



**ADDIS ABABA UNIVERSITY COLLEGE OF LAW  
AND GOVERNANCE STUDIES  
SCHOOL OF LAW**

**Taxation of Vehicle as Employment Fringe Benefits:  
Assessment of Legal and Practical Challenges**

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**Advisor: Taddese Lencho (LLB, LLM, PhD)**

September 2020,

Addis Ababa

Ethiopia

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*A thesis submitted in partial fulfillment of the requirements for the Award of  
Master of Laws (LL. M) in Business Law at School of Law, College of Law and  
Governance Studies, Addis Ababa University*

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**Declaration**

I, Haile Bayisa, hereby declare that the thesis titled, “*Taxation of Vehicle as Employment Fringe Benefits: Assessment of Legal and Practical Challenges*” is my original work and that it has not been submitted for any degree or examination in any other university. I also pledge that all sources used in any form are duly acknowledged.

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*Dedication*

***To my parents***

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**Acronym**

FBT	Fringe Benefits Tax
MOR	Ministry of Revenues
MOF	Ministry of Finance
FITP	Federal Income Tax Proclamation
FITR	Federal Income Tax Regulation
IRS	Internal Revenue Services

## **Abstract**

*Ethiopia introduced detail (not detail enough) rules for the taxation of fringe benefits in the recent income tax reform conducted in 2016. The provision of vehicle by employers to their employees is provided as one of the taxable fringe benefits in the Federal Income Tax Regulation No. 410/2017. The research considers whether the FBT in general and vehicle FBT in particular, is being effectively implemented.*

*The thesis identifies and examines the legal and practical challenges in the implementation of the vehicle fringe benefits as employment income tax in Ethiopian Income Tax System. The study has adopted a mixed legal research method which employed both doctrinal and non-doctrinal legal research approaches. Document analysis of legal and extra-legal materials is made. Data from field work is gathered through in-depth interviews from different stakeholders. The research found out that FBT is not being implemented effectively against employment income. There are legal and practical challenges for the failure. The main problem is lack of clarity in the laws in setting parameters to determine what private use and business use of the vehicle is. Further, the FBT is riddled with some practical challenges. Particularly, there is lack of awareness and understanding among employers and tax administration organs about the vehicle FBT, absence of clear and implementable rules, and absence of adequate administrative control from the tax authority. The thesis found out that the tax authority prefers to deny deductions to corporations on computing their taxable income when they provide fringe benefits. This mainly because employers are easy targets. Based on the findings of the research, the thesis recommends that the MOF and MOR to issue clear, easily understandable and implementable rules and guidelines. Further, the tax administration should work on creating awareness about the FBT.*

Key Terms: Fringe Benefits Tax, vehicle fringe benefits, Ethiopian Income Tax System

## Chapter One

### General Introduction

#### 1.1. Background of the Study

Employers provide different kinds of fringe benefits<sup>1</sup> to their employees in addition to or instead of cash compensation for their services in accordance with employment agreement. The fringe benefits are usually offered in the form of housing, the use of company car for personal purposes, discounted goods and services for employees.<sup>2</sup> There has been a problem of taxing fringe benefits as part of employment income. At conceptual level, there are those who do not consider [in-kind] fringe benefits as income like cash wages or salaries.<sup>3</sup> Besides, “problems arise from the definition of fringe benefits, the difficulty in allocating general benefits among employees, and the difficulty in distinguishing genuine benefits from benefits that are consumed in the course of employment or that are a necessary condition of employment.”<sup>4</sup> Further, valuation of the in-kind fringe benefits stands out as one of the major challenges for taxation.<sup>5</sup> In spite of the conceptual and practical challenges, there has been a growing practice of including fringe benefit in the definition of taxable employment income, in different tax systems.<sup>6</sup>

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<sup>1</sup> As this paper is related with vehicle use as fringe benefits, the term fringe benefits, is used for in-kind fringe benefits, unless specifically stated otherwise. This usage is supported by the FITR (n 13), as it uses “fringe benefits” for in-kind benefits.

<sup>2</sup> Lee Burns and Richard Krever, ‘Individual Income Tax’, in Victor Thuronyi (ed), *Tax Law Design and Drafting*, vol 2 (International Monetary Fund: 1998) 492

<sup>3</sup> *ibid*

<sup>4</sup> *ibid*

<sup>5</sup> Rueven Avi-Yonah and others, *Global Perspectives on Income Taxation*, ( Oxford University Press 2011) 23

<sup>6</sup> *ibid*

In the Ethiopian tax system, fringe benefits have been explicitly included in the taxable income of employees since 1961.<sup>7</sup> Nevertheless, the implementation of the rules on the taxation of these benefits had been difficult. This is mainly due to lack of detail rules, as it is in most jurisdictions. Taddese Lencho concludes that “one of the most obvious misses of the Ethiopian income tax has been its inability to come up with detailed rules governing the taxation of employment fringe benefits, particularly those provided in-kind to employees.”<sup>8</sup> As a result of this laxity of the system in laying down detail rules, scholars argued that the Ethiopian tax system<sup>9</sup> was unfair towards employees that receive their income in cash instead of those paid in-kind, thus, it violated the principle of tax equity.<sup>10</sup>

In its bid to solve this equity problem, the Ethiopian government issued detail rules for taxation of fringe benefits in its 2016 income tax reform. One of the experts behind the reform, Wollela Abehodie, has stated that the policy behind the income tax reform was to ensure fairness in the tax system by including taxation of fringe benefits and its valuation methods.<sup>11</sup> In addition to the equity principle, the government broadens its tax base to raise revenue, one of the clearly stated objectives of the Ethiopian tax system. The FITP states its objective as making the “tax system

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<sup>7</sup> Proclamation to Provide for Payment of Income Tax No. 173/1961, *Negarit Gazeta*, 20<sup>th</sup> year, No. 13, Article 8.

<sup>8</sup> Taddese Lencho, *The Ethiopian Income Tax System: Policy, Design and Practice*, (Phd. Dissertation, University of Alabama: unpublished, 2014) 335, available at <[www.acumen.lib.ua.edu/content/u0015/0000001/0001504/](http://www.acumen.lib.ua.edu/content/u0015/0000001/0001504/)> accessed on 11 November 2019

<sup>9</sup> The term “tax system” for Ethiopia may be questionable by some who expect the tax system to be “...an orderly arrangement of rules and institutions...”, but this research takes point made by Taddese regarding tax system, in which he claims that “To the extent it is possible to detect a hierarchy of institutions, laws, and procedures (however imperfectly these are understood), it is possible to write about a tax system...”, see Taddese Lencho, ‘The Ethiopian Tax System: Excesses and Gaps’ (2012) 20 (2) *Michigan State International Law Review* 328-329

<sup>10</sup> Taddese Lencho (n 8).

<sup>11</sup> Interview Wollela Abehodie (PHD), ‘Getting Acquainted with New Tax Law’, *The Reporter*, (Addis Ababa, 18 June 2016), <<https://www.thereporterethiopia.com/content/getting-acquainted-new-tax-law>>, last accessed on November 6 2019

fair” by including “incomes that are so far not subject to tax into the tax net.”<sup>12</sup> One of the obvious inclusions in the reform is the issuance of detailed rules on the type of taxable fringe benefits and their valuation methods.

Article 12 of the FITP includes in the definition of “employment income” “the value of fringe benefits received by an employee in respect of past, current or future employment.” Like the previous tax laws, the FITP delegated the Council of Ministers to issue regulations that determine “the value and taxation of fringe benefits.” Accordingly, the Council of Ministers issued Regulations Council of Ministers Federal Income Tax Regulation No.410/2017<sup>13</sup> (FITR) for the implementation of the FITP.

The FITR came up with types of taxable and exempt fringe benefits.<sup>14</sup> The provision of vehicle by an employer to an employee is one of the listed kinds of fringe benefits that are subjected to employment income tax under the Regulation.<sup>15</sup> According to Article 14/1 of the Regulation, vehicle fringe benefit is stipulated as “A vehicle provided by an employer to an employee wholly or partly for the private use of the employee...” At the center of the stipulation is that the vehicle must be “provided by an employer to an employee” which is availed for the employee for his “private use” in its entirety or in part.

The government has started pushing for the implementation of the employment fringe benefits rules. The MOR is calling for the employers to calculate and withhold taxable FBT.<sup>16</sup> However, since the inclusion of detailed rules for the taxation of fringe benefits is new to the Ethiopian tax

<sup>12</sup> See second paragraph of preamble of the Federal Income Tax Proclamation, Proclamation No.979/2016, *Fed. Neg. Gaz*, Year 22, No.104 (FITP).

<sup>13</sup> Council of Ministers Federal Income Tax Regulation No.410/2017, *Fed. Negarit. Gazeta*, 23<sup>rd</sup> year, No.82, Addis Ababa, August 25, 2017 (FITR).

<sup>14</sup> *Ibid*, Article 8. Debt waiver, household personnel, housing, discounted interest loan, meal or refreshment, expenditure, property or services, an employee share scheme, vehicle and residual fringe benefits are listed types of taxable fringe benefits.

<sup>15</sup> *Ibid*, Article 8 (1/) cum 14

<sup>16</sup> Fasika Tadesse, ‘ERCA Compels Banks to Pay Taxes on Employees Fringe Benefits’, *Addis Fortune*, (Addis Ababa,...)<<https://addisfortune.net/Articles/erca-compels-banks-to-pay-taxes-on-employees-fringe-benefit/>> accessed on 6 November 2019

system, some employers are not clear with the tax rules on how to do valuation, calculate and deduct the values of fringe benefit.<sup>17</sup> As a result, they are facing difficulty in implementation of the rules set in the FITR. In general, officers in the tax administration organ concede that there is huge gap in implementation of FBT.<sup>18</sup> However, unless the tax laws are effectively and consistently implemented, the objective of ensuring equity will not be achieved.

## **1.2. Statement of the Problem**

Ethiopia introduced rules, but not detailed enough as will be shown in the next chapters, of the types and valuation of employment fringe benefits for taxation purposes in 2017. There were two stated reasons for taxation of fringe benefits in general, and vehicles in particular: ensuring equity and raising the government's revenue.

Vehicle as employment fringe benefit was introduced as one of the taxable kind of benefits. The implementation of FBT has resulted in both legal and practical challenges, which this thesis is aimed at discussing. One major legal problem that can be raised here is lack of definition of "private use" and "business use" in the Regulation. Thus, this raises problems in case the vehicle is used for both business and private uses. There is no clear rule on how the employer tracks the private and business use of the vehicle to ensure fair computation of the taxable income. This obscurity in the provisions of the law has resulted in the ineffectiveness the FBT.

On the practical side, various stakeholders are not clear with the provisions of the laws regarding fringe benefits taxation. In addition, mere fact of introducing the law does not result in equitable tax system on employment income taxation, because the consistency and predictability in the implementation stage matters. Taxation of Vehicle as employment fringe benefits also introduces challenges that are in some cases applicable to all fringe benefits taxation, as well as its own peculiar challenges which will be identified during the study.

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<sup>17</sup> Ibid

<sup>18</sup> Interview conducted with Ato Teressa Ensessu, Director, Tax Operation Directorate, MORs (Addis Ababa, Ethiopia, December 20 2019).

### 1.3. Scope of the Study

This paper focuses on the normative framework and practical challenges in implementation of the taxation of vehicle as employment fringe benefits in Ethiopia. It explores and analyses the federal income tax laws which deal with employment income tax (Schedule “A” of the FITP and Tax Regulation), with special emphasis to taxation of vehicle when it is provided as fringe benefits to employees. Further, the research is limited to practical challenges faced by tax administration at the federal level. Thus, the research does not discuss the provisions of income tax laws of the regional states, albeit their similarity with the federal income taxes.<sup>19</sup> Thus, any reference is not made to regional laws.

### 1.4. Brief Review of Literature and Previous Written Works

The literatures show that many countries are taxing fringe benefits in general and the provision of vehicle as employment fringe benefits by the employer to an employee in particular.<sup>20</sup> Literatures on tax law in Ethiopia are very rare. Two materials stand out as major contributions to understanding the past status of taxation of fringe benefits: Taddese Lencho’s PhD dissertation and Solomon Teshome’s undergraduate thesis<sup>21</sup> are available literatures on the issue of Fringe benefits taxation. Taddese’s and Solomon’s are written before the introduction of the current rules on the taxation of fringe benefits. Thus, the writers called for the introduction of detailed rules for the implementation of taxes on fringe benefits to ensure tax equity and other tax policy goals.

This research deals with the challenges in the implementation of the introduced taxation of vehicle as employment fringe benefits. There has not been literature that assesses the

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<sup>19</sup> Taddese Lencho, ‘Income Tax Assignment Under the Ethiopian Constitution: Issues to Worry About’, (2010), Mizan Law Review Vol. 4 No.1, 32

<sup>20</sup> Victor Thuronyi, *Comparative Tax Law*, (Kluwer Law International 2003), 249-253; Rueven Avi-Yonah and others (n 5); Lee Burns and Richard Krever (n 2).

<sup>21</sup> Solomon Teshome, *The scope of tax exclusion under the Ethiopian employment income tax regime*, (LLB thesis, AAU University Law library, unpublished 2008).



implementation even after two years since the FITR. Thus, the aim of this research is to contribute to fill in this gap.

### **1.5. Research Objectives**

The research has general and specific objectives. In its general objective, it aims at identifying, assessing, and analyzing the legal and practical challenges of taxation of vehicle as employment fringe benefits in the Ethiopian tax system and give recommendations.

