under the VAT regime. The absence of an exchange, consideration, or value added in subrogation recoveries suggests that not all recoveries should be deemed as taxable supply. The insurer has a representative capacity that takes the right from the insured, so the VAT law must protect this representative capacity and cannot frame a rule that undermines this. A direct application of Article 40 (6) without assessing the representative element of subrogation recoveries by the insurer risks overextension of VAT into compensatory legal mechanisms.

¹¹⁷ VAT Proclamation No. 285/2002, Federal Negarit Gazeta, 8th year, No. 33, Article 7(1)(a), (2), (3), 6.

CHAPTER THREE

COMPARATIVE LEGAL PERSPECTIVES

3.1 Introduction

This chapter deals with how VAT and subrogation recoveries are treated under the law in selected jurisdictions such as the EU, New Zealand, Australia, and South Africa, and seeks to identify comparative insights to be used to examine and inform Ethiopian practice. The discussion of such jurisdictions represents systems of diverse taxation. Among these various countries' different legal prescriptions on the relations between VAT laws and the subrogation rights of insurers. Assessing the experience of countries with different legal prescriptions, this paper intends to emphasize how each country has approached the issue. The comparison would consequently relate to the research problem of legal and practical uncertainties arising under the Ethiopian 2024 VAT Proclamation, particularly the subrogation rights of insurers.

3.2 Synthesis and Lessons to Be Learned

In contrast to the Ethiopian approach under the 2024 VAT legislation, jurisdictions such as New Zealand, Australia, and South Africa have developed more coherent and context-based legal frameworks for addressing the VAT implications of insurance subrogation. These frameworks are designed to preserve the compensatory nature of insurance and maintain core VAT principles, including neutrality, legal certainty, and administrative clarity.

The New Zealand approach only considers subrogation recoveries to be an amount of consideration for a taxable supply if the insurer was entitled to claim an input tax credit on the original compensation payment. This conditional treatment establishes a direct and rational linkage between input tax entitlement and output tax liability, ensuring that VAT applies only to the extent that the insurer substitutes for a VAT-registered insured in recovering a taxable amount. importantly, the output VAT is calculated only based on the net repair cost. This method ensures the insurer's tax obligation is aligned with their real economic burden through their legal representative capacity, thereby avoiding over-taxation and ensuring conceptual consistency within the VAT system.

Australia's GST framework also has another implication to handle the issue. Subrogation recoveries cannot be considered as a taxable supply, because payments by third parties to an insurer are classified as "non-consideration", which is requirements for a transaction to fall within the scope of GST. This approach distinguishes the commercial supplies and legal remedies, thereby protecting the compensatory character of subrogation and preventing double taxation. However, a closer look reveals a potential drawback. Since subrogation recoveries are exempted, the insurer may not be entitled to claim input tax credits on the original compensation payments. Thus, while the Australian model ensures doctrinal consistency and avoids taxing compensatory flows. On the other hand, South Africa exempts both the original insurance compensation payments and subrogation recoveries from VAT. This approach is grounded in the consideration that insurance claim settlements and subsequent recoveries are compensatory legal mechanisms rather than commercial transactions.

The key lesson learned from the above-stated countries is that effective VAT treatment of subrogation depends on a clear statutory design that distinguishes legal remedies from taxable supplies, while recognizing the insurer's contractual and representative capacity. Legal certainty, administrative guidance, and well-defined taxable events are essential to avoid unnecessary burdens on the insurer's recovery rights and to support the development of the insurance sector.

These comparative lessons highlight the practical need for Ethiopia to adopt clear and more coherent VAT rules on subrogation, supported by detailed guidelines and strengthened institutional capacity, all of which directly address the doctrinal and practical challenges identified in Chapter four.

3.3 VAT treatment of insurance and subrogation in selected jurisdictions

3.3.1 European Union

The European Union (EU) adopted the VAT system in the 1960s.¹¹⁸ The EU approach is the most dominant, which is followed by many countries in the world.¹¹⁹ Despite its early adoption, the EU

¹¹⁸ Walter Hellerstein, and Timothy H Gillis, *The VAT in the European Union, Views on VAT - Tax Notes*, (2010).

¹¹⁹ H. Zee, *Taxing the Financial Sector: Concepts, Issues, and Practices*, (International Monetary Fund), (2004), P. 60-74.

has failed to apply VAT to financial services, even after forty years of regulatory development.¹²⁰ Under the EU's VAT system, Financial and insurance services are generally exempt.

The VAT law within the EU is primarily governed by the Council Directive 2006/112/EC (the "VAT Directive"). Article 135(1)(a) up to (g) provides that most financial services, such as loans, credit, deposit accounts, and securities transactions, are exempt from VAT. Similarly, insurance and reinsurance services are expressly exempt under Article 135(1)(a).¹²¹

However, the tax exemption model of financial services is under debate.¹²² For example, financial institutions cannot recover input VAT on purchases related to exempt supplies, leading to rooted VAT costs and economic distortions. To find an option, discussions were initiated by the European Commission in 2006 to assess the reaction of both economic operators and national tax administrations.¹²³ The Commission raised concerns that the exemption regime weakens tax neutrality, reduces input VAT recovery, and undermines the international competitiveness of the relevant companies.¹²⁴ Another concern is the lack of harmonization between EU countries so that the same financial services are treated differently in each nation.¹²⁵ In most EU member states, insurance services are exempt from VAT. However, the EU VAT system adopted special insurance taxes rather than VAT on premiums in many jurisdictions.¹²⁶ These special taxes do not follow VAT's design principles, but are considered compatible with the EU framework.¹²⁷

With regard to subrogation, it does not create a new taxable supply by itself. The EU approach treats the VAT consequences of subrogation recoveries arises only if the original transaction has

¹²⁰ Rita De La Feria and Michael Walpole. Option for Taxing Financial Supplies in Value Added Tax: EU VAT and Australian GST Model Compared, (International and Comparative Law Quarterly), (2009), P. 4.

