Federal Democratic Republic of Ethiopia

Federal Income Tax Proclamation No. 979/2016

Technical Notes

Ministry of Finance and Economic Cooperation

February 2018

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Disclaimer

The organizations, ERCA, MoFEC and the WBG, using their best efforts in the time available, have endeavored to provide high-quality services hereunder and have relied on information provided to them by different resources.

Although the information presented in these explanatory notes has been carefully prepared, it is not a legally binding document. Therefore, users of these notes are required to refer to the Income Tax Proclamation and other income tax related laws and regulations for obtaining legally binding information.

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List of Abbreviations

ERCA	Ethiopian Revenue and Customs Authority
FDRE	Federal Democratic Republic of Ethiopia
IFRS	International Financial Reporting Standards
ITP	Income Tax Proclamation
LIFO	Last In First Out
MoFEC	Ministry of Finance and Economic Cooperation
PLC	Private Limited Company
TAP	Tax Administration Proclamation
TIN	Tax Identification Number
UN	United Nations

Federal Income Tax Proclamation No. 979/2016
Explanatory notes

These technical notes provide an Article-by-Article explanation of the Income Tax Proclamation (“ITP”).

1. Short Title

This Article provides that the Proclamation may be cited as the Federal Income Tax Proclamation No. 979/2016.

2. Definitions

This Article defines terms used in the ITP.

Initially, it is provided that terms used in the ITP that are defined in the Tax Administration Proclamation (“TAP”) shall have the meaning in the TAP unless defined otherwise in the ITP. The policy is that definitions of terms common to the tax laws will be specified only in TAP with a cross-reference in the primary tax law. This is intended to achieve consistency in interpretation across the tax laws. It also facilitates ease of amendment of definitions and avoids the uncertainties that can arise when a term that is used in several tax laws is amended for the purposes of one tax law but not the others.

This is relevant to the following terms: “approved form”, “Authority”, “body”, “company”, “fiscal year”, “international agreement”, “international organisation”, “member”, “membership interest”, “Ministry”, “Minister”, “partnership”, and “person”. The meanings of these terms are discussed in the technical notes to TAP.

Sub-articles (1)-(27) provide definitions of specific terms used in the ITP. The definition in these sub-articles applies unless the context requires otherwise. The main definitions are discussed below.

Amount

This term is relevant to many provisions in the ITP that refer to an "amount".

The definition is inclusive so that "amount" otherwise has its normal meaning. In the context of the ITP, "amount" means the total of something in value (such as income, consideration, cost, or expenditure).

It is expressly provided that an amount includes an "amount-in-kind". Consequently, an amount can either be in money or in kind (such as a benefit).

> **Example**
>
> ABC Co sells goods to XYZ Co for 1,000 birr. XYZ Co may pay 1,000 birr cash for the goods or it may provide services that have a value of 1,000 birr. Regardless of how XYZ Co pays for the goods, the 1,000 birr cash or the value of the services are both treated as an amount for the purposes of the ITP. This is relevant to both the receipt by ABC Co as seller and the payment by XYZ Co as purchaser.

Business

This term is central to the operation of Schedule 'C', which provides for the business income tax. In particular, 18(1) provides for the imposition of business income tax on a person conducting a business.

The definition of "business" has three inclusions. Paragraph (a) provides that "business" means any industrial, commercial, professional, or vocational activity conducted for profit. Such an activity comprises a business regardless of whether it is conducted continuously or short-term.

The main example of an "industrial activity" is manufacturing, i.e. the substantial transformation of raw materials or component parts into intermediate or finished goods. Other examples of an industrial activity include the processing of minerals, refining of petroleum, and milling of timber.

It is intended that the reference to "commercial activity" be interpreted broadly to mean any activity conducted for financial gain. The key indicators that an activity is conducted for financial gain are profit motive and the existence of system and organisation to the activity conducted (i.e. it is more than just a hobby or recreational activity). Examples of a commercial activity include the exchange of goods or services (i.e. the buying and selling of goods, and the provision of services including those services that are not professional services), and agricultural, pastoral, horticultural, forestry, handicraft, or fishing activities. It is intended that an activity can come within paragraph (a) even if the activity is not a "trade" under the Commercial Code (see Articles 6 – 9 of the Commercial Code), provided the activity is conducted for profit. The requirement that the activity be conducted for profit means that subsistence activities (such as subsistence agricultural activities) are not treated as a business.

A "professional activity" involves the application of skill, based on theoretical knowledge usually acquired through higher education, to the affairs of others to meet their needs. Common examples of professions are legal practice, medical practice, dentistry, architecture practice, accountancy, pharmacy, and optometry.

A "vocational activity" also involves the application of skill to the affairs of others to meet their needs. The acquisition of a vocational skill may be through specialised training. The conduct of a trade skill, such as a builder, electrician, or plumber, is an example of a vocational activity.

While normally a business is conducted continuously (i.e. there is repetition of commercial activity), paragraph (a) makes it clear that even a short-term industrial, commercial, professional, or vocational activity is a business. For this reason, the ITP refers to the "conduct" of a business rather than the "carrying on" of a business.

Paragraph (a) expressly excludes the activity of rendering services as an employee (which may otherwise be within the broad meaning of a vocational activity). This is because employment income is subject to tax under Schedule 'A'. "Employee" is defined in Article 2(7). Paragraph (a) also expressly excludes the rental of buildings because rental income is subject to Schedule 'B'.

Paragraph (b) provides that "business" means any other activity recognised as a trade under the Commercial Code. Article 5 of the Commercial Code lists activities that are treated as a trade. These activities are automatically treated as a business for the purposes of the ITP. It is noted that Article 5(2) of the Commercial Code refers only to rental of movable property and, therefore, paragraph (b) does not apply to the rental of immovable property.

Paragraph (c) provides that "business" means any activity of a share company or private limited company regardless of the objects of the company. This aligns with Article 10(2) of the Commercial Code. This means that any activity undertaken by a share company or private limited company is a business. However, there is an exception for the activity of rental of buildings. Again, this is because rental income is subject to Schedule 'B'.

Business asset

This term is primarily relevant to Article 21(1)(b) (which includes the gain made by a taxpayer on the disposal of a business asset in business income) and Article 22(1)(d) (which allows a deduction for a loss made by a taxpayer on disposal of a business asset).

"Business asset" is defined to mean any asset held or used in the conduct of a business to derive business income. "Asset" is not separately defined and is intended to have its ordinary meaning, namely any resource of a business from which future economic benefits are expected to flow. The word "asset" has been used in preference to the word "property" which, if read narrowly, would unduly limit the scope of the definition of business asset. An asset is a business asset regardless of whether it is revenue or capital in nature. Consequently, for example, the structural assets of a business (such as commercial premises, plant, and equipment) are business assets.

Examples of business assets include trading stock, depreciable assets (see Article 25(7)(b)), business intangibles (see Article 25(7)(a)) and goodwill. In broad terms, "goodwill" is an intangible asset comprising that part of the overall value of a business that is not reflected in its tangible or other intangible assets. The value may be derived from a brand, location, or the human capital of the business workforce.

The determination of whether an asset of a person is a business asset depends first on the characterisation of the person's activities as a "business" (separately defined in Article 2(2)). In broad terms, a business is any activity undertaken for profit. If a person is conducting a business, an asset of the person is a business asset for the purposes of the ITP when the following conditions are satisfied:

(1) The asset is "held" or "used" in the conduct of a business. The reference to "held" is intended to cover both assets held in reserve (for example, an item of machinery held in reserve and ready to use if demand increases) and assets of an intangible nature (for example, financial assets - shares, debts, and the like). The word "conduct" is used (rather than "carrying on") to align with the broad definition of "business" in Article 2(2), particularly the inclusion of a short-term commercial activity that may not involve the repetition of activity.

(2) The asset is held or used wholly or partly to derive business income. As business income does not include exempt income (see Article 21(2)), an asset that is used solely to derive exempt income is not a business asset even if it is an asset of a business. An asset that is partly used to derive business income and partly to derive exempt income is a business asset. However, apportionment applies in determining any depreciation deduction that may be allowed in respect of the asset, and in relation to any gain or loss arising on disposal of the asset.

Derive

This term is central to the operation of the ITP as it defines the time when income is taken into account for tax purposes. For example, for business income tax purposes, the concept of derived defines the time when an amount is included in business income.

Paragraph (a) applies for the purpose of business income tax (i.e. tax imposed under Article 18 and business income tax payable by a non-resident conducting an international air transportation business under Article 50) and rental income tax (i.e. tax imposed under Article 13). For these taxes, “derived” means received or receivable depending on a person’s method of tax accounting as determined under Article 20(2). For a person accounting for business or rental income tax on an accruals basis, “derived” means the arising of the right to receive an amount of business or rental income (i.e. derived means “receivable”). For a person accounting for business or rental income tax on a cash basis, “derived” means received. “Received” is defined in Article 2(19) to mean an actual receipt or a constructive receipt.

Paragraph (b) applies for the purposes of the taxes imposed under Schedules ‘A’ and ‘D’. For these taxes, derived means received (as defined in Article 2(19)). Consequently, these taxes are accounted for on a cash basis.

Dividend

This term is primarily relevant to the source rule for dividends (Article 6(4)(a)), the non-deductibility rules (Article 27), the imposition of non-resident tax on dividends and collection of the tax by withholding (Articles 51 and 89), and the imposition of Schedule 'D' tax on dividends derived by a resident and the collection of the tax by withholding (Articles 55, 64, and 90).

"Dividend is defined to mean a distribution of profits by a body to a member. "Body" is defined in Article 2(5) of TAP and includes a company, partnership, or other body of persons. "Member" is defined in Article 2(20) of TAP and means a shareholder in company, partner in a partnership, and any other person with a membership interest (i.e. ownership interest (see Article 2(21) of TAP)) in a body. While a dividend is normally associated with a shareholding in a company, the definition of dividend is broad to align with the broad definition of "body. The main example of a dividend is a distribution of profits by a company to a shareholder or by a partnership to a partner.

The definition expressly includes the following amounts:

(1) An amount returned by a body to a member in respect of a membership interest in the body on a partial reduction in capital to the extent that the amount returned to the member exceeds the amount by which the nominal value of the membership interest in the body is reduced (paragraph (a)). In the absence of this provision, the whole amount may be treated as a capital amount under general principles.

Example

X Plc paid shareholders 20 birr per share as consideration for a reduction in the nominal value of the share from 100 birr to 90 birr. In this case, 20 birr is paid to the shareholder, but the nominal value of the share is reduced by only 10 birr. The effect of paragraph (a) of the definition of "dividend" is to treat 10 birr per share as a dividend (i.e. a distribution of profits) and 10 birr as the reduction in capital.

(2) An amount returned by a body to a member on redemption or cancellation of a membership interest, including on liquidation of a company or termination of a partnership, to the extent that the amount returned exceeds the nominal value of the membership interest (paragraph (b)). Again, in the absence of this provision, the whole amount may be treated as a capital amount under general principles.

(3) A disguised dividend being any of the following:

* The amount of any loan made by a body to a member or a related person of the member when the loan is, in substance, a distribution of profits. Factors relevant to determining whether a loan is, in substance, a distribution of profits include whether a fair market rate of interest is payable or, if payable, whether the interest is expected to be paid, and whether the loan is expected to be repaid.

* The amount of any payment made by a body to a member or related person of a member for an asset or services provided by the member or related person to the company to the extent to which the payment is, in substance, a distribution of profits. Such a payment may be a distribution of profits to the extent to which it is in excess of the fair market value of the asset or services provided determined as at the time the asset or services were provided.

* The fair market value of any asset or services provided by a body to a member or a related person of a member to the extent to which the supply is, in substance, a distribution of profits. Such a supply may be a

distribution of profits to the extent to which the fair market value of the asset or services provided exceeds any consideration given for the asset or services.

* The amount of any debt obligation owed by a member or a related person to the company that has been released by the company to the extent to which the release is, in substance, a distribution of profits.

Employee

This term is primarily relevant to the employment income tax under Schedule 'A'.

Employee" is defined to mean an individual engaged, whether on a permanent or temporary basis, to perform services under the direction and control of another person.

The definition expressly excludes an independent contractor, which is separately defined in Article 2(15). An independent contractor is engaged in a business activity and, therefore, the remuneration derived by an independent contractor is business income. The determination of whether an individual is an employee or independent contractor involves examining a number of factors, including whether the hirer has the legal right to control the manner in which the work is done and the degree of integration of the activities of the individual in the business of the hirer. The following factors are relevant in determining the degree of an individual's integration in the business of the hirer:

* Whether the individual is engaged on a continuous basis.

* The place where the services are performed, in particular whether they are performed at the hirer's place of business.

* Whether the hirer controls the timing and scheduling of the work.

* Whether the hirer provides the working tools, plant, and other relevant facilities necessary for the individual to perform his or her work.

The definition expressly includes a director or other holder of an office in the management of a body, and government appointees and elected representatives, such as judge or parliamentarian. While, in legal form, an office holder is not an employee, there is little difference in economic substance between an office holder and an employee. In both cases, the remuneration is paid essentially for the labour of the person providing the services as employee or office holder. Consequently, employees and office holders are treated the same under the ITP.

Employer

This term is relevant to the withholding of tax from employment income under Article 85. The obligation to withhold tax is imposed on the employer of the employee.

"Employer" is defined to mean a person who engages or remunerates an employee. "Person" is defined in Article 2(26) of TAP to mean an individual, body, government, local government, or international organisation. "Body" is defined in Article 2(5) of TAP to mean a company, partnership, public enterprise or public financial agency, or other body of persons. The broad definition of "person" means, for example, that the Government of Ethiopia and regional Governments in Ethiopia that engage an individual as an employee are employers for the purposes of the ITP. This is relevant, for example, to the obligation to withhold tax from employment income under Article 88.

The definition of employee in Article 2(7) is central to the definition of employer. Any person who engages or remunerates an employee (as defined) is an employer. The reference to a person who "remunerates" an employee is intended to cover arrangements in corporate groups whereby one company may engage the employee but another company in the group actually pays the remuneration to the employee as part of a centralised payments function within the group.

Financial reporting standards

This term is relevant to Article 20(2) (which provides that the taxable income of a taxpayer under the business income tax is calculated by reference to financial statements prepared in accordance with financial reporting standards) and Article 47(4) (which provides that "debt" and "equity" for the purposes of the thin capitalisation rule have their meanings under financial reporting standards).

"Financial reporting standards" is defined to mean the financial reporting standards stipulated under the Financial Reporting Proclamation. Article 5 of the Financial Reporting Proclamation stipulates that the international financial reporting standards ("IFRS") or IFRS for small and medium enterprises issued by the International Accounting Standards Board (or its successor) as adopted, adapted, or amended by the Accounting and Auditing Board of Ethiopia are to be used when preparing financial statements.

Gross income

This term is primarily relevant to categorisation of taxpayers under Article 3.

"Gross income" is defined to mean the total income taxable under Schedules 'B' or 'C' derived by a taxpayer without deduction of expenditures. In broad terms, therefore, the gross income of a taxpayer is the total business and taxable rental income of the taxpayer.

Under Article 3, a taxpayer with an annual gross income of 1,000,000 birr or more is a Category 'A' taxpayer. A taxpayer with an annual gross income of 500,000 birr or more but less than 1,000,000 birr is a Category 'B' taxpayer. A taxpayer with an annual gross income of less than 500,000 birr is a Category 'C' taxpayer.

Immovable property

This term is primarily relevant to 6(4)(c) (which provides rules for determining when income is Ethiopian source income). It is relevant in determining the source of rental income from the lease of immovable property and the source of gains on direct and indirect disposals of immovable property.

The definition of "immovable property" is inclusive so that immovable property otherwise has its ordinary meaning under Ethiopian law. Article 1130 of the Civil Code provides that land and buildings are immovable property. Articles 1131-1139 of the Civil Code provide that any intrinsic elements of land and buildings (such as crops and trees prior to being separated from the land, and third party rights such as the rights of lessees and tenants) or accessories to land and buildings are immovable property.

The definition expressly includes mining and petroleum rights, and mining and petroleum information, as defined in Article 36 as immovable property. The inclusion of mining and petroleum rights is largely declaratory of the meaning of "immovable property" under the Civil Code, but they have been included in the definition out of abundant caution. This is particularly relevant to the taxation of gains on disposal of such rights or information.

Income

This term is central to the operation of the ITP as income tax is imposed under the Schedules by reference to amounts of income.

"Income" is defined broadly to mean every form of economic benefit, whether in cash or kind, and derived from every source and in every form paid, credited, or received. It expressly includes non-recurring gains, such as capital gains.

Independent contractor

This term is relevant to the definition of "employee" in Article 2(7), which excludes an independent contractor.

"Independent contractor" means an individual 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 to be performed. The distinction between an employee and an independent contractor is discussed above in the explanation for "employee".

Interest

This term is primarily relevant to the source rule for interest (Article 6(4)(g)), the deductibility of interest expenditure (Articles 23 and 47), the imposition of non-resident tax on interest and collection of the tax by withholding (Articles 51 and 89), and the imposition of Schedule 'D' tax on interest derived by a resident and the collection of the tax by withholding (Articles 56, 64, and 90).

"Interest" is defined broadly to reflect the fact that there is enormous flexibility on international monetary markets as to how financial instruments may be structured. This is particularly important for the imposition of non-resident tax on interest under Article 51.

Interest is defined to mean an amount that is consideration for the use of money or for being given time to pay. The main examples are interest paid by a financial institution on deposits with the institution or paid by a company on debentures issued by the company. However, the definition is broad and includes interest paid on any loan no matter who the lender is. The focus is on the character of the return derived on a transaction as interest and not on the character of the payer or recipient.

An amount can be interest regardless of whether it is paid as a lump sum or periodically, and however it may be described. Consequently, any amount that is, in substance, consideration for the use of money or for being given time to pay is interest. The definition includes discounts and premiums, as these are amounts paid for the use of money. For example, a bill of exchange may be issued at a discount on its face value with the full amount of the face value payable on maturity of the bill. A 90-day bill with a face value of 100 birr may be issued for 90 birr. This means that the issuer of the bill receives 90 birr on issue and pays 100 birr on maturity. The difference of 10 birr is referred to as discount, but is economically the equivalent of interest. A premium is really additional interest and may be payable by a borrower with a low credit rating to compensate for the greater risk involved with the loan.

The definition also includes any other functionally equivalent amount, such as an amount payable for the time value of money under a derivative financial instrument or a payment of defaulted interest by a guarantor.

Management fee

This term is relevant to Article 6(4)(g) (which provides a source rule for management fees), and Articles 51 and 89 (which provides for the imposition and collection of non-resident tax on management fees).

"Management fee" is defined to mean an amount paid as consideration for the rendering of any managerial or administrative service, other than an amount that is employment income (as defined in Article 12). A management fee is commonly charged by a parent company to a subsidiary for centralised management services provided by the parent company to the subsidiary.

Received

This term is primarily relevant to the tax accounting (i.e. timing) rules in the ITP. Employment income is subject to tax under Schedule 'A' when it is received. The timing rule for the taxes imposed under Schedules B, C, and D is specified by the word "derived", which is defined in Article 2(5). Paragraph (a)(1) of the definition of "derived" provides that a taxpayer accounting for business or rental income tax on a cash basis derives an amount when the amount is received. Paragraph (b) of the definition of "derived" provides that an amount is derived for the purposes of any other tax imposed under the ITP when the amount is received.

"Received" is defined inclusively so that it otherwise has its ordinary meaning, namely to take into one's possession (i.e. an actual receipt). The definition expands upon the ordinary meaning to legislatively provide for a principle of constructive receipt.

Paragraph (a) treats an amount as received by a person if it is applied on his or her behalf. This may be at the request of the person or under any law. For example, if an employee instructs his or her employer to pay part of his or her salary to a third party (such as the employee's spouse) the employee is treated as having received the salary even though it is actually received by the third party. Similarly, if an amount owing to a person is paid to a creditor of the person under a garnishee order, the person is treated as having received the garnisheed amount.

Paragraph (b) treats an amount as received by a person if it is reinvested, accumulated, or capitalised for the benefit of the person. For example, any interest on a term deposit that is reinvested by a bank for the benefit of the depositor is treated as received by the depositor.

Paragraph (c) treats an amount as received by a person if it is credited to an account, or carried to a reserve for the benefit of the person. For example, if a foreign parent company has lent money to its Ethiopian subsidiary and the interest payable under the loan is credited to the parent company in an inter-company loan account, the parent company is treated as having received the interest at the time the amount is so credited.

Paragraph (d) treats an amount as received by a person if it is otherwise made available to the person. For example, an employee cannot delay a receipt of salary by simply refusing to collect the salary from his or her employer. Once the salary is available for collection, the employee is treated as having received it.

Royalty

This term is primarily relevant to the source rule for royalties (Article 6(4)(g)), the imposition of non-resident tax on royalties and collection of the tax by withholding (Articles 51 and 89), and the imposition of Schedule 'D' tax on royalties derived by a resident and the collection of the tax by withholding (Articles 54, 64, and 90).

"Royalty" is defined broadly. The definition follows international norms and is consistent with the definition commonly found in tax treaties. The following amounts whether paid on a periodic basis or as a lump sum are treated as royalties:

(1) An amount as consideration for the use of, or the right to use any copyright of a literary, artistic, or scientific work, including cinematography films, and films and tapes for radio, television, or internet broadcasting.

(2) An amount as consideration for the receipt of, or right to receive, visual images or sounds, or both, transmitted by satellite, cable, optic fibre, or similar technology in connection with television, radio, or internet broadcasting.

This ensures that payments for the use of new technologies are treated as royalties.

(3) An amount as consideration for the use of, or the right to use any patent, invention, trademark, design or model, plan, secret formula or process, or other like property or right.

(4) An amount as consideration for the use of, or the right to use any industrial, commercial, or scientific equipment (such as equipment lease rentals).

(5) An amount as consideration for the use of, or the right to use any information concerning industrial, commercial, or scientific experience. This will include any consideration for the supply of knowhow. It is not intended that this paragraph includes the consideration for the supply of services. The distinction between knowhow and services can be difficult to make. In broad terms, knowhow is pre-existing knowledge and information that is secret that a person is given a right to use. On the other hand, in this context, the provision of services involves using one's customary skills to bring knowledge and information into existence.

(6) An amount as consideration for the supply of assistance that is ancillary and subsidiary to, and is furnished as a means of enabling the application or enjoyment of property or a right referred to in (1) - (5) above. This is the only circumstance in which a service fee is treated as a royalty.

Tax year

This definition is mainly relevant to the imposition of taxes under the ITP on an annual basis. For example, Article 18(1) imposes business income tax annually by reference to the taxpayer's tax year.

The tax year is specified separately for individuals and bodies.

For an individual, paragraph (a) provides that the tax year is the one-year period from the 1st Hamle to 30th Sene. However, the Authority may, on application by an individual, grant the individual permission to use a different one-year period as the individual's tax year. To ensure consistent revenue flows to the Government for its budget year, it is usual for individuals to be required to use the Government's budget year as their tax year for income tax purposes. However, it has been past practice in Ethiopia for the Authority to grant permission to some classes of individual to use a different period as their tax year. The main example is farmers and this ensures that their tax year ends at the end of harvesting when they have the cash flow to pay tax.

For a body (defined in Article 2(5) of TAP), paragraph (b) provides that the tax year is the accounting year of the body, i.e. the one-year period ending on the date of the annual balance of the financial accounts of the body (Article 28). Allowing a body to use its accounting period as its tax year avoids the compliance costs that would otherwise be incurred if the body has to prepare two sets of accounts based on different periods. It is particularly relevant to a company (whether incorporated in Ethiopia or elsewhere) that forms part of a multinational group as it allows the company to use the financial accounting period of the group as its tax year.

"Tax year" also includes a transitional tax year under Article 28 when a taxpayer changes its tax year. A transitional tax year is a short tax year between the end of a former tax year and the beginning of the new tax year. For example, if a body that has been using the period January 1 to December 31 as its tax year is given permission to use the period April 1 to March 31 as its tax year, the period January 1 – March 31 in the year of change is the taxpayer's transitional tax year.

Taxpayer

This term is central to the operation of the ITP.

"Taxpayer" is defined to mean a person liable for tax under the ITP. The basic structure of the ITP is that tax is imposed on persons who satisfy certain conditions. For example, Article 18(1) imposes business income tax on a person conducting business who has taxable income for a tax year. A person liable for business income tax is then treated as a taxpayer for the purposes of the ITP.

Technical fee

This term is relevant to the source rule for technical fees (Article 6(4)(g)) and the imposition of non-resident tax on technical fees and collection of the tax by withholding (Articles 51 and 89).

The following are technical fees:

(1) A fee for technical, professional, or consultancy services.

(2) A fee for the provision of services of technical or other personnel. This covers a fee paid for the hiring out of labour. It will also cover, for example, a fee paid by a subsidiary to a parent company for the secondment of an employee of the parent company to the subsidiary.

Trading stock

This term is relevant to the calculation of business income under Article 21(1)(a) and the allowance of deductions under Article 22(1)(b).

The definition of "trading stock" is inclusive so the term otherwise has its ordinary meaning, namely any property that is turned over (i.e. traded) in the ordinary course of business. Ordinarily, trading stock is tangible movable property (i.e. goods), but any property that is capable of being traded can be trading stock. This includes immovable property and intangible property, such as shares in a company. Thus, for example, if a person's business is to buy and sell shares (i.e. a share trader), the shares are the trading stock of the business. However, if the shares are part a purely passive investment activity of the person, they are not trading stock.

Paragraph (a) includes anything that is produced, manufactured, purchased, or otherwise acquired for manufacture, sale, or exchange. This includes semi-finished and finished goods.

Paragraph (b) includes raw materials and consumables (such as oils and glues) used in a production or manufacturing process.

Paragraph (c) includes livestock, which are animals raised for profit to produce food or fibre (such as wool). While animals raised for labour would also be within the ordinary meaning of livestock, animals used as beasts of burden or working beasts are expressly excluded from being trading stock as they are not traded.

Underlying ownership

This term is relevant to Article 34 (which provides for the carry forward of losses by a bodies), Article 44 (which provides for the tax treatment of transfers of mining or petroleum rights), and Article 48 (which provides for tax treaties).

"Underlying ownership" is defined to mean a membership interest in a body held, directly or indirectly through an interposed body or bodies (i.e. by tracing through interposed bodies), by an individual or a person not ultimately owned by an individual (such as a government). In other words, the underlying ownership in a body is the ultimate beneficial ownership in the body. "Membership interest" is defined in Article 2(21) of TAP.

The definition is illustrated by two examples.

Example 1

X Co is a company that is owned by two individuals, A and B. X Co has a loss carry forward for a tax year. A holds 60% of the shares in X Co and B holds 40%. In this case, both A and B hold their shares directly in X Co and, therefore, their shareholding is also their underlying ownership interest in X Co. If A were to sell their shares to C, then there is a change in more than 50% of the underlying ownership of X Co.

Example 2

Holders Co owns all the shares in X Co. In turn, two individuals, A and B hold the shares in Holders. A holds 60% of the shares in Holders and B holds 40%. As Holders wholly owns X Co, A has an indirect ownership interest and, therefore, an underlying ownership interest, in X Co of 60% and B has an indirect ownership interest and underlying ownership interest of 40%. If A were to sell their shares in Holders to C, there is a change in more than 50% of the underlying ownership of X Co.

Withholding agent

This term is relevant to Part Ten, which imposes obligations on a withholding agent.

"Withholding agent" is defined to mean a person liable to withhold tax under Part Ten from a payment made by the person. The persons required to withhold tax are specified in Articles 88 to 92. "Withholding agent" also includes a person required to self-withhold tax under Article 93 from an amount received by the person.

Withholding income

This term is relevant to Part Ten, which imposes obligations on a withholding agent in relation to withholding income.

"Withholding income" is income specified in Articles 88 to 93.

3. Categories of Taxpayer

This Article identifies three categories of taxpayer (Categories 'A', 'B', and 'C') for the purposes of the business and rental income taxes. A simplified business income tax system applies to a Category 'B' taxpayer under Article 33 and a standard assessment system applies to a Category 'C' taxpayer under Article 49. The rules for filing of tax declarations (Article 83) and payment of business income tax (Article 84) differ depending on the category of the taxpayer.