In order to achieve the general objective, the research has the following specific objectives:

- To identify, examine and analyze the federal income tax laws of Ethiopia;
- To identify the major legal problems associated with taxation of vehicle fringe benefits;
- To assess the practical challenges in the administration of tax on vehicle as employment fringe benefits;
- To evaluate whether the tax system has achieved the principles and objectives the Ethiopian tax policy, with emphasis on equity, raising revenue and efficiency in taxing vehicle fringe benefit;
- To identify the practical problems faced by employers in withholding employment income tax on vehicle fringe benefits provided for employees; and
- Recommend alternative means for effective implementation to address the gaps.

### **1.6. Research Questions**

In general, the research wrestles to answer what the legal and practical challenges in the implementation of the taxation of vehicle as employment fringe benefits in the Ethiopian tax system are.

Particularly, the research attempts to answer the following specific questions:

1. What does taxation of vehicle mean in the context of employment fringe benefits; what are the meaning, scope and content of taxation of vehicle as fringe benefits?
2. What are the legal challenges on taxation of vehicle as employment fringe benefits under the Ethiopian tax system?

3. What are the practical challenges to comply with, or administer vehicle tax as employment fringe benefits?
4. Does the implementation achieve the objectives of taxation of fringe benefits?
5. What are the alternative solutions, if there are legal and practical problems that need reform?

### **1.7. Research Methodology and Methods**

The paper followed the mixed approach to legal research. Accordingly, the research is to be conducted based on doctrinal legal research methods (desk research) and non-doctrinal research methods (fieldwork). Accordingly, primary and secondary sources in the doctrinal legal research are used. In view of that, the research involves examining, analyzing and explaining of a variety of Ethiopian tax laws such as the Federal Income Tax Proclamation No. 979/2016 (the FITP), FITR and other subsidiary laws found to be necessary. Secondary sources in doctrinal legal research like books, Articles, websites, dictionaries and organizations' reports are used to discuss, explain, interpret, and analyze what the laws stipulate and what they ought to say on the area of the study. References are also made to tax cases, though they are very limited in number.

The research has also highlighted on other countries' experiences with the aim of describing issues raised in the paper. Due to limited space, accessibility of source materials, language and to ensure manageability of the subject-matter, only three countries (Australia, USA and South Africa) are selected for comparison. In the selection of the countries, the researcher has made attempt to align the selection with the purpose of the research, which is identifying and bringing the applicable lessons to the Ethiopian tax system.

To understand the legal and practical challenges on the implementation of the taxation of vehicle as employment fringe benefits under the employment income tax rules, non-doctrinal legal research are conducted. Qualitative data collection techniques are applied. Accordingly, primary and secondary data collection techniques are applied to get relevant data for the research.

Therefore, in order to gather firsthand information from relevant officials, semi-structured in-depth interviews with experienced government officers from MOR and MOF are conducted. Since these officials are directly involved in the tax policy design, initiation, drafting, and enforcement of tax rules, the officials are key and primary stakeholders in identifying the

challenges. They have given direct insights on the legal and practical challenges facing the enforcement of the tax rules. Much emphasis has been made on approaching the most relevant officers based on their experience and relation with employment tax filing system at the federal level.

From the providers of vehicle fringe benefits, the finance officers and legal departments of selected government institutions and private companies are interviewed. The research has requested and found out that all selected employers provide vehicle to their employees for private use. After that, face to face interviews are conducted with officers, who have relevant experiences, of selected federal government institutions and private employers that provide vehicle as employment fringe benefits to their employees in order to identify the legal and practical challenges they are facing in implementing the laws. Thus, based on convenience and availability, MOF and MOR are selected ministries for interview because both are involved in provision of vehicle fringe benefits on one hand and are organs that enforce the tax law on the other. Further, from private employers, the officers of two selected banks, one public enterprise and one beer producing company are interviewed in order to understand the legal and practical challenges in the implementation by these institutions. The Finance officers of Wegagen Bank S.C and Cooperative Bank of Oromia S.C were interviewed. The human resource management and legal department personnel of Ethiopian Insurance Corporation S.C. were interviewed. Besides, Tax and Treasure Manager of BGI Ethiopia was interviewed to get insight from different sector employers. The researcher has made an in-depth examination of the interviews to assess the implementation of the tax rules.

Qualitative data analysis methods are employed to reach at the findings. Accordingly, the primary and secondary data obtained from the in-depth interviews are recorded in audio or written form, organized and prepared for analysis.

### **1.8. Significance of the Study**

Contrary to many tax systems, research on tax laws and their implementation is very scanty in Ethiopia. Particularly, research has not been done on FBT after the introduction of FITP and FITR. Thus, the findings in this research may contribute to improve the existing national

knowledge on the tax system of Ethiopia in general, and tries to shed light on the current status of the implementation of the taxation of vehicle fringe benefits.

The research might be a source of inspiration for future researchers to conduct further research on the area. Besides, it can be an important input for students, researchers, policy makers and any other stakeholder on the issue of income tax, employment income tax and the treatment of vehicle FBT under the Ethiopian tax system. Finally, the research is helpful to further develop the income tax law.

### **1.9.Limitations**

The major limitation of this research is the spread of COVID-19 at the time of gathering data. Most institutions and informants were not welcoming to cooperate with the researcher for fear of the spread of the Virus. Private as well as government institutions were not responsive to cooperate. Thus, the finding of the research cannot be taken as representative of all perspectives and experiences in Ethiopia. However, the concerns raised in the research cannot be dismissed for these limitations.

Due to financial and time constraints, the sample that are taken for the interviews are small. Hence, one of the limitations of the study is that the findings and outcomes cannot be spread to larger populations. The second limitation is in connection with freedom of information. Accessing data from stakeholders is found to be difficult task. Most government authorities do not have publicly accessible data. Besides, the researcher could not get relevant letters written by the MOR and banks for the purpose of this research as authorities are could not find the letter themselves.

Limited literature regarding the topic is the third limitation. This research is written under the impact of acute paucity of literature. The researcher has tried to use internationally available literatures to fill the gap. Further, there are also limited income tax cases decided by court or administrative organs, which are mostly not available. Particularly, due to legal limitation on the tax law in making the dispute settlement accessible to employees, there are no available cases that deal with fringe benefits taxation. Thus, this has created gap in showing the full picture of the problems.

### 1.10. Ethical Considerations

The researcher has taken into account the following ethical considerations during the interviews and entire research process:

- **Informed consent**; the interviewees are requested to give their full consent to participate in an interview after being informed of the content and goals of the research;
- **Privacy and Confidentiality**; the research participants are informed that their privacy and confidential information are protected.

### 1.11. Thesis Organization

The research has four chapters, including the general introduction, in chapter one. Chapter two is devoted to discussion of conceptual and theoretical framework of taxation of fringe benefits in general with particular attention to vehicle as fringe benefits. So, the chapter deals with definition of fringe benefits, rationales behind introduction of taxation of fringe benefits, discussion of issues with taxation of fringe benefits and Vehicle fringe benefits.

Chapter three will be devoted to discussion of taxation of vehicle as employment fringe benefits under Ethiopian tax system. Thus, the researcher will analyze data and findings of the research. The actual evaluation of the legal and practical frameworks and the challenges will be made in this chapter. Practical challenges in relation to implementation of the laws will be discussed and in this chapter. Finally, conclusion and recommendations will be presented in chapter four.

## Chapter Two

### Conceptual and Theoretical Framework of Taxation of Vehicle as Employment Fringe Benefits

#### Introduction

Different literatures show countries began to capture and include different fringe benefits under their employment income tax about three decades ago. One of the areas under which tax systems are showing legal convergence is the inclusion of fringe benefits into employment income tax.<sup>22</sup> Nevertheless, due to different facts like history, politics, socio-economic and legal systems, the tax treatments of employees' fringe benefits differ across jurisdictions.<sup>23</sup> The scope and types of fringe benefits taxed are not similar across jurisdictions. There is also difference in effectiveness of tax systems on taxation of fringe benefits. Conceptual and administrative problems have contributed to the ineffectiveness.<sup>24</sup> Conceptually, certain states consider "fringe benefits as tax-free remuneration so that attempts to expressly bring the value of fringe benefits within the tax base are subject to political resistance."<sup>25</sup> Further, due to this misconception about fringe benefits, they are left out of the definition of income by statute or remain without application because of absence of clear guidelines in the law.<sup>26</sup> Despite the differences, the general trend shows that countries are trying to tax fringe benefits for various reasons.

There are convincing theoretical and practical reasons for the taxation of fringe benefits.<sup>27</sup> Scholars argue that the basic theoretical principles of any tax system, which are fairness and efficiency, cannot be fulfilled without taxation of fringe benefits.<sup>28</sup> One of the common fringe

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<sup>22</sup> Victor Thuronyi (n. 20) 15

<sup>23</sup> Id 247

<sup>24</sup> Lee Burns and Richard Krever, (n. 2)

<sup>25</sup> *ibid*

<sup>26</sup> David M. Graf, 'Taxation of Fringe Benefits', (1985) 27 S Tex L Rev 251

<sup>27</sup> Lee Burns and Richard Krever, (n. 2)

<sup>28</sup> David J. Collins, 'Taxation of Fringe Benefits - An Economist's Perspective', (1987) 4 Austl. Tax F. 95, 98-100

benefits provided to employees by their employers as a compensation for services is the private use of employer owned vehicles. But the taxation of the income derived by employees from this benefit has been facing challenges like the taxation of other fringe benefits discussed above.

This chapter discusses the definitions and theoretical foundations for the taxation of fringe benefits in general and vehicle fringe benefits in particular. The main goals of FBT are ensuring tax equity, efficiency, and revenue generation. In addition, some jurisdictions tax vehicle fringe benefits for regulatory objectives like environmental protection by putting more tax based on CO<sup>2</sup> emissions (UK). However, this paper emphasizes on the tax principles rather than regulatory goals. So, the discussions in following sections are limited to equity and efficiency principles.

## 2.1. Definition and Types of Fringe Benefits

Literatures define fringe benefits, also known as perks, in different ways. Varying definitions are adopted by different writers. Be that as it may, some selected working definitions can be used for the purpose of this research. Black's Law Dictionary defines perk or perquisite as "a privilege or benefit given in addition to one's salary or regular wages."<sup>29</sup> This definition, as elusive as it may be, is comprehensive enough because of its generality as all "privileges and benefits" provided by employer to an employee, in addition to salary or wages, can be subsumed in it. In an almost similar statement, Lee Burns and Richard Krever defined fringe benefit as "...any monetary or nonmonetary benefit derived from employment that does not constitute cash salary or wages."<sup>30</sup> This definition is also broad as it includes all payments made either in monetary or an in-kind form in addition to salary or wages. Stressing on the in-kind benefits aspect of fringe benefits provided by employers, Donald Rutherford defined fringe benefits as "benefits in kind which constitute part of the remuneration of many employees, especially managers..."<sup>31</sup>

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<sup>29</sup> *Black's Law Dictionary* (9<sup>th</sup> ed., 2006)

<sup>30</sup> Lee Burns, and Richard Krever, (n. 2)

<sup>31</sup> Donald Rutherford, *Routledge Dictionary of Economics*, (2<sup>nd</sup> ed, London and New York: Taylor & Francis e-Library 2002)

The Internal Revenue Services (IRS) defines “fringe benefits” as “...a form of pay for the performance of services.”<sup>32</sup> As can be seen from the definition, the IRS’ definition recognizes fringe benefits as a method of compensation for rendering services. Further, under the US tax system, incomes received by independent contractor, partner, or directors are also subjected to FBT when the incomes are received in the form of fringe benefits.<sup>33</sup> Hence the law is not limited to incomes gained from employment only. In general, from the above definitions of fringe benefits, one can gather that fringe benefits are economic benefits, or compensations, which can be provided in cash or in an in-kind form, by an employer to an employee, (sometimes to an independent contractor, e.g. USA), in addition to regular salary or wages. For the purpose of this thesis, the term fringe benefit is used interchangeably with in-kind forms of payment because the research concentrates on vehicle fringe benefits.

There are different types of fringe benefits subjected to tax under different tax systems. Some of the benefits are not clearly included in, or are excluded from, the tax liability. Thus, since all fringe benefits are not subjected to tax, the scope of taxable fringe benefits changes from jurisdiction to jurisdiction. As can be seen from the definitions, there is no limitation as to which kind of benefits are not fringe benefits if they are given in addition to regular salaries. Free personal use of a business cell phone, nap pods and on-site masseuses, meals, expense allowances, recreation facilities, snacks and beverages, commuting subsidies, clothing, low-interest loans, debt waiver, sports and leisure facilities, a company car, a low-interest mortgage, free health insurance, etc. are some of the common fringe benefits.<sup>34</sup>

## **2.2. The Basis and Theoretical Foundations for Taxation of Fringe Benefits**

The basis for the taxation of fringe benefits is that they fulfill the definition of income looked at from the point of view of definition of Comprehensive Income Tax Base (CITB).<sup>35</sup> Haig Simons defines income as “the increase or accretion in one's power to satisfy his wants in a given period in so far as that power consists of (a) money itself, or (b) anything susceptible of valuation in

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<sup>32</sup> Department of the Treasury Internal Revenue Service, *Employer's Tax Guide to Fringe Benefits For use in 2019*, (Publication 15-B), 2, available at <<https://www.irs.gov/pub/irs-prior/p15b--2019.pdf>>

<sup>33</sup> *ibid*

<sup>34</sup> *ibid*

<sup>35</sup> David J. Collins (n 26).



terms of money.”<sup>36</sup> Henry C. Simons, developing on the definition provided by Haig Simons, tried to capture the definition of income as “the algebraic sum of: (1) the market value of rights exercised in consumption; and (2) the change in the value of the store of property rights between the beginning and end of the period in question.”<sup>37</sup> Simons tried to capture every economic gain, irrespective of “...whether the income is realized in cash or in-kind (thus, so-called imputed incomes [fringe benefits] are considered income)...” in the definition of income for the purpose of taxation with aim to reach out tax burden apportionment in an equitable manner to all incomes.<sup>38</sup> Many states have adopted this definition of income in their actual income tax systems. Thus, based on that definition of income, they have begun taxing various fringe benefits. Regarding theoretical foundations for taxation of fringe benefits equity, in its variant as horizontal and vertical conception, is raised as the main rationale of the FBT.