¹²¹ The basic regulation of the European VAT system is the so-called Value Added Tax System Directive (VATSD), Council Directive 2006/112/EC of 28 November 2006 on the common system of value added tax, [2006] OJ L347/1, Since then, amended several times.

¹²² De La Feria and Walpole (Supra note 119) P. 12.

¹²³ Consultation Paper on Modernizing Value Added Tax Obligations for Financial Services and Insurances, (European Commission), (2006).

¹²⁴ Krzysztof Biernacki, The VAT in the Bank System', (Journal of Governance and Regulation, Volume 2), (2013), p. 2. See also P.R. Merrill, VAT Treatment of the Financial Sector, Tax Analysts, (2011), P. 163-185.

¹²⁵ *ibid.*

¹²⁶ Malcolm Gillis (Supra note 64) 33.

¹²⁷ *ibid.*

constituted a taxable supply. That is, if the underlying insurance service is exempt, any subrogated recovery does not constitute a taxable supply. This was confirmed by the EU court of justice case, for instance, in Case C-42/22 (*Generali Seguros SA v. Autoridade Tributária e Aduaneira*),¹²⁸ where the Court of Justice of the EU (CJEU) ruled that even resale of salvaged items acquired through subrogation remained VAT-exempt, as part of the insurer's core indemnity function. So, the determining factor is whether VAT existed at the level of the insured and the third-party transaction.

3.3.2 New Zealand

New Zealand introduced its modern Goods and Services Tax (GST) in 1985, which can be called the modern GST model and has influenced many other jurisdictions in developing their consumption tax.¹²⁹ Unlike many other jurisdictions, New Zealand maintains a relatively streamlined GST system with few exemptions. Items classed as “necessities”, such as food, children's clothing, medical care, education services, and energy, were not exempted but are subject to GST at the standard rate.¹³⁰

The New Zealand GST allows some input taxes attributable to exempt financial services, which means zero-rating some financial services even when these services are supplied for the domestic market. But New Zealand GST is known by its elective zero-rating mechanism for financial services; financial intermediation services rendered for registered persons whose taxable supplies exceed 75% elect to treat as zero-rated for GST purposes, enabling them to claim full input credits.

Before, “there is a trend to taxing non-life insurance under the New Zealand VAT systems, non-Life insurance is universally exempted from the VAT, irrespective of a country's VAT treatment of other financial services.”¹³¹ The insurance premium and payments for compensatory damage

¹²⁸ Case C-42/22, *Generali Seguros SA v Autoridade Tributaria e Aduaneira*: Judgment of the Court 9ECJ) (Ninth Chamber) of 9 March 2023.

¹²⁹ Richard Krever, *Designing and Drafting VAT Laws for Africa*, (in Richard Krever (ed) *VAT in Africa*, Pretoria University Law Press, South Africa), (2008)P. 13-18.

¹³⁰ Christine Peacock, *Malaysian GST Handbook*, (2015), P. 5.

¹³¹ Alan Schenk and Howell H Zee, *Financial Services and the Value-Added*, P. 73.

settlements for registered person subject to GST.¹³² Section 5(13) of the GST Act of 1985 provides that *“if a registered person receives a payment under a contract of insurance, whether or not the person is a party to the contract, the payment is, to the extent that it relates to a loss incurred in the course or furtherance of the registered person’s taxable activity, deemed to be consideration received for a supply of services performed by the registered person.”* This means that, even where a settlement is for compensatory damage, a registered third-party claimant receiving a settlement payment is deemed to have made a taxable supply and is liable for GST.

Crucially for insurers, Subrogation payments in New Zealand are deemed consideration of a supply of service by the insurer only if an input tax credit has been allowed to the insurer for the payment in respect of which the subrogation payment is made.¹³³ Section 20(3) of the Act 2000 is amended to allow registered persons making subrogation payments to claim input tax credits for those payments, ensuring their GST entitlements align with the underlying economic transactions. Means subrogation is treated as supplying a taxable service, but only when it has previously claimed input tax credits on the original payment. It is conditionally taxed to reverse or adjust already paid GST in relation to a taxable supply. This framework can create a coherent tax framework if an insurer didn't claim input credits on the original payment (e.g., indemnity to a policyholder), no GST arises on the subrogation recovery.

But subrogation recovery is subject to output tax if input tax credits were claimed on the primary compensation payment. This can be used to identify that the New Zealand approach has allowed insurers to act within their capacity. The idea under Article 40(6) of the New VAT proclamation of Ethiopia is logically the same as what is provided, but the legal framework was not clear and incorporated provisions that misled for application. Although the absence of a clear legal framework that is compatible with the principle of subrogation leads to the imposition of VAT on taxable supply, which is actually free from VAT, like subrogation recoveries, which are paid for an unregistered beneficiary.

¹³² New Zealand Goods and Services Tax Act 1985, Section 5(13).

¹³³ New Zealand Goods and Services Tax Act 1985, Section 5(13B).