Sub-article (1) provides for three categories of taxpayer for the purposes of the ITP:

(1) Category 'A' taxpayer: all bodies and any other person having an annual gross income of Birr 1,000,000 or more are Category 'A' taxpayers. "Gross income" is defined in 2(12) to mean the total income of a taxpayer taxable under Schedules 'B' or 'C' without deduction of expenditures. "Body" is defined in Article 2(5) of TAP to mean a company, partnership, public enterprise or public financial agency, or other body of persons whether formed in Ethiopia or elsewhere.

(2) Category 'B' taxpayer: all persons, other than a body, having an annual gross income of Birr 500,000 or more but less than Birr 1,000,000 are Category 'B' taxpayers.

(3) Category 'C' taxpayer: all persons, other than a body, having an annual gross income of less than Birr 500,000 are Category 'C' taxpayers.

Sub-article (2) provides that the Authority may, on the basis of tax declarations filed by a taxpayer or any other information available to the Authority, determine whether the taxpayer's category has changed for a tax year.

Sub-article (3) provides that the Minister of Finance and Economic Cooperation may change the annual gross income thresholds in sub-article (1) for the classification of a taxpayer as a Category 'A' taxpayer, Category 'B' taxpayer, or Category 'C' taxpayer. The Minister is required to undertake economic analysis in determining whether to change the gross income thresholds and the amount of the new thresholds. Further, the Minister is required to change the gross income thresholds at least every five years. This is intended to provide a flexible and simple mechanism for adjusting the thresholds without having to amend the ITP.

4. Permanent establishment

This Article defines "permanent establishment" for the purposes of the ITP. The term is relevant in determining whether income is Ethiopian source income (Article 6), the taxation of certain payments made to non-residents (Article 51), the transfer pricing rules (Article 79), the withholding of tax (including self-withholding) from certain payments (Articles 89, 90, and 93).

The definition of "permanent establishment" follows closely the definition in tax treaties and it is intended that the learning on tax treaties is relevant to the interpretation of the definition, particularly the Commentary to the OECD Model Tax Convention on Income and Capital.

Sub-article (1) states the basic notion of a permanent establishment, namely a fixed place of business through which the business of a person is conducted. This means that there must be: (i) a place of business; (ii) the place of business must be fixed (i.e. have a degree of permanency); and (iii) a business activity must be conducted through the place of business (for example, it cannot just be a vacant office). The requirement, therefore, is that a place of business must be established. There is no time limit for a place of business to constitute a permanent establishment, although the 183-day time period in sub-articles (2)(c) and (3) may provide some guidance on this to avoid very short-term operations from being a permanent establishment. The definition has five specific inclusions.

Sub-article (2) specifically treats certain physical presences as a permanent establishment. Sub-article (2)(a) treats a place of management, branch, office, factory, warehouse, or workshop as a permanent establishment. These places are largely illustrative of the types of places that can qualify as a permanent establishment under the general principle stated in sub-article (1). Each inclusion is to be interpreted broadly. For example, "office" includes any office no matter what activity is conducted through the office. However, there is an exception for an office that has representation of the person's business as its sole activity (i.e. the office is merely a liaison office). This exception is necessary because the activities of a liaison office (being merely representation) are too remote from the derivation of income for an amount of income to be accurately allocated to the activity. To qualify for the exception, the liaison office must not engage in the negotiation of contracts of sale or supply. The negotiation of contracts is not simply a liaison or representative function, but rather is a core business activity.

Sub-article (2)(b) treats a mine site, oil or gas well, quarry, or other place of exploration for, or extraction of, natural resources as a permanent establishment. "Natural resources" is not defined and, therefore, has its ordinary meaning, namely any naturally occurring materials or things that have economic value. The main examples of natural resources are minerals, oil and gas, timber, water, and fish. Again, the listed establishments are largely illustrative of the types of places that can qualify as a permanent establishment under the general principle stated in sub-article (1).

Sub-article (2)(c) treats the furnishing of services as a permanent establishment but only when the services continue for the same or a connected project for a period or periods aggregating more than 183 days in any one-year period. The 183-day period is tested over any one-year period and not by reference to the tax year. The 183-day period may comprise two or more periods within any one-year period provided they relate to the same or a connected project. A person may furnish services personally or through employees or other personnel (such as an independent contractor). The determination of whether projects are connected depends on all the facts and circumstances, including consideration of the following:

(1) Whether the projects are covered by a single master contract.

(2) Whether the projects would have been undertaken under a single contract in the absence tax considerations.

(3) Whether the contracts covering the different projects were concluded with the same customer or an associate of the customer.

(4) Whether the conclusion of additional contracts with a customer is a logical consequence of a previous contract concluded with that customer or an associate of the customer.

(5) Whether the nature of the services provided under the different projects is the same or similar.

(6) Whether the same individuals are performing the services under the different projects.

Importantly, the determination of whether projects are connected should be considered from the perspective of both the service provider and their customer. The Regulations may provide guidance on the meaning of "connected project".

Sub-article (3) treats a building site, or a construction, assembly or installation project, or supervisory activities (such as the services of a consulting engineer) connected with such site or project as a permanent establishment, but only when the site, project, or activity continues for more than one hundred eighty three days. The Regulations will provide a rule to prevent fragmentation of activity between related persons so as to avoid the one hundred eighty three -day threshold.

Sub-article (4) specifies two situations when an agent is treated as a permanent establishment of the principal. The first is when the agent regularly concludes, or substantially negotiates, contracts on behalf of the principal. This is the case regardless of whether the contracts are concluded in the name of the principal or agent. Consequently, the focus is on the agent's role in the negotiation of contracts and not the formal act of signing or concluding the contract. In particular, it is intended that a commissionaire (or undisclosed principal) arrangement can give rise to the agent being a permanent establishment of the principal. Under such an arrangement, an agent may contract with a customer of the principal in the agent's own name rather than in the name of the principal. As far as the customer is concerned, they believe they are dealing with the commissionaire, but, under the contractual arrangements between the commissionaire and the principal, title to the goods passes direct from the principal to the customer.

The second is when the agent maintains a stock of goods from which the agent regularly delivers goods on behalf of the principal. The ability to make timely delivery of trading stock is considered central to any sales activity.

In both cases, an agent is not a permanent establishment if the agent is of independent status. Sub-article (5) defines "agent of independent status" to mean an agent that acts for a number of principals as clients, such as a share broker or general import agent. The definition makes clear that an agent who acts solely or principally for one person will be an agent of independent status only if the commercial and financial relations between the agent and the principal are consistent with such relations that would exist between independent persons. This is particularly relevant when the agent and principal are related persons (e.g. the agent may be a member of the same multinational enterprise as the principal).

5. Residence

This Article provides rules for determining when a person is a resident or non-resident of Ethiopia.

Sub-article (1) provides that the following persons are residents of Ethiopia:

(1) A resident individual (defined in sub-articles (2), (3), and (4)).

(2) A resident body (defined in sub-article (5)).

(3) The Government of Ethiopia, and any regional state or city administration in Ethiopia.

Sub-article (2) provides three alternative tests for determining whether an individual is a resident individual. Paragraph (a) provides that an individual who has a domicile in Ethiopia is a resident individual. In broad terms, the "domicile" of an individual is the place where the individual has a permanent home.

Paragraph (b) provides that a citizen of Ethiopia who is a consular, diplomatic, or similar official (such as a trade official) posted abroad is a resident individual. The inclusion of Ethiopian Government officials working abroad as residents is necessary as often they will be exempt from tax in the country of service, particularly under international agreements (such as the Vienna Convention on Diplomatic Relations and the government service article in tax treaties). The exemption applies in the country of service on the assumption that the foreign government official will be taxed in their home country.

Paragraph (c) provides that an individual is a resident individual if the individual is present in Ethiopia for 183 days in any one-year period. This test is primarily relevant to foreign nationals working on assignment in Ethiopia. Such persons will normally have a home outside Ethiopia, but are considered to be a resident if they are present in Ethiopia for the 183-day period.

The 183-day period may be consecutive days or the aggregate of several periods of presence within the relevant one-year period. The 183-day period is tested by reference to any one-year period and not the tax year. If the 183-day period were tested by reference to the tax year, then an individual whose physical presence in Ethiopia straddles the end of a tax year (so that they are in Ethiopia for part of two tax years) can be present in Ethiopia for substantially more than 183 days without being a resident in either tax year. The Regulations will provide guidance on the counting of days under this test.

If an individual satisfies any of the tests in sub-article (2) for a tax year, the individual is treated as a resident for the whole of the year. This is subject to the part year residence rules in sub-articles (3) and (4). Sub-article (3) applies to an individual who becomes a resident during the tax year and sub-article (4) applies to an individual who ceases to be a resident during the tax year. In both cases, the individual is resident only for the days in the tax year on which they were physically present in Ethiopia.

Sub-article (5) provides two alternative tests for determining whether a body is a resident body. Paragraph (a) provides that a body is a resident body if the body is incorporated or formed in Ethiopia. It is intended that "formed" be interpreted broadly so as to accommodate the broad definition of "body" in Article 2(5) of TAP (i.e. it covers partnerships and unincorporated bodies of persons in addition to companies). For example, the reference to "formed" will cover a company created by statute, and a partnership or unincorporated body of persons created by contract.

Paragraph (b) provides that a body is a resident body if it has its place of effective management in Ethiopia. The place of effective management of a body is the place where the high-level management, commercial, and financial decisions necessary for the conduct of the body's business as a whole are taken. This is determined having regard to all the facts and circumstances of the body. In the case of a company, the effective management of the company would ordinarily be with the board of directors and, therefore, the place where the board meets would ordinarily be the place of effective management. In the case of a partnership, the place of effective management would ordinarily be the place where the meetings of partners take place. In the case of any other body of persons, the place of effective management would ordinarily be the place where the management committee of the body meets. It is emphasised that the place of effective management of a company is different from the place where the day-to-day management decisions are taken. A body may have multiple places of (day-to-day) management, but only one place of effective management.

Sub-article (6) provides that a "resident company" is a company that is a resident body. Taking account of the definition of "resident body" in sub-article (5), a resident company is a company that is incorporated in Ethiopia or has its place of effective management in Ethiopia. This is relevant to the source rule in Article 6(4)(c)(3) and the rules on corporate reorganisations in Article 35.

Sub-article (7) provides that a non-resident is a person who is not a resident of Ethiopia. Taking account of sub-articles (1) and (5), the following are non-residents:

(1) A foreign national who is not present in Ethiopia, continuously or intermittently, for more than 183 days in any one-year period.

(2) A body that is incorporated and formed outside Ethiopia and has its place of effective management outside Ethiopia.

(3) A foreign government or political subdivision of a foreign government.

(4) An international organisation.

6. Source of Income

The article is relevant to the territorial limitation on the imposition of the tax under Article 7 and the foreign income rules in Articles 45, 46, and 64(3). Article 7 provides that the ITP applies to the worldwide income of residents of Ethiopia and the Ethiopian source income of non-residents.

The article specifies income that is Ethiopian source income. Any income that is not Ethiopian source income is foreign income (sub-article (5)). This is relevant to the foreign tax credit applicable to resident persons in respect of foreign income derived (Articles 45 and 64(3)) and the quarantining of foreign losses (article 46).

Sub-article (1) provides two alternative tests for determining whether employment income (defined in Article 12) is Ethiopian source income. First, employment income is Ethiopian source income to the extent that it is derived (i.e. received) in respect of employment exercised in Ethiopia, regardless of where it is paid (paragraph (a)). This aligns with the taxing rule in Article 15 of tax treaties and means that the place of performance is the basic rule for determining the source of employment income. If an employment is performed partly in Ethiopia and partly outside Ethiopia, then the employment income must be apportioned between those sources. Apportionment is provided for by the words "to the extent" in paragraph (a). Second, employment income is Ethiopian source income if it is paid by, or on behalf of the Government of Ethiopia, regardless of where the employment is exercised (paragraph (b)). This aligns with the taxing rule in Article 19 of tax treaties.

Sub-articles (2) and (3) provide the basic rules for determining when business income is Ethiopian source income. Sub-article (2) applies to residents of Ethiopia and sub-article (3) applies to non-residents. Sub-articles (2) and (3) apply to all amounts treated as business income under Article 21, including the gross proceeds from the sale of trading stock, the provision of independent services, and the disposal of business assets. A particular item of business income that is not Ethiopian source income under sub-article (2) or (3) may still be Ethiopian source income under sub-article (4), which applies to certain classes of income.

Sub-article (2) provides that business income derived by a resident of Ethiopia is Ethiopian source income except to the extent that the income is attributable to a business conducted by the resident through a permanent establishment outside Ethiopia. “Resident of Ethiopia” is defined in Article 5(1) and “permanent establishment” is defined in Article 4. The effect of this rule is that all business income of a resident of Ethiopia is Ethiopian source income except when the income is attributable to a fixed overseas business operation of the resident. This aligns with the taxing rule in Article 7 of tax treaties.

The words “to the extent” in sub-article (2) contemplate apportionment when business income is partly attributable to a business conducted through a foreign permanent establishment. In this case, the business income derived must be apportioned between Ethiopian source income and foreign income. Apportionment is done on any reasonable basis having regard to all the facts and circumstances.

Sub-article (3) provides that business income derived by a non-resident person is Ethiopian source income if it satisfies one of three alternative tests. The main test is in paragraph (a), which provides that the business income of a non-resident is Ethiopian source income to the extent to which it is attributable to a business conducted by the non-resident through a permanent establishment in Ethiopia. “Non-resident” is defined in Article 5(7) and “permanent establishment” is defined in article 4. This rule is the same as the taxing rule in Article 7 of the OECD Model Double Tax Convention on Income and Capital and the learning under tax treaties is relevant in the interpretation of paragraph (a).

The words "to the extent" in sub-article (3) contemplate apportionment when business income is only partly attributable to a business conducted through an Ethiopian permanent establishment. In this case, the business income derived must be apportioned between Ethiopian source income and foreign income. Apportionment is done on any reasonable basis having regard to all the facts and circumstances.

Paragraphs (b) and (c) are integrity measures intended to support the main source rule in paragraph (a). Under paragraph (b), business income of a non-resident person is Ethiopian source income to the extent to which it is attributable to sales in Ethiopia by the non-resident of goods or merchandise of the same or similar kind as those sold through a permanent establishment in Ethiopia of the non-resident. This would apply, for example, if the head office of a non-resident made direct sales to customers in Ethiopia of the same goods that it sells through a permanent establishment in Ethiopia. Such direct sales could be made, for example, over the internet. Under paragraph (c), business income of a non-resident is Ethiopian source income to the extent to which it is attributable to other business activities (such as the provision of services) conducted by the non-resident of the same or similar kind to that conducted by the non-resident through a permanent establishment in Ethiopia.

Paragraphs (b) and (c) correspond to the taxing rule in Article 7 of the UN Model Double Taxation Convention between Developed and Developing Countries and the learning under tax treaties based on the UN Model is relevant in the interpretation of paragraphs (b) and (c).

Sub-article (4) provides source rules for specific items of income. For employment and business income, these rules apply despite the application of sub-articles (1), (2), and (3). This is particularly relevant to business income and means that an amount of business income specified in sub-article (4) may be Ethiopian source income either because it comes within sub-article (2) or (3), or because, while not coming within those sub-articles, it comes within sub-article (4). As sub-article (4) supports the application of sub-articles (2) and (3), if an amount of business income is Ethiopian source income under sub-article (2) or (3), there is no need to consider sub-article (4). However, if an amount of business income is not Ethiopian source income under sub-article (2) or (3), it is necessary to consider whether the amount is Ethiopian source income under sub-article (4).

For example, interest derived by a non-resident financial institution that does not have a permanent establishment in Ethiopia is not Ethiopian source income under sub-article (3). However, if the interest income is paid by a resident of Ethiopia (other than as an outgoing of a foreign permanent establishment) or by an Ethiopian permanent establishment of a non-resident, the interest is Ethiopian source income under sub-article (4)(g).

Sub-article (4)(a) provides that a dividend paid by a resident body is Ethiopian source income. "Dividend" is defined in Article 2(6). The main example of a dividend is a distribution of profits by a company to a shareholder. "Resident body" is defined in Article 5(5) to mean a body that is either (i) incorporated or formed in Ethiopia; or (ii) has its place of effective management in Ethiopia.

Sub-article (4)(b) provides that the following is Ethiopian source income:

(1) Rental income derived from the lease of immovable property located in Ethiopia (sub-article (4)(b)(1). "Immovable property" is defined in Article 2(13).

(2) Rental income derived from the lease of movable property located in Ethiopia that is subject to tax under Article 58 (sub-article (4)b)(2)). It is noted that Article 58 does not apply to lease payments for movable property (such as equipment lease payments) that are "royalties" within

paragraph (d) of the definition of "royalty" in Article 2(20) (see the exception in Article 58(2)). The source rule in sub-article (4)(g) applies to lease payments that are royalties. For this reason, sub-article (4)(b)(2) is expressly limited to Article 58 lease payments to avoid overlap with sub-article (4)(g).

Sub-article (4)(c) provides that the following gains are Ethiopian source income:

(1) A gain arising on the disposal of immovable property located in Ethiopia (sub-article (4)(c)(1)). "Immovable property" is defined in Article 2(13) to include a mining or petroleum right, or information relating to a mining or petroleum right. As the definition is inclusive, "immovable property" will have its general law meaning (such as land and buildings). Sub-article (4)(c)(1) aligns with the taxing right in Article 13(1) of tax treaties.

(2) A gain arising on the disposal of a membership interest in a body, if more than 50% of the value of the membership interest is derived, directly or indirectly through one or more interposed bodies, from immovable property located in Ethiopia is Ethiopian source income (sub-article (4)(c)(2)). "Body" is defined in Article 2(5) of TAP. The main examples of a body are companies and partnerships. "Membership interest" is defined in Article 2(21) of TAP to mean an ownership interest in the body (such as shares in a company). "Immovable property" is defined in Article 2(13) to include a mining or petroleum right, or information relating to a mining or petroleum right. As the definition is inclusive, "immovable property" will have its general law meaning (such as land and buildings).

The purpose of this inclusion is to counter arrangements aimed at avoiding sub-article (4)(c)(1) by a person holding an interest in immovable property in Ethiopia (such as a mining right) through a body and then selling the interest in the body rather than selling the interest in the immovable property. The value of an interest in a body (such as shares in a company) will reflect the value of the assets owned by the body (such as a mining right or rights). The application of sub-article (4)(c)(2) is illustrated by the following examples.

Example 1

Foreign Company 1 holds 100% of the issued shares in Foreign Company 2 and the only asset of Foreign Company 2 is a mining right in Ethiopia:

Foreign company 1

Foreign company 2

Mining right in Ethiopia

If Foreign Company 2 sells the mining right, any gain arising on the sale is Ethiopian source income under sub-article (4)(c)(1). If, instead, Foreign Company 1 sells its shares in Foreign Company 2, any gain arising on the sale is Ethiopian source income under sub-article (4)(c)(2) as more than 50% of the value of the shares is derived directly from the mining right (i.e. immovable property) in Ethiopia.

Example 2

Foreign Company 1 holds 100% of the issued shares in Foreign Company 2, Foreign Company 2 holds 100% of the issued shares in Foreign Company 3. The only asset of Foreign Company 2 is the shares in Foreign Company 3 and the only asset of Foreign Company 3 is a mining right in Ethiopia:

Foreign company 1

Foreign company 2

Foreign company 3

Mining right in Ethiopia

If Foreign Company 3 sells the mining right, any gain arising on the sale is Ethiopian source income under sub-article (4)(c)(1). If, instead, Foreign Company 2 sells its shares in Foreign Company 3, any gain arising on the sale is Ethiopian source income as more than 50% of the value of the shares is derived *directly* from the mining right (i.e. immovable property) in Ethiopia. If, instead, Foreign Company 1 sells its shares in Foreign Company 2, any gain arising on the sale is Ethiopian source income as more than 50% of the value of the shares is derived *indirectly* (through the intermediary of Foreign Company 2) from the mining right (i.e. immovable property) in Ethiopia.

Sub-article (4)(c)(2) aligns with the taxing right in Article 13(4) of tax treaties.

(3) A gain arising on disposal of a share in, or bond issued by, a resident company. "Resident company" is defined in Article 5(7) to mean a company that either: (i) is incorporated in Ethiopia; or (ii) has its place of effective management in Ethiopia.

Sub-article (4)(d) provides that an insurance premium is Ethiopian source income if the premium relates to the insurance of a risk in Ethiopia.

Sub-article (4)(e) provides that the income from a performance or sporting event in Ethiopia is Ethiopian source income. This is relevant to Article 53, which provides for the taxation of non-resident entertainers, and applies whether the income is derived directly by the entertainer or through a company they control. This aligns with the taxing right in Article 18 of tax treaties.

Sub-article (4)(f) provides that the winnings from a game of chance are Ethiopian source income if the game of chance is held in Ethiopia. This is relevant to income taxed under article 57.

Sub-article (4)(g) provides that interest, a royalty, management fee, technical services fee, or any other income subject to tax under the ITP is Ethiopian source income if it is either:

(1) Paid by a resident of Ethiopia, unless the amount paid is an expenditure of a business carried on by the resident person through a permanent establishment outside Ethiopia (sub-article (4)(g)(1)).

(2) Paid by non-resident person as an expenditure of business carried on by the person through a permanent establishment in Ethiopia (sub-article (4)(g)(2)).

"Interest" is defined in Article 2(16). For interest, sub-article (4)(g) aligns with the taxing rule in Article 11 of tax treaties (see Article 11(5) of tax treaties). In theory, the source rule for interest would be based on the location where the loan funds are used (i.e. a place of utilisation rule). However, given the fungibility of money, such a rule is not practical. It is for this reason that the international norm is to adopt residence of the payer as a proxy for place of use of the loan funds.

"Royalty" is defined in Article 2(20). For royalties, sub-article (4)(g) aligns with the taxing rule in Article 12 of tax treaties based on the UN Model (see Article 12(5) of the UN Model). Again, in theory, the source rule for royalties would be based on the place where the relevant property is used. This may be feasible for royalties payable for the use or right to use industrial or intellectual property rights when the right is registered in the

Ethiopia. However, it is more difficult to apply such a rule for equipment lease rentals and know how payments because of the mobility of the equipment or know how. The international norm, therefore, is to adopt residence of the payer as a proxy for place of use of the property.

Management fees and technical fees are defined in Article 2(17) and 2(23), respectively. While these fees are items of business income ordinarily covered by sub-article (3) for non-residents, non-resident tax is imposed under Article 51 on such fees paid to non-residents that do not have a permanent establishment in Ethiopia. The source rule for such fees is aligned with the rule for royalties.

7. Scope of Application

This Article sets out the jurisdictional limits on the taxes imposed under the ITP.

Sub-article (1) provides that the ITP applies to residents of Ethiopia with respect to their worldwide income. Thus, a resident is taxed on both Ethiopian source income and foreign income. For foreign income, a resident is allowed a credit against their Ethiopian tax for foreign tax paid by the resident with respect to foreign income (Article 45 (Schedule 'C' income) and Article 64(3) (Schedule 'D' income)).

Sub-article (2) provides that the ITP applies to non-residents only with respect to their Ethiopian source income as defined in Article 6.

8. Schedules of Income

This Article specifies the Schedules applicable under the ITP.

Sub-article (1) provides that income is taxable under the ITP according to the following Schedules:

(1) Schedule 'A' - income from employment.

(2) Schedule 'B' – income from rental of buildings.

(3) Schedule 'C' - income from business.

(4) Schedule 'D' - other income.

(5) Schedule 'E' - exempt income. Income that comes within Schedule 'E' is not subject to tax.

Sub-article (2) provides that a taxpayer that derives income from different sources that is subject to tax under the same Schedule for a tax year shall be taxable under the Schedule on the total income for the year. For example, a taxpayer carrying two or more businesses is subject to tax under Schedule 'C' on the total amount of business income from all the businesses. Similarly, a taxpayer renting out two or more buildings is subject to tax under Schedule 'B' on the total amount of the rental income from all buildings. Sub-article (2) is subject to Article 64(2), which provides that tax imposed on income under Schedule 'D' is a final tax on the income. Thus, there is no aggregation of income taxable under Schedule 'D'.

This is the only consolidation rule applicable under the ITP. If, for example, a taxpayer derives income taxable under Schedule 'B' and income taxable under Schedule 'C', the ITP applies separately to each class of income.

9. Obligation to Pay Income Tax

This Article provides that every person deriving income must pay income tax in accordance with the ITP and the TAP. The ITP provides for the substantive liability for income tax and TAP provides for the assessment and collection of the tax.

10. Imposition of Employment Income Tax

This Article provides for the imposition of employment income tax on employees. Employment income tax is imposed monthly and collected through employer withholding under Article 88 or self-withholding by the employee under Article 93.

Sub-article (1) provides for the imposition of employment income tax. Employment income tax is imposed for each calendar month, at the rates specified in Article 11, on an employee who has received employment income during the month. Sub-article (1) specifies the key concepts underlying the imposition of employment income tax.

First, sub-article (1) identifies the persons who are liable for employment income tax (i.e. the taxpayer). It is provided that employment income tax is imposed on an "employee", which is defined in Article 2(7) to mean an individual engaged, whether on a permanent or temporary basis, to perform services under the direction and control of another person. The definition expressly includes a director or other holder of an office in the management of a body (such as a director of a company), and Government appointees and elected persons holding a public office, such as a judge or parliamentarian. The definition expressly excludes an independent contractor (defined in Article 2(15)). An independent contractor conducts a business and is subject to business income tax under Article 18.

Second, sub-article (1) identifies the tax base by reference to the concept of "employment income", which is defined in Article 12. In broad terms, "employment income" is the remuneration received from employment, including remuneration-in-kind (i.e. fringe benefits) and fees received by office holders.

Third, sub-article (1) provides for the imposition of the employment income tax on a periodic basis, by reference to the "calendar month". Sub-article (4) provides that the employment income attributable to the months of Nehassie and Pagumen are aggregated and treated as the employment income of a single calendar month. If an employee is employed for part of a month, sub-article (1) applies to the part month. While employment income tax is imposed on a monthly basis, the tax is reported and paid quarterly under Articles 83 and 84. This is relevant only when an employee is required to file a tax declaration under Article 83(2).

Fourth, sub-article (1) provides that employment income is taxed in the calendar month in which it is received, which is defined in Article 2(19) to include an actual or constructive receipt.

Finally, sub-article (1) provides that employment income tax is imposed at the rate or rates of tax specified in Article 11. A marginal rate scale applies under Article 11.

Sub-article (2) provides for the calculation of the amount of employment income tax payable by an employee for a calendar month. The tax is calculated by applying the rate or rates of tax specified in Article 11 to the total employment income received by the employee for the calendar month. Sub-article (3) provides that an employee is not allowed a deduction for any expenditure incurred in deriving employment income. Consequently, employment income is imposed the gross amount of employment income received by an employee during a month.

Sub-article (5) applies when Article 83(1) applies to an employee (i.e. when an employee is not required to file a tax declaration because the employee has a single employer). In this case, sub-article (5) provides that the employment income tax payable by the employee is a final tax on the employment income of the employee and the tax is discharged if the employer has withheld tax from the income in accordance with Article 88.

11. Employment Income Tax Rates

This Article specifies the employment income tax rates. A marginal rate scale applies to employment income. The rates are specified by reference to the monthly employment income of employees.

12. Employment Income

This Article defines "employment income". The employment income tax payable by an employee for a calendar month under

Article 10 is calculated by reference to the total employment income of the employee for the month.

Sub-article (1) specifies the amounts included in the employment income of an employee (see Article 2(7) definition). Sub-article (2) provides that employment income does not include exempt income. Income that is exempt income is specified in Schedule 'E'.