### 2.2.1. Ensuring Tax Equity

Fairness is one of the basic principles against which the overall tax system as well as its components is measured. Many scholars agree that a good tax system should be fair. Thus, it is established that one of the principles of taxation is ensuring tax equity. Equity is an obscure concept; thus very difficult to reach at clear and agreeable definition of the term.<sup>39</sup> Despite the vagueness of the term, there is consensus among scholars that any “tax system should be equitable, i.e. that each taxpayer should contribute his or her fair share to the cost of government.”<sup>40</sup> In order to reach at equitable tax system, economists have come up with two theoretical paradigms: the benefit theory of taxation and ability-to-pay theory of taxation.<sup>41</sup>

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<sup>36</sup> R.M. Haig, 'The Concept of Income - Economic and Legal Aspects' in R.M. Haig, ed., *The Federal Income Tax* (New York: Columbia Press 1921), at 7. As cited in David J. Collins (n 26).

<sup>37</sup> Simons, *Personal Income Taxation*, p. 50, as cited in Taddese Lencho (n 8), p. 181

<sup>38</sup> Taddese Lencho, (n 8), 182

<sup>39</sup> Joseph Stiglitz, and Jay Rosengrad, *The Economics of The Public Sector* (4th ed. W. W. Norton Company, Inc. 2015) 524, see also Taddese Lencho (n 8) 46

<sup>40</sup> Richard A. Musgrave and Peggy B. Musgrave, *Public Finance in Theory and Practice* (5<sup>th</sup> ed. McGraw-Hill 1989) 218

<sup>41</sup> The theories are discussed in detail in Taddese Lencho (n 8) 54-72

The benefits theory of taxation is not relevant to understand this research as it has limited application and is rarely used in tax systems. However, since it is found relevant for comparison with ability-to-pay theory it is necessary to discuss some points. As aptly captured by Richard A. Musgrave and Peggy, this theory states that “an equitable tax system is one under which each taxpayer contributes in line with the benefits which he or she receives from public services.”<sup>42</sup> This theory relates and approximates the tax paid and government expenditure policies in order to make sure taxpayers money can be used to benefit the people in terms of provision of government services.<sup>43</sup> Benefits theory of taxation posits that tax is just only if it is paid as “price” by citizens in order to obtain public services from their government.<sup>44</sup> This theory is criticized for two reasons: first, it is difficult to show the benefit a taxpayer receives from government services in proportion to her payment; second, the theory fails to be effective in ensuring income redistribution.<sup>45</sup> However, with all its flaws, the benefits theory of taxation is applied in some specific circumstances in which fees, user charges, tolls and etc. are used to finance public services directly.<sup>46</sup>

The ability-to-pay theory is the principal justification for employment income tax, including FBT. According to this theory tax should be paid based on “capacity” to pay.<sup>47</sup> Accordingly, it calls for “People with equal capacity to pay the same, and for people with greater ability to pay more.”<sup>48</sup> There are two elements of equity: horizontal equity, which dictates that equal payment of tax by persons with equal capacity, and vertical equity, which states that persons who have more should pay more tax.<sup>49</sup> Taking income as indicator of capacity, whether it is received in fringe benefits forms, like vehicle private use from employer, or in cash form, these equity principles call for payment of tax on both. So, employees with the same amount of income, cash and in-kind payments included, should pay equal amount of tax (horizontal equity); and employees with

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<sup>42</sup> Richard A. Musgrave and Peggy B. Musgrave (n 40) p, 219

<sup>43</sup> *ibid*

<sup>44</sup> Taddese Lencho (n 8) 54

<sup>45</sup> Richard A. Musgrave and Peggy B. Musgrave (n 40) 219

<sup>46</sup> *ibid*

<sup>47</sup> *Id*, 223

<sup>48</sup> *ibid*

<sup>49</sup> *ibid*

different amount of income, cash and in-kind fringe benefits included, should pay different amount of income (vertical equity) in a fair tax system. This would ensure horizontal as well as vertical equity.

Various actual tax systems introduced FBT with the intention to ensure tax equity. For instance, the USA introduced FBT in 1984 with the main rationale of ensuring tax equity. Stating this rationale the Staff of Joint Committee on Taxation stated:

without any well-defined limits on the ability of employers to compensate their employees tax-free by providing noncash benefits having economic value to the employee, new practices will emerge that could shrink the income tax base significantly . . . [and] further shift a disproportionate tax burden to those individuals whose compensation is in the form of cash.<sup>50</sup>

The statement indicates that, the obvious purpose of broadening tax base was to ensure equity among employees whose income is paid in an in-kind fringe benefits and cash forms. Furthermore, the Joint Committee stated the need to limit the list of non-cash compensation as a means of ensuring (increased) equity.<sup>51</sup>

In actual tax systems, the private use of vehicle is commonly provided as compensation for employment services in many tax systems. Moreover, it is one of the commonly provided benefits to high ranking officials, which are paid well in comparison to other employees, in private as well as government sectors,<sup>52</sup> so, vertical equity requires that tax should be imposed on the vehicle benefits.<sup>53</sup>

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<sup>50</sup> The Staff of Joint Comm. On Taxation, 98TH CONG., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984* (Comm. Print 1984) available at <https://www.jct.gov/publications.html?func=startdown&id=3343>

<sup>51</sup>Staff of the Joint Comm. on Tax'n, 98th Cong., *General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984*, at 841 (Comm. Print 1984) as cited in Yehonatan Givati (n 56)

<sup>52</sup> Taddese Lencho (n 8), 336

<sup>53</sup> Michelle Harding, *Personal Tax Treatment of Company Cars and Commuting Expenses: Estimating Fiscal and Environmental Costs*, (OECD Taxation Papers No. 20, 2014) 9

The private use of a vehicle, provided in addition to regular salary that is not taxed can result in more economic gain for an employee that is receiving it. This is against the principle of vertical equity, hence, violates the ability-to-pay principle of taxation. Similarly, there can be a breach of horizontal equity when the private use of a vehicle, provided as part of regular salary, that is not taxed can result in more economic gain for an employee that is receiving it. Therefore, this also violates the ability-to-pay principle of taxation. Generally, ignoring fringe benefits in tax law or practice results in inequitable distribution of tax burden. This results in violation of the principle of equity, one of the cardinal principles of taxation. In the same vein, if the government fails to tax vehicle which is provided as employment fringe benefits, the result will be violation of distributional objectives of government and violation of the principle of tax equity.

### 2.2.2. Efficiency

Efficiency is one of the grounds of measuring whether a tax system is good tax system or bad. It is a wide ranging concept in taxation. Taddese sums up that efficiency mainly deals with “the costs of taxation.”<sup>54</sup> He aptly observed that when the term “efficiency” is deployed with adjectives, the cost of taxation includes, on one hand, administrative costs, costs which are born by the tax administration and compliance costs, costs which are born by taxpayers.<sup>55</sup> When the term efficiency is applied without adjective, “efficiency cost of taxation” shows what is called “dead-weight loss,” an economics term to refer to the tax induced change in behavior of people because of the imposition of or disregard to tax rather than market interaction.<sup>56</sup> There are debates regarding how much taxation or the choice of tax base affects the behavior of economic agents in their economic choices, however, it is admitted by many scholars that tax interferes in the economic preference of taxpayers.<sup>57</sup> Thus, the efficiency principle, which is related with the maxim of tax neutrality, recommends a system in which “a tax interferes as little as possible with

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<sup>54</sup> Taddese Lencho (n 8) 76

<sup>55</sup> Ibid, and see also Richard A. Musgrave and Peggy B. Musgrave (n 40) 277-295

<sup>56</sup> *ibid*

<sup>57</sup> Taddese Lencho, (n 8) 80

people's economic behavior."<sup>58</sup> Tax experts and theoreticians agree that failure to tax and enforce fringe benefits effectively results in distortion of the economic decisions of employees and employers in choosing the method of payment- the employees choose to be paid in in-kind fringe benefits to avoid tax and employers pay in-kind benefits form to attract employees.<sup>59</sup>

Failure to tax fringe benefits impacts individual behavior in terms of preference of compensation for their services, and it enables large firms to attract employees with better qualification by offering diversified remuneration package in contrast to small firms, creating competitive advantage for them.<sup>60</sup> Eva Gutiérrez-i-Puigarnau and Jos N. Van Ommeren have identified three distortionary effect of failure to tax vehicle fringe benefits: First, expenditure on car is increased as households demand more expensive cars which they would not have bought had it been by private costs. Second, it will induce workers to drive long distances privately. Third, it may encourage workers to increase the number of cars they hold.<sup>61</sup>

In addition to the tax effect on the economic choices of employees and employers, there are other efficiency variants that should be considered during imposition and enforcement of FBT-which are: administrative and compliance costs, which can be subsumed under administrative feasibility. As quoted in Taddese, Joseph Sneed, has tried to capture the reach of administrative feasibility as follows:

administrative feasibility is *structural unity* and *simplicity* of the tax, *convenience and ease in assessment* and collection from the standpoint of both government and taxpayer,

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<sup>58</sup> Michael J. Graetz & Deborah H. Schenk, 'Federal Income Taxation: Principles and Policies' 89 (7th ed. 2013), as cited in Yehonatan Givati, 'Googling a Free Lunch: The Taxation of Fringe Benefits', (2016) 69 Tax L. Rev. 275.

<sup>59</sup> Charles T. Clotfelte, 'Equity, Efficiency, And The Tax Treatment Of In-Kind Compensation', (1979) 32 (1) National Tax Journal 51-60

<sup>60</sup> Michelle Harding (n 53)

<sup>61</sup> Eva Gutiérrez-i-Puigarnau and Jos N. Van Ommeren, 'Welfare Effects of Distortionary Fringe Benefits Taxation: The Case of Employer-Provided Cars', (2011) 52 (4) International Economic Review 1105-1122

*certainty* of obligations imposed on both tax gatherer and taxpayer, *adequate powers* in government to deal effectively with the recalcitrant and fraudulent...<sup>62</sup>

What can be gathered from the statement made by Sneed is that administrative feasibility of tax would require, among others, the practicability of tax from the perspective of both the payer and collector. The practicability is to be reflected in the convenience and ease in assessment and collection of the tax.<sup>63</sup> Moreover, the obligation of taxpayers should be clear, or *certain*. Taddese posits that while some countries comply with the administrative feasibility criteria by recognizing their “practical limitations and constraints of taxation”, others states adopt good taxes which remain on papers.<sup>64</sup> Contrary to that, some states shy away from reaching out to achieve equity, efficiency and other principles by using administrative constraints as an excuse.<sup>65</sup>

In case of fringe benefits taxation, the main challenge raised by tax authorities and/or taxpayers has been administrative difficulty.<sup>66</sup> This is due to the challenges fringe benefits posed in valuation, and its process.<sup>67</sup> Thus, countries have to make a decision to impose FBT to go through the challenge in assessment of the taxable value of fringe benefits by evaluating their administrative capacity as well as the possible administrative costs associated with the valuation processes. Balance has to be stricken between going through the administrative challenge to enforce the law on one hand or leaving the fringe benefits untaxed on the other, which will result in tax inequity.

### **2.3. Common Issues with Taxation of Fringe Benefits**

Taxing fringe benefits in general and vehicle in particular results in some practical challenges in any tax system.<sup>68</sup> First, valuation of the benefits is one of the most daunting tasks for tax systems.

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<sup>62</sup> Sneed, the Criteria for Federal Tax Policy, p. 573, as cited in Taddese Lencho (n 8) 81

<sup>63</sup> Taddese Lencho (n 8) 83

<sup>64</sup> *ibid*

<sup>65</sup> *ibid*

<sup>66</sup> Rueven Avi-Yonah and others (n 5) 24

<sup>67</sup> *ibid*

<sup>68</sup> Rueven Avi-Yonah and others, (n 5) 24; Daniel Halperin, ‘Broadening the Base-The Case of Fringe Benefits’, (1984) 37 National Tax Journal 271

Second is administrative challenge<sup>69</sup> - tracking and separating business and personal use of mixed usage items provided as employment fringe benefits.<sup>70</sup> Taxation of vehicle provided by employers is no exception regarding these challenges.