3.3.3 Australia

Australia implemented its Goods and Services Tax (GST) on 1 July 2000, replacing the wholesale sales tax system and consolidating a variety of state and territory-level taxes and duties.¹³⁴ The Australian GST system is influenced by both the EU and New Zealand models. In its design, the Australian GST strikes a middle ground, while broadly exempting financial services like the EU, it also permits “reduced input tax credit” claims on exempt financial services, somewhat like New Zealand’s approach.¹³⁵

In the insurance sector, the Australian GST law mandates full taxation of non-life (General) insurance services, such as those covering property and casualty losses. This taxation is implemented through two distinct mechanisms: first, the pooling service provided by the insurer (funded by premiums) is subject to GST; second, the repair or replacement of the insured assets, when carried out, is also taxed.¹³⁶ Life insurance, however, is classified as an exempted and zero-rated supply for some health insurance policies.¹³⁷ For registered persons, the GST system allows them to claim input tax credits for the GST imposed on insurance premiums, for offsetting the tax burden, and simplifying the GST treatment of insurance policies. Additionally, insurance undertakings themselves are entitled to input tax relief on their purchases, which supports economic neutrality and prevents tax cascading.¹³⁸

With respect to subrogation, the Australian GST framework adopts an exempting approach for subrogation recoveries, treating third-party payments as non-consideration. “Under the Australian Goods and Services Tax (GST), unlike the insured, who would seek to recover a GST-inclusive value of the loss, the insurer only recovers the GST-exclusive value. This means the insurer is focused on its net cost for the loss. Which does not include GST”.¹³⁹ The legislation states that the payment from the third party to the insurer is not consideration, one of the requirements for a

¹³⁴ Rebecca Millar and Denis McCarthy, *The Future of Indirect Taxation: Recent Trends in VAT and GST Systems Around the World – Australia*, (Social Science Research Network), (2012) P. 21.

¹³⁵ Graeme Cooper and Richard Vann, *Implementing the Goods and Services Tax*, (Sydney Law Review 337), (1999) P. 344.

¹³⁶ Krever and Teoh (Supra note 17) 2.

¹³⁷ *ibid.*

¹³⁸ Otto A. Altenburger, Rudolf Diewald and Max Götttsche (Supra note 18) 347.

¹³⁹ Krever and Teoh (Supra note 17) 3.

supply to be a taxable supply. this is crucial because it means that the insurer does not make a taxable supply in the subrogation arrangement. As a result of this treatment, any amount recovered by the insurer is not subject to GST or exempt from GST.¹⁴⁰ At the same time, the registered party cannot claim an input tax credit on the amount paid to the insurer.¹⁴¹ However, this treatment may have unintended financial implications for insurers. Since subrogation recoveries have been exempted, the insurer could be restricted from claiming input tax credits on the original compensation payments made to policyholders. This could result in a VAT burden that undermines the principle of tax neutrality and increases the insurer's net cost.

3.3.4 South Africa

South Africa implemented the Value-Added Tax (VAT) system in 1991, broadly following the New Zealand GST system, which has a few spaces for exemptions and zero-rated.¹⁴² The 1991 South African VAT legislation exempted financial services. However, legislative amendments in 1996 and 1999 imposed VAT on specific elements of financial services, particularly fees, commissions, and other services directly related to the provision of certain financial products.¹⁴³ South Africa has gone further than many countries in expanding the reach of VAT on financial services.

The South African approach limits VAT exemptions to interest charges and related components that function as penalties or discounts. In contrast, VAT applies to services such as currency exchange, cheque and credit arrangements, equity and security transactions, banking and financial advisory services, and brokerage functions. This expansive inclusion of financial services under VAT is guided by detailed administrative interpretations and is frequently updated in consultation with the financial industry.¹⁴⁴

¹⁴⁰ A New Tax System (Goods and Services Tax) Act 1999, Section 78-35.

¹⁴¹ *ibid*, Section 78-75.

¹⁴² Alain Charlet and Jeffrey Owens, *An International Perspective on VAT*, (Future, Tax Notes International), (2007), P. 943-945. On the other hand, basic foodstuffs, agricultural products, and housing subsidies were zero-rated in the South African VAT system, which has seen some departures from the New Zealand model.

¹⁴³ Davis Tax Committee (2014), *First Interim Report on VAT to the Minister of Finance*, P. 75.

¹⁴⁴ South African, *Short-Term Insurance Act, (1998) (Act No. 53 of 1998)*. And the *Amendment Act (2013)*, by the *Financial Services Laws General Amendment, Gazette 37351*.

With respect to the insurance sector, the Value-Added Tax Act No. 89 of 1991 provides that all standard insurance premiums are subject to VAT at the standard rate of 15%. This includes premiums on both short-term general policies and long-term insurance products. These premiums are taxable regardless of whether the policyholder is a business or an individual.

However, the payment of insurance claims, i.e., benefit payouts made by insurers to insured parties, is generally not subject to VAT. Two justifications have been given for this: first, VAT has actually been paid on the premium, and secondly, compensation payment both at settlements of claim and recoveries has a nature of compensation rather than being a transaction, so it should be protected this nature by avoiding VAT. In particular, under Section 16(3)(c) of the VAT Act of South Africa, and guidance published by the South African Revenue Service (SARS) considered that subrogation recoveries from third parties are not consideration paid for a supply made by the insurer. So, subrogation recoveries are not treated as taxable supplies.¹⁴⁵

In general, South Africa's approach has imposed VAT on fee-based services on one side and exempted insurance-related legal activities, such as compensatory payments and subrogation recoveries. on the other side, the country has tried to create a balance between revenue objectives and challenges of taxing financial intermediation.

¹⁴⁵ *ibid*, Section 16(3) c.

CHAPTER FOUR

ETHIOPIAN VAT TREATMENT OF SUBROGATION: LEGAL AND PRACTICAL CHALLENGES

4.1 Introduction

Many countries in the world have shown their interest in expanding their indirect tax regimes. Particularly, VAT is widely adopted by these countries as an option to tax the service sector, which was previously untaxed, including various financial and insurance-related services. The reasons behind adopting a tax that can widen the tax base are the need to make the system more neutral and efficient, and the rising fiscal pressures due to increased demands on public finances.¹⁴⁶ But the application of VAT on sectors like insurance services is complex most of the time.