Sub-article (1)(a) includes in employment income any salary, wages, allowances, bonuses, commissions, gratuities (such as tips), or other remuneration received by an employee in respect of a past, present, or future employment. There must be a sufficient connection between the amount received and employment. The connection is expressed by the requirement that the relevant amount must be received "in respect of" employment. It is intended that the connection be interpreted broadly. However, any amount that is a pure gift (e.g. a wedding present given by an employer to an employee) would not be employment income. The connection to employment may be to a past employment (such as deferred remuneration) or a future employment (such as a signing on fee).

Sub-article (1)(b) includes in employment income the value of a fringe benefit received by an employee in respect of a past, current, or future employment. A fringe benefit is non-cash remuneration. Examples of fringe benefits include: subsidised housing, private use of a motor vehicle, free or discounted goods or services, and low interest loans. Sub-article (4) obliges the Council of Ministers to make Regulations for determining the value of fringe benefits.

Sub-article (1)(c) includes in employment income any amount received by an employee on termination of employment. An amount is included under sub-article (1)(c) regardless of whether it is paid voluntarily by the employer, under the terms of the employee's employment contract, or as a result of legal proceedings. Sub-article (1)(c) expressly includes a redundancy payment and any other amount received as compensation for loss of employment, such as a severance or golden handshake payment. A "golden handshake payment" is an amount that an employer is obliged to pay under an employment contract usually with a senior employee in the event that the employee's employment is terminated.

The inclusion of an amount in employment income depends on the application of the jurisdictional limits under the ITP as set out in Article 7. A resident employee is taxed on worldwide employment income, while a non-resident employee is taxed only on Ethiopian source income. Under Article 6(1)(a), employment income received in respect of employment exercised in Ethiopia is Ethiopian source income. If the employment is partly exercised in Ethiopia and partly outside Ethiopia, the employment income must be apportioned with the part relating to the exercise of employment in Ethiopia treated as Ethiopian source income and the part relating to the exercise of employment in outside Ethiopia treated as foreign income. Under Article 6(1)(b), employment income that is paid by, or on behalf of, the Government of Ethiopia is received from sources in Ethiopia regardless of where the employment is exercised. Thus, for example, the remuneration of an Ethiopian Government official working abroad is Ethiopian source income.

Sub-article (3) applies when an employer pays employment income to an employee without withholding tax from the payment (or some of the payment) and then pays an amount equal to the withholding tax payable on the employment income to the Authority. In this case, the amount of the tax paid by the employer is added to the employment income of the employee.

Example

Suppose that an employee's salary for a month is 20,000 birr on which employment income tax of 5,498 birr is payable. The employer pays the employee the full amount of the salary without withholding tax under Article 88 and then separately pays the 5,498 birr to the Authority. The effect of Article 12(3) is that the tax paid by the employer is added to the employee's salary in determining the employee's monthly employment income. Consequently, the employee's employment income is 25,498 birr.

13. Imposition of Rental Income Tax

This Article provides for the imposition of rental income tax for a tax year at the rate or rates specified in Article 14 on a person who has taxable rental income for the year. Rental income tax is imposed annually, assessed on a self-assessment basis (Article 25 of TAP), and may be collected through a current payments system (Article 86).

Sub-article (1) specifies the key concepts underlying the imposition of rental income tax.

First, sub-article (1) identifies the persons who are liable for rental income tax (i.e. the taxpayer). It is provided that rental income tax is imposed on a person who has rented out a building or buildings during a tax year. However, sub-article (3) provides that Schedule 'B' does not apply to a person deriving income from the casual rental of a building. This income is subject to tax under Schedule 'D' (Article 58). "Person" is defined in Article 2(26) of TAP to mean an individual, body, government, political subdivision of a government, and international organisation. "Body" is separately defined in Article 2(5) of TAP and includes a company, partnership, and any other body of persons. A person liable for rental income tax is treated as a "taxpayer" for the purposes of the ITP (see Article 2 definition of "taxpayer").

Second, sub-article (1) identifies the tax base by reference to the concept of "taxable rental income", which is defined in Article 15 to mean the total income derived by a person from the rental of a building or buildings during a tax year reduced by the deductions allowed in respect of the rental income. Importantly, the tax base under the rental income tax is a net concept after taking into account the expenditures incurred in deriving rental income.

Third, sub-article (1) provides for the imposition of the rental income tax on a periodic basis, by reference to the "tax year". Consequently, a person liable to rental income tax must calculate their taxable rental income by reference to the tax year. "Tax year" is defined in Article 2(21). For individuals, the tax year is the one-year period from 1st Hamle to 30th Sene, although some individuals may be given permission to use their accounting period as their tax year. For a body, the tax year is the body's reporting period for financial accounting purposes. Article 28(2) provides that the accounting year of a taxpayer is the period of 12-months ending on the date of the annual balance of the financial accounts of the taxpayer.

The requirement to calculate taxable rental income by reference to the person's tax year means that it is necessary to allocate amounts of rental income and expenditures to particular tax years. Article 15(1) provides that rental income is taken into account in the tax year in which it is "derived". Paragraph (a) of the definition of "derived" in Article 2(5) makes clear that the method of accounting for rental income tax depends on whether the taxpayer accounts for the tax on a cash or accrual basis. If the taxpayer accounts on an accrual basis, rental income is derived in the tax year in which the right to receive the rental income arises. If the taxpayer accounts on a cash basis, rental income is derived when it is "received", which is defined in Article 2(19) to include an actual or constructive receipt. Thus, the rental income tax is imposed on a cash or accrual basis depending on the circumstances of the taxpayer.

Finally, sub-article (1) provides that rental income tax is imposed at the rate or rates of tax specified in Article 14. At the time of enactment, the rate of rental income tax for bodies was 30%. A marginal rate scale applies to individuals.

Sub-article (2) provides for the calculation of the rental income tax payable by a taxpayer for a tax year. This involves applying the rate or rates of tax applicable to the taxpayer under Article 14 to the taxable rental income of the taxpayer for the year. As stated above rental income tax may be collected in advance under the current payments system in Article 86. Article 86(5) and (7) provides that an instalment of rental income tax paid by a taxpayer for a tax year is credited against the rental income tax liability of the taxpayer for the year.

14. Rental Income Tax Rates

This Article specifies the rental income tax rates.

Sub-article (1) provides that the rate of tax applicable to a body is 30%. This applies to all entities treated as a body under the definition in Article 2(5) of TAP.

Sub-article (2) provides for a marginal rate structure to apply to individuals.

15. Taxable Rental Income

The tax base for the rental income tax is the taxable rental income of a taxpayer for a tax year. This Article provides for the calculation of taxable rental income of taxpayer for a tax year.

Sub-article (1) provides that the taxable rental income of a taxpayer for a tax year is the gross amount of income derived by the taxpayer from the rental of a building or buildings for the year reduced by the total amount of deductions allowed to the taxpayer under the Article for the year. Consequently, there are two components to the calculation of taxable rental income: (i) total rental income: and (ii) total deductions. Total rental income is defined in sub-article (2) and total deductions allowed are specified in sub-articles (5) and (7). If a taxpayer has rented out more than one building during a tax year, sub-article (1) makes it clear that the calculation of the taxpayer's rental income for the year is the aggregate of the income derived from all buildings. This is also provided for in Article 8(2).

An amount is included in the rental income of a taxpayer in the tax year in which it is "derived" by the taxpayer. As explained above, for the purposes of the rental income tax, the meaning of "derived" (as defined in Article 2(5)) depends on whether the taxpayer is a cash or accrual basis taxpayer. Rental income tax, therefore, is accounted for on a cash or accrual basis depending on the circumstances of the taxpayer.

Sub-article (2) provides that the gross amount of income derived by a taxpayer from the rental of a building for a tax year includes the following:

(1) All amounts derived by the taxpayer during the year under the lease agreement, including any lease premium or similar amount (sub-article (2)(a)). Article 2(1) defines "amount" to include an amount-in-kind and, therefore, rental income includes both cash amounts and amounts received as in-kind benefits.

Sub-article (2)(a) includes all amounts derived by the taxpayer during the year under the lease agreement. This mainly covers ordinary rental income, but also expressly includes any lease premium or similar amount derived by the taxpayer under the lease. A lease premium is a non-refundable lump sum amount paid by the lessee to the lessor upon signing the lease agreement. It is an amount paid as consideration for the grant of the lease as opposed to the use or enjoyment of the building. However, a lessor often charges a lease premium to obtain an upfront return on the lease of a building, which is then reflected in the lessee being charged a lower rent payable under the lease agreement. In this case, a lease premium is really just additional rent paid under the lease agreement.

(2) All payments made by the lessee during the year on behalf of the lessor according to the lease agreement (sub-article (2)(b)).

(3) The amount of any bond, security, or similar amount that, during the year, the taxpayer is entitled to retain as a result of damage to the building and that has not been used by the taxpayer in repairing the damage to the building (sub-article (2)(c)). A lease agreement will normally require the lessee to pay a bond as security against any damage to the leased building. Normally, any part of the bond that is not used by the lessor for repairs to the building is repaid to the lessee at the end of the lease. However, if the lease agreement provides that the lessor can retain the whole of the bond at the end of the lease, sub-article (2)(c) includes the amount of the bond (net of the cost of repairs) in the lessor's rental income in the tax year in which the bond is retained. This will usually be the year that the lease terminates.

(4) The value of any renovation or improvement made under the lease agreement to the land or building when the cost was borne by the lessee in addition to the rent payable to the taxpayer (sub-article (2)(d)). This is relevant when an improvement made by the lessee reverts to the lessor at the end of the lease. The reference to "value" is a reference to the fair market value determined under Article 3 of TAP.

Sub-article (2) is expressed to be subject to sub-articles (3) and (4). Sub-article (3) applies when a taxpayer leases a furnished building. In this case, sub-article (3) makes clear that the rental income derived by the taxpayer includes any amount attributable to the lease of the furniture or equipment.

Sub-article (4) provides that rental income does not include exempt income. Schedule 'E' lists amounts that are exempt income for the purposes of the ITP.

Sub-articles (5) - (7) provide for deductions in computing the taxable rental income of a taxpayer for a tax year. Sub-article (5) applies to a taxpayer who does not keep records and sub-article (7) applies to a taxpayer who does keep records.

Sub-article (5) provides that a taxpayer who does not keep records is entitled to a deduction for the following amounts:

(1) Any fees and charges, but not tax, levied by a regional or city administration in respect of the land or building leased and paid by the taxpayer during the year (sub-article (5)(a)). A deduction is allowed only when the fee or charge has been paid. Given the simplified nature of the calculation under sub-article (5), a deduction is allowed under sub-article (5)(a) on a cash basis.

(2) A notional amount equal to 50% of the total rental income derived by the taxpayer for the year as an allowance for expenditure incurred in relation to the leased premises (sub-article (5)(b)). The amount allowed as a deduction is an unvouched amount and no deduction is allowed for any actual expenditures (such as the cost of repairs and maintenance) incurred by the taxpayer in relation to the leased building. The only actual expenditures that a taxpayer is allowed a deduction for are fees and charges paid to a regional or city administration in respect of the building deductible under sub-article (5)(a).

Sub-article (6) makes it clear that sub-article (5) does not apply to a taxpayer required to maintain books of account under the ITP, namely a Category 'A' or 'B' taxpayer (see Article 3). For a Category 'A' or 'B' taxpayer, deductions are allowed in accordance with sub-article (7). This means that a Category 'A' or 'B' taxpayer cannot rely on sub-article (5) by simply deciding not to keep records.

Sub-article (7) provides that a taxpayer who keeps books of account is allowed a deduction for expenditures incurred (on either a cash or accrual basis) during a tax year in deriving rental income including:

(1) An amount paid by the taxpayer during the year for the lease of land on which the building is situated (sub-article (7)(a)).

(2) An amount paid by the taxpayer during the year for repairs, maintenance, interest, or insurance premiums in relation to the building (sub-article (7)(b) and (d)).

(3) An allowance for the depreciation of the building and, if the building is leased as a furnished building, the depreciation of furniture and equipment (sub-article (7)(c)). Depreciation is calculated in accordance with the Regulations.

(4) Any fees and charges, but not tax, levied by a regional or city administration in respect of the land or building leased.

16. Sub-leases

This Article applies when the taxpayer is a sub-lessor of a building.

Sub-article (1) provides that the taxable rental income of the sub-lessor for a tax year is calculated according to the following formula:

$$A - (B + C)$$

where:

A is the total rental income received by the sub-lessor for the year;

B is the total rental income paid by the sub-lessor to the lessor for the year;

C is the total expenses necessarily incurred by the sub-lessor to derive rental income (other than rent taken into account under component '**B**').

Sub-article (2) provides that the owner of a building who allows a lessee to sub-lease the building is also liable for the rental income tax payable by the sub-lessor if the sub-lessor fails to pay the tax.

17. New Rental Building Notification

This Article specifies a notification requirement in relation to new buildings.

There are two steps in the notification process. First, sub-article (1) provides that the owner of a newly constructed building and the builder must notify the Kebele administration or local administration in which the building is located of the following matters:

(1) Details of the completion of construction of the building

(2) The name, address, and TIN of the person or persons liable for rental income tax in respect of the building.

The notification must be provided at the time construction of the building is completed.

Second, sub-article (2) obliges the Kebele administration or local administration to provide the information contained in the sub-article (1) notice to the Authority.

18. Imposition of Business Income Tax

This Article provides for the imposition of business income tax on a person that has taxable income for a tax year. The business income tax is imposed annually, assessed on a self-assessment basis (Article 25 of TAP), and may be collected through a current payments system (Article 86).

Sub-article (1) provides for the imposition of the tax. Business income tax is imposed for each tax year at the rate or rates specified in Article 19 on every person that has taxable income for the year. Sub-article (1) specifies the key concepts underlying the imposition of business income tax.

First, sub-article (1) identifies those who are liable for business income tax (i.e. the taxpayer). It is provided that business income tax is imposed on a person conducting a business. This really specifies two requirements: (i) there must be a "person"; and (ii) the person must conduct a "business".

"Person" is defined in Article 2(26) of TAP to mean an individual, body, government, political subdivision of a government, and international organisation. "Body" is defined in Article 2(5) of TAP and includes a company, partnership, and any other body of persons. The definition of "person" is broad and is intended to cover every possible "entity" that may conduct a business. For non-corporate bodies, such as a partnership, it is the entity (and not the owner or owners of the entity) that is the person liable for business income tax in relation to the business activities of the entity. However, under Article 16 of TAP, the entity's representative for tax purposes is responsible for paying any business income tax payable by the entity. For example, the partners in a partnership are responsible for the payment of the business income tax payable by the partnership. Further, the imposition of business income tax on a person means that, if a person carries on more than one business, the business income and expenditures of all businesses of the person are aggregated in calculating the person's taxable income for a tax year. Article 8(2) confirms the consolidation of business income from multiple businesses under Schedule 'C'.

Business income tax is imposed only on those persons who are conducting business. Article 2(2) defines "business" to mean any industrial, commercial, professional, or vocational activity, or any other activity recognised as a trade under the Commercial Code. Further, the definition treats all activities of a company as a business regardless of the objects of the company. The definition of “business” makes it clear that an activity can be a business regardless of whether it is conducted continuously or for a short term. The term “conducting” (rather than, “carrying on”) is used in sub-article (1) so as to accommodate the broad definition of “business” in Article 2(2), particularly the fact that a short-term activity may constitute a business for tax purposes. Two activities are excluded from the definition of business: (i) employment; and (ii) the rental of buildings. The definition of “business” excludes employment as employment income is taxed separately under Schedule ‘A’ and excludes the rental of buildings as rental income is covered by Schedule ‘B’ or Article 58 (in the case of casual rentals).

While “person” is defined broadly, some entities included in the definition may not conduct business. For example, the performance of normal government functions by ministries or departments of the Federal or regional Governments would not be a business activity. Similarly, the activities of an international organisation, such as the United Nations and its specialised agencies would not normally be classified as business activities.

The income arising from activities that do not constitute a business are not subject to business income tax. Income from employment is taxed under Schedule ‘A’, income from rental of buildings is taxed under Schedule ‘B’, and other classes of income may be taxed under Schedule ‘D’.

Second, sub-article (1) identifies the tax base by reference to the concept of “taxable income”. This is defined in Article 20 to mean the total business income of a taxpayer for a tax year reduced by total deductions allowed to the taxpayer for the year. “Business income” is defined in Article 21 and deductions are allowed under Article 22. Importantly, the tax base under the business income tax is a net concept after taking into account the expenditures incurred in deriving business income.

A person conducting a business may not be liable for business income tax because the person's income is exempt income. For example, a non-profit organisation conducting a business that relates to its core non-profit functions (such as religious organisation operating a religious bookshop) may derive only exempt income (see Article 65(1)(m)) and, therefore, have no taxable income.

Third, sub-article (1) provides for the imposition of business income tax on a periodic basis by reference to the "tax year". Consequently, a person liable to business income tax must calculate their taxable income by reference to their tax year. "Tax year" is defined in Article 2(21). For an individual, the tax year is the one-year period from 1st Hamle to 30th Sene, although some individuals (such as farmers) may be given permission to use their accounting period as their tax year. For a body, the tax year is the body's reporting period for financial accounting purposes. This is a rule of convenience to avoid bodies having to do separate accounts for the business income tax purposes. The requirement to calculate taxable income by reference to the person's tax year means that it is necessary to allocate amounts of business income and expenditures to particular tax years. In broad terms, Article 20(2) provides that financial accounting rules apply to allocate income and expenditures to tax years, subject to some modifications in the ITP and regulations reflecting the differences between tax and accounting.

Finally, sub-article (1) imposes business income tax at the rate or rates of tax specified in Article 19. The rate of business income tax for bodies is 30%. A marginal rate scale applies to individuals.

Sub-article (2) provides for the calculation of the business income tax payable by a taxpayer for a tax year. This involves applying the rate of business income tax specified in Article 19 to the taxable income of the person for the year. For example, if the taxable income of a company for a tax year is 5,000,000 birr, the business income tax payable by the company for the year is 1,500,000 birr

(5,000,000 birr x 30%). As stated above, business income tax may be collected in advance under the current payments system in Article 86. Article 86(5) provides that an instalment of business income tax paid by a taxpayer for a tax year is credited against the business income tax liability of the taxpayer for the year.

19. Business Income Tax Rates

This Article specifies the business income tax rates.

Sub-article (1) provides that the rate of tax applicable to a body is 30%. This applies to all entities treated as a body under the definition in Article 25 of TAP

Sub-article (2) provides for a marginal rate structure to apply to individuals.

Sub-article (3) provides that the marginal rate structure applies also to micro-enterprises defined in sub-article (4).

20. Taxable Business Income

This Article provides for the calculation of the taxable income of a taxpayer subject to business income tax for a tax year. It is relevant to Article 18 (which imposes business income tax on a person who has taxable income for a tax year). The concept of "taxable income" states the tax base under the business income tax. It is the amount against which the rate or rates of business income tax specified in Article 19 is applied in determining the amount of business income tax payable by a taxpayer for a tax year.

Sub-article (1) provides that the taxable income of a taxpayer for a tax year is the total business income of the taxpayer for the year reduced by the total amount of deductions allowed to the taxpayer for the year. There are, therefore, two components in the calculation of taxable income: "total business income" (as defined in Article 21) and "deductions" (as allowed under Article

22). For example, if a taxpayer has total business income for a tax year of 2,000,000 birr and total deductions of 1,700,000 birr for the year, the taxable income of the person for the year is 300,000 birr (2,000,000 - 1,700,000).

Sub-article (2) provides that the taxable income of a taxpayer for a tax year must be determined in accordance with the profit and loss statement or income statement of the taxpayer for the year, provided the statement has been prepared in accordance with financial reporting standards stipulated under the Financial Reporting Proclamation No. 847/2016. Article 5 of the Financial Reporting Proclamation stipulates that the international financial reporting standards ("IFRS"), or IFRS for small and medium enterprises, issued by the International Accounting Standards Board (or its successor) as adopted, adapted, or amended by the Accounting and Auditing Board of Ethiopia are to be used when preparing financial statements. Sub-article (2) is intended to achieve a close alignment as between taxable income and financial accounting profit so as to ease compliance and administrative burdens.

The reliance on financial accounting standards in calculating taxable income is subject to any modifications made in the ITP, regulations made by the Council of Ministers, and directives issued by the Minister. Such modifications may modify or clarify the application of financial accounting standards in computing taxable income. For example, Article 27(1)(g) denies a deduction for an amount carried to a reserve or provision in the financial accounts of a person carrying on business. Thus, a deduction is allowed under the ITP only for expenditures actually incurred and not for amounts carried to accounting reserves or provisions in anticipation of future expenditures.

21. Business Income

This Article specifies the amounts included in business income for the purposes of the ITP. It is relevant to Article 20, which provides for the calculation of the taxable income of a taxpayer for a tax year. The total business income of the taxpayer for the tax year is one component of the calculation.

Business income is defined in sub-article (1) by reference to the "tax year". Tax year" is defined in Article 2(21). For an individual, the tax year is the one-year period from 1^{st} Hamle to 30^{th} Sene unless the individual has been given permission to use their accounting year as their tax year. For a body, the tax year is the body's reporting period for financial accounting purposes. Thus, the calculation of the total business income of a taxpayer is an annual calculation.

Sub-article (1) states three inclusions in business income. In broad terms, sub-article (1)(a) includes in business income the gross amounts derived by the taxpayer from the conduct of a business. This is a reference to the ordinary proceeds arising from the conduct of a business. The reference to "gross" amounts means that the amount included in business income is the total amount derived without deduction of expenditures. This is because deductions for expenditures are allowed separately under Article 22. Sub-article (1)(a) expressly includes the following in business income:

(1) The gross proceeds from the disposal of trading stock. In broad terms, trading stock is goods that are turned over in the ordinary course of the taxpayer's business, i.e. the goods that a taxpayer trades in (see Article 2(24)).

(2) The gross fees from the provision of services. It is expressly provided that this does not include "employment income", which is defined in Article 12. Employment income is subject to separate taxation under Schedule 'A'.

An amount is included in business income of a taxpayer under sub-article (1)(a) in the tax year in which it is "derived" by the taxpayer. "Derived" is defined in Article 2(5). For the purposes of the business income tax, a person accounting for tax on a cash basis derives an amount when it is received (separately defined in Article 2(19)) and a person accounting for tax on an accruals basis derives an amount when the right to receive arises (i.e. when the amount is receivable).

Article 2(1) defines "amount" to include an amount-in-kind. Thus, business income includes both cash amounts and amounts received as in-kind benefits.

Sub-article (1)(b) includes in business income a gain arising on disposal of a business asset, which is defined in Article 2(3) to mean any asset used or held in the conduct of a business solely or partly to derive business income. An asset is a business asset regardless of whether it is revenue or capital in nature. While trading stock is a business asset under the Article 2(3) definition, paragraph (b) does not apply to trading stock as it is expressly covered by paragraph (a). Generally, the capital assets of a business decline in value as they are used in the business and the annual decline in value is allowed as a deduction (see Articles 22(1)(c) and 25). Consequently, the main inclusion under paragraph (c) will be depreciation deductions that have been, in effect, "recaptured" in the consideration for the disposal of a depreciable asset or business intangible (i.e. the asset has been disposed of for more than its net book value for tax purposes). There may be occasions, however, when a person will dispose of other types of business asset for a gain above cost and paragraph (b) will also include the gain in business income.

A gain on disposal of a business asset is included in business income under paragraph (b) in the tax year in which the asset is "disposed" (as determined under Article 67). Sub-article (3) provides that the gain arising on disposal of a business asset is calculated as the consideration for the disposal less the net book value of the asset at the time of disposal. "Consideration" is determined under Article 70 and "net book value" is determined under Article 69. In broad terms, the net book value of an asset is the original cost of the asset reduced by depreciation deductions allowed in respect of the asset.

Sub-article (4) applies when a business asset disposed of is also a taxable asset under Article 59. In this case, the gain on disposal of the asset included in business income under sub-article (1)(b) is limited to the amount (if any) by which the cost (Article 68) of the asset exceeds the net book value (Article 69) of the asset at the time of disposal (sub-article (4)(a)). This means that the amount included in business income is limited to the depreciation deductions allowed in respect of the asset that have been recouped on disposal of the asset. Sub-article (4)(b) expressly provides that any gain above cost is taxed under Article 59.

The application of sub-article (4) is essentially limited to a taxable asset that is a building that is a depreciable asset, such as commercial premises. It ensures that the amount of recouped depreciation deductions is taxed at the same rate as the tax value of the depreciation deductions allowed in respect of the building (i.e. 30% in the case of a body). Consequently, the recaptured depreciation deductions are taxed under Schedule 'C' and the gain above cost is taxed under Schedule 'D'.

Sub-article (4) will have no application to buildings that are not depreciable assets. Sub-article (4) will also have no application to shares and bonds as these are not depreciable assets.

Example 1

X Plc conducts a trading business in Ethiopia. It purchased an item of computer equipment for 100,000 birr and subsequently sold the computer equipment for 75,000 birr. The computer equipment is a depreciable asset and X Plc has been allowed 50,000 birr depreciation deductions prior to selling the equipment. The consideration for the disposal of the equipment is 75,000 birr and the net book value of the equipment at the time of disposal is 50,000 birr (100,000 birr - 50,000 birr). Thus, the gain on disposal is 25,000 birr (75,000 birr - 50,000 birr). This is included in business income under Article 21(1)(b). This, in effect, represents depreciation deductions allowed to X Plc that it has recouped on disposal of the computer equipment.

Example 2

Suppose, instead, that the consideration for the disposal of the equipment is 120,000 birr. In this case, the gain on disposal is 70,000 birr (120,000 birr - 50,000 birr) and is included in business income under Article 21(1)(b). The gain represents 50,000 birr in recouped depreciation deductions and $20,000 birr of gain above cost.

Example 3

Suppose the same facts as in Example 2 except that the asset is a commercial building that is both a depreciable asset for the purposes of Article 25 and a taxable asset for the purposes of Article 59. If the consideration for the disposal of the building is 120,000 birr, then the gain on disposal included in business income under Article 21(1)(b) is 50,000 birr (100,000 birr (cost) - 50,000 birr (net book value)). This gain represents recouped depreciation deductions and is taxed at the 30% rate.

The difference between consideration for the disposal and the cost of the building (20,000 birr) is a capital gain taxable under Article 59 at the 15% rate.

Paragraph (c) includes any other amount that is expressly included in business income under the ITP.

Sub-article (2) provides that business income does not include exempt income. Schedule 'E' lists amounts that are exempt income for the purposes of the ITP. Thus, for the purposes of the ITP, a reference to business income does not include exempt income.

22. Deductible Expenditures

This Article provides for the deduction of expenditures in the calculation of the taxable income of a taxpayer for a tax year under Article 20. As discussed above, there are two components to the calculation of taxable income – total business income and total deductions. The total deductions allowed to a taxpayer for a tax year are subtracted from the taxpayer's total business income for the year to arrive at the amount of taxable income of the taxpayer for the year.

Sub-article (1) sets out amounts allowed as a deduction. Sub-article (1)(a) states the basic deduction rule, namely that a deduction is allowed for expenditures to the extent necessarily incurred by a taxpayer in deriving, securing, and maintaining amounts included in business income. To qualify for a deduction, there must be a sufficient connection between the expenditure and the derivation of business income so that it can be said that the expenditure was incurred "in" deriving the income. An expenditure incurred for a purpose other than deriving business income is not allowed as a deduction. For example, there is no deduction for expenditure incurred in deriving exempt income (by virtue of Article 21(2), business income does not include exempt income). Similarly, there is no deduction for expenditure incurred for some purpose other than deriving business income, such as for a private purpose (e.g. personal consumption).

A deduction is allowed under sub-article (1)(a) only "to the extent" to which the expenditure was incurred in deriving business income. Thus, expenditure incurred partly to derive business income and partly for some other purpose (such as to derive exempt income or for a private purpose) must be apportioned so that only that part relating to the derivation of business income is allowed as a deduction. Apportionment should be done on any reasonable basis having regard to the facts of the case (see Article 76).