Valuation of the benefits can be “costly and administratively complicated procedure for employees and employers.”<sup>71</sup> The ideal system in identifying the value of fringe benefits for tax purposes “is the value of the benefit to the employee, because this is the cash or economic equivalent for the taxpayer.”<sup>72</sup> This ideal system cannot be achieved because it is “impossible to levy a tax on the basis of the subjective valuation by a taxpayer.”<sup>73</sup> Therefore, in order to solve these challenges countries adopted “fair market value or retail prices” of the benefit as standard to determine the value of fringe benefits.<sup>74</sup> It is argued that

It is logical to assume that for most taxpayers the value of benefits derived equals the amount other persons would pay for those benefits in a market transaction. Valuation based on market value best achieves the equity and efficiency objectives of fringe benefits taxation.<sup>75</sup>

Practically, states have adopted different approaches to solve the problem of valuation. Since determining the market value for fringe benefits can be administratively complicated and costly for both employees and employers, some countries “provide rules of thumb for determining market value for most common benefits.”<sup>76</sup> Some countries like United States, Italy, United Kingdom, Sweden and Germany, tried to solve valuation problem by attaching standard value to some fringes through “valuation tables” and gross up the amount with employee’s income.<sup>77</sup>

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<sup>69</sup> Jay A. Soled & Kathleen DeLaney Thomas, ‘Revisiting the Taxation of Fringe Benefits’, (2016) 91 Washington Law Review 786

<sup>70</sup> Rueven Avi-Yonah and others, (n 5) 24

<sup>71</sup> Lee Burns, and Richard Krever, (n. 2) 498

<sup>72</sup> *ibid*

<sup>73</sup> *ibid*

<sup>74</sup> *ibid*

<sup>75</sup> *ibid*

<sup>76</sup> *ibid*

<sup>77</sup> Rueven Avi-Yonah and others, (n 5)

China also uses the market value method to calculate vehicle fringe benefits. The taxable amount is calculated based on the price specified in the purchase document or as determined by tax authorities.<sup>78</sup> The amount is grossed-up with other incomes, and the tax rate is applied on the grossed-up amount.<sup>79</sup>

Another challenge regarding taxation of fringe benefits are the administrative complications. Taxation of benefits results in “burdensome recordkeeping” either on the employees or employers, depending who bears the tax burden.<sup>80</sup> This particularly becomes arduous for employers when they provide fringe benefits to large number of employees. This is confirmed by Australian National Audit Office (ANAO). The Audit Office reported:

The application of FBT law can be relatively complex and resource intensive for many employers. The complexity and extent of resources employers require to effectively administer FBT will largely depend on the number of people they provide fringe benefits and the range and number of benefits provided. There are also specific requirements relating to different categories of benefits and for some benefits the employer is given some choice over the method used to calculate their FBT liability. This level of complexity increases the risk of non-compliance.<sup>81</sup>

In general, valuation and administrative challenges are raised as main problems of taxation of different fringe benefits. Vehicle fringe benefit is no exception in this regard. Therefore, as already mentioned above, there is a need to balance going through the administrative challenge to enforce the law with leaving fringe benefits untaxed.

#### **2.4. Tax Design and Structure of Fringe benefits**

Different tax systems follow different approach in designing their tax laws to tax fringe benefits. There are two major basic designs of FBT.<sup>82</sup> The first approach is to adopt an independent FBT

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<sup>78</sup> *ibid*

<sup>79</sup> *ibid*

<sup>80</sup> Jay A. Soled (n 69)

<sup>81</sup> Australian National Audit Office, Administration of Fringe Benefits Tax, (Audit Report No.49 2004–05) 13 , available at <<http://www.anao.gov.au>> as accessed on December 1, 2019

<sup>82</sup> Lee Burns, and Richard Krever, (n. 2)



from the main income tax system.<sup>83</sup> The Australian tax system uses this peculiar approach in designing its FBT.<sup>84</sup> The country adopted *The Fringe Benefits Tax Act 1986*<sup>85</sup> and *The Fringe Benefits Tax Assessment Act 1986*<sup>86</sup> separately from the main income tax act. Because of adoption of this separate legal and institutional framework for FBT, it has enabled it to have comprehensive and detailed rules and administration for FBT. The Australian tax system has detail administrative rulings and court cases regarding each FBT.<sup>87</sup> The second approach so far taken is “to carefully coordinate the income tax system to achieve the exact same overall tax burden on any given fringe benefit as would be the case if the employer paid cash to the employee instead of providing the fringe benefit.”<sup>88</sup> The majority of the countries have followed on this approach.

Some differences also can be seen on who bears the tax burden. Australia and New Zealand have adopted peculiar approach in this regard. They impose FBT at employer level.<sup>89</sup> That means, when an employer provides fringe benefits, the employee does not bear the tax burden; rather, the income is taken as income of the employer.<sup>90</sup> Accordingly, the employer is the taxpayer and bearer of the administrative burden of the tax. On the one hand, this approach has an advantage of ensuring administrative simplicity. The tax authorities can simply audit employers rather than employees which are larger in number.<sup>91</sup> On the other hand, it has disadvantages as the wrong person i.e. the employer is taxed, when he/she is not the recipient of the income. As a result, it is criticized for its failure to measure the income of employees correctly.<sup>92</sup> Hence, this approach is beneficial to tax particularly targeted fringe benefits that are difficult to assign to individual

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<sup>83</sup> Ibid

<sup>84</sup> Ibid

<sup>85</sup> The Fringe Benefits Tax Act 1986 1986

<sup>86</sup> Fringe Benefits Tax Assessment Act 1986 1986

<sup>87</sup> See <<https://www.ato.gov.au/law/?anchor=Law#Law/table-of-contents/Mode=topic>> to access the administrative rulings and court cases regarding FBT, accessed on June 20 2020.

<sup>88</sup> Lee Burns, and Richard Krever, (n. 2) 494

<sup>89</sup> Ibid, see also Victor Thuronyi (n. 20) 252

<sup>90</sup> Rueven Avi-Yonah and others, (n 5) 24

<sup>91</sup> Lee Burns, and Richard Krever, (n. 2)

<sup>92</sup> ibid

employees. Adopting it for all fringe benefits is problematic because it cannot ensure tax equity among employees.<sup>93</sup> In other jurisdictions, fringe benefits tax is imposed on employees, and withheld by employers like any employment income tax. In many jurisdictions, fringe benefits are grossed up with salary and wages to get the ability of the employee to pay the tax. As already discussed above the main challenge of this approach is administrative and valuation difficulties.<sup>94</sup>

## **2.5. Taxation of Vehicle as Employment Fringe Benefits**

Commonly referred as company car use, vehicle provision by employers to employees for personal or private use is taxable income in many jurisdictions. As discussed above, assessing the taxable amount of the personal use of company car/vehicles has complicated administrative challenges and valuation procedures. Due to this, countries have adopted various approaches to overcome these complications.

### **2.5.1. Taxation of Vehicle in Some Selected Countries**

In this section, the approaches taken by three countries i.e. Australia, USA and South Africa in the taxation of vehicle fringe benefits will be analyzed. It is necessary to mention that the socio-economic, technological and cultural situations of the countries are different from Ethiopia. However, the study is made with the intention to obtain some lessons from the systems and propose alternative approaches for Ethiopia. The selected countries have developed well-structured fringe benefit systems. Thus, Ethiopia can use some of the developments in these countries rather than “reinventing the wheel.”<sup>95</sup>

#### **2.5.1.1. Australia**

Comparatively speaking, Australia has well-developed FBT rules and administration systems. The country has separate FBT law in terms of design and structure. Australia adopted *The Fringe Benefits Tax Act 1986* and *The Fringe Benefits Tax Assessment Act 1986* in 1986. One of peculiar features of the Australian tax system is that FBT is imposed at the employer level. So, the tax burden as well as the administration falls on employers who provide fringe benefits to

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<sup>93</sup> Victor Thuronyi (n. 20)

<sup>94</sup> Rueven Avi-Yonah and others (n 5) 24

<sup>95</sup> According to Victor Thuronyi, the advantage of comparative approach to study tax laws is “...to learn about new possibilities from studying actual practice, to convince by example, and to avoid reinventing the wheel.” Victor Thuronyi (n. 20) 4

their employees. Accordingly, employers who provide fringe benefits are required to register at the Australian Taxation Office (ATO) for the purpose of filing returns in a given fringe benefit tax year, which runs from 1 April to 31 March.<sup>96</sup>

Provision of employer's car<sup>97</sup> for private use of employee is one of the fringe benefits subjected to tax under the law. There are two options for the calculation of taxable value of vehicle fringe benefits under the Australian tax system. These are *statutory formula method* and *operating cost method*.<sup>98</sup> Since 2011, a year in which the country abandoned the marginal tax rate for fringe benefits the statutory formula method, which adopted 20% flat rate, is applicable to all car fringe benefits regardless of distance travelled by the employee.<sup>99</sup> Accordingly, "The taxable value of the car fringe benefits is the statutory rate multiplied by the car's base value."<sup>100</sup> The calculation is as follows:

$$\text{Taxable value} = ((A \times B \times C) \div D) - E$$

Where:

A = the base value of the car

B = the applicable statutory percentage (20%)

C = the number of days in the FBT year when the car was used or available for private use of employees

D = the number of days in the FBT year

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<sup>96</sup> <[https://www.ato.gov.au/General/Fringe-benefits-tax-\(FBT\)/Registering-for-FBT/](https://www.ato.gov.au/General/Fringe-benefits-tax-(FBT)/Registering-for-FBT/)>

<sup>97</sup> Car is defined as "a sedan or station wagon any other goods-carrying vehicle with a carrying capacity of less than one tonne, such as a panel van or utility (including four-wheel drive vehicles) any other passenger-carrying vehicle designed to carry fewer than nine passengers."

[https://www.ato.gov.au/General/Fringe-benefits-tax-\(FBT\)/Types-of-fringe-benefits/Car-fringe-benefits/](https://www.ato.gov.au/General/Fringe-benefits-tax-(FBT)/Types-of-fringe-benefits/Car-fringe-benefits/)

<sup>98</sup>The Website of the Authority

<sup>99</sup> *ibid*

<sup>100</sup> *ibid*

E = the employee contribution.<sup>101</sup>

Source: Australian Taxation Office (ATO) website

The operating cost method takes “a percentage of the total costs of operating the car during the FBT (FBT) year” to determine the taxable value of the car fringe benefits.<sup>102</sup> Pursuant to this method, percentage of the total cost of operating the car changes based on the actual private use of the vehicle by employees.<sup>103</sup> The option of using any of the methods is left to the employers; but, they have to collect sufficient records in case they opted to use operating cost method since this method depends on calculation of total operating costs.<sup>104</sup>

The calculation is as follows:

$$\text{Taxable value} = (A \times B) - C$$

Where:

A: is the total operating costs

B: is the percentage of private use

C: is the employee contribution.

Source: Australian Taxation Office website

Repairs, maintenance, fuel, registration and insurance fees, leasing costs (in case the employer is not the owner of the vehicle) are included in the total operating costs to calculate the taxable amount.<sup>105</sup> The total operating cost is multiplied by the percentage of private use. After that the contribution (or expenses made by the employee) of the employee is deducted to reach at the taxable value.

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<sup>101</sup> *ibid*

<sup>102</sup> *ibid*

<sup>103</sup> *ibid*

<sup>104</sup> *ibid*

<sup>105</sup> *ibid*

The Australian tax system has description of private use. Accordingly, private use “is any use of...” the “...car by an employee or their associate that is not for income-producing purposes of the employer or the associate”.<sup>106</sup> As already mentioned, one of the controversial areas is identifying the taxable value of the mixed use vehicles. The Australian system has set a boundary between business and personal travel. It is also clearly set that the change in vehicle or employer constitutes new commitment.<sup>107</sup>

Australia has set the obligation of employers to keep records as well as enumerated what the contents of the record should be. Accordingly, any employer that provides vehicle fringe benefit must keep a record that contains the following items:

- calculations
- worksheets
- employee declarations
- elections
- invoices
- receipts
- bills of sales
- lease documents
- travel diaries
- logbooks
- Odometer records.<sup>108</sup>

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<sup>106</sup> *ibid*

<sup>107</sup> *ibid*

<sup>108</sup> <[https://www.ato.gov.au/general/fringe-benefits-tax-\(fbt\)/reporting,-lodging-and-paying-fbt/record-keeping/](https://www.ato.gov.au/general/fringe-benefits-tax-(fbt)/reporting,-lodging-and-paying-fbt/record-keeping/)> accessed on February 10/2020

### 2.5.1.2. United States of America

After much controversy regarding taxation of fringe benefits, the US tax system adopted laws that made fringe benefits taxable in 1986.<sup>109</sup> The FBT rules were integrated into the main income tax system. Accordingly, the value of fringe benefits is made taxable income unless there is clear statutory exclusion.<sup>110</sup> The Internal Revenue Service (IRS) defines fringe benefits as “...a form of pay for the performance of services.”<sup>111</sup> As can be seen from the definition, fringe benefit is not limited to pay for employees; rather it includes all pays made for performance of services. So, payments made to independent contractors and directors are also subjected to FBT when they receive benefits.<sup>112</sup> Further, in a similar manner with other tax systems, the employer is considered the provider of the fringe benefits even if the benefit is provided by third parties like customers or clients to the employee or service provider.<sup>113</sup> The employee/service provider or another third party who did not render service for the employer can receive the benefit, but the benefit is taxable to the income of the employee/service provider.<sup>114</sup>

Different valuation methods are designed by the IRS. Basically, all fringe benefits are subject to general and special valuation rules.<sup>115</sup> The subjective valuation of employees is not taken into consideration. Rather, the general valuation rule, which is fair market value, is used.<sup>116</sup> Fair market value is defined as “the amount an employee would have to pay a third party in an arm's-

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<sup>109</sup> Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 494 (codified as amended in scattered sections of 26 U.S.C.) as cited in Jay A. Soled & Kathleen DeLaney Thomas (n 69)

<sup>110</sup> Department of the Treasury Internal Revenue Service, *Publication 15-B, Employer's Tax Guide to Fringe Benefits: For Use In 2020*, (2019) 3 available at <https://www.irs.gov/pub/irs-pdf/p15b.pdf> accessed on 1 April 2020.