From basic Insurance service products, which are general (non-life) insurance and life insurance, applying VAT on life insurance presents difficulties with their substantial savings components, which make figuring out the exact value added more difficult.¹⁴⁷ Sometimes it's possible to calculate the value-added portion of a financial transaction at a conceptual level, but it does not mean it can be effectively taxed under a VAT regime, or that all financial services should fall under a VAT.¹⁴⁸ Determining which types of insurance transactions should be subjected to tax and framing a proper method for taxing them requires detailed legal and economic consideration analysis.¹⁴⁹

Countries are challenged by the difficulty of designing rules that appropriately capture taxable value in complex insurance operations without distorting consumer behavior or compromising the integrity of risk-sharing mechanisms when they try to modernize their VAT frameworks. Ethiopia's recent reforms, like the introduction of VAT on general insurance and extended application to subrogation recoveries under Proclamation No. 1341/2024, also raise such a type of legal and operational discourse. This research focuses on identifying legal and practical discourses

¹⁴⁶ Vicky Barham, SN Poddar and John Whalley, *The TAX Treatment of Insurance Under a Consumption Type, Destination Basis VAT*, (National Tax Journal), (1987), P. 171.

¹⁴⁷ *ibid.*

¹⁴⁸ Gillis (Supra note 64) 9.

¹⁴⁹ *ibid.*

related to insurers' subrogation recoveries and examines how the current framework fails to treat the subrogation recoveries exercised by insurers in a representative capacity correctly.

If not appropriately applied, VAT can challenge the development of a country's financial and insurance sectors. Their challenge is undermining effective financial intermediation necessary for channeling domestic savings into productive investment.¹⁵⁰ That a comprehensive inclusion of financial services within the VAT framework has proved impracticable in most jurisdictions. This is partly due to administrative complexities that hinder accurate tax assessment, as well as the nature of many financial services, such as not being a final consumption, and, hence, falling outside the core objective of consumption-based taxation systems like VAT, and like the legal capacity of service providers or service suppliers exists in subrogation recoveries.¹⁵¹

In the context of subrogation, treating all recoveries as taxable supplies without clearly considering the legal representative capacity of the insurance company undermines the nature of the subrogation right. Additionally, the uncertainty in the interpretation and application of the VAT rule governing subrogation recoveries under the current VAT law has led to incorrect treatment of subrogation recoveries, increased administrative burdens, increased disputes, and impediments to effective recovery mechanisms.

4.2 Doctrinal Gaps in Applying VAT on Subrogation: Taxable Supply, Representative Capacity, and Legal Uncertainty

4.2.1 The Route of Supply and the Insurer's Representative Capacity in Subrogation

In insurance services, neither the gross premium received from policyholders nor the claims paid out to the insured properly indicates the true value of the service provided.¹⁵² Both major insurance transactions substantially relate to monetary transfer rather than the provision of a quantifiable taxable service. Subrogation allows the insurer to step into the legal position of the insured to recover amounts from a liable third party, rather than directly engaging in a commercial exchange of goods or services. The legal confusion surrounding VAT treatment of subrogation recoveries

¹⁵⁰ Gillis (Supra note 64) 9.

¹⁵¹ *ibid.*

¹⁵² *ibid.*

by insurer arise from the dislocation of the route of the supplies that insurers have exercised by their representative capacity. before apply VAT to subrogation recoveries, it's necessary to clearly identify the route of supply and the legal capacity in which the insurer acts when exercising the subrogation right. Accordingly, determining VAT liability in subrogation recoveries cannot be resolved by seeing the fact of recovery. It must be assessed by tracing the underlying supply and identifying whether the insurer is acting in its own principal right or in a representative capacity on behalf of the insured. Subrogation recoveries by the insurer cannot be seen as a transaction occurring only between the insurer and the liable third party.

Subrogation is the right of the insurer to claim a payment from third party wrongdoer after indemnification. It is a legal mechanism that transfers the insured's right of recovery to the insurer and does not create a new transaction between the insurer and the third party. In this instance, the original transaction has occurred between the insured and the third-party liable person. The insurer steps into the shoes of the insured and enforces the insured's original claim against the liable third party. This means for the purpose of VAT the legal and tax character of any recovery must follow the nature of the original relationship between the insured and the third party, rather than being recharacterized as an independent supply by the insurer.

The distinction is crucial to identify the VAT liability of the insurer on subrogation recoveries. where the insured is a VAT-registered person, and the original claim involves a taxable supply of goods or services, any recovery from the liable third party would ordinarily attract VAT at the level of the insured. In such cases, if the insurer claims recovery through subrogation from the liable third party after indemnifying the insured by using its representative capacity, the recovery should be subject to VAT. Under this conditional scenario, the insurer's obligation to account for output VAT arises not because subrogation itself constitutes a taxable supply, but because the underlying transaction was taxable in the first place.

Conversely, where the insured is not a VAT registered person, not required to be registered, or where the original loss does not arise from a taxable activity, there is no VAT obligation at the level of the insured. In these circumstances, treating the insurer's subrogation recovery as a taxable supply lacks doctrinal justification. Because the insurer is merely enforcing a transferred legal

right from the insured and it does not independently constitute as a taxable supply without considering the taxable status of the original transaction.