An amount is allowed as a deduction under sub-article (1)(a) in the tax year in which it is incurred. This will depend on the person's financial accounting method (see Article 20(2)). In broad terms, a person accounting on a cash basis incurs expenditure when it is paid and a person accounting on an accruals basis incurs expenditure when the obligation to pay arises (i.e. when it is payable).

Sub-article (1)(b) allows a deduction for the cost of trading stock disposed of by a taxpayer during a tax year. As trading stock would normally be expected to hold its value while it is held by the taxpayer, a deduction is allowed only for the cost of trading stock sold during the tax year and not the total cost of trading stock purchased during the year.

The cost of trading stock disposed of during a tax year is determined according to financial reporting standards. Since the price of trading stock may vary over time, a mechanism is needed to determine the trading stock that has been disposed of in a tax year. A formula has been developed for financial accounting purposes to determine the cost of the trading stock disposed of during a year. The cost of trading stock disposed of in a tax year is calculated as the sum of the value of trading stock on hand at the beginning of the year (i.e. opening value) plus the cost of trading stock acquired during the year (i.e. purchases) less the value of trading stock on hand at the end of the year (i.e. closing value).

In the ordinary case, the opening value of trading stock is the closing value of the trading stock for the previous tax year. The closing value of trading stock is the lower of cost or net realisable value. Because trading stock is normally sold for more than its cost, the closing value of trading stock will usually be valued at cost. In other words, the net realisable value of trading stock on hand will normally be more than its cost. However, it may be that trading stock does lose value before it is sold. For example, it may be damaged or be less marketable due to a sudden change in consumer tastes or fashion, or technological developments. In this case, the net realisable value may be less than cost and valuing closing trading stock at net realisable value allows a taxpayer to recognise a decline in the value of trading stock prior to sale.

Example

ABC Co acquired trading stock for 1,000 birr during the tax year. It is expected that the trading stock will be sold for 1,500 birr. The trading stock is on hand at the end of the year. The closing value of the trading stock is 1,000 birr being the lesser of cost (1,000 birr) and net realisable value at the end of year (1,500 birr). The profit embedded in the trading stock will not be recognised until the tax year in which it is sold.

Suppose, however, that the trading stock is damaged while on hand and is worth only 500 birr at the end of the year. The closing value of the trading stock is 500 birr being the lower of the cost (1,000 birr) and the net realisable value at the end of the year (500 birr). This allows the loss in value to be recognised before the trading stock is actually sold.

The determination of the cost of trading stock on hand at the end of a tax year depends on whether the trading stock is purchased or manufactured. If the trading stock is purchased, the usual rules on cost in Article 68 apply. Generally, the cost will be the total consideration given to acquire the stock. Financial accounting has developed two methods for determining the cost of trading stock on hand that has been manufactured or produced, namely the direct-cost and absorption-cost methods Both methods include in the cost of trading stock the costs directly connected with the manufacture of the trading stock such as the cost of raw materials and the cost of labour to produce the stock. The key difference between the two methods is in the treatment of "overhead" expenditures. The direct-cost method includes in the cost of trading stock only "variable" overhead costs. These are costs, such as electricity, which are tied to production (i.e. they increase or decrease as production increases or decreases). The absorption-cost method includes all overhead costs related to the production of trading stock, including fixed overhead expenses such as factory rent. The direct-cost method would be used only by taxpayers using cash accounting.

If a taxpayer can identify trading stock on hand at the end of the tax year with sufficient particularity to know which items of stock have been sold during the year, the cost of trading stock on hand at the end of the tax year will be the actual cost of that stock. This might be the case, for example, for a taxpayer who sells motor vehicles. If particular items of trading stock are not identifiable and different items have different costs, financial accounting uses surrogate methods to determine which stock has been disposed of and which remains on hand. The two methods recognised under IFRS are the first-in-first-out ("FIFO") method and the average cost method. Under the FIFO method, trading stock is treated as sold in the order of acquisition and, under the average cost method, trading stock on hand at year end is assumed to comprise a proportionate amount of stock from all the different costs for stock acquired during the year. IFRS does not permit the use of the last-in-first-out "LIFO") method (which assumes that the last acquired stock is sold first). The concerns with LIFO are: (i) it is only in rare cases that LIFO reflects the commercial reality; and (ii) LIFO overstates the cost of trading stock sold during the tax year thereby reducing taxable income.

Sub-article (1)(c) allows a deduction for the decline in value of a person's depreciable assets or business intangibles from use during the tax year in deriving amounts included in business income. "Depreciable asset" and "business intangible" are defined in Article 25(7). In broad terms, a depreciable asset is tangible movable property (such as plant, equipment, fixtures and fittings, vehicles, and computers) or a structural improvement to immovable property (such as commercial premises) that has a useful life in excess of one year and that declines in value through use in deriving business income. In other words, a depreciable asset is a capital asset of a business and the depreciation deduction for a tax year effectively allocates part of the capital cost of the asset to each tax year forming part of the expected useful life of the asset.

In broad terms, business intangibles are industrial and intellectual property, contractual rights, and capital expenditures (such as prepayments) that have a useful life in excess of one year and which decline in value through use in deriving business income. In other words, a business intangible is a capital asset of a business and the depreciation deduction for a tax year effectively allocates part of the capital cost of the business intangible to each tax year in the expected useful life of the business intangible. It is noted that the decline in value of business intangibles is referred to as "amortisation" in financial accounting. However, as a drafting simplification measure, the term "depreciation" is used in the ITP to refer to both depreciation and amortisation.

Article 25(2) provides that depreciation deductions are determined in accordance with the Regulations. The rules in the Regulations are based on the expected useful life of the depreciable asset or business intangible.

Sub-article (1)(d) allows a deduction for a loss on disposal of a business asset during the tax year. Business asset" is defined in Article 2(3) to mean any asset used or held in a business wholly or partly to derive business income. An asset is a business asset regardless of whether it is revenue or capital in nature. While trading stock is a business asset, sub-article (1)(d) does not apply to trading stock as it is expressly covered by sub-article (1)(b). A loss in relation to a business asset is allowed as a deduction in the tax year in which the asset is disposed (see Article 67). As an integrity measure, Article 27(1)(m) provides that no deduction is allowed for a loss on disposal of a business asset by a taxpayer to a related person (defined in Article 4 of TAP).

Sub-article (3) provides that the loss arising on disposal of a business asset is the net book value of the asset at the time of disposal less the consideration for the disposal. "Net book value" is defined in Article 69. In broad terms, the net book value is the cost of the asset (see Article 68) reduced by depreciation deductions (if any) allowed in respect for the asset (Article 25). "Consideration" is defined in Article 70. In broad terms, the consideration for the disposal of a business asset is the price received or receivable for the asset.

Example

X Plc conducts a trading business in Ethiopia. It purchased an item of computer equipment for 100,000 birr and subsequently sold the computer equipment for 25,000 birr. The computer equipment is a depreciable asset and X Plc has been allowed 50,000 birr depreciation deductions prior to selling the equipment. The consideration for the disposal of the equipment is 25,000 birr and the net book value of the equipment at the time of disposal is 50,000 birr (100,000 birr - 50,000 birr). Thus, the loss on disposal is 25,000 birr (50,000 birr - 25,000 birr). This, in effect, means that the computer equipment has actually declined in value at a rate faster than anticipated under the depreciation rules.

Sub-article (1)(e) allows a deduction for any other amount that is specifically deductible under the ITP. It is noted that most expenditures will be deductible under sub-article (1)(a), which applies if there is a sufficient connection between the expenditure, and the derivation of business income, so that it can be said that the expenditure has been incurred "in" deriving business income. However, a deduction may be specifically allowed under another provision in the ITP (such as a deduction under Article 24 for a charitable donation or under Article 26 for a loss carried forward) and the purpose of sub-article (1)(e) is to cross-refer to such deduction provisions.

Sub-article (1) is expressed to be subject to the ITP. This means that a provision of the ITP may preclude an amount from being deductible or modify the amount of the deduction. For example, Article 27 lists expenditures or losses for which no deduction is allowed, Article 23 provides for limitations on the deductibility of interest, and Article 82(6)(a) empowers the Authority to deny a deduction if there is insufficient documentary evidence to substantiate the incurring of expenditure.

23. Interest Expenditure

This Article provides for deductibility of interest expenditure incurred by a taxpayer.

Sub-article (1) sets out the basic principle of deductibility for interest expenditure. A taxpayer is allowed a deduction for interest incurred if the taxpayer has used the proceeds or benefit of the debt or other instrument or agreement that gives rise to the interest to derive business income. In broad terms, this requires a tracing of the use of the loan funds. If the loan funds are used to derive business income, then the interest expense paid in relation to the loan funds is deductible. For example, if the loan funds are used to purchase equipment used by the taxpayer in deriving business income, the interest paid on the loan is deductible under sub-article (1). The reference in sub-article (1) to "other instrument or agreement" is intended to accommodate the broad definition of "interest" in Article 2(16).

Sub-article (1) is expressed to be subject to sub-article (2) and to Article 47, which provide for limitations on the deductibility of interest expense. Sub-article (2) specifies the following limitations:

(1) No deduction is allowed for interest paid or payable by a taxpayer in excess of the rate used between the National Bank of Ethiopia and commercial banks increased by 2 percentage points (sub-article (2)(a)). This is an integrity measure intended to prevent the use of excessive interest rates to shift profits. For example, if the interest rate used in loan transactions between the National Bank of Ethiopia and commercial banks is 10%, then sub-article (2)(a) puts a ceiling of 12% on the interest rate giving rise to deductible interest. Consequently, if a taxpayer borrows 1,000,000 birr at 15% per annum and pays 150,000 birr to the lender for a tax year, the amount of the deduction for interest for the year is limited to 120,000 birr (i.e. based on a maximum 12% interest rate).

    There are two exceptions to the limitation in sub-article (2). First, it does not apply if the interest is paid to a financial institution recognised by the National Bank of Ethiopia. Second, it does not apply when the interest is paid to a foreign bank permitted to lend to persons in Ethiopia. These exceptions reflect the fact that a financial institution may charge an interest rate in excess of the ceiling specified in sub-article (2) based on the risk profile of the borrower.

(2) No deduction is allowed for interest paid or payable by a taxpayer to a related person (defined in 4 of TAP) who is a resident of Ethiopia (defined in Article 5) unless the related person is subject to tax in respect of the interest under subject to under Schedule 'D' (sub-article (2)(b)). This is intended to prevent tax planning that arbitrages between tax rates thereby resulting in base erosion whereby the company is allowed a deduction at the corporate rate of 30% but the shareholder is not taxed on the interest income. Sub-article (2) denies the company a deduction for the interest in this case resulting in the profits being used to pay the interest being taxed at the 30% rate through the non-deductibility rule.

Article 47 denies a deduction for interest paid by a foreign-controlled resident company on excessive debt capitalisation (referred to as "thin capitalisation").

24. Charitable Donations

This Article provides a deduction for charitable donations.

Sub-article (1) provides that a taxpayer is allowed a deduction for the following donations:

(1) A donation made to an Ethiopian charity or Ethiopian society within the meaning in the Charities and Societies Proclamation (see sub-article (3)).

(2) A donation made in response to an emergency call issued by the Government: (i) to defend the sovereignty and integrity of Ethiopia; (ii) to prevent, or provide relief in relation to, a man-made or natural disaster; or (iii) to prevent, or provide relief in relation to, an epidemic; or (iv) for any other similar cause.

A deduction is allowed under sub-article (1) only for the purpose of determining the taxable income of a taxpayer under Schedule

'C'. This means that no deductions are allowed for donations for the purposes of calculating a tax liability under Schedules 'A', 'B', and 'C'.

Sub-article (2) provides for an annual limitation on the amount of a deduction that a taxpayer is allowed under sub-article (1). The total deduction allowed to a taxpayer for tax year for donations is limited to 10% of the taxpayer's taxable income for the year.

25. Depreciation of Depreciable Assets and Business Intangibles

This Article provides for the calculation of the amount of the depreciation deduction that a taxpayer is allowed for a tax year under Article 22(1)(c).

Sub-article (1) sets out the basic principle of deductibility. A taxpayer is allowed a deduction for the amount by which the value of the taxpayer's depreciable assets and business intangibles have declined during the tax year. "Depreciable asset" and "business intangible" are defined in sub-article (7). In broad terms, "depreciable assets" are the physical assets of a business, such as commercial buildings, plant, equipment, machinery, fixtures and fittings, vehicles, and computers held or used to derive business income that decline in value through wear and tear, and business intangibles are industrial and intellectual property, contractual rights, and other capital expenditures (such as prepayments) that decline in value through being held or used in deriving business income.

Sub-article (2) provides that the decline in value of a depreciable asset or business intangible for a tax year is to be calculated in accordance with the Regulations.

The calculation of the depreciation deduction is illustrated by the following example:

Example 1

X Plc acquires a computer on 1 July 2017. The computer costs 40,000 birr and is used solely to derive business income. The computer is a depreciable asset as defined in sub-article (7) and the tax year of X Plc is July 1 – June 30. A deduction is allowed for the annual decline in value of the computer (Article 22(1)(c)). It is assumed for the purposes of the example that the depreciation rate applicable to the computer is 25% and that the computer is depreciated on a straight-line basis (the actual rate and basis of depreciation is specified in the Regulations). Consequently, the decline in value and, therefore, depreciation deduction, for the 2017/2018 tax year is 10,000 birr (40,000 birr x 25%). Similarly, the decline in value and depreciation deduction for the next three tax years is also 10,000 birr. At the end of the fourth tax year, the cost of the computer has been fully depreciated and no further depreciation deductions are allowed.

Sub-article (2) is expressed to be subject to the ITP providing otherwise. Sub-articles (3) and (4) limit the amount of the depreciation deduction in certain situations. Sub-article (3) applies if a depreciable asset or business intangible is used for only part of the tax year in deriving business income. The most likely situation when this will occur is when a taxpayer acquires the asset part way through the year. There are two steps in the calculation of the annual depreciation. First, the decline in value for the year is determined under sub-article (2) as if the asset were used for the whole of the tax year in deriving business income. Second, that amount is then multiplied by a fraction that represents the number of days in the tax year that the asset is used to derive business income divided by the total number of days in the year. An asset is treated as held for use on any non-working day in a tax year (e.g. a Sunday or a public holiday). For example, if a taxpayer acquired a depreciable asset on the last day of the tax year, the taxpayer would be entitled to a deduction for only 1/365th of the decline in value otherwise available for the year.

The application of sub-article (3) is illustrated by the following example:

Example 2

Assume that in Example 1 above X Plc acquired the computer on February 1, 2018 and that X Plc's tax year is the period July 1 - June 30. This means that X Plc used the computer to derive business income for only 150 of the 365 days in the 2017/2018 tax year. Consequently, the depreciation deduction for the 2017/2018 tax year is 4,109 birr ((40,000 birr x 25%) x $^{150}/_{365}$). X Plc is allowed a depreciation deduction of 10,000 birr in each of the next three tax years. At the end of the 2020/2021 tax year, X Plc has been allowed total depreciation deductions of 34,109 birr in relation to the computer. If the computer is used for the whole of the 2021/2022 tax year, the remaining value of the computer (5,892 birr) is allowed as a deduction in that year.

Sub-article (4) applies when a depreciable asset or business intangible has been used partly to derive business and partly for some other purpose (such as deriving exempt income or a private purpose). In this case, there are two steps in the calculation of the decline in value. First, the decline in value for the year is determined under sub-article (2) in the normal way. That amount is then multiplied by the fraction that represents the business use of the asset during the year to calculate the annual depreciation deduction. In other words, the amount allowed as a deduction under sub-article (1) is the proportion of the decline in value calculated under sub-article (2) that relates to the use of the asset to derive business income.

The application of sub-article (4) is illustrated by the following example:

Example 3

Assume that in Example 1 above, X Plc uses the computer 75% of the time to derive business income and 25% of the time to derive exempt income. The decline in value of the computer under sub-article (2) for the 2017/2018 tax year is 10,000 birr. However, sub-article (4) requires this to be apportioned between taxable and exempt use. Consequently, the deductible amount of the decline in value is the proportion that relates to taxable use – 7,500 birr (10,000 birr x 75%). Assuming the same use, the decline in value and depreciation deduction for the next three tax years is also 10,000 birr and 7,500 birr, respectively. At the end of the fourth tax year, the cost of the asset has been fully depreciated and no further depreciation deductions are allowed.

If a taxpayer disposes of a depreciable asset or business intangible, any gain on disposal is included in business income under Article 21(1)(b) and any loss is allowed as a deduction under Article 22(1)(d). A gain is calculated as the consideration for the disposal reduced by the net book value of the asset or intangible at the time of disposal (Article 21(3)). A loss is calculated as the net book value of the asset or intangible reduced by the consideration for the disposal (Article 22(3)). The "net book value" of a depreciable asset or business intangible is determined under Article 69 as the cost of the asset or intangible (Article 68) reduced by the depreciation deductions allowed under Article 25 in respect of the asset or intangible.

Example 4

Assume that, in Example 1, X Plc sells the computer on January 31, 2020 for 25000 birr. X Plc has been allowed a depreciation deduction of 10,000 for each of the 2017/2018 and 2018/2019 tax years. The depreciation deduction for the 2019/2020 tax year is 5,890 birr (10,000 birr x 215/365). Consequently, the net book value of the computer at the time of disposal is 14,110 birr (40,000 birr – 25,890 birr). X Plc has made a gain on the disposal of the computer of 1,089 birr (25,000 – 14,110 birr). This amount is included in business income under Article 21(1)(b). This represents an amount that has been allowed as a depreciation deduction but which has been recovered by X Plc on the disposal of the computer. It means that the computer has not, in reality, depreciated as rapidly as the tax system had anticipated it would.

Suppose, instead, that the computer was sold for 10,000 birr on January 31, 2020. The net book value of the computer at the time of disposal is 14,110 birr. X Plc has made a loss on the disposal of the computer of 4,110 birr (14,110 birr – 10,000 birr). This amount is allowed as a deduction under Article 22(1)(d). This represents the additional wear and tear suffered by the computer not captured in the depreciation deductions because the computer has, in reality, depreciated more rapidly than the tax system had anticipated it would.

Sub-article (5) applies to a disposal of a depreciable asset or business intangible that has been only partly used to derive business income. Similar to the application of sub-article (4), sub-article (5) requires the gain or loss to be apportioned so that only the part relating to the use of the asset to derive business income is included in business income or allowed as a deduction.

Example 5

Assume that in Example 4, X Plc has used the computer 75% of the time to derive business income and 25% of the time to derive exempt income. The decline in value for the each of the 2017/2018 and 2018/2019 tax years is 10,000 birr and the depreciation deduction for each year is 7,500 birr (10,000 birr x 25%). The decline in value for the 2019/2020 tax year is 5,890 birr and the depreciation deduction is 4,420 birr (5,890 birr x 75%). Under Article 69(1), the net book value of the asset is the cost of the asset ((Article 68) reduced by the depreciation deductions allowed in respect of the asset or that would have been allowed but for Article 25(4). In other words, the cost of the asset is reduced by the full decline in value over the X Plc's period of ownership. Consequently, the net book value of the computer at the time of disposal is 14,110 birr (40,000 birr – 25,890 birr). If X Plc sells the computer for 25,000 birr, X Plc has made a gain on the disposal of the computer of 10,890 birr (25,000 birr – 14,110 birr). The amount of the gain included in business income is 8,170 birr (10,890 birr x 75%) being the portion of the gain that relates to use of the computer to derive business income. The balance represents the use of the computer to derive exempt income for which no depreciation deductions were allowed.

Similarly, if X Plc sold the computer for 10,000 birr, X Plc has made a loss on the disposal of the computer of 4,110 birr (14,110 birr - 10,000 birr). This means that the computer has declined in value through use greater than anticipated through the depreciation deductions. However, part of this greater decline in value relates to the use of the computer to derive exempt income and, therefore, the amount of the loss must be apportioned so that only that part of the loss relating to the use of the computer to derive business income is allowed as a deduction. Consequently, the amount of the loss allowed as a deduction is 3,080 birr (4,110 birr x 75%).

Sub-article (6) provides that the depreciation of a depreciable asset or business intangible commences when the asset or intangible is ready and available for use in deriving business income. This is largely declaratory of the position under the financial accounting standards. However, in the case of a building constructed by a taxpayer, it is expressly provided that depreciation of the building does not commence until the regulatory authority has issued the taxpayer with a certificate of completion for the building. There have been examples of taxpayers putting tenants into partially completed buildings. For example, a taxpayer may put tenants into the completed ground floor of building while the first story is still being completed. These taxpayers have been claiming depreciation deductions for the building from the date that tenants are first put into the building even though the building is not complete. This practice is illegal and sub-article (6) makes it clear that depreciation deductions for buildings do not commence until the taxpayer has a certificate of completion for the building from the relevant regulatory authority.

26. Loss Carry Forward

This Article provides for a five-year carry forward period for business losses.

Sub-article (1) provides that a taxpayer has a loss for a tax year if the total amount of deductions allowed to the taxpayer for the year (other than a loss carried forward deduction) exceeds the total business income of the taxpayer for the year. The amount of the excess is the amount of the loss for the year. In determining whether a taxpayer has a loss for a tax year, the deduction allowed under the Article for a loss carried forward from a previous tax year is ignored. This ensures that the amount of a loss is calculated separately for each tax year.

If a taxpayer has a loss for a tax year, sub-article (2) provides that the loss is carried forward and allowed as a deduction in calculating the taxpayer's taxable income for the following tax year. Sub-article (3) provides that, if a loss is not fully deducted under sub-article (2), it is carried forward to the next following tax year and so on until it is fully deducted but only for a maximum carry forward period of five tax years after the end of the tax year in which the net loss was incurred. Thus, a loss cannot be carried forward for more than five tax years.

Sub-article (4) provides that a taxpayer has a lifetime limit of two losses carried forward under sub-articles (2) and (3).

Sub-article (5) provides that a loss is to be carried forward under sub-articles (2) and (3) in accordance with the Regulations.

27. Non-deductible Expenditures and Losses

This Article sets out expenditures for which no deduction is allowed under the ITP.

The following are non-deductible expenditures:

(1) An expenditure of a capital nature except to the extent provided for under Article 22(1)(c) (i.e. depreciation deductions) (sub-article (1)(a)). The basic structure of the deduction provisions is that operating expenditure (such as salary and wages, electricity, and insurance) is fully deductible in the tax year incurred. Capital expenditure is either depreciated over the expected useful life of the expenditure or included in the cost of a business asset.

(2) An increase in the share capital of a company or the basic capital of a registered partnership (sub-article (1)(b)). "Company" is defined in Article 2(7) of TAP and "partnership" is defined in Article 2(23) of TAP.

(3) Voluntary pension or provident fund contributions in respect of an employee in excess of 15% of the monthly employment income of the employee (sub-article (1)(c)). The amount of the employment income of an employee for a month is determined under Article 12. "Employee" is defined in Article 2(7).

(4) Dividends and paid-out profit shares (sub-article (1)(d)). These amounts are not expenditures incurred by a body to derive business income, but rather an application by the body of business income after it has been derived.

(5) An expenditure or loss to the extent recovered or recoverable under a policy of insurance, or a contract of indemnity, guarantee, or surety (sub-article (1)(e)). A deduction is denied in this case because the initial loss

suffered by a taxpayer will be recovered once the insurance or indemnity, guarantee, or surety is paid, and, therefore, no net loss will be incurred.

(6) A fine or penalty imposed, or punitive damages awarded, for violation of any law, regulation, or contract (sub-article (1)(f)). The non-deductibility rule is intended to achieve public policy objectives by preventing a taxpayer from effectively reducing the real cost of a fine, penalty, or punitive damages through obtaining a tax deduction for the fine, penalty, or punitive damages.

(7) An amount that a taxpayer has transferred, in its financial accounts, to a reserve or provision for expenditures or losses not yet incurred but expected to be incurred in a future tax year (sub-article (1)(g)). A taxpayer creates a reserve fund or provision in their financial accounts to ensure that financial resources are available to meet future business obligations and to accurately reflect the profitability of the company. Contributions to a reserve fund or a provision do not, however, amount to a present outgoing and no deduction is available until the amounts in the reserve fund or provision are actually incurred as expenditures. This is an important difference between the business income tax and financial accounting rules, which require reserves and provisions to be created to meet certain future expected outgoings.

(8) Income tax paid under the ITP or under a foreign tax law, or recoverable value added tax (sub-article (1)(h)). The payment of income tax is an application of income after it has been earned and not expenditure incurred in deriving business income. Recoverable value added tax is not deductible because it is recovered by a registered person through the input tax credit mechanism.

(9) Representation expenditures of an employee in excess of 10% of the employment income of the employee (sub-article (1)(i)). "Employee" is defined in Article 2(7) and "employment income" is defined in Article 12.

(10) Expenditure incurred in the provision of entertainment (sub-article (1)(j)). "Entertainment" is defined in sub-article (2) to mean the provision to any person of food, beverages, tobacco, accommodation, amusement, recreation, or hospitality of any kind.

Two exceptions are stated to the non-deductibility rule. First, the non-deductibility rule does not apply when the taxpayer's business involves the provision of entertainment (such as a taxpayer operating a café, restaurant or bar).

Second, the non-deductibility rule does not apply to the extent that the expenditure is allowed as a deduction under a Directive issued by the Minister relating to food provided to employees for free by an employer conducting a mining, manufacturing, or agricultural business.

(11) A donation or gift except as provided for in Article 24 (sub-article (1)(k)). A donation or gift is an application of business income after it has been derived and not expenditure incurred in deriving business income.

(12) Personal consumption expenditure (sub-article (1)(l)). Again, this is an application of income after it has been derived and not expenditure incurred to derive business income. While such expenditure would not satisfy the criteria for deduction in Article 22(1)(a), the ITP adopts the common drafting practice of reconfirming the non-deductibility of domestic or private expenditures to avoid any doubt over the issue. Article 22 (1)(a) contemplates apportionment of expenditures incurred partly to derive an amount included in business revenue and partly for private or domestic purposes.

(13) A loss on disposal of a business asset by a taxpayer to a related person (sub-article (1)(m)). "Related person" is defined in Article 4 of TAP. This is an integrity measure to prevent base erosion through loss transactions between related persons.

(14) Expenditure to the extent that a deduction is disallowed for the expenditure under the Regulations (sub-article (1)(n)).

28. Accounting Year

This article applies when a taxpayer is permitted to use its accounting year as its tax year for the purposes of the ITP.

Sub-article (1) provides that the Article applies to the following taxpayers:

(1) An individual granted permission to use the individual's accounting year as his or her tax year under paragraph (a) of the definition of "tax year" in Article 2(21).

(2) A body as defined in Article 2(5) of TAP. A body is required to use its accounting year as its tax year under paragraph (b) of the definition of "tax year" in Article 2(21).

Sub-article (2) provides that the accounting year of a taxpayer referred to in sub-article (1) is the period of 12 months ending on the date of the annual balance of the financial accounts of the taxpayer.

Sub-article (3) provides that a taxpayer referred to in sub-article (1) must not change its accounting year for tax purposes unless it obtains prior approval, in writing, from the Authority and complies with any conditions that may be attached to the approval.

Sub-article (4) provides that the Authority may, by notice in writing, revoke an approval under sub-article (3) for a taxpayer to use a different period as its accounting year if the taxpayer fails to comply with any of the conditions attached to the approval.

Sub-article (5) applies when the accounting year of a taxpayer referred to in sub-article (1) changes as a result of sub-article (3) or (4). In this case, the period between the last full accounting year prior to the change and the date on which the new accounting year commences is treated as a separate accounting year referred to as a "transitional accounting year" (see Article 2(21)(c)). A transitional accounting year will be for a period of less than 12 months.

Example

ABC Plc uses the calendar year as its financial accounting year and, therefore, also as its tax year (Article 2(21)(b)). ABC Plc is taken over by Multinational Ltd, which uses the 12-month period ending on June 30 as it financial accounting period. As a result of the takeover, ABC Plc must now also use that period as its financial accounting year. ABC Plc obtains approval of the Authority to change its tax year to the 12-months ending on June 30 and the change commences from 1 July 2018 to coincide with its new financial accounting year. As a result of this change, the last tax year under the old tax year is the 12-months ending on 31 December, 2017. The new tax year commences on 1 July 2018. The period 1 January 2018 - 30 June 2018 is treated as a separate accounting year referred to the transitional accounting year. This is treated as a tax year under the definition in Article 2(21)(c) of the definition in TAP.