<sup>111</sup> *ibid*

<sup>112</sup> *ibid*

<sup>113</sup> *ibid*

<sup>114</sup> *ibid*

<sup>115</sup> *Id*

<sup>116</sup> *ibid*

length transaction to buy or lease the benefit. Determine this amount on the basis of all the facts and circumstances.”<sup>117</sup>

Valuation methods to determine the value for vehicle fringe benefits under the US tax system is determined by “fair market value”, or general valuation rule and three special valuation rules.<sup>118</sup>

The general valuation rule

is the amount the employee would have to pay a third party to lease the same or similar vehicle on the same or comparable terms in the geographic area where the employee uses the vehicle? A comparable lease term would be the amount of time the vehicle is available for the employee's use, such as a 1-year period.<sup>119</sup>

Alternatively, the following three special valuation rules are applicable:

- a. the cents-per-mile rule.
- b. commuting rule (for commuting use only); or
- c. lease value rule.<sup>120</sup>

The cents-per-mile can be used when the employee regularly uses the vehicle for trade or business and shows the vehicle can be leased on a cents-per-mile basis.<sup>121</sup> According to this valuation method, fair market value of a personal use of vehicle can be determined “by multiplying the standard mileage rate by the total miles the employee drives the vehicle for personal purposes.”<sup>122</sup> Personal use is defined as “any use of the vehicle other than use in your trade or business.”<sup>123</sup> The standard mileage rate changes annually. For instance, the rate is 57.5

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<sup>117</sup> Id 24

<sup>118</sup> *ibid*

<sup>119</sup> *ibid*

<sup>120</sup> *ibid*

<sup>121</sup> *Ibid*, that means when 50% of the annual mileage is used for business purposes or when the employer provides commuting transportation for at least three employees each work day.

<sup>122</sup> *ibid*

<sup>123</sup> *ibid*

cents per mile for 2020.<sup>124</sup> The tax authority requires consistency when employers use cents-per-mile method of valuation of the vehicle fringe benefits.<sup>125</sup>

The second special valuation rule is commuting rule. This valuation method is applicable on ‘one-way commute’ from work to home or home to work by multiplying each day by \$1.50 (in 2020).<sup>126</sup> If more than one employee use the vehicle for commute, the employer is required to calculate each employees’ use by the same formula.<sup>127</sup> There are detail requirements, which the space does not allow us to discuss, for this valuation rule to be applicable.

The third and the last special valuation rule is the lease value rule, which is used to determine the value of vehicle fringe benefits by using its annual lease value.<sup>128</sup> There is a set formula for this valuation rule to be applicable. An annual lease value table that is used to figure out the annual lease value and determine the provided fringe benefits is appended for calculation.<sup>129</sup>

### 2.5.1.3. South Africa

Employment income tax, which is included in the main Income Tax Act 58 of 1962, defines employment income as inclusive of benefits-in-kind, wages, salaries and other employment related payments.<sup>130</sup> Hence, the South African tax system integrated the FBT into the main income tax through its 1984 Act as a Seventh Schedule to the Income Tax Act of 1962. The main income tax act defines income, delimits and defines fringe benefits, provides for taxable benefits, and enumerates the time, types and rules of valuation of fringe benefits.<sup>131</sup> Private use of vehicle provided by employers or their associated institutions to employees is one of the listed taxable

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<sup>124</sup> Ibid; See also Department of the Treasury Internal Revenue Service, *Publication 15-B, Employer’s Tax Guide to Fringe Benefits: For Use In 2016*, (2016) 22, the standard mileage rate was 54 cents per mile in 2016.

<sup>125</sup> Department of the Treasury Internal Revenue Service (n 110)

<sup>126</sup> Id 26

<sup>127</sup> ibid

<sup>128</sup> ibid

<sup>129</sup> Id 27

<sup>130</sup> Income Tax Act 58 of 1962 162 seventh schedule (7)(1.3.1 – 1.3.4)

<sup>131</sup> Id, see Seventh Schedule Benefits or Advantages Derived by Reason of Employment or The Holding of Any Office (paras. 1-20), (added by s. 46 of Act 121 of 1984)



benefits.<sup>132</sup> The obligation to do the valuation of the vehicle FBT is imposed on the employer, even if the vehicle is provided by other associated institution.<sup>133</sup> In calculating the taxable value of vehicle fringe benefits, the costs incurred by the employee or contributions made by the employee are deducted.<sup>134</sup>

The South African Tax System provides for statutory valuation formula to determine the taxable value of a vehicle fringe benefit. Accordingly, the value of the vehicle fringe benefits is determined to be 3.5% of the “determined value” of the vehicle for each month tax payment if the vehicle does not include maintenance plan in the purchase price.<sup>135</sup> But, if the vehicle includes maintenance plan in the purchase price, the rate is reduced to 3.25%.<sup>136</sup> When the employee uses the vehicle for both business and private purposes, the private use part is the only part that is subjected to FBT.<sup>137</sup> The formula is “fixed % per month x determined value of the motor vehicle *or* actual costs incurred under an “operating lease” plus fuel.”<sup>138</sup>

Since “determined value” is the base for the calculation of the taxable value, the Income Tax Act defines the term. The “determined value” of the vehicle depends on the method of acquisition of the vehicle by the employer. Accordingly, when the employer purchases the vehicle, “the original cost (excluding any finance charge, interest or sales tax payable by him, or value-added tax)” is taken as the determined value of the vehicle.<sup>139</sup> Where the employer holds the vehicle under lease or hire-purchase agreement, the retail market value of the vehicle is taken as determined value.<sup>140</sup> In other cases, the tax law provides that “the market value of... [the] motor

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<sup>132</sup> Id, seventh schedule (para. 7)

<sup>133</sup> South African Revenue Service (SARS), *Guide For Employers in Respect of Fringe Benefits Tax* (2018 Tax Year, Revision 6, 2018) 3 Available at <https://www.sars.gov.za/AllDocs/LegalDoclib/Notes/LAPD-IntR-IN-2013-05%20%20IN72%20Right%20of%20Use%20Motor%20Vehicle.pdf>

<sup>134</sup> *ibid*

<sup>135</sup> *Id* 9

<sup>136</sup> *Ibid*

<sup>137</sup> *Ibid*

<sup>138</sup> *Id* 10

<sup>139</sup> Income Tax Act 58 of 1962 (n 130)

<sup>140</sup> *Ibid*

vehicle at the time when the employer first obtained the vehicle or the right of use” taken into consideration to calculate the taxable value.<sup>141</sup>

The tax law further provides for method of calculation of depreciation of the vehicle. Hence, the depreciation allowance is “a depreciation allowance calculated according to the reducing balance method at the rate of 15 per cent for each completed period of 12 months...”<sup>142</sup>

Deductions of expenses by an employee as well the “business use” part are allowed. The law provides that operating costs like fuel, maintaining the vehicle, which includes the cost of repairs, servicing, lubrication tyres etc. are deducted from the vehicle FBT. Distance travelled is taken into account by tax authorities for the calculation of taxable value of vehicle fringe benefits when the employee keeps accurate records of the distances he travelled for private and domestic purposes, and business purposes. The employee is required to keep accurate records in the form of logbook, which must contain

- the odometer reading on the first day of the tax year.
- odometer reading on the last day of the tax year; and
- for all business travel –
  - ✓ the date of the travel;
  - ✓ the kilometers travelled; and
  - ✓ business travel details (where and reason for trip).<sup>143</sup>

The tax authority has discretion to reduce the tax due to the employee based on fairness and reasonableness when the employee travels 1000 kilometers or used for less than 12 months.<sup>144</sup>

The law also has provisions for exempted vehicle use. For instance, the law exempts sporadic and incidental private uses of vehicle from employment FBT.

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<sup>141</sup> Income Tax Act 58 of 1962 (n 130)

<sup>142</sup> Id

<sup>143</sup> South African Revenue Service (SARS) (n 133) 12-13

<sup>144</sup> Id 11

## Chapter Three

### **Taxation of Vehicle as Employment Fringe benefits in the Ethiopian Tax System: Assessment of Legal and Practical Challenges**

#### **Introduction**

The purpose of this chapter is to describe, examine and analyze the FBT in the Ethiopian Income Tax System in general. It specifically deals with the taxation of vehicle fringe benefits, and assesses the implementation in Ethiopia. First, the detailed rules for FBT are introduced into the Ethiopian Tax System with the intention of ensuring vertical and horizontal equity among taxpayers. Hence, it aims to answer to the criticism against the system for being inequitable because of lack of implementation of FBT. Second, the main intention behind introduction of FBT is connected with the main goal of taxation- i.e. raising revenue for the government by broadening the tax base. Thus, this chapter wrestles with the question of how the vehicle fringe benefit is being implemented in accordance with the law and policy and identifying what the challenges are in the implementation in Ethiopia.

#### **3.1. Overview of Ethiopian Employment Income Tax and the Place of FBT**

Employment income has been subjected to income tax since the adoption of modern income tax laws in 1944.<sup>145</sup> Currently, schedule “A” of the FITP deals with employment income tax. There are elements that should be fulfilled for the employment income tax to apply. Since these elements have direct relevance for the application of FBT, it is necessary to discuss the elements.

The first element that needs definition is the term employee. It is axiomatic that the definition of employee is one of the most important elements to impose employment income tax under tax law. Most often, employees are conflated with independent contractors, thus the requirement of the definition of employee. The Ethiopian tax system is not an exception in confusing categorization of incomes regarding independent contractors and employees, and income from other sources

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<sup>145</sup> Taddese Lencho, ‘Towards Legislative History of Modern Taxes in Ethiopia (1941-2008),’ [2012] 25 (2) Journal of Ethiopian Law 9

like royalty income and dividend.<sup>146</sup> Thus, accurate definition of employees and employment income are very crucial. The FITP defines an employee as

...an individual engaged, whether on permanent or temporary basis, to perform services under the direction and control of another person, other than as an independent contractor, and includes a director or other holder of an office in the management of a body, and government appointees and elected persons holding public offices.<sup>147</sup>

The legislature, in this definition, has tried to capture all individuals who perform service for another person, or employer, by excluding independent contractors as their income is taxed under Schedule “C”, which is business income tax. The law further provides for the definition of an independent contractor as “...an individual who is engaged to perform services under an agreement by which the individual retains substantial authority to direct and control the manner in which the services are performed.”<sup>148</sup>

The most important elements in both definitions are “direction and control” element.<sup>149</sup> While the employee works under “direction and control” of an employer, the independent contractor holds “substantial authority” and control regarding the manner of performance of the service.<sup>150</sup> In practice, the taxpayers and the tax authority have been confused in characterizing income as an employment income or other incomes because of failure to heed to these elements.<sup>151</sup> Employment income has been confused with income from business, schedule “C”, royalty and interest, in some cases.<sup>152</sup> Studying withholding practices in three higher education institutions regarding characterization of income as employment income or independent contractor, Taddese concluded that “...ambiguities, generalities, and at times inconsistencies among the different

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<sup>146</sup> For the broader discussion of this subject, see Taddese Lencho, 'In the Eyes of The Withholder: The PAYE and Its Discontents in Ethiopia ' [2014] 26 (2) Journal of Ethiopia Law

<sup>147</sup> FITP (n 12), Article 2/7

<sup>148</sup> Ibid, Article 2/15

<sup>149</sup> Taddese Lencho (n 8) 292

<sup>150</sup> Ibid

<sup>151</sup> Ibid

<sup>152</sup> Ibid

rules governing...” the income types have ensued in contradictions, thus causing “substantial discretion and authority over the characterization of income” for the withholding agents.<sup>153</sup>

The clarity of the definition helps in alleviating the problem of income characterization. The categorization of income has substantial effect on whether a FBT should be charged or not. This is because only employees are subjected to FBT under Ethiopia tax laws, unlike some tax systems which impose FBT on independent contractors as well (USA). But if the vehicle is provided for the service of an independent contractor, the private use of the vehicle does not result in employment FBT because an independent contractor is not an employee. Further, the categorization of income as an employment or independent contractor income can affect FBT if employees engage in tax planning. That means, the employee and the employer can restructure their agreements to client and independent contractor relationship to avoid FBT.

The second important element of employment income tax is the definition of income from employment. Employees can get income from different sources of income from their employers in different capacity. A certain employee can earn income from his employer as a compensation for his service, as a shareholder, if he has shareholding right, as a gift or etc. Thus, for the income to be subject to employment income tax, it should be ascertained that the income has arisen from employment relationship. Generally, the FITP defines “income” in a comprehensive manner; theoretically based on accretion concept of income.<sup>154</sup> Pursuant to Article 2 (14) of the Proclamation, Income is “every economic benefit, including recurring and non-recurring gains, in cash or *kind* from whatever source derived and in whatever form paid, credited, or received.” (Emphasis added). The definition includes all incomes in cash and in-kind forms.

The Proclamation does not define employment income in a general form. Rather, it enumerates the following types of employment incomes that are subjected to income tax: salary, wages, bonus, commission, allowances, gratuity, payments upon termination of employment contract, or compensation for redundancy, the value of fringe benefits, or other payments received by an employee that arises from past, current or future employment.<sup>155</sup> As can be seen from the

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<sup>153</sup> Id 297

<sup>154</sup> The accretion concept, according to Victor Thuronyi, “holds that any realized accession to wealth is income.” Victor Thuronyi (n. 20) 235

<sup>155</sup> FITP (n 12), Article 12/1 (a)

enumeration of the types of incomes, the list is illustrative. Thus, other incomes can be subjected to employment income as long as the incomes are earned as compensation for employment related services.