The tax base shift from "taxable transaction" to the broader concept of "taxable supply" under Article 2(47) of the proclamation removes the transactional threshold that the previous law considered and replaces it with a wide supply-based standard to decide which activities fall within the VAT.¹⁵³ To the experts, this legislative choice is only a deliberate move to widen the tax base, but not to understand and protect the legal aspect of the subrogation right and indemnity principle.¹⁵⁴

There is an inconsistency in how Article 40(4) should be cumulatively interpreted with Article 40(6) about the output VAT on subrogation applied.¹⁵⁵ Recent cases from the Federal First Instance court provide a valuable judicial insight into the evolving interpretation of VAT obligation in subrogation-related recoveries. For instance, two notable cases are EIC vs Nyala Insurance Corporation and NICE Insurance vs Nyala Insurance, which demonstrate the practical and legal confusion surrounding the VAT treatment of recoveries between insurers, particularly when one insurer seeks reimbursement for a claim payment made to a repair service provider.¹⁵⁶

In both cases, the plaintiff insurer (EIC and NICE Insurance) had paid a payment for garage repair services on behalf of their insured clients. The compensation payment paid for the garage included both the repair cost and a separately calculated 15% VAT. Subsequently, these insurers pursued reimbursement from the insurer which has given an insurance policy for the liable third party under subrogation and claimed not only the VAT-inclusive amount paid to the garage but also an additional 15% VAT applied over the total amount of compensation by treating the entire compensation as a taxable supply to the recovering insurer. For example, E.I.C. paid 40,000 birr

¹⁵³ Interview with Ato Fikadu Yami, Litigation Directorate Director, Legal Services Directorate, Ethiopian Insurance Corporation (E.I.C). (Addis Ababa, 29 June 2025).

¹⁵⁴ Interview with Ato Fikadu Yami (Supra note 152). Ato Getu Melke, Legal Department Director, Nyala Insurance. and Ato Aron Kassaye, Legal Department Director, United Insurance. (Addis Ababa, 29 & 30 June 2025).

¹⁵⁵ Interview with Elias Taye, Finance Manager Head, United Insurance, (Addis Ababa, 30 June 2025).

¹⁵⁶ Ethiopian Insurance Corporation Vs Nyala Insurance Corporation, Federal First Instance Court, File No 17063, Decided on 12 April 2025 GC). NICE Insurance Vs Nyala Insurance Corporation, Federal First Instance Court, File No. 16294, Decided on 26 May 2025 G.C)

in damages and 6,000 birr VAT a total of 46,000 to a repair garage, and then asked reimbursement from Nyala Insurance totaling 52,900 birr, adding 6,900 birr (15% VAT on 46,000) based on Article 40(6). Nyala Insurance rejected the excess claim, then prompting litigation.

In both cases, the presiding judge, who heard both cases, rejected the excess VAT claims. The court justified this by saying the initial compensation amount already includes VAT, so it cannot serve as the basis for an additional VAT charge when claimed from another insurer. The judgment was grounded on Article 40 of the new VAT proclamation and Article 13 of Regulation No. 570/2025, by state that the payment of compensation for damage is considered as included VAT. Therefore, the court reasoned that once a VAT-inclusive payment is made to a third party (in this case, for a repair garage), any subsequent reimbursement by another insurer does not constitute a new taxable supply and cannot justify an additional output VAT charge.

The cases show the legal ambiguity in which Article 40(6) is applied and the practical consequences of misinterpreting legal principles and recoveries in subrogation recoveries, but the judicial reasoning discloses that there is a conceptual misplacement of the VAT inquiry. The critical issue under VAT treatment of subrogation recoveries is not whether the original compensation payments were VAT-inclusive or not, but whether the underlying claim settlement constituted a taxable supply in the first place, and the legal route of the supply. The court only base their analysis on the VAT-inclusive character of the repair payment, and misses the necessary examination of the original taxable relationship between the insured and the liable third party. In subrogation recoveries, output VAT liability should follow the tax status of the original supply and the VAT registration of the insured. As a result, the judgment avoided double taxation in the cases at hand, but it failed to articulate a principal rule capable of addressing the case by examining whether the insured is VAT-registered and the original claim would have attracted output VAT. This missing point limits the precedential value of the decision and maintains legal uncertainties in the application of Article 40(6), especially regarding representative capacity and the conditional taxability of subrogation recoveries.

Furthermore, VAT is being wrongly applied even when the beneficiary of the compensation is a non-registered person, which contradicts the intent of Article 40(4) of the new VATP.¹⁵⁷ The

¹⁵⁷ Interview with Ato Getu Melke and Ato Fikadu Yami (Supra note 153)

Amharic Version phrasing can lead to reading that registration is only required for non-resident persons. As a result, some insurers interpret the law to mean that input tax credit is allowed for all resident persons, regardless of their VAT registration status.¹⁵⁸ When this view is read together with Article 40(6), which deems subrogation recoveries taxable at all times, it creates confusion. Then the insurer ends up treating all recoveries as taxable, even when the original compensation is paid for a non-registered person.¹⁵⁹ Despite internal debate among the legal and finance departments, this interpretation has now become the industry-wide approach. This ambiguity emanates from poor legislative drafting and has led to mistreatment of subrogation recoveries, inconsistent practice, legal uncertainty, and increase burden on the court by unnecessary litigation, which could have been avoided through clear statutory language.

The VAT regulation, rather than clarifying the scope of VAT liability on subrogation recoveries, appears to further broaden the interpretation by treating all recoveries through subrogation as taxable, regardless of recognize the insurer representative nature of subrogation recoveries try to stipulated under Article 40(4), and undermines the intent of the cumulative requirement put under Article 40(6) and 40(4).¹⁶⁰ The regulation failed to align with the conditional logic of the proclamation.¹⁶¹ Even the technical note elaborate a detail about the new VATP appears to suggest that VAT registration is required only for non-resident persons. This has led to the interpretation that, when a claim payout is made to a resident person, the insurer is liable to output VAT, regardless of the original claim compensation recipient's registration status.¹⁶²

In this respect, the regulation not only fails to resolve existing legal uncertainty but also contributes to practical confusion, litigation, and potential unnecessary taxation within the insurance sector.¹⁶³

¹⁵⁸ Interview with Ato Getu Melke and Ato Fikadu Yami (Supra note 153).