The rules for the calculation of taxable income are specified by reference to the fiscal year (defined in Article 2(11) of TAP). As the tax rules may change from year to year (e.g. tax rates may change), it is necessary to know which tax rules apply to an accounting year of a taxpayer that is different from the fiscal year. It is also necessary to know which tax rules apply to a transitional accounting year. Sub-article (6) specifies that it is the law applicable for the fiscal year in which accounting year (including transitional accounting year) ends that applies.

29. Change in Tax Accounting Method

This Article provides a procedure for a taxpayer to change their method of tax accounting. Changes in accounting method need to be carefully regulated as they can give rise to the risk of under-taxation (or the possibility of over-taxation).

Sub-article (1) provides that a person may make a written application to the Authority for permission to make a change in their method of tax accounting. The Authority may approve an application only if the person has demonstrated that the change is necessary to properly measure the taxpayer's taxable income. Ordinarily, a change made in accordance with financial accounting requirements would be accepted for tax purposes. Three examples of situations when sub-article (1) applies are: (1) when a taxpayer changes from cash to accruals accounting, or vice versa: (2) when a taxpayer changes from direct costing to absorption costing for trading stock, or vice versa; (iii) when the Category of the taxpayer changes (see Article 3).

Sub-article (2) provides that, if a taxpayer's method of accounting changes, the taxpayer must make adjustments in the tax year of change to items of income, deduction, or credit, or to any other items affected by the change so that no item is omitted and no item is taken into account more than once. This is particularly relevant when a person changes accounting methods from cash to accruals accounting or from accruals to cash accounting. In the absence of sub-article (2), a change in tax accounting method could result in items of income being recognised twice (for example, when derived under accruals accounting and again when received under cash accounting) or not at all (for example, not recognised when the invoice is issued under cash accounting and then also not recognised when received under accruals accounting). Sub-article (2) requires persons to recognise accrued amounts and received amounts appropriately to prevent these results. It is expressly provided that sub-article (2) applies when a taxpayer's Category changes under Article 3.

Example

Serkalem carries on law practice and accounts for business income tax on a cash basis. The business expands and, at the start of the 2019/20 tax year, Serkalem is given permission by the Authority to change to the accruals method. Serkalem has issued invoices in the 2018/19 tax year that are not paid until the 2019/20 tax year. In the absence of sub-article (2), amounts invoiced in the 2018/19 tax year will not be taxed in that year because they have not been received under the cash method nor will they be taxed in the 2019/20 tax year because they accrued in the 2018/19 tax year under the accruals method. Sub-article (2) avoids this outcome by requiring Serkalem to include the 2018/19 invoiced amounts in business income for the 2019/20 tax year.

Suppose the opposite happens. Serkalem is using the accruals method and, at the start of the 2019/20 tax year, Serkalem is given permission by the Authority to use the cash method because her business has contracted. In the absence of sub-article (2), amounts invoiced in the 2018/19 tax year will be taxed in that year because they have accrued in that year (accruals method) and then they will be taxed again in the 2019/20 tax year because they have been received in that year (cash method). Sub-article (2) avoids this outcome by requiring Serkalem to exclude the amounts from business income in the 2019/20 tax year.

30. Bad Debts

This Article allows a deduction for bad debts.

Sub-article (1) provides that a taxpayer is allowed a deduction for a bad debt in a tax year when the following conditions are satisfied:

(1) The taxpayer has previously included the amount of the debt in business income.

(2) The debt or part of the debt has been written off in the taxpayer's financial accounts during the year. Thus, the timing of the tax deduction corresponds to the treatment of the amount as a bad debt for financial accounting purposes.

(3) Legal action has been taken to recover the debt but the debt is irrecoverable.

A bad debt deduction is relevant to a taxpayer accounting for tax on an accruals basis. The effect of the bad debt deduction is to rewrite the amount previously included in business income on an accruals basis. This is necessary because, generally, taxpayers accounting for tax on an accruals basis include amounts in business income before the amounts are actually received (i.e. the right to receive usually arises before the actual receipt).

Sub-article (2) makes it clear that the amount that a taxpayer is allowed as a deduction under sub-article (1) is not to exceed the amount written off in the taxpayer's financial accounts as a bad debt. This is relevant if the amount written off is less than the total debt outstanding.

Example

X Plc has supplied goods to Y Plc during a tax year for price of 1,000 birr. X Plc accounts on an accruals basis and has included the 1,000 birr in its business income for the year. Y Plc is in

> financial difficulties and has not paid the price by the end of the tax year. X Plc has unsuccessfully taken legal action to recover some or all of the unpaid amount. During the following tax year, X Plc has reasonable grounds for believing that only 50% of the debt will be recovered. As a result, X Plc writes off 50% of the debt in its financial accounts for the following tax year. The effect of Article 30(2) is that the amount of the deduction is limited to the amount actually written off in X Plc's accounts. This is the case even if there is some doubt about the recoverability of the entire debt.

If a deduction is allowed under this Article for a bad debt and some or all of the debt is subsequently recovered, the amount recovered is re-included in business income under Article 73.

Sub-article (3) provides that the Article does not apply to the bad debts of financial institutions. This is because the rules made under Article 31(a) in relation to the loss reserve of financial institutions include the treatment of bad debts.

31. Financial Institutions and Insurance Companies

This Article provides that the Regulations may specify rules for the following:

(1) The deduction of the loss reserve of financial institutions.

(2) The deduction of the reserve for unexpired risks of insurance companies (other than life insurance companies).

(3) The calculation of the taxable income of life insurance companies.

32. Long-term Contracts

This Article provides for the income tax treatment of business income and expenditures arising under a long-term contract.

There are two financial accounting methods used for long-term contracts: the percentage-of-completion method and the completed-contract method. Under the percentage-of-completion method, profit is recognised in proportion to the progress made on the contract during the relevant accounting period. In other words, the profit is recognised as it "emerges" over the life of the contract. Under the completed-contract method, profit is not recognised until the contract is substantially performed. Financial accounting standards now clearly require the percentage-of-completion method to be used as it is a better measure of "periodic accomplishment" over the life of the contract. From a tax perspective, the completed-contract method gives rise to an unwarranted deferral of tax and, therefore, sub-article (1) requires recognition of business income and expenditures arising under a long-term contract on the basis of the percentage-of-completion method. Under sub-article (2), the percentage of completion is determined by reference to the actual costs incurred as a percentage of the estimated total contract costs.

Sub-article (1) makes it clear that only expenditures that are deductible under the ITP are taken into account in applying the percentage of completion method. For example, a fine incurred by a building contractor is not deductible under Article 27(1)(f) and, therefore, is not taken into account in applying the percentage of completion method.

"Long-term contract" is defined in broad terms in sub-article (6). Importantly, it is not confined to contracts in relation to real property transactions, but rather includes any contract for the manufacture, installation, or construction of movable property (including a contract for the performance of services related to such a contract), provided the work under the contract is not completed within a tax year. However, a contract under which it is estimated that the work will be completed within 12 months from the commencement of work is not a long-term contract. Thus, the key feature of a long-term contract is that work under the contract extends over more than one tax year. Common examples of long-term contracts include contracts for the construction of buildings, bridges, dams, pipelines, tunnels, and other civil engineering projects; construction management contracts in relation to such projects; the construction of major items of plant; and contracts for the refurbishing of hotels and other business premises.

An example of the percentage of completion method is set out below. In the example, the estimated taxable income under the contract is allocated to tax years based on the contract costs incurred during the year as a percentage of estimated total contract costs (determined at the commencement of the contract). This percentage is multiplied against the total profit anticipated under the contract to determine the profit (and, therefore, taxable income) for each year.

Example

Builders Plc enters into a construction contract to be completed over four tax years. The construction contract is Builders' only business activity in Ethiopia. All the amounts derived under the contract are included in business income and all expenditures incurred are deductible either outright or on a depreciation basis. The total estimated profit (and, therefore, estimated taxable income) under the contract is 10,000,000 birr. The percentage completed for each tax year is based on costs actually incurred as a percentage of total estimated costs. Builders' taxable income for each tax year under the contract is calculated as follows:

Year	1	2	3	4
% completed	10%	20%	30%	40%
Taxable income (birr)	1,000,000	2,000,000	3, 000,000	4,000,000

If the actual taxable income under the contract is equal to the estimated taxable income, then this is Builders' final tax position in respect of the contract. If the actual taxable income is, say, 12,000,000 birr, then Builders has taxable income in the final year of the contract equal to 6,000,000 birr (i.e. an additional amount of taxable income of 2,000,000 birr). Similarly, if the actual taxable income is 8,000,000 birr, then Builders has a taxable income in the final year of the contract equal to 2,000,000 birr (i.e. the taxable income is reduced by 2,000,000 birr).

Sub-articles (3) and (4) provide that if, in the tax year in which a long-term contract is completed, the taxpayer has made a final year loss and the taxpayer has ceased to carry on business in Ethiopia, the loss may be carried back to the preceding two tax years and applied against the amount included in business income under the contract for those years starting with the immediately preceding tax year.

Sub-article (5) provides that a person has a "final year loss" if the total actual taxable income under the contract (i.e. total business income less total deductions) is less than the estimated taxable income used to allocate business income and deductions to tax years during the life of the project, and the amount of the difference exceeds the difference between business income and allowable deductions as determined under sub-article (1) for the final year.

The loss carry back rule in sub-articles (3) and (4) applies only if the taxpayer ceases to carry on business in Ethiopia when the contract is completed. For example, the taxpayer may be a company that is liquidated at the end of the contract or the taxpayer may be a non-resident that has no other business operations in Ethiopia. The loss carry back rule does not apply if the person has continuing activities in Ethiopia – in this case, the normal loss carry forward rule in Article 28 applies. The application of sub-article (3) is illustrated by the following example.

Example

Suppose that, in the previous example, Builders is a non-resident company and that this is Builders' only project in Ethiopia. Suppose, further, that the actual taxable income under the contract is 5,000,000 birr. This means that the actual taxable income under the contract is 5,000,000 birr less than expected (10,000,000 birr – 5,000,000 birr). Consequently, there will be no taxable income in the final year of the contract (the estimated taxable income of 4,000,000 birr is reduced to zero). This still leaves a final year loss of 1,000,000 birr. As this cannot be carried forward, sub-article (3) provides that it can be carried back and allowed as a deduction in the previous tax year. This involves re-opening Builders' tax assessment for that year and reducing Builders' taxable income for that year to 2,000,000 birr.

33. Simplified Tax System for Category 'B' Taxpayers

This Article provides a simplified system for calculating the taxable income of a Category 'B' taxpayer. Article 3 defines a Category 'B' taxpayer as a taxpayer, other than a company, with an annual gross income of Birr 500,000 or more but less than Birr 1,000,000.

The Article provides that the taxable income of a Category 'B' taxpayer is calculated in the normal way under the ITP subject to the following modifications:

(1) The cash basis of accounting is used in determining when business income is derived and expenditures are incurred. An amount is derived under cash-basis accounting at the time the amount is received (defined in Article 2(19)) and expenditure are incurred under cash-basis accounting at the time the expenditure is paid.

(2) The depreciation rate for depreciable assets and business intangibles under Article 25 is 100%. In other words, the cost of depreciable assets and business intangibles is expensed.

(3) The cost of acquiring items of trading stock is allowed as a deduction in the tax year in which the trading stock is acquired and not in the tax year in which the items are sold (i.e. the trading stock rule in Article 22(1)(b) based on financial accounting standards does not apply to a Category 'B' taxpayer).

(4) The period for retention of records, and the amendment of assessments, under TAP is 3 years. Thus, the record-keeping and amendment periods are shorter for a Category 'B' taxpayer than for Category 'A' taxpayers (as provided for in Articles 17(2) and 28(2)(b) of TAP, respectively).

34. Change in Control of a Body

This Article provides for a limitation on the carry forward of losses by a body when there has been a change in the underlying ownership of the body. This is an anti-avoidance measure to prevent the trading in loss entities.

Sub-article (1) provides that a body can carry forward a loss for a tax year only when the same person holds more than 50% of the underlying ownership of the body during the loss and carry forward years, and all intervening tax years. The limitation on the carry forward applies to losses under Article 26 and foreign losses under Article 46.

“Body” is defined in Article 2(5) of TAP to mean a company, partnership, public enterprise, or public financial agency, or other body of persons. “Underlying ownership” is defined in Article 2(25) to mean an ownership interest in a body held, directly or indirectly through an interposed body or bodies, by an individual or a person not ultimately owned by an individual (such as a government).

Example

X Share Co is a company that is owned by two individuals, A and B. X Share Co has a loss carry forward for a tax year. A holds 60% of the shares in X Share Co and B holds 40%. In this case, both A and B hold their shares directly in X Share Co and, therefore, their shareholding is also their underlying ownership interest in X Share Co. If A were to sell their shares to C, then there is a change in more than 50% of the underlying ownership of X Share Co.

Suppose, instead, that Holders Share Co owns all the shares in X Share Co. In turn, two individuals, A and B hold the shares in Holders. A holds 60% of the shares in Holders and B holds 40%. As Holders wholly owns X Share Co, A has an indirect ownership interest and, therefore, an underlying ownership interest, in X Share Co of 60% and B has an indirect ownership interest and underlying ownership interest of 40%. If A were to sell their shares in Holders to C, then there is a change in more than 50% of the underlying ownership of X Share Co.

If there is a change in more than 50% in the underlying ownership of a body, any loss carried forward incurred for a tax year prior to the change is not allowed as a deduction in a tax year after the change. However, sub-article (2) provides for an exception when both the following conditions are satisfied:

(1) The body conducts the same business after the majority change in underlying ownership as it conducted before the change. In other words, the body conducted the same business in the loss year, the carry forward year, and all intervening tax years.

(2) Either there is no new business activity entered into before the loss has been fully deducted or, if there is a new business activity, it was not entered into with the principal purpose of utilising the body's tax losses.

If these conditions are satisfied, it is clear that the person acquiring the body did so to acquire the business of the body not the tax losses. In this case, the deduction of the carry forward losses is allowed. The determination of the principal purpose of adding a new business activity depends on all the facts. For example, if the added business is closely related to the existing business, then it may be argued that the principal purpose is not to access the losses.

35. Corporate Reorganisations

This Article provides for tax-free reorganisations within corporate groups.

Sub-article (1) applies when the following conditions are satisfied:

(1) A resident company transfers a business asset to another resident company. "Resident company" is defined in Article 5(6) to mean a company that is incorporated in Ethiopia or a company that has its place of effective management in Ethiopia. The application of the tax-free transfer rule in the

Article is limited to transfers between resident companies to ensure that the transferred asset remains within the Ethiopian tax base. A transfer to a non-resident company may have the effect of taking the asset out of Ethiopia's tax base as any subsequent gain made on disposal of the asset may be foreign income of a non-resident.

(2) The transfer is as part of a reorganisation. " "Reorganisation" is defined in sub-article (3) to mean any of the following:

(a) A merger of two or more resident companies.

(b) The acquisition or takeover of 50% or more of the voting shares and 50% or more of all other shares value of a resident company solely in exchange for shares in another resident company that is a party to the reorganisation.

(c) The acquisition of 50% or more of the assets of a resident company by another resident company solely in exchange for shares with voting rights but no preferential right to dividends that is a party to the reorganisation.

(d) A division of a resident company into two or more resident companies.

(e) A spin off. This is a form of corporate reorganisation under which a division or part of a company ("parent company") is separated (or "spun off") into a new company with the parent company distributing the shares in the new company to its shareholders on a *prorata* basis. The outcome is that the parent company has divested itself of ownership of the division or part that has been spun off into the new company but in a way that its shareholders retain their interest in that division or part through their shareholding in the new company. One reason for a company to enter into a spin off arrangement is the separation of assets having different risk profiles.

(3) The Authority is satisfied that the merger, acquisition, takeover, division, or spin off does not have a principal purpose of tax avoidance (sub-article (4)).

If these conditions are satisfied, the following occurs:

(1) The transfer is not treated as a disposal of the asset by the transferor for the purposes of the ITP (sub-article (1)(a)).

(2) The transferee is treated as having acquired the business asset for an amount equal to the transferor's cost of the asset at the time of the transfer (sub-article (1)(b)). The transferor's cost is determined under Article 68. This is relevant in calculating any gain or loss to the transferee on a subsequent disposal of the asset. Sub-article (2) provides that, if the business asset transferred is a depreciable asset or business intangible, the reference in the sub-article (1)(b) to the cost of the asset is a reference to the net book value of the asset or intangible at the time of the transfer. The net book value of an asset is determined under Article 69 and, in broad terms, is the cost of the asset reduced by depreciation deductions.

(3) If the transferee has issued shares in exchange for the transferred asset, the cost of the shares is the cost of the transferred asset at the time of the transfer. Sub-article (2) provides that, if the business asset transferred is a depreciable asset or business intangible, the reference in the sub-article (1)(c) to the cost of the asset is a reference to the net book value of the asset at the time of the transfer.

The effect of sub-article (1) is that the transferor's cost (or net book value) of the transferred asset is "rolled over" to the transferee company. This means that:

(1) Taxation of the gain (or loss) that had accrued in relation to the asset prior to the transfer of the asset is deferred until the transferee subsequently disposes of the asset.

This means that the part of the gain that accrued while the transferor owned the asset is taxed to the transferee.

(2) If the business asset is a depreciable asset or business intangible, the transferee takes over the depreciation position of the transferor and continues to depreciate the asset accordingly.

36. Chapter Four Definitions

This Article provides for the definition of terms used in Chapter Four of Part Four. An explanation of the definition of the main terms used in Chapter Four is provided below. The definition of other terms is self-explanatory.

Development expenditure

This term is relevant to Article 40 (which provides for the deductibility of development expenditure incurred by a licensee or contractor).

"Development expenditure" means capital expenditure incurred by a licensee or contractor in undertaking development operations. For mining, "development operations" is defined in Article 36(5)(a) to mean authorised operations under a mining licence. A "mining licence is granted under the Mining Operations Proclamation. For petroleum, "development operations" is defined in Article 36(5)(b) to mean authorised operations relating to development and production under a petroleum agreement that has been entered into with the Government under the Petroleum Operations Proclamation.

Consequently, development expenditure is capital expenditure incurred by a licensee in undertaking activities authorised under a mining licence or by a contractor in undertaking development and production activities authorised under a petroleum agreement.

Development expenditure is confined to expenditure that is characterised as capital in nature. Generally, capital expenditure is expenditure that has a useful life in excess of one year. The normal deduction rules in Chapter One of Part Four apply to expenditure of a revenue nature (i.e. operating expenditure) incurred in undertaking development operations. Further, development expenditure is confined to capital expenditure incurred in undertaking activities that are "authorised" under a mining licence or petroleum agreement. The deduction of other capital expenditure is determined under the normal operation of the deduction rules in Chapter One of Part Four.

The definition expressly includes the following:

(1) Expenditure incurred by a licensee or contractor in the acquisition of an interest in a mining right or petroleum agreement, but not including an interest in an exploration right that is acquired: (i) from the Government; or (ii) under a farm-out agreement. Expenditure incurred in acquiring an interest in an exploration right from the Government or under a farm-out agreement is excluded as this is treated as exploration expenditure (see Article 36(6)(a)(1)). Expenditure incurred in acquiring an interest in a mining right or petroleum agreement in any other circumstances is development expenditure, including expenditure incurred to acquire an interest in an exploration right other than from the Government or under a farm-out agreement.

(2) Expenditure incurred by a licensee or contractor the acquisition of mining or petroleum information other than exploration information acquired: (i) from the Government; or (ii) under a farm-out agreement. Expenditure incurred in acquiring exploration information from the Government or under a farm-out agreement is excluded as this is treated as exploration expenditure (see Article 36(6)(a)(2) of the definition of "exploration expenditure"). Expenditure incurred in acquiring all other mining or petroleum

information is development expenditure, including expenditure incurred to acquire exploration information other than when acquired from the Government or under a farm-out agreement.

(3) Social infrastructure expenditure incurred by a licensee or contractor in relation to development operations under a mining right or petroleum agreement. "Social infrastructure expenditure" is defined in Article 36(19) to mean capital expenditure that a licensee or contractor is required to incur under a mining right (in this case a mining lease) or a petroleum agreement (in relation to development and production activities) on the construction of a public school, hospital, road, or other similar social infrastructure. Importantly, it is only social infrastructure expenditure that a licensee is required to incur under a mining right or petroleum agreement that qualifies as development expenditure. The deductibility of voluntarily incurred social infrastructure expenditure will depend on the normal operation of the deduction rules in Chapter One of Part Four.

The definition expressly excludes expenditure incurred in acquiring a depreciable asset. "Depreciable asset" is defined in Article 25(7)(b) to mean tangible movable property that is wholly or partly used in the production of business income and which is likely to lose value because of wear and tear, or obsolescence. This means, in effect, that development expenditure is confined to intangible expenditure (including in the acquisition of a mining right and mining information, and the acquisition of an interest in a petroleum agreement and petroleum information).

Exploration expenditure

This term is primarily relevant to Article 39 (which provides for the deductibility of exploration expenditure incurred by a licensee or contractor).

"Exploration expenditure" is defined to mean capital expenditure incurred by a licensee or contractor in undertaking exploration operations. For mining, "exploration operations" is defined in Article 36(8)(a) to mean authorised operations undertaken under a mining exploration right. A "mining exploration right" means a reconnaissance, exploration, or retention licence granted under the Mining Operations Proclamation (Article 36(15)). For petroleum, "exploration operations" is defined in Article 26(8)(b) to mean authorised operations relating to exploration under a petroleum agreement.

Consequently, exploration expenditure is capital expenditure incurred by a licensee in undertaking activities authorised under a reconnaissance, exploration, or retention licence, or by a contractor in undertaking exploration activities authorised under a petroleum agreement.

Exploration expenditure is confined to expenditure that is characterised as capital in nature. Generally, capital expenditure is expenditure that has a useful life in excess of one year. The normal deduction rules in Chapter One of Part Four apply to expenditure of a revenue nature (i.e. operating expenditure) incurred in undertaking exploration operations. Exploration expenditure is confined to expenditure incurred in undertaking activities that are "authorised" under the mining exploration right or petroleum agreement. The deduction of other expenditure is determined under the normal operation of the deduction rules in Chapter One of Part Four.

The definition expressly includes on the following:

(1) Expenditure incurred by a licensee or contractor on the acquisition of an interest in an exploration right, but only if the interest is acquired: (i) from the Government; or (ii) under a farm-out agreement. "Exploration right" is defined to mean a reconnaissance, exploration, or retention licence granted under the Mining Operations Proclamation or an

exploration licence issued under a petroleum agreement (Article 36(9) and (12)).

An exploration right will usually be acquired from the Government on the initial issuing of the relevant licence or on entering into of a petroleum agreement. In broad terms, a farm-out agreement is entered into when a licensee or contractor wants to spread the risk of exploration (see Article 43). It involves a person agreeing to undertake or finance some or all of the work commitments of a licensee under a mining exploration right or contractor under a petroleum agreement. A key characteristic of an exploration right acquired from the Government or under a farm-out agreement is risk and uncertainty.

Expenditure incurred in relation to the acquisition of an exploration right in other circumstances is not treated as exploration expenditure as there is likely to be less risk and uncertainty concerning the right as it is likely to involve access to known mineral or petroleum resources. Consequently, the cost of the right is properly treated as development expenditure (see paragraph (a)(1) of the definition of "development expenditure").

(2) Expenditure incurred by a licensee or contractor on the acquisition of exploration information, but only if the information is acquired: (i) from the Government; or (ii) under a farm-out agreement. "Exploration information" is defined in Article 36(7) to mean information relating to the search for minerals under a mining exploration right (i.e. a reconnaissance, exploration, or retention licence) or the search for petroleum under an exploration licence issued under a petroleum agreement. Exploration information acquired in other circumstances is likely to relate to known resources and, therefore, the cost of the information is properly treated as development expenditure (see paragraph (a)(2) of the definition of "development expenditure").

(3) Social infrastructure expenditure incurred by a licensee or contractor in relation to exploration operations in accordance with a mining exploration right or petroleum agreement. "Social infrastructure expenditure" is defined in Article 36(19) to mean capital expenditure that a licensee or contractor is required to incur under a mining right (in this case a reconnaissance, exploration, or retention licence) or petroleum agreement (in this case under an exploration licence) on the construction of a public school, hospital, road, or other similar social infrastructure. Importantly, it is only social infrastructure expenditure that a licensee or contractor is required to incur under the mining right or petroleum agreement that qualifies as exploration expenditure. The deductibility of voluntarily incurred social infrastructure expenditure will depend on the normal operation of the deduction provisions in Chapter One of Part Four.

The definition expressly excludes expenditure incurred in acquiring a depreciable asset. "Depreciable asset" is defined in Article 25(7)(b) to mean tangible movable property that is wholly or partly used in the production of business income and which is likely to lose value because of wear and tear, or obsolescence. This means that, in effect, that exploration expenditure is confined largely to intangible expenditure (including in the acquisition of rights and information). However, the depreciation rate for depreciable assets first used in exploration operations is 100% (Article 39(2)). Thus, there is consistent treatment as between exploration expenditure (intangibles) and the cost of acquiring depreciable assets (tangibles) used in exploration operations.

Social infrastructure expenditure

This term is relevant to the Article 36 definitions of "development expenditure" and "exploration expenditure".

"Social infrastructure expenditure" is defined to mean capital expenditure incurred by a licensee or contractor on the construction of a public school, hospital, road or any similar social infrastructure. A licensee or contractor may be required to incur such expenditure under a mining right or petroleum agreement.

The deductibility of social infrastructure expenditure depends on the phase of operations in respect of which it is incurred. Social infrastructure expenditure that a licensee or contractor is required to incur under an exploration right is treated as exploration expenditure and, therefore, allowed as a deduction under Article 39(1) in the tax year in which the expenditure is incurred. Similarly, social infrastructure expenditure that a licensee or contractor is required to incur under a mining licence or petroleum agreement in relation to development and production operations is treated as development expenditure and, therefore, the expenditure is depreciated under Article 40.

The normal operation of the deduction rules in Chapter One of Part Four applies to determine the deductibility of any social infrastructure expenditure voluntarily incurred by a licensee or contractor. In particular, this will depend on whether the expenditure is incurred in the production of business income (deductible) or whether the expenditure is an application of business income already earned (non-deductible). This is determined according to all the facts and circumstances. Deductibility will also depend on whether the expenditure is revenue or capital in nature.

Subcontractor

This term is relevant to Article 37(4).

A "subcontractor" is defined to mean a person supplying services to a licensee or contractor in respect of mining or petroleum operations undertaken by the licensee or contractor. It is expressly provided that a person supplying services to a licensee or contractor as an employee (defined in Article 2(7)) is not a subcontractor. The employment income tax imposed under Schedule 'A' applies to employment income paid by a licensee or contractor to an employee.

37. Taxation of Licensees and Contractors

This Article sets out the basic principles of taxation of licensees and contractors.

Sub-article (1) provides that a licensee or contractor is subject to tax in accordance with the ITP, but subject to modifications in Chapter Four of Part Four. This means that licensees and contractors are subject to the normal operation of the ITP, including withholding tax, but as modified by Chapter Four of Part Four. Thus, all the provisions of the ITP apply to a licensee or contractor except to the extent that Chapter Four of Part Four modifies the application of those provisions.

"Contractor" is defined in Article 36(1) to mean a person who has entered into a petroleum agreement with the Government of Ethiopia under the Petroleum Operations Proclamation. "Licensee" is defined in Article 36(11) to mean a person who has been granted a reconnaissance, exploration, retention, or mining licence under the Mining Operations Proclamation.

Sub-article (2) expressly provides that, if there is any inconsistency between Chapter Four of Part Four and the other provisions of the ITP, Chapter Four of Part Four has priority.