The tax period of employment income tax is a month or its parts.<sup>156</sup> The tax is imposed on gross income that means there is no deduction or adjustments for expenses paid by the employee to earn employment income tax.<sup>157</sup> The tax is withheld by an employer, and it is final withholding tax.<sup>158</sup> Further, the employer has obligation to aggregate the employment incomes its employees receive and withhold employment income taxes if it is aware that its employees have more than one employment relationship.<sup>159</sup>

As can be seen from the enumerated list of incomes, the value of fringe benefits is recognized as one of taxable employment income under the law. So, the value of fringe benefits is a taxable income when they are provided to employees. The current proclamation is not the first to include fringe benefits into the income tax system. Fringe benefits have been included, as an integral part of the definition of employment income, in the Ethiopian Income Tax System since 1961. According to Article 8 of the Income Tax Proclamation No. 173/1961:

Taxable income from employment shall include all payments in cash and *all benefits in kind* unless our Minister of Finance shall by regulations exclude certain categories of payments in cash or benefits in kind from income from employment. (Emphasis added).

Even though the law has had provided for taxation of fringe benefits, the taxation has not been implemented against employees because of lack of detailed rules.<sup>160</sup> As a result, the Ethiopian tax system has been criticized for its inequity since it is effective only against cash income from employment.<sup>161</sup>

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<sup>156</sup> *ibid* Article 10/1

<sup>157</sup> *id* Articles 10/2-3 and Article 88/1

<sup>158</sup> *Id* 10/4 and Article 88

<sup>159</sup> *Id* Article 88/2

<sup>160</sup> Solomon Teshome, (n 21).

<sup>161</sup> Taddese Lencho (n 8) 266

### 3.2. Objectives of FBT

Ethiopia has policy goals to achieve in imposing tax on different taxpayers. According to Taddese, “Raising Revenues”; “Economic Development” “Equity,” “Modernization of the Ethiopian Tax System and Tax Administration” are the “fundamental goals of Ethiopian tax policy.”<sup>162</sup> The Growth and Transformation Plan 2015/16 – 2019/20 (GTP - II) also provides that the “...enforcement of tax laws, broadening the tax base...”<sup>163</sup> are major tax policy objectives of the country. The government has undertaken legal reform by introducing FBT in order to broaden the tax base and ensure tax equity.

With the stated objectives of making “the tax system fair and...” broadening the tax base by “bringing income that are so far not subject to tax into the tax net”, the government introduced detailed rules to capture the ignored fringe benefits in 2017.<sup>164</sup> Accordingly, the Council of Ministers issued FITR which determines the values and types of employment fringe benefits. The Regulation came up with ten types of taxable fringe benefits.<sup>165</sup> Hence, debt waiver, household personnel, housing, discounted interest loan, meal or refreshment, expenditure, property or services, an employee share scheme, vehicle and residual fringe benefits are listed types of taxable fringe benefits.<sup>166</sup> While the government has issued the FITR to achieve the fundamental policies of revenue generation and equity policies by adopting legal reform measures. Thus, all employment incomes, whether paid in an in-kind or cash form, are made taxable. For instance, vehicle fringe benefits is made taxable, to the minimum, to ensure equity among employees who receive transport cost in cash, which was taxable, and employees who received car for private purposes. However, the objective has not materialized because of practical and legal challenges that will be discussed in the coming sections.

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<sup>162</sup> Taddese Lencho, ‘Articulating Ethiopia’s Current Tax Policy: Sources and Fundamental Objectives’, in Taddese Lencho and Kyle Logue(eds.),*The Ethiopian Tax System: Some Contemporary Issues and Problems*, (2014) 6 Ethiopian Business Law Series 14

<sup>163</sup> National Planning Commission, *FDRE Growth and Transformation Plan 2015/16 – 2019/20* (GTP - II) (September 2015, Addis Ababa) 6

<sup>164</sup> Wollela Abehodie (PhD) (n 11), see also Preamble of the FITP (n 12), para. 2.

<sup>165</sup> FITR (n 13), Article 8,

<sup>166</sup> Ibid Article 8 (1/ a-j)

### 3.3. FBT under the Ethiopian Tax Laws

The income tax laws of Ethiopia do not define the employment fringe benefits. Rather, the FITR enumerates the benefits that can be regarded as employment fringe benefits for taxation purposes. The Regulation provides for positive limb and negative limb fringe benefits. In the positive limb, it lists down taxable fringe benefits and stipulates the circumstances under which the benefits become as taxable employment fringe benefits. In the negative limb definition, it curves out, and puts restrictions on, some benefits from the ambit of FBT. In general, the law requires three elements to impose FBT on fringe benefits. These are establishment of the fact that: (1) the recipient is an employee, (2) the provider is an employer, and (3) the payment arises from the employment relationship. All elements have to be established simultaneously for FBT to apply. So, this leads us to question who is an employee for the purpose of FBT under Ethiopian tax laws.

As discussed before, an “employee” is a person who is hired to carry out “services under the direction and control of” another person. But for fringe benefits purposes, the term “employee” is extensively defined to include “Related persons of the employee.”<sup>167</sup> When an employer makes available fringe benefits to “related persons of the employee”, but not to the employee directly, the FBT is withheld from income of the employee. The Federal Tax Administration Proclamation No. 983/2016<sup>168</sup> “related person” is defined as “relatives of an individual.” Long list of persons are included in the definition: the spouse, an ancestor, lineal descendant, brother, sister, uncle, aunt, nephew, niece, stepfather, stepmother, or adopted child of the employee or spouse of the employee, parent of the adopted employee, and persons in an irregular union with the employee are included in related persons definition. Thus, fringe benefits provided by an employer to any of these persons are taxable to the employee because the benefit is considered to be the income of the employee.

The second element is that the fringe benefits have to be provided by an employer. As discussed before, the FITP, defines an employer as “a person who engages or remunerates an employee.”<sup>169</sup>

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<sup>167</sup> FITR (n 13), Article 7/2 (b)

<sup>168</sup> Federal Tax Administration Proclamation, 2016, Procl. No.983, Federal *Negarit Gazette*, 22<sup>nd</sup> year No.103, Article 4/4

<sup>169</sup> FITP (n 12), Article 2/8



However, the FITR's definition of an employer for the purpose of FBT includes third parties, in addition to the employer who has direct control over the employee. Accordingly, the Regulation defines "an employer" as inclusive of "related person<sup>170</sup> of the employer and a third party acting under an arrangement with an employer."<sup>171</sup> When related persons of an employer supply benefits to an employee as a compensation for services for the employer, the benefits are taxable pursuant to FBT rules.<sup>172</sup> This kind of benefit arises, for instance, when a customer of the employer provides vehicle to the employee of an employer by contractual agreement with the employer. Or a subsidiary can provide fringe benefits on behalf of a parent company to employees of the later or vice avers. In such and similar cases, the employer is duty bound to withhold income tax from the value of fringe benefits provided third parties.

The third element that needs to be fulfilled is that the benefit has to arise from employment relationship. Thus, in a similar manner with any employment income, a fringe benefit has to be given as a compensation for the service of an employee. However, relationship between an employer and employee might not be clear always. There are borderline cases that can be confusing. One such case can be when the employee is a family member of the employer and the employer allows the employee to use company vehicle for private purposes, it can be confusing. The employer can claim that the value of the use is a family gift, which is provided out of affection, not compensation for services. Confusing cases can also arise when the employee is shareholder of the employing company. In such case, when an employee receives benefit in his capacity as shareholder, the benefit is not subject to fringe benefit taxation, because it can be provided as a dividend, and dividends are not subject to FBT. Rather, dividend is subjected to 10% dividend tax.<sup>173</sup> This kind of obscure relationships can result in tax planning unless critical analysis is conducted to identify the factor behind the provision of the benefit.

The illustration of the taxable fringe benefits has also negative limb listing. By negative limb listing, we mean the provision of benefit that fulfills all the above mentioned criteria, but are

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<sup>170</sup> For definition of "Related person", see Article 4 of the Federal Tax Administration Proclamation (n 168).

<sup>171</sup> FITR (n 13), Article 7/2 (a)

<sup>172</sup> Id Article 7/2 (b)

<sup>173</sup> FITP (n 12), Article 55

excluded for different social, economic, administrative and other policy reasons. The Regulation exempts some benefits from taxation because of administrative feasibility and equity concerns, (for instance, subsidy to meals or refreshment provided in canteen, cafeteria, or dining). Thus, minimum (*De minimis*) benefits, subsidies of housing of non-managerial employee, provision of mobile phone and fees paid for cost of use of mobile phone, education tuition, paid by the employer, provision of security guard services, providing uniforms and related work materials and tuition fees are exempted benefits.<sup>174</sup>

### 3.4. Vehicle Fringe Benefits Taxation in Ethiopia: The legal framework

#### 3.4.1. Definition

Vehicle fringe benefits are the most common in Ethiopia.<sup>175</sup> As a result, it is one of the listed employment fringe benefits that are subject to employment income tax under the FITR.<sup>176</sup> According to the Regulation:

“A vehicle provided by an employer to an employee wholly or partly for the private use of the employee is a vehicle fringe benefit.”<sup>177</sup>

As one of the fringe benefits, the elements for the FBT to arise apply to vehicle fringe benefits. Therefore, the first element set to identify vehicle provided for private use as fringe benefits is that the vehicle has to be provided by an employer. It is discussed above that the term “employer” includes other institutions that can provide the employee with the vehicle in place of the employer. The Regulation provides that “an “employer” includes “a related person of the employer and [/or] a third party acting under an arrangement with an employer or a related person of the employer.”<sup>178</sup> As discussed in the previous section, the term “employee” is also broader than a worker who directly performs the employment contract. It rather, includes “a

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<sup>174</sup> FITR (n 13), Article 8 (4/a-j)

<sup>175</sup> Interview with Ato Ephrem Sitotaw, Tax Audit Team Leader, Large Tax Payers Division, MOR (Addis Ababa, Ethiopia, 3/17/2020)

<sup>176</sup> FITR (n 13), Article 8 (1/i)

<sup>177</sup> Id, Article 14/1

<sup>178</sup> Id, Article 7 (2/a)

related person of employee.”<sup>179</sup> Thus, even if the employer or related company or person to the employer, for whom employment service is provided, does not give the vehicle to employee, the employer is taken as provider of the fringe benefit. The obligation to withhold employment income tax that arises from the fringe benefit falls upon the employer.<sup>180</sup> The involvement of third party may give rise to administrative complications regarding fringe benefits taxation, when the FBT rules begin to be implemented.

The other element is that the vehicle should actually be used or made available for private use, even if the employee did not actually use the vehicle. One problem with the law is that it does not give definition for what constitutes private use. This is relevant because the employee may use the vehicle irregularly, infrequently and incidentally to business related works. Thus, there has to be clear definition with enumeration of which instances constitute private use of the vehicle. Without such definition, an employee who holds the car for business trip may end up paying FBT, and to the contrary, an employee who has used the vehicle for private purposes can claim that he/she is using the vehicle for business purposes. Lack of clear definition for “private use” is one of the often raised reasons for failure to withhold FBT by employers in Ethiopia.<sup>181</sup> The law further provides that, even though the employee does not make actual use of the vehicle provided by the employer, the benefit is taxable if the vehicle is made available to the employee.<sup>182</sup> The employee might not be able to/or willing to actually use the vehicle. In such cases, the law does not take into account the actual use; rather the fact that the employer has made the vehicle “available” triggers taxable benefit. However, the Ethiopian tax law does not define what making the vehicle “available” means. Thus, this can also be subject of dispute in the future when the tax law is applied aggressively.

The law has specific definition of a vehicle for fringe benefits to arise. So, the provision of any car does not give rise to FBT. Accordingly, a vehicle, for FBT purpose, refers to “a motor vehicle designed to carry a load of less than one tonne and fewer than nine passengers.”<sup>183</sup> This

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<sup>179</sup> Id, Article 7 (2/b)

<sup>180</sup> FITP(n 12), Article 88/1

<sup>181</sup> Interview with Anonymous, Finance Officer, Wegagen Bank S.C (n 193)

<sup>182</sup> FITR (n 13), Article 14/5

<sup>183</sup> Id Article 7/1 (g)

provision shows that any motor vehicle that does not fulfill these requirements cannot give rise to fringe benefits.

### 3.4.2. Valuation of Vehicle Fringe benefits under the Ethiopian Tax Laws

Valuation is a major challenge raised against the taxation of fringe benefits. Contrary to determining the value of cash based transportation payments by employers, which is equal to cash payment disbursed by employers, determining what a fair price or worth of a vehicle fringe benefit is administratively difficult. The process of determining the actual value of the benefit the provision of a vehicle confers upon employees is challenging for many tax systems. Most states solve the problem of valuation by adopting market value as a standard.