¹⁵⁹ Interview with Ato Getu Melke and Ato Fikadu Yami Supra note 153).

¹⁶⁰ Council of Ministers Value Added Tax Regulations No. 570/2025, Federal Negarit Gazeta, 31th year, No. 31, Article 13(9).

¹⁶¹ Interview with Ato Getu Melke and Ato Fikadu Yami (Supra note 153).

¹⁶² New VAT Proc No. 1341/2024, Detail Technical Notes. The technical note put in a context of registration is require only for non-resident person, "Sub-Article (4) applies only where the following conditions are satisfies..... (2) The payment is made to: (i) a resident person; or (ii) a non-resident person who is a registered person".

¹⁶³ Interview with Ato Aron Kassaye (Supra note 153).

Comparatively the New Zealand's¹⁶⁴ approach makes it clear that subrogated recoveries are only treated as taxable supplies if the insurer has recovered input VAT. Australia's¹⁶⁵ and South Africa's VAT¹⁶⁶ framework excludes subrogation entirely from the definition of taxable supplies. The comparative experience demonstrates that subrogation recoveries do not constitute taxable supplies by themselves. VAT consequences arise only where subrogation operates as a substitute for, or representative execution of, an underlying taxable supply involving a VAT-registered person. The current Ethiopian VAT system challenge lies not in recognizing this principle, but in framing it with sufficient legislative clarity and failure to clearly identify the route of supply and the legal capacity in which insurers act when exercising subrogation rights.

4.2.2 Inconsistency between the VAT Proclamation and the implementing Regulation

The legal ambiguity also exists under Article 40(1) of the VATP and Article 13(5) of the VATR concerning the direction of supply and the characterization of insurance-related compensation under VAT, which leads to challenging the handling of VAT liability. The proclamation states that *“if a registered person receives a payment under a general insurance contract in connection with a taxable activity, the payment shall be treated as consideration for a supply of services made by the registered person”*.¹⁶⁷ This statement considers the insured as the service supplier, and the insurer as the recipient of those services and payment maker. By contrast, the regulation, which declares to implement the same provision, states that *“when an insurer pays insurance compensation to a registered person, the compensation is considered as the price paid by the insurer for the services provided to the insured”*.¹⁶⁸ This inverts the role, implying that the insurer is the service provider, and the insured is services recipient. It presents a substantive legal contradiction that creates confusion in the application of VAT rules in insurance claims. Because

¹⁶⁴ New Zealand Goods and Services Tax Act 1985, Section 5(13).

¹⁶⁵ A New Tax System (Goods and Services Tax) Act 1999, Section 78-35.

¹⁶⁶ South Africa Value-Added Tax Act 89 of 1991.

¹⁶⁷ New VAT Proc No 1341/2024, Article 40(1).

¹⁶⁸ VAT Regulation No. 570/2025, Article 13(5).

a correct and predictable application of VAT depends on the clear identification of who bears the tax liability and who may claim input tax credit.¹⁶⁹

In addition to this, the existing law cannot address the multidimensional nature of insurance service, especially the claim settlements.¹⁷⁰ For example, neither the VATP nor the VATR guide on how VAT should be treated in cases of cash settlements, or in total loss scenarios where the insurer pays the maximum policy limit without reference to actual repairs. For instance, in Australia GST system even when claims are settled in cash without a VAT invoice or supply of goods, the ordinary rules apply allowing the insurer to recover GST through notional input tax credit.¹⁷¹

In contrast, Ethiopian general VAT imposition on subrogation, regardless of whether the initial settlements were taxable supply or not, undermines the nature of the subrogation right, lacks such refinement, and creates both legal ambiguity and practical burden for the insurer. These not only expose insurers to interpretive risk and noncompliance but also contravene core VAT principles that require a clear link between consideration, supply, and taxable activity.¹⁷² Jurisdictions such as South Africa have developed detailed administrative sector-specific VAT interpretive guidelines, in consultations with tax experts, insurers, finance experts, and legal practitioners, to ensure alignment and secure both legal predictability and administrative efficiency.

4.2.3 Retroactivity and the Legal Validity of Enforcement Dates

Another critical issue concerns the retroactive effect of the new VATP, which has introduced both legal inconsistency and a high VAT burden on the insurer. The new VATP stipulates that the law shall enter into force upon the date of its approval by the House of Peoples' Representatives on date of 4 July 2024,¹⁷³ but the official publication in the Federal Negarit Gazeta was on 21 August 2024. Under the Ethiopian legal system, new laws become enforceable only upon their official publication. Applying the law retroactively not only contradicts fundamental legal principles but

¹⁶⁹ Interview with Ato Fikadu Yami (Supra note 152).

¹⁷⁰ Interview with Ato Getu Melke (Supra note 153).

¹⁷¹ Notional input tax credit means an insurer or business is allowed to claim back VAT or GST on a payment even if they did not receive a VAT invoice or did not pay VAT directly on the supply.

¹⁷² Interview with Ato Getu Melke (Supra note 153).

¹⁷³ New VAT Proc No 13412024, Article 75.

also creates a burden on insurers, were unable to adjust their operations, documentation, or accounting in time.¹⁷⁴ For instance, several insurers reported having paid substantial amounts in cumulative VAT, following pressure from the tax authority despite the absence of a clear legal obligation before its official publication.¹⁷⁵ Insurers have complied by fearing significant penalties from the tax authority, and then even initiating legal proceedings in response.¹⁷⁶ During this interim period, insurers processed compensation claims without exercising VAT credits. As a result, insurers faced unexpected losses and disruptions to the indemnity principle.