Sub-article (3) specifies that the rate of business income tax applicable to a licensee or contractor is 25%. This is a concessional rate of tax as compared to the normal rate of tax applicable to bodies of 30% under Article 19. The 25% rate stated in sub-article (3) will apply even if a lower rate of tax subsequently applies to bodies under Article 19. In other words, the effect of sub-article (3) is that any lowering of the general business income tax rate applicable to bodies below 25% does not automatically apply to licensees and contractors. A lower rate will apply only if there is also an amendment to sub-article (3). This ensures fiscal stability for the Government.

Sub-article (4) provides that a licensee or contractor making a payment to a non-resident subcontractor must withhold tax at the rate of 10% from the amount of the payment. Payments made by licensees and contractors to sub-contractors would ordinarily be technical fees, which are subject to non-resident tax under Article 51. The rate of non-resident tax on technical fees is 15% (Article 51(2)(c)). A person paying a technical fee to a non-resident subject to tax under Article 51 is required to withhold tax from the payment at the rate of 15%. The effect of sub-article (4) is to reduce the withholding tax rate to 10% in the case of a technical fee paid by a licensee or contractor to a sub-contractor.

If a non-resident subcontractor does not have a permanent establishment in Ethiopia, then the effect of Articles 64(2) and 98 is that the 10% withholding tax is a final tax on the technical fee. In other words, the effect of sub-article (4) is to reduce the non-resident tax to 10% on technical fees paid by licensees and contractors to non-resident subcontractors.

If a non-resident subcontractor has a permanent establishment in Ethiopia, Article 51(2) provides that the non-resident tax does not apply to technical fees paid to the sub-contractor. However, there is still an obligation under sub-article (4) to withhold tax from the payment of the fee at 10%. As Article 64(2) does not apply, the withholding tax is not a final tax and the non-resident subcontractor is entitled to a credit for the withholding tax under Article 98 against its business income tax liability.

38. Limitation of Deductions Relating to Mining or Petroleum Operations

This Article provides for “ring fencing” of mining or petroleum operations undertaken by a licensee or contractor. This limits the consolidation of business income and deductions that otherwise applies under the Part Four (see Article 8(2)) in the calculation of the taxable income or loss of a licensee or contractor for a tax year. In the absence of ring fencing, a licensee or contractor may be able to deduct exploration expenditure incurred in relation to a new mining licence or petroleum agreement against the business income derived in relation to an existing mining licence or petroleum agreement that is already generating taxable income, thereby delaying the Government's revenue from the existing mining or petroleum operations.

The substantive provisions of the Article apply to a licensee in relation to mining operations. Sub-article (5) provides that the Article also applies, with the necessary changes made, to a contractor in relation to a contract area of the contractor under a petroleum agreement. The necessary changes include: (i) treating a reference in the Article to "licensee" as a reference to "contractor"; (ii) treating a reference in the Article to "licence area" as a reference to "contract area"; and (iii) treating a reference in the Article to "mining operations" as a reference to "petroleum operations".

Sub-article (1) provides that a deduction for expenditures to the extent incurred by a licensee in undertaking mining operations in a licence area during a tax year is allowed only against the business income derived by the licensee from such operations in the licence area during the year. This means that ring fencing applies for mining operations by reference to a licence area, which is defined in Article 36 to mean the area covered by a mining right. "Mining right" is defined in Article 36 to mean a reconnaissance, exploration, retention, or mining licence granted under the Mining Operations Proclamation.

If a licensee has more than one licence area, the effect of sub-article (1) is that there is a separate calculation of the taxable income of the licensee for each licence area. For example, if a licensee has an exploration licence for one licence area and a mining licence for another licence area, the expenditures incurred in relation to the licence area covered by the exploration licence cannot be deducted against the business income derived in relation to the licence area covered by the mining licence.

If a licensee has a loss in respect of mining operations in a licence area for a tax year, sub-article (2) provides that the loss is carried forward and allowed as a deduction against the business income derived by the licensee from mining operations in the licence area in the next following tax year of the licensee. Sub-article (4) provides that a licensee has a loss in relation to mining operations in a licence area for a tax year if the total deductions of the licensee in respect of mining operations undertaken by the licensee in the licence area during the year exceed the total amount of business income derived from such operations in the area for the year.

The effect of sub-article (3) is that a loss in relation to a licence area can be carried forward until the loss is fully deducted but subject to a maximum loss carry forward period of 10 years. The longer loss carry forward period reflects the fact that the time frame for recovering losses is potentially much longer under mining and petroleum operations, particularly taking account of ring fencing. The Regulations made under Article 26(5) will otherwise apply to a loss carried forward under this Article including a requirement that losses are carried forward and deducted in the order in which they are incurred.

39. Exploration Expenditure

This Article provides for the tax treatment of exploration expenditure.

Sub-article (1) provides that exploration expenditure incurred by a licensee or contractor is treated as a business intangible with a useful life of one year. In other words, the depreciation rate applicable to exploration expenditure is 100%.

"Exploration expenditure" is defined in Article 36(6). In broad terms, exploration expenditure is capital expenditure incurred in undertaking authorised activities in the search for minerals, or oil and gas, under a reconnaissance, exploration, or retention licence (mining operations) or an exploration licence (petroleum operations). Exploration expenditure does not include expenditure incurred in acquiring a depreciable asset (although the same tax treatment applies under sub-article (2)). Thus, exploration expenditure is intangible expenditure incurred during the exploration phase in mining or petroleum operations. The definition expressly includes expenditure incurred in acquiring the reconnaissance, exploration, or retention licence (mining operations) or an exploration licence (petroleum operations), and in acquiring information relating to exploration operations, but only when the licence or information is acquired from the Government or under a farm-out agreement. It also includes social infrastructure expenditure (defined in Article 36(19)) incurred in relation to exploration operations.

The effect of sub-article (1) is that Article 25 applies to exploration expenditure on the basis that it is a business intangible. Article 25(1) allows a licensee or contractor a deduction for a tax year for the amount by which the business intangibles of the licensee or contactor have declined in value during the year through use in deriving business income. Article 25(2) provides that the amount of depreciation deduction is determined according to the Regulations. Depreciation of a business intangible under the Regulations is based on the useful life of the intangible. Sub-article (1) provides that the useful life of exploration expenditure is one year and, therefore, the depreciation rate is 100%.

As sub-article (1) provides that exploration expenditure is a business intangible with a useful life of one year (i.e. a depreciation rate of 100%), the effect of sub-article (1) is that an outright deduction is allowed for exploration expenditure (subject to the apportionment rules in Article 25(3) and (4) applying) in the tax year the expenditure is incurred.

Exploration is considered a high risk activity because of the possibility that exploration expenditure may end up being a "sunk cost" if no minerals or petroleum is discovered, or minerals or petroleum are discovered in insufficient quantities to justify development and production. While plant and equipment (such as an oil rig) can be moved to another mine or well site if a commercial discovery is not made, intangible expenditure (such as on geological or geophysical surveys or analyses undertaken at a particular mine or well site) cannot be recovered if no commercial discovery is made. The expensing of exploration expenditure, therefore, is intended as an incentive to encourage investment in exploration for minerals or petroleum given the high risks associated with exploration operations.

Sub-article (2) provides that the depreciation rate for a depreciable asset acquired by a licensee or contractor that has its first use in exploration operations is 100%. In other words, an outright deduction is allowed for expenditure incurred in acquiring depreciable assets used in mining, or oil and gas exploration. This ensures consistency in the tax treatment of tangible and intangible expenditures during the exploration phase of mining and petroleum operations.

40. Exploration Expenditure

This Article provides for the tax treatment of development expenditure.

Sub-article (1) provides that Article 25 applies to development expenditure incurred by a licensee or contractor on the basis that it is a business intangible with a useful life of four years.

"Development expenditure" is defined in Article 36(4) to mean expenditure incurred in undertaking authorised operations under a mining licence (mining), or undertaking development and production operations under a petroleum agreement (petroleum). In broad terms, development expenditure is expenditure incurred after there has been a commercial discovery and the decision has been taken to extract the relevant resource. Development expenditure does not include expenditure incurred in acquiring a depreciable asset. Thus, development expenditure is intangible expenditure incurred during the mining or production phase in a mining or petroleum project. The definition expressly includes expenditure incurred in acquiring a mining or petroleum right, except acquisition expenditure treated as exploration expenditure (see Article 36(4)(a)(1)). It also includes expenditure incurred in acquiring information relating to mining or petroleum operations, except acquisition expenditure treated as exploration expenditure (see Article 36(4)(a)(2)) and social infrastructure expenditure (defined in Article 36(19)) incurred in relation to development operations (i.e. authorised operations under a mining lease or authorised operations relating to development and production under a petroleum agreement (Article 36(5)).

The effect of sub-article (1) is that Article 25 applies to development expenditure. Article 25(1) allows a licensee or contractor a deduction for a tax year for the amount by which the business intangibles of the licensee or contactor have declined in value during the year through use in deriving business income. Article 25(2) provides that the amount of depreciation deduction is determined according to the Regulations. Depreciation of a business intangible under the Regulations is based on the useful life of the intangible. Sub-article (1) provides that the useful life of development expenditure is four years and, therefore, the depreciation rate is 25%.

If development expenditure is incurred before commercial production, sub-article (2) provides that the expenditure is incurred at the time of commencement of commercial production rather than at the time that the expenditure was actually incurred. "Commencement of commercial production" is defined in sub-article (6) to mean the first day of the first period of 30 consecutive days during which the average level of production on the 25 highest production days in the 30-day period reaches a production level determined by the Ministry of Mines, Petroleum and Natural Gas to be commercial production. Computing the average over 25 days rather than the full 30-day period allows for the possibility of any exceptional or temporary production difficulties affecting operations in the early period of production.

The effect of sub-article (2) is that the 4-year depreciation period for development expenditure commences when commercial production commences. The deferral of the recognition of depreciation deductions for development expenditure to the time of commencement of commercial production provides for the accumulation of lower carry forward losses in the early years of the development operations thereby resulting in earlier recognition of the taxable income by a licensee or contractor.

Sub-article (3) provides for a similar rule in relation to the depreciation of a depreciable asset acquired by a licensee and contractor for use in development operations that is acquired or constructed before the commencement of commercial production.

Sub-article (4) provides a part year deduction rule for the depreciation of development expenditure and the depreciation of the cost of depreciable assets acquired for use in development operations for the tax year in which commercial production commences. The amount of the depreciation deduction is prorated by reference to the number of days in the year from the commencement of commercial production as compared to the total number of days in the year. This counters any incentive to ensure that commercial production commences near the end of a tax year so as to benefit from a full deduction for that year.

Sub-article (5) applies when a licensee disposes of a mining right or a contractor disposes of an interest in a petroleum agreement, other than under a farm-out agreement (Article 43 deals separately with farm-outs). In this case, any gain arising on the disposal is reduced by the amount of any development expenditure that has not been deducted or otherwise recouped by the licensee or contractor at the time of the disposal. For example, assume that Ethiopia Mining Co disposes of a mining licence for a gain of 100,000,000 birr and, at the time of the disposal, Ethiopia Mining Co has 10,000,000 birr in undeducted development expenditure, the effect of sub-article (5) is that the amount of the gain is reduced to 90,000,000 birr.

Sub-article (5) ensures that the development expenditure of a licensee or contractor that has not been deducted or recouped is recognised by a licensee on disposal of mining right or by a contractor on disposal of an interest in a petroleum agreement. In the absence of sub-article (5), there would be no basis on which the licensee or contractor would be able to recognise the undeducted expenditure.

Sub-article (5) applies only to the undeducted portion of any sub-article (1) development expenditure. Deducted expenditure will either have been recognised already or will be a loss carry forward deducted against the gain through the operation of Article 38. It applies also only when the licensee or contractor does not otherwise recoup the expenditure (through, for example, a payment made by the transferee under the transfer agreement).

A similar provision is not necessary in relation to exploration expenditure as the commencement of commercial production rule does not apply to such expenditure and, therefore, the expenditure will be deductible in the tax year in which it is incurred and offset against the gain on disposal of the licence.

As stated above, development expenditure does not include expenditure incurred to acquire a depreciable asset. The normal rules in Article 25 apply for the depreciation of depreciable assets used in development operations subject to the application of sub-articles (3) and (4). In particular, depreciation of depreciable assets used in development operations is based on the useful life of the asset.

41. Rehabilitation Expenditure

This Article provides for the tax treatment of rehabilitation expenditure, including contributions made to a rehabilitation fund established for the purposes of funding rehabilitation of a mine site or oil well.

Sub-article (1) provides that a contribution made by a licensee or contractor to a rehabilitation fund under the terms of an approved rehabilitation plan in relation to mining or petroleum operations is allowed as a deduction in the tax year in which the contribution was made. The following conditions must be satisfied to qualify for the deduction:

(1) There must be a contribution made by a licensee or contractor to a rehabilitation fund. "Rehabilitation fund" is defined in sub-article (6)(b). In broad terms, a rehabilitation fund is a fund or account established under the terms of a mining right or petroleum agreement to provide for the future payment of remedial work to the licence or contract area to which the mining right or petroleum agreement relates. The remedial work may relate to rectifying environmental damage or to rehabilitating the licence or contract area on completion of mining or petroleum operations, including in the case of petroleum operations, the removal of oilrigs. In the normal case, a rehabilitation fund would be an account (such as a trust account) established with a bank jointly managed by the licensee or contractor, and the Ministry of Mines, Petroleum and Natural gas. The central requirement is that the contribution is an actual outgoing of the licensee or contractor. In other words, it is more than a reserve created in the financial accounts of the licensee or contractor, or the giving of security.

(2) The contribution to the fund must be made under an approved rehabilitation plan, which is defined in sub-article (6)(a) to mean a plan for rehabilitation of a mine site or decommissioning of an oil well. The Ministry of Mines, Petroleum and Natural Gas must approve the rehabilitation plan.

Sub-article (2) provides for the deductibility of expenditure incurred by a licensee or contractor in carrying out remedial work required under an approved rehabilitation plan in relation to mining or petroleum operations. The following conditions must be satisfied to qualify for the deduction:

(1) The expenditure must be incurred in carrying out remedial work specified in an approved rehabilitation plan. Examples of remedial work include rehabilitation of the licence or contract area (including the removal of any property (such as oilrigs) used in conducting mining or petroleum operations and the rectification of any environmental damage.

(2) The remedial work must be as required under an approved rehabilitation plan as defined in sub-article (6)(a).

(3) The remedial work must not be paid for, directly or indirectly, from money made available out of the rehabilitation fund of the licensee or contractor for the mining or petroleum operations in respect of which the remedial work is undertaken. This is because a deduction has already been allowed for amounts contributed to the rehabilitation fund under sub-article (1). Thus, the deduction allowed under sub-article (2) is for expenditure incurred by a licensee or contractor on remedial work that is in excess of the amount of contributions to a rehabilitation fund.

Sub-article (3) provides that amounts accumulated in a rehabilitation fund (including interest on the investment of contributions) or withdrawn from a rehabilitation fund to pay for remedial work as required under an approved rehabilitation plan are exempt income. The accumulation is treated as exempt income because ultimately it will be used to pay for remedial work, which is a deductible expenditure. If any part of the accumulation is returned to the licensee or contractor, sub-article (4) includes the amount returned in the business income of the licensee or contractor for the tax year in which the amount is returned. Further, sub-article (5) provides that any surplus in a rehabilitation fund of a licensee or contractor at the time of completion of rehabilitation of a mine site or decommissioning of an oil well is included in the business income of the licensee for the tax year in which rehabilitation was completed.

To the extent that the amount returned under sub-article (4) or surplus returned under sub-article (5) represents contributions by the licensee or contractor to the fund, the inclusion in business income effectively reverses the deduction previously allowed for the contribution under sub-article (1). To the extent that the amount returned under sub-article (4) or surplus returned under sub-article (5) represents accumulations on contributions (such as interest), the inclusion in business income ensures that any part of the accumulation that is not used in undertaking remedial work is taxed to the licensee or contractor.

42. Deduction Allowed for Reinvestment

This Article provides for a tax concession for amounts reinvested in development projects.

Sub-article (1) provides that a licensee or contractor may deduct up to 5% from gross income in each tax year for any investment expenditure incurred by the licensee or contractor towards investment in development projects authorised by the licensing authority.

Sub-article (2) provides that the amount deducted by a licensee or contractor in a tax year in accordance with sub-article (1) forms part of the taxable income of the licensee or contractor of the next following tax year, unless it remains invested at the end of that year.

43. Farm-outs

This Article applies when a licensee or contractor has entered into a farm-out agreement.

A licensee or contractor may enter into a farm-out agreement to reduce or share the risk associated with exploration. Under a farm-out agreement, the licensee or contractor ("farmor") may transfer a percentage interest in an exploration right to another person ("farmee") in exchange for the farmee agreeing to meet some or all of the farmor's work commitments under the part of the right retained by the farmor. Increasingly, under farm-out agreements, the consideration provided by the farmee may include a cash amount in addition to the agreement to undertake some or all of the farmor's work commitments. The interest in the licence may be transferred immediately on entering into the agreement (immediate interest farm-out agreement) or the transfer of the interest may be deferred until the farmee has completed the work commitments (deferred interest farm-out agreement). The cash component of the consideration may be payable on entering into the agreement even if the transfer of the interest is deferred. Further, the farmor may be permitted to retain any cash consideration paid upfront even if the farmee does not complete the agreed work commitments and, therefore, the interest in the licence is not transferred.

Sub-article (1) specifies the conditions that must be satisfied for the Article to apply:

(1) A licensee or contractor (referred to as the "transferor") must have entered into an agreement with a person (referred to as the "transferee") for the transfer of a <u>part</u> of the transferor's interest in a mining right (defined in Article

36(15)) or petroleum agreement. The normal rules for the disposal of business assets apply when there is a transfer of the whole of the exploration right.

(2) The consideration given by the transferee wholly or partly for the interest includes the transferee undertaking some or all of the transferor's work commitments or undertaking to finance such work commitments in respect of the part of the interest retained by the transferor. This is the key requirement for the Article to apply. The normal rules for the disposal of business assets apply when the consideration for the transfer is cash only.

Sub-article (2) specifies the following consequences when the conditions in sub-article (1) are satisfied:

(1) The consideration received by the transferor for the transferred interest does not include the value of any work undertaken by the transferee in respect of the retained interest of the transferor. This means that the value of work commitments is not treated as: (i) consideration for the transferred interest; or (ii) otherwise included in business income. This is intended as an incentive to encourage mining or petroleum exploration.

(2) Article 73 applies to the amount of any cash consideration received or receivable by the transferor on the basis that it is a reimbursement by the transferor of any deductions allowed to the transferor for expenditure incurred by the transferor in respect of the transferred interest. The effect of Article 73 is that the amount treated as reimbursed deductions is business income.

(3) If the cash consideration exceeds the amount of deducted expenditure to which Article 73 applies, the excess is treated as the consideration received for the disposal of the transferred interest.

44. Indirect Transfers of Mining and Petroleum Rights

This Article provides for the collection of tax on gains derived by a non-resident person on the disposal of an interest in an entity whose value is derived principally from a mining or petroleum right or rights.

In broad terms, the value of an interest in an entity is determined largely by the value of the assets owned by the entity. For example, if the only asset held by a licensee company is a mining right or by a contractor company is an interest in a petroleum agreement, then, all things being equal, the value of the shares in the licensee or contractor company will be equal to the value of the mining right or interest in the petroleum agreement (as the case may be). Consequently, the mining right or interest in the petroleum agreement can be realised by either: (i) the licensee or contractor company selling the right or interest (direct transfer of the right or interest); or (ii) the owner of the licensee or contractor company selling the shares in the company (indirect transfer of the right or interest). The ITP provides for the taxation of the gain in both scenarios.

For a direct transfer, a mining right or interest in a petroleum agreement is a business asset of the licensee or contractor (Article 2(3) definition of "business asset"). A gain arising on the disposal of a business asset by a licensee or contractor is included in business income (Article 21(1)(b)). If a non-resident derives a gain on disposal of a business asset, the gain is included in business income only when it is Ethiopian source income (Article 7(2)). Article 6(4)(c)(1) provides that a gain derived from the disposal of immovable property located in Ethiopia is Ethiopian source income. The definition of "immovable property" in Article 2(13) includes a mining or petroleum right.

For an indirect transfer, sub-article (4) provides that a membership interest (such as shares) in a licensee or contractor is a business asset and, therefore, a gain arising on the disposal of the membership interest is included in business income (Article 21(1)(b)). If a non-resident derives a gain on disposal of a business asset, the gain is included in business income only when it is Ethiopian source income (Article 7(2)). A gain arising on disposal of a membership interest in a body is treated as Ethiopian source income if more than 50% of the value of the interest is derived, directly or indirectly through interposed entities, from immovable property located in Ethiopia. Ethiopia's taxing right over the gain of an indirect transfer of a mining right or interest in a petroleum agreement is preserved under Article 13(4) of tax treaties. The purpose of this Article is to provide a mechanism for the collection of the tax payable by a non-resident person in the case of an indirect transfer of a mining or petroleum right.

Sub-article (1) provides that, if there is a 10% or more change in the underlying ownership of a licensee or contractor, the licensee or contractor must immediately notify the Authority, in writing, of the change. "Underlying ownership" is defined is defined in Article 2(25) to mean a membership interest in a body held, directly or indirectly through interposed entities by an individual or a person not ultimately owned by individuals (such as a government). As the transaction is likely to be a transaction between two non-residents taking place outside Ethiopia, sub-article (1) is an important reporting obligation to ensure that the Authority is aware of the transaction. The 10% threshold ensures that the reporting obligation applies only to direct (rather than portfolio) investment. Even if the ultimate holding company of the licensee or contractor is listed on a stock exchange, the licensee or contractor should be aware of a transaction on the stock exchange that gives rise to a 10% or greater change in the underlying ownership of the licensee or contractor.

Sub-article (2) applies when the person disposing of a membership interest in a body to which sub-article (1) applies is a non-resident. In this case, sub-article (2) provides that the licensee or contractor is liable, as agent, for the tax payable by the non-resident on the gain made on disposal of the membership interest in the body. This avoids the difficulty in attempting to collect the tax from the non-resident who will have no assets or employees in Ethiopia. Importantly, the primary liability for payment of the tax remains with the non-resident deriving the gain. Sub-article (2) is simply providing a mechanism for the collection of the tax. As the primary liability for the tax remains with the non-resident, the non-resident should be entitled to double tax relief (such a foreign tax credit) in their country of residence in relation to the Ethiopian tax paid on the gain.

Sub-article (3) provides that the tax paid by a licensee or contractor on behalf of a non-resident under sub-article (2) is credited against the tax liability of the non-resident.

45. Foreign Tax Credit for Foreign Business Income

This Article provides for the foreign tax credit as the method of relief from international double taxation. It applies only to foreign income taxable under Schedule 'C'. Separate foreign tax credit rules apply to foreign income taxable under the other Schedules of the ITP (see Article 64(3) and (4) in relation to foreign income taxable under Schedule 'D' and the Regulations in relation to foreign income taxable under Schedule 'D'.

The need for relief from international double taxation arises because residents of Ethiopia are liable for business income tax on worldwide business income (Article 7(1)). The same income is likely to also be taxed in the foreign country of source and, therefore, subject to international double taxation. In this situation, it is usual for the residence country to provide relief and that is the purpose of the foreign tax credit. Broadly, under the foreign tax credit, a resident of Ethiopia can credit their foreign income tax payments in respect of foreign business income against the Ethiopia business income tax payable on that income.

Sub-article (1) provides for the allowance of the foreign tax credit. There are a number of conditions that must be satisfied before a taxpayer is entitled to a foreign tax credit, namely:

(1) The taxpayer must be a "resident taxpayer", i.e. a resident of Ethiopia (defined in Article 5) liable for business income tax. As Ethiopia taxes only resident taxpayers on worldwide income, the foreign tax credit is allowed only to resident taxpayers. Non-residents are taxed only on Ethiopian source income (Article 7(2)).

(2) The resident must have derived foreign income taxable under Schedule 'C' (referred to below as "foreign business income"). Article 6(5) provides foreign income is any income that is not Ethiopian source income. Article 6(1)-(4) provides rules for determining when income is Ethiopian source income. The combined effect of the Article 6(5) and the other sub-articles of Article 6 means that any income that is not Ethiopian source income is foreign income. No foreign tax credit is allowed in respect of Ethiopian source income even if foreign tax has been paid on that income because the foreign country has a different source rule than that applicable under Article 6.

    Further, the foreign income must be taxable under Schedule 'C', i.e. it must be business income (as defined in Article 21). No foreign tax credit is allowed under Article 45 for foreign tax paid in respect of foreign income that is taxable under another Schedule or is exempt income.

(3) The resident taxpayer must have paid foreign income tax in respect of the foreign income. "Foreign income tax" is defined in sub-article (6) to mean income tax imposed by the government of a foreign country or a political subdivision of a government of a foreign country (such as a state or provincial government). Income tax is a tax that is imposed on net income (after deduction of expenditures) on a realisation basis. The definition expressly includes

withholding tax, but excludes any penalty tax, additional tax, or late payment interest.

A foreign tax credit can be claimed only when the foreign tax has been paid (not payable). If the foreign tax is paid after the Ethiopia tax is paid, the assessment for the tax year in which the foreign source income was derived can be amended to allow for the credit. However, sub-article (3) limits the claiming of a foreign tax credit to two years after the end of the tax year in which the foreign income was derived. If the foreign tax is paid after that time, the credit is lost unless the Authority allows for further time for the foreign tax to be paid and still qualify for a credit.

Further, sub-article (5) requires that the resident taxpayer must have a receipt for the foreign tax. A Directive issued by the Minister may provide for the requirements of such receipts that will be accepted by the Authority. For example, the Directive may require that the receipt be certified by the Ethiopian embassy in the foreign country. Alternatively, if there is a tax treaty with the foreign country, the competent authorities of the two countries under the treaty may agree a procedure for mutual recognition of tax receipts.

If these conditions are satisfied, sub-article (1) provides that the resident taxpayer is entitled to a foreign tax credit equal to the lesser of: (i) the foreign income tax paid on the foreign business income; or (ii) the business income tax payable under Schedule 'C' on the foreign business income. This means that the amount of the foreign tax credit allowed is limited to the Ethiopian business income tax payable on the foreign business income. This is referred to as the foreign tax credit limit. It means that no foreign tax credit is allowed for foreign tax in excess of the Ethiopian business income tax payable on the foreign income. If the resident taxpayer has more than one type of tax credit for a tax year, sub-article (4) provides that the foreign tax credit is allowed first. This is because sub-article (5) makes it clear that an excess foreign tax credit for a tax year is lost as it cannot be refunded, carried back, or carried forward. Consequently, sub-article (4) limits the possibility of unused foreign tax credits by providing that the foreign tax credit is applied first before other tax credits allowed to the taxpayer. This is particularly important, as other tax credits may be refundable (such as the tax credit for advance payments of tax on imports (Article 85(2)) or instalments of tax (Article 86(5)).

As stated above, the amount of the foreign tax credit is limited to the Ethiopian business income tax payable in respect of the foreign business income. Sub-article (2) provides that this is calculated by applying the resident taxpayer's average rate of business income tax applicable for the tax year to the taxpayer's net foreign income for that year. Sub-article (6) defines a person's average rate of Ethiopia income tax for a tax year as the percentage that the business income tax payable by the taxpayer (before the foreign tax credit) for the year is of the taxable income of the taxpayer for the year. The average rate of business income tax for resident bodies will usually be 30% (as a flat rate of tax applies). The average rate of business income tax for a resident individual will depend on the application of the marginal rate scale in Article 19.

The other component of the credit limit calculation under sub-article (2) is net foreign income of the resident taxpayer. This is defined in sub-article (6) as the total foreign business income reduced by deductions allocated to that income. Deductions that relate exclusively to the derivation of foreign business income are allocated to that income. Other deductions are apportioned to the foreign business income in accordance with the principles in Article 76 on the basis that the foreign business income is a separate class of income.