Administrative difficulties in valuation used to be one of the rationales for the failure to tax fringe benefits in Ethiopia.<sup>184</sup> However, the Ethiopian government has shown political will to introduce the types and valuation rules for taxation of fringe benefits in its recent reform in 2016. Accordingly, the income tax system of the country adopted the statutory valuation method. Accordingly, the FITR sets the valuation formula of vehicle fringe benefits as follows:

$$\underline{(A \times 5\%)}$$

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*Where: "A" is the cost to the employer of acquiring the vehicle or, if the vehicle is leased by the employer, the fair market value of the vehicle at the commencement of the lease. However, in case of a vehicle imported free of duty and taxes, the value of the vehicles fringe benefit shall include the duty and taxes that would otherwise have been paid on the vehicle.*

The value of the vehicle is based on the cost to the employer. There is no independent vehicle appraisal requirement by experts. The law takes into account the list price the employer incurred to acquire the vehicle as well as affiliated costs. So, the price of the car plus all costs related to acquisition paid by the employer, if it is acquired by sale or the "fair market value" paid at the commencement of the lease, if car is acquired by lease are taken as a base value. When it provides vehicle fringe benefits, the employer is required to keep records of the acquisition of the

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<sup>184</sup> Taddese Lencho (n 8) 337

vehicle for the ascertainment of the base value of the vehicle. The Proclamation stipulates that duty and taxes are included in the cost of purchase if the vehicle is imported free of these taxes and duties when the vehicle is transferred to the employee. The law further states that when the employer has held the vehicle for more than five years, the determined value according to the above formula is reduced by 50%.<sup>185</sup>

The fringe benefit tax has deduction rules for employees who receive vehicle FBT. So, from the calculated amount in accordance with the above mentioned formula, the taxable value is gained after deduction of expenses incurred by the employee. The following are allowed expenses for deductions:

1. *Any payment made by the employee in relation to the use of the vehicle, including maintenance, repair and running costs;*
2. *When the car is provided for partial private use, the proportion of the use for business or in conduct of employment;*
3. *When the car is not fully given to the employee at all times, the proportion of the month in which the vehicle was not available for private use of the employee.*<sup>186</sup>

Generally, employment income tax is not allowed deduction of expenses.<sup>187</sup> However, when it comes to determining the taxable value of vehicle as employment fringe benefits, the law allows deduction for the costs incurred by the employee in using the vehicle.

### **3.4.3. Limitation of Tax Liability of Fringe Benefits**

The tax fixes the tax liability of employees on fringe benefits income to 10% of the salary of the employee in all situations. According to Article 19 of the FITR, “the aggregate tax liability on fringe benefits shall under any circumstance not exceed 10% of the salary income of the employee.” That means, the maximum tax liability of fringe benefits is 10% of the salary. In practice, there are situations under which employees get more than one fringe benefit. The rationale is that if the government taxes all fringe benefits, and if there were no 10% limitation, the employee could have paid more than his/her salary, hence be stripped off his/her salary. This

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<sup>185</sup> FITR (n 13), Article 14/4

<sup>186</sup> Ibid, Article 14/3 (a-c)

<sup>187</sup> FITP (n 12), Article 10/3

is why the aggregate liability is limited to 10% of the salary. Some find this provision absurd because it is unnecessary to put this much pressure on the employer in calculating the value of all fringe benefits to reduce the tax liability to 10% of the salary.<sup>188</sup> This is one of the reasons for failure to follow up and monitor the implementation of the law, claims Ato Bochu Sentayehu, Director of Legal Services at MOF.<sup>189</sup> Looked at from the point of view of administrative efficiency, some argue that it results in too much cost for employer to comply with.<sup>190</sup>

### **3.5. Challenges in Implementation of the Vehicle Fringe Benefits**

#### **3.5.1. Retrospective Application of the Law**

According to tax scholars, tax laws that “affects transactions that have been closed in the past, that is, before the law was approved and/or promulgated by the legislator” are taken as retroactive or retrospective laws.<sup>191</sup> The Income Tax Regulation provides for the retrospective application of the provisions in the Regulation. It provides that the Regulation “shall apply on income derived as of 8th day of July, 2016”<sup>192</sup>, while the Regulation was adopted as law on “24th day of August 2017.” According to this provision, the law is applicable to all fringe benefits provided before the promulgation of the Regulation. As a result, employers are required to pay FBTs because they are supposed to withhold employment income tax.<sup>193</sup> According to a tax practitioner, this has resulted in confusion for taxpayers, particularly companies are wary of being denied deduction for various fringe benefits they provided before the issuance of the Regulation.<sup>194</sup> This results in unpredictability in the tax system, which has effect on integrity of the system.

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<sup>188</sup> Interview with Ato Bochu Sentayehu, Director, Legal Services Directorate, MOF, at the office of MOF, (Addis Ababa, Ethiopia 13 May 2020)

<sup>189</sup> Ibid

<sup>190</sup> Ibid; Interview with Ato Gizaw Bekuretsion, Tax Audit Process Coordinator at MOR, Large Tax Payers Division, (Addis Ababa, Ethiopia 17 May 2020)

<sup>191</sup> Frans Vanistendael, ‘Legal Framework for Taxation’, in Victor Thuronyi (ed), Tax Law Design and Drafting, vol 2 (International Monetary Fund: 1998)

<sup>192</sup> FITR (n 13), Article 71

<sup>193</sup> FITP (n 12), Article 97

<sup>194</sup> Informal discussions with Hawaz Merawi, Corporate Legal Officer at BGI Ethiopia PLC (Addis Ababa, Ethiopia September 2020)

### 3.5.2. Lack of Clarity in the law

Though the law was passed for the taxation of fringe benefits in 2017, it still is not being effectively applied against employment income. The tax officers at the MOF and MOR as well as employers interviewed for the purpose of this research have consensus that the FBT is not being effectively implemented against employment income. It is common practice that employers are not withholding employment income tax from all fringe benefits provided to their employees.<sup>195</sup> Accordingly, the vehicle fringe benefits are not being taxed to employees in practice. One of the companies selected for interview, however, is filing FBT, not by withholding from employees, but by paying on behalf of its employees.<sup>196</sup> The law does not obligate employers to pay on behalf of their employees. However, the company has a policy of “being on the safe side of things.”<sup>197</sup> This practice of the company raises another legal question. According to 12/3 of the FITP, if an employer pays income tax on behalf of its employee, the amount it paid should be included in the employment income of the employee. Thus, under Ethiopian tax law, covering FBT for an employee results in employment income for the employee. As a result, the employer is required to withhold income tax to the extent it covers the tax liability of its employee. Because this practice is not backed up by FBT rules, if this kind of practice is adopted by other employers, it can result in irregularities and inconsistencies.

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<sup>195</sup> Interview with Ato Beris Geremew, Tax Filing Process Coordinator, Large Tax Payers Division, MORs, (Addis Ababa, Ethiopia 17 March 2020); Interview with Mrs. Mahlet Amde, Tax Operation Deputy Manager at MOR, Large Tax Payers Division, (Addis Ababa, Ethiopia, 12 May 2020); Ato Bochu Sentayehu (n 188); interview with Anonymous, Finance Officer, Wegagen Bank S.C, at the Head Office, (Addis Ababa, Ethiopia 19 May 2020); Interview with Mrs. Senedu Teka, Senior Human Resource Finance Officer, Ethiopian Insurance Company, (Addis Ababa, Ethiopia 22 May 2020); Interview with anonymous, In-house Counsel, Legal Service Department, Ethiopian Insurance Company, (Addis Ababa, Ethiopia 22 May 2020) Humnawak Belay, Finance Department Head, Cooperative Bank of Oromia (Addis Ababa, Ethiopia 19 May 2020).

<sup>196</sup> Interview with Biruk Tesfaye, Tax and Treasure Manager, BGI Ethiopia PLC, (Addis Ababa, Ethiopia 15 May 2020 and 18 May 2020). This is akin to the Australian fringe benefits system in which the employer pays FBT on behalf of employees. However, the Ethiopian tax system does not impose this kind of obligation on the employer.

<sup>197</sup> *ibid*

The first and main reason raised by stakeholders is lack of clarity in the law. Some employers have requested clarification from the MOF and MOR on range of issues, but have not yet received any response.<sup>198</sup> Thus, they are not withholding any FBT. Vehicle fringe benefit has had the same fate. It has not seen the light of the day. The tax authority has failed to issue clear directives for the implementation.<sup>199</sup> The authority does not check whether employers are withholding FBT or not.<sup>200</sup>

Some believe that the definition of vehicle fringe benefits needs further clarification.<sup>201</sup> Accordingly, the part that states "...wholly or partly for the private use" has yet to be clarified. The law should further provide how much percentage of the vehicle use should be subject to FBT: 50%, 25%, or 80%?<sup>202</sup> Most employers provide their employees vehicle fringe benefits saying "for business" use, however, when you look at the substance of the use, it is mixed use.<sup>203</sup> Employees can use companies' or employers' vehicles on weekend, which can be designated as private use.<sup>204</sup> Taking specific examples, for instance, while an employee may be driving to pick his children from school, which might be designated as private use, he can pick up certain letter that has to be delivered to his place of work. Such kinds of matters, with frequency, can complicate computation of the due tax unless specific rules are issued.

Further, the Regulation provides for allowance of deduction when the employee uses the vehicle for "business purposes." It stipulates, under Article 14/2, that "when the car is provided for partial private use, the proportion of the use for business or in conduct of employment" is deductible. Employers and tax administration officers agree that further clarification is needed to

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<sup>198</sup> Interview with Anonymous, Finance Officer, Wegagen Bank S.C, at the Head Office, (Addis Ababa, Ethiopia 19 May 2020), Humnawak (n 195). The researcher could not get the details of the issues raised by banks. Though the researcher has requested the MOF, MOR and the banks, he could not get the letter written by both parties.

<sup>199</sup> Interview with Anonymous (n 195)

<sup>200</sup> *ibid*

<sup>201</sup> Interview with Ato Beris (n 195)

<sup>202</sup> Interview with Ato Gizaw (n 190)

<sup>203</sup> *ibid*

<sup>204</sup> *ibid*



implement this provision as, in the present legal sphere, there is no parameter to determine the proportion of business and private use.<sup>205</sup> A tax auditor at the MOR asks:

If an employee uses the vehicle to commute to work, is it private use? What if he stays at night on meeting or for overtime duty and uses the vehicle to go home? In the law, the circumstance under which the use of the vehicle becomes private use or business use is not clearly set.<sup>206</sup>

Though commuting is normally taken as personal use, the problem with definition of personal use vs. business use needs clarity for the effectiveness of the law.

The law further provides for the deduction of costs in relation to the vehicle. According to the Regulation, “Any payment made by the employee in relation to the use of the vehicle, including maintenance, repair and running costs” are deductible. These kinds of expenses are deductible in other tax jurisdictions too. Different expenses like cost of repairs, servicing, lubrication of tyres and other costs are commonly deductible in various jurisdictions.<sup>207</sup> For the implementation, they have set recording keeping obligations on employees, in case the employee directly lodges his tax return, or obligate the employer to keep records when it is withholding agent.<sup>208</sup> This shows that proper procedures and processes, on how the documents have to be kept and acceptable formats have to be clearly set in the laws. However, because of lack of these procedures in the fringe benefits rules under Ethiopian laws, the implementation has been constrained.

### **3.5.3. Lack of Attention to FBT in General**

The Ethiopian tax authority was raising administrative problem as the main challenge before the introduction of FBT.<sup>209</sup> Even after the introduction of the FBT, the administrative problem continues to be the main challenge for implementation as raised by the tax authority. Most interviewees, including the tax authority officials, conceded that there is administrative lenience

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<sup>205</sup> *ibid*

<sup>206</sup> Interview with Ato Gizaw (n 190)

<sup>207</sup> Income Tax Act 58 of 1962 (n 130)

<sup>208</sup> See the Australian Tax system, [https://www.ato.gov.au/General/Fringe-benefits-tax-\(FBT\)/Reporting,-lodging-and-paying-FBT/Record-keeping/](https://www.ato.gov.au/General/Fringe-benefits-tax-(FBT)/Reporting,-lodging-and-paying-FBT/Record-keeping/)

<sup>209</sup> Taddese Lencho (n 8) 266

towards enforcement of the FBT.<sup>210</sup> Vehicle FBT is not exception in this regard. Various reasons are put forward by stakeholders for the administrative leniency. First, some question the procedure of adoption of FBT. When it was adopted, stakeholders, including the tax administration organs did not reach consensus, or agreement, on the adoption of the FBT.<sup>211</sup> So, maintaining this line of argument, most stakeholders are not aware of the laws. Second, others argued that the adoption of the FBT was mainly a response to clamor of equity from different stakeholders.<sup>212</sup> When FBT was to be introduced, many employees of tax administration organs objected to the introduction at the sensitization program prepared by the drafter experts on the tax laws.<sup>213</sup> Adequate research on the implementation, possible costs of administration and potential revenues was not done.<sup>214</sup> Some claim that these have resulted in unwillingness to aggressively follow-up and monitor the implementation of the law.<sup>215</sup> Third, is lack of awareness of the law among tax officers has resulted in administrative leniency.<sup>216</sup> Employees of the MOR do not have good understanding of the law, and some do not even know that the detail rules are passed by Regulation.<sup>217</sup>

The reasons put forward above can be contribute to the problem of FBT as it stands now. However, even before the introduction of current laws, Taddese pointed out the problem with FBT is that the top government officials are the main beneficiaries of perks.<sup>218</sup>

#### **3.5.4. Problems with Tax Administration**

In relation to administrative feasibility, tax officers believe that vehicle fringe benefit tax is difficult to comply with for employers.<sup>219</sup> As discussed in previous chapter, FBT has intricate administrative challenges by its nature due to valuation requirements and processes. Coupled

<sup>210</sup> Ato Beris (n 195); interview with Mrs. Mahlet (n 195); Interview with Mrs. Senedu (n 195)

<sup>211</sup> Interview with Ato Bochu (n 188)

<sup>212</sup> Interview with Ato Gizaw (n 190)

<sup>213</sup> *ibid*

<sup>214</sup> Interview with Ato Bochu (n 188)

<sup>215</sup> *ibid*

<sup>216</sup> Interview with Ato Beris (n 195); interview with Mrs. Mahlet (n 195)

<sup>217</sup> *ibid*

<sup>218</sup> Taddese Lencho (n 8) 336

<sup>219</sup> Interview with Ato Beris (n 195)

with absence of clear guideline or rules that can simplify the process and valuation of FBT in general and vehicle fringe benefits in particular, employers faced difficulty in calculating the taxable value of each fringe benefit.<sup>220</sup> Thus, employers left the benefits untaxed to avoid the administrative trouble. Besides, tax auditors of the MOR also claim that it is costly for the Ministry to engage in auditing and calculating each and every fringe benefit in the absence of clear laws.<sup>221</sup> Thus, they are reluctant to enforce the law. This has resulted in the absence of adequate administrative monitoring of the FBT.