4.3 Practical Challenges

4.3.1 Transitional Subrogation Recoveries: Timing and Installment

The other issue comes where subrogation recoveries were initiated and decided by the court or partially resolved during the period when General Insurance Service was exempted from VAT, but the final payments were made after the new VATP came into effect. For instance, out of court litigation or by agreement installment settlements were initiated before publication of the new VATP or court-ordered injunctions against liable third-party property enforced before the new VATP. In such cases, even though the insurer had neither claimed input tax credit nor issued VAT compliant invoices at the time of compensation, the Revenue Authority now demands VAT on the full recovered amount by citing Article 40(7) of the new VATP, which ties the timing of supply to the actual receipt of subrogation payments.¹⁷⁷ This rigid application fails to account for the transitional nature of the subrogation recovery and disregards the time under which the original compensation was paid, which discourages the amicability of alternative recovery mechanisms rather than court litigation and affects the financial benefit of the insurer.¹⁷⁸

4.3.2. Administrative Burdens

The implementation of VAT on Subrogation recoveries without clearly accounting for the insurer's representative legal capacity has introduced significant administrative confusion and

¹⁷⁴ Interview with Ato Aron Kassaye (Supra note 153).

¹⁷⁵ Interview with Anteneh Yilma, Manager, Finance Operation and General Accounting, Ethiopian Insurance Corporation (E.I.C). (Addis Ababa, 29 June 2025).

¹⁷⁶ Interview with Anteneh Yilma (Supra note 174) .

¹⁷⁷ New VAT Proc No 13412024, Article 40(7).

¹⁷⁸ Interview with Ato Fikadu Yami (Supra note 152).

burden across the insurance sector. One major source of administrative ambiguity and burden is related to regional transactions, where insurance companies settle claims for damages that occur in regional states of Ethiopia. Despite fulfilling the conditions for input tax credit, insurers have been denied credit because the tax authority adds a procedure that requires beneficiaries (insured) to physically confirm receipt of compensation for federal tax authority office. This additional procedure does not have a clear legal basis and obstructs the operational efficiency of insurers and discourages them from pursuing out-of-court subrogation settlements.¹⁷⁹ Insurers are now expected to maintain extensive proof of tax invoices from the service provider for claims settled in remote regions or paid to non-registered individuals, placing an unreasonable burden on insurers and introducing procedural delays. These challenges hinder efficient claims processing and discourage insurers from giving coverage even for risks in remote area even with investment in broader coverage.

Another challenge is also related to the input VAT entitlement when compensation is paid to unregistered persons. The tax authorities still require output VAT on all subrogated recoveries, even if the original claim settlement is not a taxable supply due to the recipient being unregistered. This has forced insurers to adopt a conservative approach by applying VAT across all recoveries regardless of VTA eligibility. This lack of clarity has undermined confidence in tax compliance and triggered increased of audit risks, litigation, and strained the relationship between the insurer and the Revenue and Customs Authority.

4.3.3. Economic Burden of VAT on Insurance Uptake and Industry Growth

While it is theoretically feasible to impose VAT on all forms of economic activity, doing so is often impractical in practical application.¹⁸⁰ Currently, in the Ethiopian insurance industry context, numerous ambiguities and practical challenges exist. One of the main concerns among insurers is the lack of clarity on how VAT should apply to subrogation, particularly in the absence of consistent legislative interpretation, as mentioned. This uncertainty has led to noncompliance risks

¹⁷⁹ Interview with Ato Getu Melke (Supra note 153).

¹⁸⁰ Sabyasachi Bala, Hardeep Kumar, Mohammad Nadeem Khalid, A Study of V.A.T. in United Arab Emirates & Its Impact on Financial Services & Insurance Industry, (International Conference on Computational Intelligence and Knowledge Economy (ICCIKE)), 2019).

and potential exposure to high penalties.¹⁸¹ Without a clear and efficient handling of VAT insurer remain vulnerable to errors that distort financial capacity and elevate compliance costs. Moreover, the VAT regime cannot carefully figure out that distort resource allocation, undermines transparency, and impose disproportionate burden of insurer already grappling with a complex compensation structure.

Most individuals now purchase only third-party vehicle insurance because it is compulsory under the law. the situation is worse for registered businesses, who often avoid insurance by citing the absence of sufficient output VAT against which to claim credit for VAT on premiums as a reason.¹⁸² The new VAT regime may unintentionally discourage risk pooling, which also leads to shrink industry growth and undermines future tax contributions from the insurance companies. Those convey several legal and practical challenges for subrogation recoveries in Ethiopia. These concerns reflect both doctrinal inconsistencies and a false impression of the operational realities of the insurance industry. The efficient tax system should not be imposing unnecessary burden on businesses. It should be protecting the legal nature of the activities and making the businesses affordable as much as possible. However, the current VAT treatment of some activities like subrogation recoveries undermines its nature and may affect long-term industry sustainability if not supported by coherent rules, clear legislative, and responsive administrative framework.

¹⁸¹ Interview with Anteneh Yilma, Manager, Finance Operation and General Accounting, Ethiopian Insurance Corporation (E.I.C). (Addis Ababa, 29 June 2025)' (n 174).

¹⁸² Interview with Ato Getu Melke and Ato Fikadu Yami (Supra note 153).

CHAPTER FIVE

CONCLUSION AND RECOMMENDATION

5.1 Conclusion

In the context of insurance “subrogation right is one of the most important doctrines and a fundamental legal principle of insurance law that substitutes the insurer in place of the insured to claim reimbursement of what it had paid to the insured, from a liable third party for a loss covered by the insurance”.¹⁸³ From the definition its able to understand that VAT treatment of subrogation needs to clearly identify the nature of subrogation and its relationship with the underlying original claim settlement VAT liability status. This legal rationale indicates that the VAT liability of subrogation recoveries by insurers should be determined primarily by identifying whether the original claim settlement involved a taxable supply, particularly where the insured is VAT registered and the underlying transaction would have attracted output tax if settled directly between the insured and a third-party liable.