The credit limit is calculated on a global basis. This means that foreign income and foreign taxes are aggregated across different foreign countries.

46. Foreign Business Losses

This Article provides a quarantining rule applicable to foreign losses, which prevents a resident taxpayer from deducting foreign expenditure against Ethiopian source business income.

Sub-article (1) provides that deductions allowed under the ITP to a resident taxpayer relating to the derivation of foreign business income taxable under Schedule 'C' (i.e. foreign business income) are deductible only against that income.

Sub-articles (2) and (3) provide for a five year carry forward period for a foreign loss incurred by a resident taxpayer for a tax year. Sub-article (6) provides that a taxpayer has a foreign loss for a tax year if the total amount of deductible expenditures incurred by the taxpayer during the year in deriving foreign business income exceeds the total amount of that income for the year. As the calculation is made according to the ITP and not the foreign tax law, there is no requirement for the loss to be certified by the foreign tax authority.

The rules for the carry forward of a foreign loss replicate those applicable to the carry forward of a loss under Article 26. Consequently, if a taxpayer has a foreign loss for a tax year, sub-article (2) provides that the foreign loss is carried forward and allowed as a deduction against the taxpayer's foreign business income for the following tax year. Sub-article (3) provides that, if a foreign loss is not fully deducted under sub-article (2), it is carried forward to the next following tax year and so on until it is fully deducted but only for a maximum carry forward period of five tax years after the end of the tax year in which the foreign loss was incurred. Thus, a foreign loss cannot be carried forward for more than five tax years.

Sub-article (5) provides that the carry forward of foreign losses under sub-articles (2) and (3) must be made in accordance with Regulations issued by the Council of Ministers.

47. Thin Capitalisation

This Article provides for a thin capitalisation rule applicable to foreign investment in Ethiopia.

Thin capitalisation practices are commonly used by multinational enterprises ("MNEs") to limit source country taxation. Thin capitalisation practices involve taking advantage of the different tax treatment between debt and equity financing. Debt financing has particular advantages for MNEs financing a subsidiary in Ethiopia. The advantage arises because interest expense is fully deductible to the subsidiary (the tax value of the deduction is 30%) and taxed at 10% to the non-resident parent under the non-resident tax in Article 51. Thus, the effective rate of Ethiopian tax rate on the profits derived by the subsidiary and repatriated to the parent as interest is 10%. This can be compared to equity financing under which dividends are paid by the subsidiary out of profits that have been taxed at the corporate rate of 30% and, in addition, non-resident tax under Article 51 at the rate of 10% applies to the dividends. This means that the effective rate of tax on an equity investment is 37%. The tax differential encourages non-residents to use excessive levels of debt to finance their Ethiopian operations so as to reduce the level of Ethiopian tax payable.

Sub-article (1) provides that a foreign-controlled resident company that has an average debt to average equity ratio in excess of 2:1 for a tax year is disallowed a deduction for the interest paid by the company during the year on the excessive debt. The sub-article applies only to a "foreign-controlled resident company", which is defined in sub-article (4)(h) to mean a resident company in which more than 50% of the membership interests in the company are held, directly or indirectly, by a non-resident person either alone or together with an associate or associates. "Membership interest" is defined in Article 2(21) of TAP and "related person" is defined in Article 4 of TAP. "Resident company" and "non-resident" are defined in Article 5. The Article does not apply if the foreign-controlled resident company is a financial institution as the business of such an institution involves dealing in debt instruments.

The calculation of the debt-to-equity ratio of a foreign-controlled resident company for a tax year is based on the average debt and average equity of the company for the year. Basing the calculation on average debt and equity (rather than the highest debt and highest equity) reduces compliance burdens and ensures that there is no denial of an interest deduction in the case of a minor breach of the debt-to-equity ratio for a short period.

The terms “average debt” and “average equity” are defined in sub-article (4)(b) and (c), respectively, and are calculated on a monthly basis. A foreign controlled resident company’s average debt for a tax year is the sum of the amount of debt at the end of each month of the year divided by 12. A similar calculation is made of average equity for a tax year. “Debt” is defined in sub-article (4)(d) to mean the debt obligations of the foreign controlled resident company on which interest is payable as determined according to financial reporting standards (i.e. IFRS). Only interest-bearing debt is taken into account in calculating the level of debt. “Debt obligation” is defined in sub-article (4) to mean an obligation to make a repayment of money to another person, including obligations arising under promissory notes, bills of exchange, and bonds, but not including accounts payable (i.e. trade credit) or an obligation in respect of which no interest is payable (i.e. interest-free debt). “Equity” is defined in sub-article (4)(f) to mean the equity of the company as determined according to financial reporting standards (i.e. IFRS). It is expressly provided that equity includes debt obligations on which no interest is payable.

Sub-article (2) provides an exception to sub-article (1) when the amount of the average debt of the company for a tax year does not exceed the arm's length debt amount. Sub-article (4)(a) defines "arm's length debt amount" to mean the amount of debt that a financial institution that is not related to the company would be prepared to lend to the company having regard to all the circumstances of the company.

Example

X Co Ltd is an Ethiopian subsidiary of a UK company. X Co uses April 1 – March 31 as its accounting year and tax years. It has deductible interest of 1,000,000 birr for a tax year and the following debt and equity amounts at the end of each month of the tax year:

Date	Debt (birr)	Equity (birr)
April 30	20,000,000	10,000,000
May 31	20,000,000	10,000,000
June 30	25,000,000	10,000,000
July 31	20,000,000	10,000,000
August 31	17,500,000	10,000,000
September 30	20,000,000	10,000,000
October 31	17,500,000	10,000,000
November 30	20,000,000	10,000,000
December 31	25,000,000	10,000,000
January 31	15,000,000	10,000,000
February 28	20,000,000	10,000,000
March 31	20,000,000	10,000,000

X Co's average debt for the year is calculated by adding up the debt amount on the last day of each month of the year (240,000,000 birr) and dividing by 12. Thus, X Co's average debt for the year is 20,000,000 birr. Similarly, X Co's average equity for the year is calculated by adding up the equity amount on the last day of each month of the year (120,00,000 birr) and dividing by 12. Thus, X Co's average equity for the year is 10,000,000 birr. Consequently, X Co's average debt to average equity ratio for the year is 2:1. As the 2:1 ratio is not exceeded, there is no breach of the thin capitalisation rule for the year and a deduction is allowed for all deductible interest.

Assume instead that X Co Ltd has the following debt and equity amounts at the end of each month of the year of assessment:

Date	Debt (birr)	Equity (birr)
April 30	20,000,000	10,000,000
May 31	23,000,000	10,000,000
June 30	23,000,000	10,000,000
July 31	20,000,000	10,000,000
August 31	20,000,000	10,000,000
September 30	23,000,000	10,000,000
October 31	23,000,000	10,000,000
November 30	20,000,000	10,000,000
December 31	20,000,000	10,000,000
January 31	23,000,000	10,000,000
February 28	20,000,000	10,000,000
March 31	20,000,000	10,000,000

X Co's average debt for the year is calculated by adding up the debt amount on the last day of each month of the year (255,000,000 birr) and dividing by 12. Thus, X Co's average debt for the year is 21,250,000 birr. Similarly, X Co's average equity for the year is calculated by adding up the equity amount on the last day of each month of the year (120,000,000 birr) and dividing by 12. Thus, X Co's average equity for the year is 10,000,000 birr. Consequently, X Co's average debt to average equity ratio for the year is 2.125:1, which exceeds the 2:1 ratio. The excess debt of X Co for the year is 1,250,000 birr (21,250,000 birr – 20,000,000 birr).

Assuming that X Co is unable to establish that the average debt amount is an arm's length amount, sub-article (1) applies to deny a deduction for 58,823 birr of the deductible interest for year (1,000,000 birr x $^{1,250,000}/_{21,250,000}$). Thus, the interest deduction of X Co for the year is limited to 941,177 birr.

Sub-article (3) extends the operation of the thin capitalisation rule to permanent establishments in Ethiopia of non-resident companies. As non-resident companies may do business in Ethiopia through a permanent establishment rather than a subsidiary, it is important, therefore, that the thin capitalisation rule applies also to permanent establishments. Sub-article (3) provides that the Article applies to a permanent establishment in Ethiopia of a non-resident company on the basis of the following:

(1) The permanent establishment is deemed to be a "foreign-owned resident company". This ensures that the Article applies to permanent establishments.

(2) The average debt-to-average equity ratio of the permanent establishment is calculated by reference to the debt obligations of the non-resident company that are attributable to the operations of the permanent establishment.

(3) The average debt-to-average equity ratio of the permanent establishment is calculated by reference to the equity of the non-resident company that is attributable to the operations of the permanent establishment.

48. Tax Treaties

This Article provides rules relating to tax treaties entered into between the Government of Ethiopia and a foreign government.

Sub-article (1) provides that the Minister may enter into a tax treaty with a foreign government or governments. Sub-article (5)(b) defines "tax treaty" to mean an international agreement for the avoidance of double taxation and prevention of fiscal evasion. The parties to a tax treaty are referred to as "Contracting States". Tax treaties are usually bilateral, although a tax treaty may be entered into on a multilateral basis.

Sub-article (2) provides for a priority rule applicable when the terms of a tax treaty are inconsistent with the provisions of the ITP. In this case, priority is given to the terms of the tax treaty. Importantly, the application of the priority rule is not limited to Schedule 'C, but applies for all purposes of the ITP. This is particularly relevant to the non-resident tax imposed under Article 51. For example, the rate of non-resident tax imposed under Article 51 on interest paid to a non-resident is 10% of the gross amount of interest. When the non-resident is a resident of a country with which Ethiopia has entered into a tax treaty, that treaty may limit the rate of tax that Ethiopia can impose to, say, 5% of the gross amount of the interest. In this case, the effect of sub-article (2) is to give priority to the lower rate provided for in the tax treaty. Two exceptions to the priority rule are stated. First, the priority rule does not override the anti-treaty shopping rule in sub-article (3). Second, the priority rule does not override the anti-avoidance provisions in Part Eight (income splitting, transfer pricing, and the general anti-avoidance rule).

As stated above, the priority rule in sub-article (2) is subject to the exception in sub-article (3), which is intended to prevent the abuse of Ethiopia's tax treaties through treaty shopping practices. The threat posed to the Ethiopia income tax base by treaty shopping is illustrated by the following simple example. Under the ITP, a non-resident company providing technical services to a resident of Ethiopia other than through an Ethiopian permanent establishment of the non-resident company is subject to non-resident tax at the rate of 15% of the gross amount of technical fees derived for the services (Article 51). If the non-resident company providing the services is a resident of country that has a tax treaty with Ethiopia, the business profits article (usually Article 7 of a tax treaty) of the treaty provides that Ethiopia can tax the technical fees only when the fee is attributable to a permanent establishment of the non-resident company in Ethiopia. If there is no permanent establishment, then there is no Ethiopian tax. Thus, if the non-resident company is resident of a country that does not have a tax treaty with Ethiopia, the tax rate is 15% of the gross amount of the technical fee; but, if the non-resident company is resident of country with which Ethiopia does have a tax treaty, the tax rate is 0%. This encourages MNEs providing technical services to businesses in Ethiopia (such as in the extractive industries sector) to establish a base company in a country that does have a tax treaty with Ethiopia so as to exclude Ethiopian tax on the technical fees.

Sub-article (3) prevents such planning arrangements by confining the benefits of a tax treaty to genuine residents of the other contracting state. Sub-article (3) applies when a tax treaty made under the Article provides that Ethiopian source income is exempt or excluded from tax or the application of the tax treaty results in a reduction in the tax payable (such as when the tax treaty provides for a lower rate of Ethiopian tax than applies under the ITP). It is provided that the benefit of the exemption, exclusion, or reduction is not available to a body that, for the purposes of the tax treaty, is a resident of the other contracting state when 50% or more of the underlying ownership of that body is held by an individual or individuals who are not residents of that other Contracting State for the purposes of the treaty. Thus, to obtain benefits under a tax treaty, the individuals who ultimately own a non-resident body that is a resident of country with which Ethiopia has entered into a tax treaty must also be a resident of that country. This prevents the establishment of a base company in a third country to take advantage of a tax treaty that the third country has with Ethiopia.

Sub-article (4) states two exceptions to sub-article (3):

(1) Sub-article (3) does not apply when the company resident of the other Contracting State is listed on a stock exchange in the other Contracting State. In this case, it is too difficult to look through to the individuals who ultimately own the company because the interests in the company will be widely held. Thus, listing on a stock exchange in the other Contracting State is sufficient to obtain treaty benefits.

(2) The company resident of the other Contracting State carries on an active business in the other Contracting State and the Ethiopian-source income derived by the company is attributable to that business. "Active business" is defined in the negative under sub-article (5)(a). It is provided that active business does not include the business of holding or managing shares, securities, or other investments unless the company is a financial institution or insurance company.

49. Taxation of Category 'C' Taxpayers

This Article provides that a Category 'C' taxpayer must pay business income tax for each tax year as determined under the Regulations.

A Category 'C' taxpayer is a person, other than a body, with an annual gross income of less than Birr 500,000 (Article 3(1)(c)).

50. Taxation of International Air Transportation Business of Non-residents

This Article imposes a separate business income tax on the international air transportation income of a non-resident. The tax is imposed on the gross income rather than net income of the non-resident. This is because of the difficulty in allocating expenditures to the derivation of international air transportation income, particularly expenditures incurred outside Ethiopia. The taxation of international air transportation income of non-residents in this way is consistent with international norms. The business income tax payable under the Article is a final tax on the international air transportation income.

Sub-article (1) provides for the imposition of the tax and, in so doing, specifies the key concepts underlying the imposition of the tax.

First, sub-article (1) identifies those who are liable for the tax. It is provided that tax is imposed on a non-resident. "Non-resident" is defined in Article 5(7) to mean a person who is not a resident of Ethiopia. "Resident of Ethiopia" is defined in Article 5(1). In the ordinary case, the operator of an aircraft will be a company and, therefore, the tax will apply to company incorporated or formed outside Ethiopia and which has its place of effective management outside Ethiopia.

Second, sub-article (1) identifies the tax base by reference to the gross amount derived by the non-resident person for the carriage of passengers, livestock, mail, merchandise, or goods embarked or loaded in Ethiopia and destined for a place outside Ethiopia (i.e. the carriage is in international traffic). Thus, the tax does not apply to business income from purely domestic air transportation within Ethiopia. Such income is taxable under the normal operation of business income tax.

As the tax is imposed on the gross amount derived from the transportation, no deductions are allowed for expenditures incurred by the non-resident in deriving the income.

Finally, sub-article (1) imposes the tax at the rate of 3% of the gross amount derived by the non-resident from the carriage.

Sub-article (2) provides that tax under sub-article (1) does not apply to the following:

(1) An amount that is exempt income. Amounts that are exempt income are specified in Article 65. An amount may be exempt from tax under an international agreement between the Ethiopia and another country, such as a tax treaty (Article 65(1)(f)). Article 8 of a tax treaty commonly provides for residence country only taxation of international transportation income.

(2) An amount that relates to a passenger embarked in Ethiopia who was in Ethiopia solely as a result of being in transit between two places outside Ethiopia.

(3) An amount that relates to the transhipment of livestock, mail, merchandise or goods. "Transhipment" is not defined and, therefore, has its normal commercial meaning, namely the shipment of goods between two places via an intermediate destination (in this case Ethiopia). Transhipment may occur because the cargo is transferred to another ship or because the shipment is consolidated with other cargo to make a larger shipment.

The international transportation business tax imposed under the Article is payable by the non-resident person deriving the transportation income. Article 87 provides for the reporting and payment of the tax.

51. Income of Non-residents

This Article provides for the imposition of "non-resident tax" on a non-resident who has derived an Ethiopian source dividend, interest, royalty, management fee, technical fee, or insurance premium. The tax is a final tax on the income (Article 64(2)) and is collected by withholding from the person paying the income

(Article 89). The tax is imposed on the gross amount of the income derived by the non-resident with no deduction allowed for expenditures incurred in deriving the income.

Separate taxation of such income is necessary largely for administrative reasons. A non-resident deriving an Ethiopian source dividend, interest, royalty, management fee, technical fee, or insurance premium may not have any physical presence in Ethiopia (such as an office or employees) or may be present in Ethiopia for only a short time (in the case of services). For example, in the case of royalties, the non-resident may simply licence a person in Ethiopia to use industrial or intellectual property in Ethiopia. The absence of any physical presence in Ethiopia means that Ethiopian business income tax under Schedule 'C' on the royalties cannot be efficiently collected on an ordinary assessment basis. In the case of technical fees, while the non-resident may have a physical presence in Ethiopia, this may be only for a short period. This also makes it difficult to tax the income on an ordinary assessment basis because the non-resident has been and gone before the end of the tax year. Further, if these items of income were taxed on an assessment basis, there are difficulties in the allocation of expenditures (particularly expenditures incurred outside Ethiopia) as deductions in working out the taxable income of the non-resident. It is very difficult for the Authority to police the allocation of foreign-incurred expenditures as deductions as against such income. For these reasons, a separate tax is imposed on the income at the time it is derived by the non-resident with the tax collected from the payer of the income by withholding under Article 89. However, income attributable to a permanent establishment in Ethiopia of the non-resident is taxed under Schedule 'C' or 'D' as the case may be.

Sub-article (1) provides for the imposition of non-resident tax on a non-resident who derives one of six types of Ethiopian source income. This tax is imposed only on a non-resident, which is defined in Article 5(7) to mean any person who is not a resident of Ethiopia. "Resident of Ethiopia" is defined in Article 5(1) to mean a resident individual, resident body, the Government of Ethiopia, or a regional or local government in Ethiopia. The effect of the Article 5(7) definition of "non-resident" is that any person who is not a resident of Ethiopia is treated as a non-resident person, including a foreign government, a political subdivision of a foreign government, and an international organisation.

Tax is imposed under sub-article (1) only in respect of Ethiopian source dividends, interest, royalties, management fees, technical fees, or insurance premiums. This really states two conditions. First, the income derived must have the character of a dividend, interest, royalty, management fee, technical fee, or insurance premium. "Dividend", "interest", "royalty", "management fee", and "technical fee" are defined in Article 2. "Insurance premium" is not defined and, therefore, has its ordinary meaning, namely an amount paid for cover against a risk under an insurance policy. Second, the income must be Ethiopian source income. The rules for determining whether income is Ethiopian source income are set out in Article 6.

Tax is imposed under sub-article (1) at the time the amount is "derived" by the non-resident. Paragraph (b) of the Article 2(5) definition of "derived" provides that an amount is derived for the purposes of the non-resident tax when it is received. By virtue of the definition in Article 2(19), "received" includes a constructive receipt. For example, if a foreign parent company has lent money to its Ethiopia subsidiary and the interest payable under the loan is credited to the foreign company in an inter-company loan account of the subsidiary, the parent company will be treated as having received the interest at the time the amount is so credited (see paragraph (c) of the definition of "received" in Article 2(19)).

While the tax is formally imposed on the non-resident recipient of the dividend, interest, royalty, management fee, technical fee, or insurance premium, the tax is collected by withholding from the person paying the income at the time of payment under Article 89. Article 64(5) provides that the liability of a non-resident for non-resident tax is satisfied to the extent that the payer withholds the tax payable from the amount paid to the non-resident. A payer who fails to withhold tax as required under Article 89 is personally liable for the tax (Article 97(3)). Withholding tax is a "tax" for the purposes of TAP (see Article 2(31)) and, therefore, any unpaid withholding tax can be recovered from the payer of the income under the collection and recovery provisions in Chapter Three of part Seven of TAP.

Sub-article (2) provides for the calculation of the amount of non-resident tax payable by a non-resident receiving an amount described in sub-article (1). The tax is calculated by applying the rate of tax specified in sub-article (2) to the gross amount received. At the time of enactment, non-resident tax payable is calculated as follows:

(1) For an insurance premium or royalty, the non-resident tax is 5% of the gross amount of the premium or royalty.

(2) For a dividend or interest, the non-resident tax is 10% of the gross amount of the dividend or interest.

(3) For a management or technical fee, the non-resident tax is 15% of the gross amount of the fee.

As non-resident tax is imposed on the gross amount of the income, no deductions are allowed for expenditures incurred by the non-resident in deriving the income.

Sub-article (3) makes it clear that a dividend, interest, royalty, management fee, technical fee, or insurance premium attributable to a permanent establishment in Ethiopia is taxed to the non-resident under the normal operation of Schedule 'C' or 'D', as the case may be. Income that is attributable to a business carried on by a non-resident through a permanent establishment of a non-resident in Ethiopia is Ethiopian source income (Article 6(3)(a)).

Article 64(1)(b) provides that Article 51 does not apply to exempt income. The amounts treated as exempt income are specified in Schedule E.

Article 64(2) provides that non-resident tax is a final tax on the income subject to the tax.

52. Taxation of Recharged Technical Fees and Royalties

This Article applies to recharged technical fees and lease payments paid to non-residents.

The Article applies when the conditions in sub-article (1) are satisfied:

(1) A non-resident supplies technical services or a lease of equipment other than through a permanent establishment in Ethiopia. "Non-resident" is defined in Article 5(7) and "permanent establishment" is defined in Article 4.

(2) The technical services are supplied, or equipment leased, to either: (i) a resident of Ethiopia (other than in relation to a business conducted by the resident through a permanent establishment outside Ethiopia); or (ii) a non-resident conducting business in Ethiopia through a permanent establishment. "Resident of Ethiopia" is defined in Article 5(1). While "technical services" is not defined, it is intended to align with the Article 2(23) definition of "technical service fee". Thus, the reference to "technical services" is intended to cover any technical, professional, or consultancy services, including the provision of the services of technical or other personnel.

(3) The technical fee for the service or royalty for the equipment lease is paid to the non-resident by another non-resident that is a related party of the recipient of the services or leased equipment. "Related party" is defined in Article 4 of TAP.

(4) The related party recharges the technical fee or royalty to the recipient of the services or leased equipment.

If these conditions are satisfied, sub-article (2) provides that the ITP applies as if the related party has supplied the services or leased equipment to the recipient and the recharged amount is a technical fee or royalty. This ensures that the non-resident tax in Article 51 applies to the recharged amount.

This Article is an integrity measure intended to prevent avoidance of the non-resident tax through centralised payments systems within MNEs. In absence of the Article, it may be argued that the recharged amount is a reimbursement of expenses and not a technical fee or royalty. The effect of the Article is that the tax treatment of the recharged amount is the same as if the recipient of the services or leased equipment paid the amount direct to the non-resident supplier.

53. Taxation of Non-resident Entertainers.

This Article provides for the taxation of non-resident entertainers and sportspersons.

Tax is imposed under sub-article (1) on_a non-resident entertainer, or group of non-resident entertainers, who has derived income from the participation by the entertainer or group in a performance in Ethiopia. The rate of tax is 10% of the gross income derived from the performance. No deduction is allowed for expenditures incurred in deriving the income.

"Non-resident" is defined in Article 5(7). "Entertainer" is defined in sub-article (3)(a) to include a musician or sportsperson. "Sportsperson" is not defined and, therefore has its ordinary meaning, namely an individual who participates in an activity involving physical exertion and skill in which the individual (including as member of a team) competes against another or others for entertainment. The definition of "entertainer" is inclusive so that "entertainer" otherwise has its ordinary meaning, namely a person whose work is to entertain others, such as a singer, dancer, or comedian. "Group" is defined to include a sporting team, such as a soccer team. The reference to a group of entertainers otherwise has its ordinary meaning and will include, for example a musical band or theatre troupe. "Performance" is defined to include a sporting event, such as soccer match. "Performance" otherwise has its ordinary meaning, such as concert given by a musician or a band of musicians.

Sub-article (2) applies when the income for a performance by an entertainer, including as member of a group, is derived not by the entertainer but by another person. In this case, sub-article (2) provides that sub-article (1) applies to the gross income derived by that other person. It is commonly the case that entertainers do not derive income from a performance directly but through a company that they control and, therefore, the entertainer's fee is paid to the company. Sub-article (2) ensures that the tax imposed under sub-article (1) is not avoided in this case.

Article 64(1)(b) provides that Article 53 does not apply to exempt income. The amounts treated as exempt income are specified in Schedule E.

Article 62(2) provides that the tax under Article 53 is a final tax on the income of the entertainer.

54. Royalties

This Article provides for the imposition of income tax on domestic royalties.

Sub-article (1) provides that a resident of Ethiopia who has derived a royalty is liable for income tax at the rate of 5% of the gross amount of the royalty. "Resident of Ethiopia" is defined in Article 5(1) and "royalty" is defined in Article 2(20). Tax is imposed under the Article at the time the royalty is "derived" by the resident. Paragraph (b) of the Article 2(5) definition of "derived" provides that an amount is derived for the purposes of Article 54 when it is received. As tax is imposed on the gross amount of the royalty, no deductions are allowed for expenditures incurred by the resident in deriving the royalty.

Sub-article (2) provides that a non-resident deriving an Ethiopian source royalty that is attributable to a permanent establishment of the non-resident in Ethiopia is liable for income tax at the rate of 5% of the gross amount of the royalty. "Permanent establishment" is defined in Article 4 and "non-resident" is defined in Article 5(7). A royalty is an Ethiopian-source royalty under Article 6(4)(g) if it is paid by: (i) a resident of Ethiopia (other than as an expenditure of a business conducted by the resident through a permanent establishment outside Ethiopia); or (ii) a non-resident as an expenditure of a business conducted by the non-resident through a permanent establishment in Ethiopia. Article 51 applies to an Ethiopian-source royalty paid to a non-resident that is not attributable to an Ethiopian permanent establishment of the non-resident.

Article 64(1) provides there is no tax is payable under Schedule 'D' if:

(1) The royalty is subject to tax under another Schedule. This is relevant when the royalty is business income of the resident of Ethiopia or non-resident who has derived the royalty. Consequently, if the core business of the resident or non-resident is to derive royalties, the royalty is included in the business income of the resident and is taxable under Schedule 'C'. This would apply, for example, when the taxpayer's business is the development and licensing of industrial or intellectual property rights, knowhow, or the leasing of equipment.

(2) The royalty is exempt income of the resident of Ethiopia deriving the royalty (see Schedule 'E').

The Article applies to a royalty derived by a resident of Ethiopia regardless of whether the royalty is Ethiopian source income or foreign income. If the royalty is foreign income and the resident has paid foreign tax (such as withholding tax) in respect of the royalty, Article 64(3) provides that the foreign tax is allowed as a credit against the Ethiopian tax payable on the royalty. However, the amount of the credit is not to exceed the Ethiopian tax payable in respect of the foreign-source royalty. It is noted that, as Ethiopian tax is imposed at the rate of 5%, there may be little or no Ethiopian tax paid in respect of foreign source royalties once the credit for foreign withholding tax is allowed. Any royalty that is not Ethiopian-source income is treated as foreign income (Article 6(5)). Thus, after taking account of Article 6(4)(g), the following royalties are foreign income: (i) a royalty paid by a foreign permanent establishment of a resident of Ethiopia; or (ii) a royalty paid by a non-resident other than as an expenditure of an Ethiopian permanent establishment.

The tax is collected through withholding. Article 90(1) obliges a resident of Ethiopia or permanent establishment in Ethiopia of a non-resident to withhold tax from a royalty subject to tax under Article 54 at the rate specified in Article 54 (i.e. 5%) from the gross amount of the royalty. If a non-resident without a permanent establishment in Ethiopia pays the royalty, the resident deriving the royalty must self-withhold under Article 93(3)(a). Article 64(5) provides that the liability of a resident or non-resident for income tax under Article 54 is satisfied to the extent that the payer of the royalty withholds the tax payable from the amount of the royalty paid. A payer who fails to withhold tax as required under Article 90(1) is personally liable for the tax (Article 97(3)). Withholding tax is a “tax” for the purposes of TAP (Article 2(31) of TAP) and, therefore, any unpaid withholding tax can be recovered from the payer under the collection and recovery provisions in TAP.

Article 64(2) provides that the Article 54 tax is a final tax on the royalties.

55. Dividends

This Article provides for the imposition of income tax on domestic dividends.