#### **5.3.4. The Uncertainty on Corporate Income Tax Deduction for Payment of Fringe Benefits**

All business expenses are deductible except in some prohibited grounds. Some are prohibited because they are of personal expenses or for some policy reason: fines, bribes, taxes, entertainment and etc. are of these type.<sup>222</sup> Nevertheless, some countries transfer the tax of “unattributable fringe benefits”, which are “impractical to identify the specific employees who received the benefit or to quantify the benefits each one received”, to employers by denying deduction for fringe benefits as business expense.<sup>223</sup> Deduction denial is one of the methods applied by countries to tax fringe benefits.<sup>224</sup> It transfers the tax burden to employers who provide fringe benefits.

Legally speaking, Ethiopia taxes fringe benefits at employee level, i.e. employers are required to withhold income tax when they provide any fringe benefits.<sup>225</sup> Therefore, Ethiopia does not have clear legal ground to deny fringe benefits expenses in lieu of employment income tax not withheld by the employer, though the practice has been haphazard. According to Article 20 (1) of the FITP, taxable business income of business persons is total business income reduced by allowed deductions for the tax year. In enunciating the acceptable expenses that can be deducted,

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<sup>220</sup> Interview with Ato Ephrem (n 175); Interview with Humnawak (n 195); Interview with Ato Bochu (n 188)

<sup>221</sup> Interview with Ato Ephrem (n 175)

<sup>222</sup> Victor Thuronyi (n. 20) 274

<sup>223</sup> David Elkins, 'Taxing Fringe Benefits: The Israeli Experience' (2005) 31 Int'l Tax J 15

<sup>224</sup> Victor Thuronyi (n. 20) 250. For instance, Sweden denies deduction to employers who provide medical benefits to its employees.

<sup>225</sup> Federal Income Tax

the FITP allows “any expenditure” to be deducted as long as the expenses are “necessarily incurred” by business persons in the tax year for the purposes of “deriving, securing and maintaining amounts included in business income.”<sup>226</sup> Salaries and benefits paid in cash are included in the permissible deductions for corporation in calculating their business income without question by auditors of tax authority. The practice regarding fringe benefits is murky. The tax auditors stated that only some companies have been audited since the promulgation of the current income tax laws.<sup>227</sup> However, there has not been a case in which companies presented the fringe benefits they provided for deduction purposes.<sup>228</sup> The auditors did not check whether the employers have withheld employment income tax on fringe benefits, if any. Since the authority has five years<sup>229</sup> of inspection period, this time may not be an ideal time to evaluate the controversies that can arise. However, one can imagine the problems that might ensue. The first problem regarding fringe benefits is that tax auditors at the tax authority deny deductions by claiming that provision of car to a certain employee is not “necessary” for the business. In normal course of things, if an employer makes business decision that some of its employees deserve vehicle fringe benefits, the employer has to be able to obtain deduction for its expenses. However, the auditors of the tax authority sometimes deny depreciation allowance as business expense because the employer should not have given employees. Thus, controversies arise regarding depreciation allowance for cars fringe benefits. This is due to absence of clear legal parameters that limits the power of the auditors. This can be mitigated by making the businesses, rather than the auditors, the judge on what is “necessary” business expense.<sup>230</sup> Failure to withhold employment income tax from fringe benefits is another ground for denial of deductions.<sup>231</sup>

Mixed usage of vehicle fringe benefits complicates the matter more. Most of the time, vehicle fringe benefits are provided mixed purposes, i.e. business as well as private purposes.<sup>232</sup> In such

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<sup>226</sup> FITP (n 12), (Article 22/1 (a)).

<sup>227</sup> Interview with Ato Ephrem (n 175)

<sup>228</sup> *ibid*

<sup>229</sup> Article 17 (2/b) cum 18 of the Federal Tax Administration Proclamation (n 168)

<sup>230</sup> Taddese Lencho, Business Tax Class Lecture, (June, 2019)

<sup>231</sup> See *Alfa Foods PLC V. Ministry of Revenues* (unpublished 2019) FDRE Tax Appeal Commission p. 8

<sup>232</sup> Interview with Ato Gizaw (n 190)

cases, tax auditors of the MOR deny deductions without going into the details by claiming that the expense is unnecessary. As one scholar noted, this discretion makes tax auditors of the tax authority opportunistic in giving them the right to deny deductions for vehicle fringe benefits as deductible expenses to corporations.<sup>233</sup> This makes the corporations liable to pay income tax on their expenses. In general, the unpredictable nature of the decisions of the tax auditors regarding the mixed usage harms business competition, fairness and economic efficiency in general.

The other problem is the daunting nature of the administration of calculating every fringe benefits for expense purposes by the tax administration. According to the auditors at the MOR, it is costly for the tax administration to go through and calculate every employees fringe benefits cost unless clear rules are issued for the implementation for employer's recording keeping.<sup>234</sup> As it currently stands, the tax auditors at the MOR says there is no consistent record keeping system the employers use in presenting their claims for deduction in case of vehicle fringe benefits.<sup>235</sup> Hence, the obscurity remains to be challenging.

It is discussed in previous sections that taxation of fringe benefits at the employment income level is not being implemented effectively. This has been mitigated by denying deductions to companies when they file their corporate income tax by claiming that the provisions of fringe benefits are not "necessary" in accordance with the FITP. Besides, the auditors of tax authority has been denying deductions because employers do not keep accurate records.<sup>236</sup> What can be concluded from this is the implementation of fringe benefits tax in general, and vehicle fringe benefits in particular has long way to go. Due to the short span of life of the fringe benefits tax, corporations as well as tax authorities are not certain about what to do with deduction of fringe benefits as expenses in equal manner with employees' salaries.

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<sup>233</sup> Taddese Lencho (n 230) (June, 2019)

<sup>234</sup> Interview with Ato Gizaw (n 190); Interview with Ato Ephrem (n 175)

<sup>235</sup> *ibid*

<sup>236</sup> Interview with Ato Ephrem (n 175)

## Chapter Four

### Conclusions and Recommendations

#### 4.1. Conclusions and Findings

Fringe benefits were considered to be “tax free” income in most tax system before three decades ago. Most countries started to stretch the tentacles of their tax laws only after finding out there are convincing conceptual, theoretical and practical reasons for taxation of fringe benefits.<sup>237</sup>

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<sup>237</sup> Lee Burns, and Richard Krever, (n. 2)

Equity and efficiency principles of taxation were the main impetus behind the introduction of FBT.

In the Ethiopian tax system raising revenue and equity are the main driving forces behind the introduction of FBT. Raising revenue and equity are the basic tax policies of the country.<sup>238</sup> As clearly stipulated in the Growth and Transformational Plan (GTP II), which contains the general tax policy of the country, the government has planned to overhaul the tax system “[T]hrough improving tax administration systems, tax administration capacity, enforcement of tax laws, broadening the tax base and automation of tax administration systems.”<sup>239</sup> In its bid to implement this general policy, the government is trying to reach out to the hitherto ignored income sources like fringe benefits by the instrumentality of tax laws.

Coming to the laws, the FITP states that the objective of tax reform in 2016 was aimed at ensuring equity and broadening the tax base.<sup>240</sup> Accordingly, The Council of Ministers adopted the previously disregarded rules for the taxation for FBT in 2017. Due to its failure to clearly legislate on the taxation of fringe benefits, the Ethiopian tax system has been criticized for being inequitable by tending toward taxing incomes in cash forms only. In order to solve this issue and broaden the tax base with the intention to raise more revenue to the coffers of the government, the government showed political will in issuing detailed rules for taxation of fringe benefits. The FITR has come up with a list of types of benefits subject to FBT, and their valuation methods.

Vehicles provided by employers to their employees form part of the taxable benefits. The law has defined what a vehicle fringe benefit is; it has also provided for the valuation formula. However, the law is not being implemented due to various reasons. This research found out that employers and tax administrators are not effectively implementing the FBT in general and vehicle FBT in particular. So, the tax system remains to be unfair among the taxpayers, and the government is not getting its fair revenue from employment income.

There are practical and legal challenges for failure to implement the tax laws. The main reason behind failure to implement the vehicle FBT is lack of clarity in the law. Lack of clarity of law is

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<sup>238</sup> Taddese Lencho (n 149)

<sup>239</sup> National Planning Commission, (n 163) 6

<sup>240</sup> FITP (n 12), preamble, paragraph 2

so severe that the tax administration officers and employers alike raise the problem. The law fails to be clear to be practicable in the following areas:

- Separation of private and business use of vehicle: it is common practice that employers give employees vehicle for both private and business use, that the employees use it as such even when they were given the vehicles for one of the two. They do not separate between the two. The taxable value of vehicle fringe benefits should target the private use portion. However, there is no clear law that that can guide employers to extract the private use and withhold income tax.
- Requirements of record keeping: the regulation provides that expenses by employees are deductible when they are given the vehicle for private use. So, record-keeping is necessary for various purposes like deduction of expenses for the employee. The law does not provide for record-keeping obligation or what the effect would be if the employee or employer fails to keep record in FBT. It also fails to list out what the record should include.
- Lack of clear guideline on determination of market value of the vehicle.
- The other is uncertainty regarding deduction of fringe benefits provided as employment payment by corporations. Corporations are denied expenses made for fringe benefits by tax auditors.
- Retrospective application of the FITR has created another problem.

As shown in this research, the implementation of the FBT depend upon practicable rules, procedures and methods which tax administrators and taxpayers can comprehend and comply with easily. This requires thorough record keeping by employees about their private use and the withholding agents: employers. The current law lacks the procedures and methods of valuation that are understandable and easily implementable. The information that should be included in the records should be reasonably listed out so that taxpayers know their obligations and made available for auditing when the tax administration authorities require for investigation. The detailed content and form of records should be issued in a guideline to ease compliance costs for withholding agents, employers, and taxpayers, or employees.



In addition, the failure of the implementation of the FBT is attributable to other practical challenges. There is an acute lack of understanding among withholding agents and administration officers about the FBT in general and vehicle FBT in particular. Most of the MOR officers are not aware that the FBT has been issued under the FITR. Even though the provisions of the Regulation lack clarity, it is unexpected that the MOR officers lack basic information like the issuance of the detailed rules for taxation of fringe benefits. This shows that the provisions of the law in relation to FBT in general and a vehicle fringe benefit in particular have a long way to go to be implemented.

In general, tax system is failing in the taxation of fringe benefits mainly due to legal loopholes. The vehicle FBT suffers from inadequate, clear and implementable rules for employers to comply with the law. Coupled with the absence of administrative willingness to implement the FBT by issuing clear and implementable rules, the FBT has not been exploited as a potential area for revenue and ensuring tax equity. Therefore, the law fails to achieve the fundamental tax policies and objectives of the country because of lack of implementation of the tax law.

#### **4.2. Recommendations**

The failure to enforce the FBT law results in the country's loss to achieve its fundamental tax policies of raising revenue for the government and equity. Based on the study of other tax systems on how they implemented FBT, and in order to achieve the tax objectives of the country, the researcher submits the following recommendations:

1. The MOF and MOR should conduct action research on FBT to understand how much the government is not earning in terms of revenue. They have to strike a balance between cost of administration and the revenue that will be obtained from the enforcement of the law.
2. The MOF should issue clear guidelines that can make implementation of the fringe benefit tax laws possible: The Ministry should issue directive in accordance with Article 99/2 of the FITP, and Article 136/2 of the Income Tax Administration. The directive that should be adopted must include the clear parameters for separation of business and private use of vehicle provided by employers to their employees. In doing that the directive should include checklist for circumstances under which the vehicle is said to be used for private purposes to impose FBT.

Further, to make the implementation easy and flexible, employees should be consulted and contribute their comments during the drafting process of the directive.

3. **Creating awareness:** as we have seen above, one of the bottlenecks for the implementation of the FBT in general, and vehicle FBT in particular is lack of adequate awareness about the law. It is found out that tax officers at the MOR are not aware of the existence of detail rules for the taxation of fringe benefits. Thus, the Ministry should engage in awareness and sensitization program.
4. **Enforcement of the FBT:** The tax administration should be vigilant in enforcement of the tax law as fringe benefits income in both public and private sectors. In discussing with stakeholders and the tax administration authority, the MOR, should aggressively work on implementation of the FBT. The Ministry should also work on educating the public, particularly employers, officers of the Ministry and other stakeholders about the law.
5. **Imposing record keeping obligation on employers:** detail, consistent and standardized record should be kept by employers for the separation of private and business use of the vehicle as well as for other purposes like deduction of expenses incurred by the employee in using the vehicle. In addition, accurate record of the cost the employer incurred to acquire the vehicle would allow for the determination of the taxable value of vehicle fringe benefits.
6. **Issuing standards for record keeping procedures:** The tax authority should issue standards that the employers should comply with. For the purposes of simplicity, clarity and consistency, the tax authority should issue standardized record keeping procedures and contents. This eases the methods of valuation of vehicle fringe benefits, as well as other fringe benefits, to determine the taxable value.
7. **The MOR should prepare clear, consistent and dependable fringe benefits filing system for employers.** The Ministry should give response to clarification request sent by Banks through issuing general guideline for all stakeholders.

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