On the other hand, VAT is not due upon subrogation recoveries if the insured involved is not registered or required to be registered in the first place. Where the transaction at the level of the insured is exempted, such as in cases involving non registered person or VAT-exempt supplies, the subrogation recoveries would not attract VAT. Subrogation recoveries cannot independently generate VAT obligation. Insurance companies may supply or do several taxable services in their principal capacity, but in subrogation recoveries, they act in a representative capacity on the right of the insured. Treating all recoveries by insurers as independent taxable supplies without regard to the insured’s VAT status or the nature of the underlying transaction misleads and transforms a legal remedy into a fictional taxable event.

Under the current Ethiopian VAT framework, the controversy surrounding VAT on subrogation recoveries does not emanate from the inclusion of subrogation within the VAT framework, but from the absence of a clear and principled linkage between the tax liability of subrogation recoveries and the underlying original claim settlements. These drawbacks of the legislation provisions governing subrogation recoveries have led to inconsistent treatment across insurers and

¹⁸³ George E Rejda and Namara Michael (Supra note 69). p 184.

tax authorities. The insurer acts by their representative capacity in subrogation does not totally let insurers free from output VAT obligation. The general rule is that insurers have a representative capacity by the insured where they are exercised subrogation right. So whatever obligations on insurers may assume in VAT, we must remember that the obligations of the insurers are contingent upon the obligations of insureds.

According to the data collected through interviews and case analysis, the current Ethiopian VAT framework concerning subrogation recoveries lacks the doctrinal clarity necessary for applying VAT based on a conditional approach. The ambiguous drafting of Article 40(4) and 40(6) of the VAT proclamation and Regulation No. 570/2025, particularly regarding the VAT registration status of the insured, has led to inconsistent interpretations among insurers, tax authorities, and courts. In practice, the lack of clarity under the legislation can lead to different challenges, such as illegal VAT Collection, administrative disputes, and increased litigation. These problems undermine the core principles of the modern VAT system. Which should aim to be efficient, neutral, and predictable in the eyes of the law.

Furthermore, the current framework imposes retroactive effect on claims finalized before the law's publication in the Federal Negarit Gazeta, and does not accommodate common recovery methods such as installment payments and sale of pre-judgement secured properties by the insurer. These legal and administrative shortcomings have challenged practical recovery efforts and discouraged insurers from exercising subrogation claims through efficient and out-of-court mechanisms.

Comparative experience from those jurisdictions addressed in Chapter Three of the research illustrates that a clear legislative design that distinguishes legal remedies exercised by legal representation from taxable supplies is necessary for treating subrogation recoveries without undermining the nature of subrogation. These jurisdictions achieve coherence by either explicitly linking the taxability of subrogation recoveries with prior input tax entitlements or exempting subrogation recoveries because of it lacks consideration element. Legal certainty, administrative guidance, and well-defined taxable events are essential to avoid unnecessary burdens on insurers' recovery rights and to support the sustainable development of the insurance sector. In contrast, the current VAT framework of Ethiopia is not clear in a sufficient way to correctly treat subrogation recoveries by giving attention to a representative capacity of insurer, route of supply, or taxable status of the underlying original transactions,

Therefore, considering the legal nature of subrogation recovery, the representative capacity of the insurer must be clearly recognized in the VAT framework. The current Ethiopian VAT legislations are not structured in a way that can be clearly identified when subrogation recoveries should attract VAT. These weaknesses of the legislation create uncertainty in the interpretation and application of provisions governing subrogation recoveries, weakening the recovery mechanism, increasing litigation, and discouraging efficient claims settlement practices.

5.2 Recommendation

- ❖ It is necessary to formally recognize the conditional applicability of VAT on subrogation recoveries. Subrogation recoveries attract VAT based on the nature of the original compensation payment. If the insured is VAT registered, the subrogation recoveries by the insurer acting in a representative capacity should be subject to VAT. Where the underlying transaction was not subject to VAT, subrogation recoveries cannot be subject to VAT.
- ❖ The provisions of the VAT proclamation and regulation, which create ambiguities in VAT treatment of subrogation recoveries by insurer should be amended in a way that can clearly distinguish between insurers acting as independent suppliers and insurers acting as legal representatives of insured parties in subrogation. Explicit recognition of representative capacity would prevent the misclassification of recovery action as an autonomous taxable supply and avoid doctrinal confusion in both administrative and judicial settings.
- ❖ The Ministry of Revenue should issue sector-specific administrative guidelines that clearly differentiate VAT-inclusive and VAT-exclusive claim settlement mechanisms, including repair, replacement, cash settlement, and total loss scenarios. This will reduce ambiguity, ensure consistent application, and support both compliance and efficient tax administration.
- ❖ Institutionalize stakeholders' involvement in making VAT laws for the insurance sector. This helps to improve legal clarity on sector-specific VAT rules. Ethiopia should formally involve insurance industry stakeholders in drafting VAT laws, regulations, and guidelines. The collaboration would benefit from aligning the tax policy with industry realities, enhancing compliance, and minimizing legal disputes.
- ❖ It is necessary to design a simplified tax credit mechanism. A simplified credit mechanism and clear guidance on how input tax credit interacts with subsequent recoveries can allow insurers

to offset VAT without administrative challenges and significantly reduce disputes and compliance costs.

- ❖ Finally, it is necessary to give training for tax officials and judges on insurance-specific VAT issues, which would promote consistent interpretation and reduce unnecessary litigation. Judicial awareness of the structure and objective of VAT law will enhance consistent case outcomes and improve legal predictability.

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