Sub-article (1) provides that a resident of Ethiopia who has derived a dividend is liable for income tax at the rate of 10% of the gross amount of the dividend. "Resident of Ethiopia" is defined in Article 5(1) and "dividend" is defined in Article 2(6). Tax is imposed under the Article at the time the dividend is "derived" by the resident. Paragraph (b) of the Article 2(5) definition of "derived" provides that an amount is derived for the purposes of Article 55 when it is received. As tax is imposed on the gross amount of the dividend, no deductions are allowed for expenditures incurred by the resident in deriving the dividend.

Sub-article (2) provides that a non-resident deriving an Ethiopian source dividend that is attributable to a permanent establishment of the non-resident in Ethiopia is liable for income tax at the rate of 10% of the gross amount of the dividend. "Permanent establishment" is defined in Article 4 and "non-resident" is defined in Article 5(7). A dividend paid by a resident body (Article 5(5)) is an Ethiopian-source dividend under Article 6(4)(a). Article 51 applies to an Ethiopian-source dividend paid to a non-resident that is not attributable to an Ethiopian permanent establishment of the non-resident.

Article 64(1) provides there is no tax is payable under Schedule 'D' if:

(1) The dividend is subject to tax under another Schedule. This is relevant when the dividend is business income of the resident of Ethiopia or non-resident who has derived the dividend. Consequently, if the core business of the resident or non-resident is to derive dividends, the dividend is included in the business income of the resident and is taxable under Schedule 'C'. This would apply, for example,

to financial institutions as their business involves keeping a fund of liquid assets such as shares earning dividend income.

(2) The dividend is exempt income of the resident of Ethiopia deriving the dividend (see Schedule 'E').

The Article applies to a dividend derived by a resident of Ethiopia regardless of whether the dividend is Ethiopian source income or foreign income. If the dividend is foreign income and the resident has paid foreign tax (such as withholding tax) in respect of the dividend, Article 64(3) provides that the foreign tax is allowed as a credit against the Ethiopian tax payable on the dividend. However, the amount of the credit is not to exceed the Ethiopian tax payable in respect of the foreign-source dividend. It is noted that, as Ethiopian tax is imposed at the rate of 10%, there may be little or no Ethiopian tax paid in respect of foreign source dividends once the credit for foreign withholding tax is allowed. Any dividend that is not Ethiopian-source income is treated as foreign income (Article 6(5)). Thus, after taking account of Article 6(4)(a), a dividend paid by a non-resident body is foreign income.

The tax is collected through withholding. Article 90(2) obliges a resident body to withhold tax from a dividend subject to tax under Article 55 at the rate specified in Article 55 (i.e. 10%) from the gross amount of the dividend. If a non-resident body pays the dividend, the resident deriving the dividend must self-withhold under Article 93(3)(b). Article 64(5) provides that the liability of a resident or non-resident of Ethiopia for income tax under Article 55 is satisfied to the extent that the payer of the dividend withholds the tax payable from the amount of the dividend paid. A payer who fails to withhold tax as required under Article 90(2) is personally liable for the tax (Article 97(3)). Withholding tax is a "tax" for the purposes of TAP (Article 2(31) of TAP) and, therefore, any unpaid withholding tax can be recovered from the payer under the collection and recovery provisions in TAP.

Article 64(2) provides that the Article 55 tax is a final tax on the dividends.

56. Interest

This Article provides for the imposition of tax on domestic interest payments.

Sub-article (1) provides that a resident of Ethiopia who has derived interest is liable for income tax in respect of the interest. For interest paid on a savings account with a resident financial institution, the rate of tax is 5% of the gross amount of the interest. For all other interest receipts, the rate of tax is 10% of the gross amount of the interest.

"Resident of Ethiopia" is defined in Article 5(1) and "interest" is defined in Article 2(16). Tax is imposed under the Article at the time the interest is "derived" by the resident. Paragraph (b) of the Article 2(5) definition of "derived" provides that an amount is derived for the purposes of Article 56 when it is received. As tax is imposed on the gross amount of the interest, no deductions are allowed for expenditures incurred by the resident in deriving the interest.

Sub-article (2) provides that a non-resident deriving Ethiopian source interest that is attributable to a permanent establishment of the non-resident in Ethiopia is liable for income tax in respect of the interest. For interest paid on a savings account with a resident financial institution, the rate of tax is 5% of the gross amount of the interest. For all other interest receipts, the rate of tax is 10% of the gross amount of the interest.

"Permanent establishment" is defined in Article 4 and "non-resident" is defined in Article 5(7). Interest is Ethiopian-source interest under Article 6(4)(g) if it is paid by: (i) a resident of Ethiopia (other than as an expenditure of a business conducted by the resident through a permanent establishment outside Ethiopia); or (ii) a non-resident as an expenditure of a business conducted by the non-resident through a permanent establishment in Ethiopia. Article 51 applies to Ethiopian-source interest paid to a non-resident that is not attributable to an Ethiopian permanent establishment of the non-resident.

Article 64(1) provides there is no tax is payable under Schedule 'D' if:

(1) The interest is subject to tax under another Schedule. This is relevant when the interest is business income of the resident or non-resident who has derived the interest. Consequently, if the core business of a resident or non-resident is to derive interest, the interest is included in the business income of the resident or non-resident and is taxable under Schedule 'C'. This would apply, for example, to a financial institution or other person carrying on business as a moneylender.

(2) The interest is exempt income of the resident of Ethiopia deriving the interest (see Schedule 'E').

The Article applies to any interest derived by a resident of Ethiopia regardless of whether the interest is Ethiopian source income or foreign income. If the interest is foreign income and the resident has paid foreign tax (such as withholding tax) in respect of the interest, Article 64(3) provides that the foreign tax is allowed as a credit against the Ethiopian tax payable on the interest. However, the amount of the credit is not to exceed the Ethiopian tax payable in respect of the foreign source interest. It is noted that, as Ethiopian tax is imposed on foreign-source interest at the rate of 10%, there may be little or no Ethiopian tax payable in respect of foreign source interest once the credit for foreign withholding tax is allowed. Any interest that is not Ethiopian-source income is treated as foreign income (Article 6(5)). Thus, after taking account of Article 6(4)(g), the following interest payments are foreign income: (i) interest paid by a foreign permanent establishment of a resident of Ethiopia; or (ii) interest paid by a non-resident other than as an expenditure of an Ethiopian permanent establishment.

The tax is collected through withholding. Article 90(3) obliges a resident of Ethiopia or permanent establishment in Ethiopia of a non-resident to withhold tax from interest subject to tax under Article 56 at the rate specified in Article 56 (i.e. 5% or 10% as the case may be) from the gross amount of the interest. If a non-resident without a permanent establishment in Ethiopia pays the interest, the resident deriving the interest must self-withhold under Article 93(3)(a). Article 64(5) provides that the liability of a resident or non-resident for income tax under Article 56 is satisfied to the extent that the payer withholds the tax payable from the amount of the interest paid. A payer who fails to withhold tax as required under Article 90(3) is personally liable for the tax (Article 97(3)). Withholding tax is a "tax" for the purposes of TAP (Article 2(31) of TAP) and, therefore, any unpaid withholding tax can be recovered from the payer under the collection and recovery provisions in the TAP.

Article 64(2) provides that the Article 56 tax is a final tax on the interest.

57. Income from Games of Chance

This Article provides for the imposition of tax on a person who derives income from games of chance.

Sub-article (1) provides that a person who derives income from winning at games of chance held in Ethiopia is liable for income tax at the rate of 15% on the gross amount of the winnings. Sub-article (4) defines "games of chance" to mean a game whose outcome depends primarily on chance rather than the skill of the participant, including a lottery or tombola. Tax applies only in relation to games of chance held in Ethiopia. The tax is imposed on any person deriving income from a game of chance in Ethiopia whether a resident or non-resident.

Tax is imposed under the sub-article (1) at the time the winnings are "derived" by the person. Paragraph (b) of the Article 2(5) definition of "derived" provides that an amount is derived for the purposes of Article 57 when it is received.

Sub-article (2) makes it clear that no deduction is allowed for any loss incurred by the person from games of chance.

Sub-article (3) sets out a threshold for the application of tax under the Article. It is provided that no tax is payable when the winnings are less than 1,000 Birr.

The tax is collected through withholding. Article 91 obliges the person paying the winnings to withhold tax from gross amount of the winnings at the rate specified in Article 57 (i.e. 15%). Article 64(5) provides that the liability of a person for income tax under Article 57 is satisfied to the extent that the payer withholds the tax payable from the amount paid to the person. A payer who fails to withhold tax as required under Article 91 is personally liable for the tax (Article 97(3)). Withholding tax is a "tax" for the purposes of TAP (Article 2(31) of TAP) and, therefore, any unpaid withholding tax can be recovered from the payer under the collection and recovery provisions in TAP.

Article 64(2) provides that the Article 57 tax is a final tax on the winnings.

58. Income from Casual Rentals

This Article provides for the imposition of tax on a person who derives income from the casual rental of property.

Sub-article (1) provides that a person who derives income from the casual rental of property in Ethiopia shall be liable for income tax on the annual gross rental income at the rate of 15% of the gross amount of the rental income. Tax under sub-article (1) applies to the income from the casual rental of any property, such as land, buildings and movable property (such as furniture). Tax is imposed under the sub-article (1) at the time the rental income is "derived" by the person. Paragraph (b) of the Article

2(5) definition of "derived" provides that an amount is derived for the purposes of Article 58 when it is received.

No tax is payable under the Article if:

(1) The income is a royalty taxable under Article 51 or 54 (sub-article (2)). Paragraph (d) of the Article 2(20) definition of "royalty" includes an amount as consideration for the use of, or the right to use any industrial, commercial, or scientific equipment (such as an equipment lease rental). Article 51 applies to Ethiopian-source royalties paid to non-resident other than as income of an Ethiopian permanent establishment of the non-resident and Article 54 applies to royalties paid to residents of Ethiopia and Ethiopian permanent establishments of non-residents. Consequently, when the rent arising from the lease of movable property is both a royalty taxable under either Article 51 or 54, and rental income taxable under Article 58, priority is given to taxation under Article 51 or 54 (as the case may be).

(2) The income is exempt income of the person deriving the income (Article 64(1)(b)). Schedule 'E' lists income that is exempt income for the purposes of the ITP.

The tax payable under the Article is collected by assessment. A person liable for tax under the Article for a tax year must file a tax declaration on a transaction basis under Article 83(7). The tax declaration must be filed within two months after the date of the casual lease transaction. The tax payable for a casual lease transaction is due by the due date for filing the tax declaration in relation to the transaction (i.e. by the end of the second month after the casual lease transaction). A tax declaration filed under 83(7) is a self-assessment declaration (see the definition of "self-assessment declaration" in Article 2(29) of TAP). Consequently, tax payable under the Article is a self-assessed liability.

Article 64(2) provides that the Article 58 tax is a final tax on the rent.

59. Gains on Disposal of Certain Investment Property

This Article provides for the imposition of tax on a person who has made a gain on disposal of immovable property, shares, or bonds.

Sub-article (1) provides that a person who derives a gain on the disposal of immovable property, shares, or bonds (referred to as a "taxable asset') is liable to pay income tax on the amount of the gain. Sub-article (7) provides that the reference to "immovable property" does not include a building that is held and wholly used as a private residence for 2 years prior to the disposal of the building. Thus, a person is not liable for tax under the Article on the disposal of their private residence provided that the 2-year holding period is satisfied. In other respects, "immovable property" has its ordinary meaning under the law of Ethiopia. "Disposal" is defined in Article 67. In the ordinary case, there is a disposal of a taxable asset when there has been a transfer of the legal title to the asset.

Sub-article (1) applies to both residents of Ethiopia and non-residents. In the case of a non-resident, a gain is taxable only if the gain is Ethiopian source income (Article 7(2)). The following gains are Ethiopian source income:

(1) A gain on disposal of immovable property located in Ethiopia (Article 6(4)(c)(1)).

(2) A gain on disposal of a membership interest in a body (wherever resident), if more than 50% of the value of the interest is derived, directly or indirectly through one or more interposed bodies, from immovable property located in Ethiopia (Article 6(4)(c)(2)). "Body" is defined in Article 2(5) of TAP, and "membership interest" is defined in Article 2(21) of TAP.

(3) A gain on disposal of shares in a resident company (Article 6(4)(c)(3)). By virtue of Article 5(5) and (6), a resident company is a company that: (i) is incorporated in Ethiopia; or (ii) has its place of effective management in Ethiopia.

(4) A gain on disposal of bonds issued by a resident company (Article 6(4)(c)(3)). By virtue of Article 5(5) and (6), a resident company is a company that: (i) is incorporated in Ethiopia; or (ii) has its place of effective management in Ethiopia.

Taxable assets are divided into two classes. Class 'A' taxable assets comprise immovable property (see sub-article (7)(b)) and Class 'B' taxable assets comprise shares and bonds (see sub-article (7)(c)).

Sub-article (2) provides that the rate of income tax applicable to a gain on disposal of a Class 'A' taxable asset is 15% and the rate of income tax applicable to a gain on disposal of a Class 'B' taxable asset is 30%.

Article 64(1) provides there is no tax is payable under Schedule 'D' if the gain is exempt income of the person deriving the gain (see Schedule 'E').

Sub-article (3) provides for the calculation of the amount of the gain on disposal of a taxable asset by a person. The gain is calculated as the amount by which the consideration for the disposal of the asset exceeds the cost of the asset at the time of disposal. "Consideration" is defined in Article 70 and "cost" is defined in Article 68.

Sub-article (4) provides for the recognition of losses on disposal of taxable assets. This will be particularly relevant for shares as the market price may increase or decrease depending on the performance of the company. A loss made by a person on disposal of a taxable asset during a tax year is offset against gain made on disposal of a taxable asset of the same class during the year. Consequently, a loss on disposal of a Class 'A' asset can be offset only against a gain on disposal of a Class 'A' asset, and a loss on disposal of a Class 'B' asset may be offset only against a gain on disposal of a Class 'B' asset. Sub-article (5) provides for the calculation of the amount of the loss on disposal of a taxable asset by a person. The loss is calculated as the amount by which the cost of the asset at the time of disposal exceeds the consideration for the disposal. "Cost" is defined in Article 68 and "consideration" in Article 70.

The availability of the offset is subject to the following conditions:

(1) A person may offset a loss on disposal of a taxable asset only against a gain made on disposal of a taxable asset of the same class under the Article (sub-article (4)(a)). Thus, a loss cannot be offset against a gain on disposal of a business asset taxable under Schedule 'C' (see Article 21(1)(b)). In other words, there is quarantining of losses on investment assets. However, the unused amount of a loss can be carried forward indefinitely until fully used to offset gains on disposal of taxable assets of the same class (sub-article (4)(b)).

(2) No loss is recognised on the disposal of a taxable asset by a person to a related person (sub-article (4)(c)). This is an integrity measure intended to prevent the artificial creation of losses through related party transactions to offset against gains taxable under the Article. "Related person" is defined in Article 4 of TAP.

(3) The person has substantiated the amount of the loss to the satisfaction of the Authority (sub-article (4)(d)).

Sub-article (6) provides that the tax-free reorganisation rule in Article 35 applies also to the disposal of a taxable asset that is also a business asset.

The tax payable under the Article is collected by assessment. A person liable for tax under the Article for a tax year must file a tax declaration on a transaction basis under Article 83(7). The tax declaration must be filed within two months after the date of the disposal transaction. The tax payable for a tax year is due by the due date for filing the tax declaration for the disposal transaction (i.e. by the end of the second month after the date of the disposal transaction (Article 84(3)). A tax declaration filed under 83(7) is a self-assessment declaration (see the definition of "self-assessment declaration" in Article 2(29) of TAP). Consequently, tax payable under the Article is a self-assessed liability.

60. Windfall Profit

This Article provides for the imposition of tax on the windfall profits from business.

Sub-article (1) provides that a person deriving a windfall profit from the conduct of a business is liable for tax at the rate specified in a Directive issued by the Minister. "Windfall profit" is defined in sub-article (4) to mean any unearned, unexpected or other non-recurring gain.

Sub-article (2) provides that the Directive may provide for the following: (i) the amount of income considered to be a windfall profit; (ii) the businesses that are subject to tax on windfall profits; (iii) the date on which the tax imposed under the Article comes into effect; and (iv) the manner in which the tax is assessed and other matters relating to the administration of the tax.

Sub-article (3) provides that the Minister may prescribe different amounts of windfall profit and different rates of tax for different types of businesses.

61. Undistributed profit

This Article provides for the imposition of tax on the undistributed profits of a body.

Tax is imposed at the rate of 10% on the after-tax undistributed profits of a body to the extent the after tax profits have not been reinvested by the body. "Body" is defined in Article 2(5) of TAP.

The details of the tax will be provided in a Directive issued by the Minister.

62. Repatriated Profit

This Article provides for a tax on the repatriated profits of an Ethiopian permanent establishment of a non-resident.

Sub-article (1) imposes tax on a non-resident with a permanent establishment in Ethiopia at the rate of 10% of repatriated profits of the permanent establishment (defined in Article 4).

Sub-article (2) provides that the mode of application of the tax will be provided for in Regulations issued by the Council of Ministers.

63. Other Income

This Article provides for the imposition of tax on a person who has derived income not otherwise taxable under the ITP. In other words, the Article provides for taxation of a residual category of income.

The Article provides that a person who derives any income that is not taxable under Schedule ‘A’, ‘B’, ‘C’, or the other Articles of Schedule ‘D’ is liable for income tax at the rate of 15% on the gross amount of the income. Tax is imposed under the Article at the time the income is “derived” by the person. Paragraph (b) of the Article 2(5) definition of “derived” provides that an amount is derived for the purposes of Article 63 when it is received.

The Article applies to both residents of Ethiopia and non-residents. In the case of a non-resident, income is taxable only if the income is Ethiopian source income (Article 7(2)). Article 6 provides rules for determining the source of income. Article 6(4)(g) provides that income not mentioned elsewhere in Article 6 is Ethiopian-source income if it is paid by: (i) a resident of Ethiopia (other than as an expenditure of a business conducted by the resident through a permanent establishment outside Ethiopia); or (ii) a non-resident as an expenditure of a business conducted by the non-resident through a permanent establishment in Ethiopia.

"Income" is defined in broad terms in Article 2(14) to mean every form of economic benefit, including non-recurring gains in cash or kind, from whatever source derived and in whatever form paid, credited, or received.

Article 64(1)(b) provides that no tax is payable under Schedule 'D' if the income is exempt income of the person deriving the income (see Schedule 'E').

The tax payable under the Article is collected by assessment. A person liable for tax under the Article for a tax year must file a tax declaration on a transactional basis. The tax declaration must be filed within two months after the date of the transaction that gives rise to the income (Article 83(7)). The tax payable for a tax year is due by the due date for filing the tax declaration for the transaction (i.e. by the end of the second month after the date of the transaction (Article 84(3)). A tax declaration filed under 83(7) is a self-assessment declaration (see the definition of "self-assessment declaration" in Article 2(29) of TAP). Thus, tax payable under the Article is a self-assessed liability.

64. General Provisions Relating to Schedule 'D' Income

This Article provides for general rules applicable to items of income taxable under Schedule 'D'.

Sub-article (1) provides that no tax is payable under Schedule 'D' if:

(1) The income is subject to tax under another Schedule (sub-article (1)(a)). Consequently, an amount that may be taxable under both Schedule 'D' and either Schedule

'A' (employment income), Schedule 'B' (rental income), or 'C' (business income) is taxable only under Schedule 'A', 'B', 'C', as the case may be. Thus, sub-article (1)(a) operates as a reconciliation rule giving priority to taxation under Schedules 'A', 'B', and 'C'. For example, interest derived by a resident financial institution may be both business income taxable under Schedule 'C' and interest taxable under Article 56. The effect of sub-article (1)(a) is that the interest is taxable under Schedule 'C'.

(2) The income is exempt income of the person deriving the income. Items of exempt income are listed in Schedule 'E'.

Sub-article (2) provides that tax imposed on income under Schedule 'D' is a final tax on the income. Consequently, the income is not aggregated with any other income of the person deriving the income. Further, the liability of a taxpayer for income tax under Articles 51, 52, 53, 54, 55, 56, and 57 is discharged if a withholding agent has withheld the tax from the income in accordance with Part Ten. The Authority can rely on the powers in Part Seven of TAP for the recovery of unpaid withholding tax.

Sub-articles (3) and (4) provide double tax relief to a resident of Ethiopia deriving a foreign source royalty, dividend, interest, gain on disposal of a taxable asset, or income subject to tax under Article 63. Such income is foreign income if it is not Ethiopian-source income under Article 6 (see Article 6(5)). Sub-article (3) provides a tax credit for any foreign tax paid in respect of the foreign income. The credit is allowed on an item-by-item of income and sub-article (4) provides that there is no carry forward of any unused foreign tax under sub-article (3). This means that any unused foreign tax credit is lost.

65. Exempt Income

This Article lists amounts that are exempt income for the purposes of the ITP. The Article applies for the purposes of Schedules 'A' – 'D'.

Sub-article (1) provides that the following amounts are exempt income for the purposes of the ITP:

(1) An amount paid by an employer to an employee to cover the actual cost of medical treatment of the employee (sub-article (1)(a)(1)).

(2) An allowance provided by an employer to an employee in lieu of means of transportation granted under a contract of employment (sub-article (1)(a)(2)). The amount of the allowance treated as exempt income is subject to any limitation provided for in a Directive issued by the Minister.

(3) A hardship allowance provided by an employer to an employee (sub-article (1)(a)(3)). A hardship allowance is an additional amount paid to an employee to compensate the employee for working in difficult conditions. The difficult conditions may relate, for example, to the dangerous nature of the work or the remoteness of the location of the workplace. The amount of the hardship allowance treated as exempt income is subject to any limitation provided for in a Directive issued by the Minister.

(4) Transport expenses and per diem payments made by an employer to an employee travelling for the purposes of employment (sub-article (1)(a)(4)). The amount transport expenses and per diem treated as exempt income is subject to any limitation provided for in a Directive issued by the Minister.

(5) Travelling expenses paid by an employer to an employee recruited from place other than the place of employment on joining or completion of employment (sub-article (1)(a)(5)). The exemption applies in relation to travelling expenses incurred both in Ethiopia and overseas. For example, it can apply to an employee required to relocate to a new place of employment in Ethiopia. In the case of a foreign employee relocating to Ethiopia, the exemption

applies to travel expenses from and to their country of origin. Travelling expenses are exempt only if they are paid pursuant to specific provisions of the employee's contract of employment.

(6) The value of food and beverages provided for free to an employee by an employer conducting a mining, manufacturing, or agricultural business (sub-article (1)(a)(6)).

(7) Allowances paid by the Ethiopian Government to an employee engaged in public service for the Government in a foreign country (sub-article (1)(a)(7)). The purpose of the allowance is to compensate diplomats and other Government officials posted abroad for the higher cost of living in the country of the posting. While the main class of employee to which the exemption applies will be Ethiopian diplomats and consular officials in foreign missions, the exemption applies to any Government employee posted abroad. For example, it will apply to Customs officials posted to the port in Djibouti, and to trade officials posted abroad.

(8) Allowances paid to members and secretaries of boards of public enterprises, public bodies, or study groups established by the Federal or State Government, or a City administration (sub-article (1)(b)).

(9) A contribution by an employer to a pension, provident, or other retirement fund for the benefit of an employee provided the monthly total of contributions paid in respect of the employee does not exceed 15% of the monthly employment income of the employee (sub-article (1)(c)).

(10) A pension but only to the extent that the pension is exempt from tax under the Public Servants Pension Proclamation or the Private Organisation Employees Pension Proclamation (sub-article (1)(d)).

(11) An amount derived by the Federal, or a State or Local Government of Ethiopia, or the National Bank of Ethiopia, from activities that are incidental to official government operations (sub-article (1)(e)).

(12) An amount that is exempt from tax under an international agreement, but only to the extent provided for under the agreement (sub-article(1)(f)). "International agreement" is defined in Article 2(14) of TAP. The definition of international agreement has two inclusions. First, it includes an agreement between the Government of Ethiopia and a foreign government or governments. A tax treaty is an example of such an international agreement. A tax treaty may exclude a taxing right asserted under the ITP thereby resulting in the income being treated as exempt income. For example, Ethiopia's jurisdiction to tax the business income of a non-resident may be excluded by a tax treaty because the treaty definition of "permanent establishment" may be narrower than the definition in Article 4.

Second, the definition of "international agreement" includes an agreement between the Government of Ethiopia and an international organisation. "International organisation" is defined in Article 2(15) of TAP to mean an organisation the members of which are sovereign States or the Governments of States. Examples of an international organisation are the African Development Bank and the United Nations and its Specialised Agencies such as the IMF and World Bank. For example, the United Nations Convention on the Privileges and Immunities of the Specialised Agencies includes exemptions from tax for the Specialised Agency and officials of the Agency. Similarly, the Vienna Convention on Diplomatic Relations includes exemptions from tax for diplomats and consular staff.

(13) An amount that is exempt from tax to the extent provided for under a provision (referred to as an "exemption

provision") in an agreement entered into by the Government of Ethiopia when the following conditions are satisfied: (i) the agreement is for the provision of financial, technical, humanitarian, or administrative assistance to the Government; and (ii) the Minister of Finance and Economic Cooperation has concurred, in writing, with the exemption provision (sub-article (1)(g)).

Importantly, the exemption is limited to agreements for the provision of assistance to the Government of Ethiopia. The exemption does not apply to exemption provisions in other agreements with the Government, such as a normal commercial agreement for the supply of goods to the Government.

(14) A public award for outstanding performance in any field or an award granted under Article 135 of TAP (sub-article (1)(h)). An award for outstanding performance is exempt income only if it is a "public" award. The exemption does not apply to private awards, such as may be provided by an employer to an employee for outstanding work by the employee.

Article 135 of TAP provides for a reward paid to a tax officer for outstanding performance or a taxpayer for exemplary discharge of his or her tax obligations. It also provides that the Minister shall provide details of a reward under this article by Directive.

(15) An amount as compensation for personal injury or the death of another person (sub-article (1)(i)). The reference to compensation for the death of another person would cover, for example, a death gratuity paid by an employer to the family of an employee who was killed in a work accident.

(16) A cash amount, or the value of property, acquired by gift or inheritance, other than a gift that is employment, rental, or business income (sub-article (1)(j)). This is subject to the

application of Article 59 to a subsequent disposal of any gifted property that is a taxable asset. The exemption does not apply if the gift is properly characterised as employment, rental, or business income. For example, a wedding present provided by an employer to an employee would be exempt income, but a gratuitous bonus payment by an employer to an employee for good performance would be characterised as employment income.

(17) A scholarship or bursary for attendance at an educational institution (sub-article (1)(k)). The terms “scholarship” and “bursary” are not defined and, therefore, have their ordinary meaning, namely an amount provided gratuitously to provide financial support for the purposes of study. An amount is not within the ordinary meaning of scholarship or bursary if there is an obligation on the recipient to provide services to the donor. The exemption is based on social policy reasons.

(18) Maintenance or child support payments (sub-article (1)(l)). These payments are considered a personal expenditure of the payer and, accordingly, the payer is not allowed a deduction for the payment (see Article 27(1)(l)). As these payments are made on a periodic basis, they may be characterised as ordinary income and taxed under Article 63 to the recipient. If these payments are taxable to the recipient but non-deductible to the payer, then the income used by the payer to make the payment is, in effect, double taxed. For this reason, these payments are treated as both non-deductible and non-assessable (i.e. exempt income). This also replicates the tax position of intra-family payments made within marriage.

(19) The income of a non-profit organisation other than business income that is not directly related to the core function of the organisation (sub-article (1)(m)).

As an integrity measure to prevent abuse, the exemption does not apply to business income that is not directly related to the core function of the organisation. The determination of whether a business activity of a non-profit organisation is directly related to the core function of the organisation is a question of fact and degree determined having regard to all the circumstances. For example, a religious bookshop conducted by a religious organisation would ordinarily be directly related to the core function of the organisation, but a petrol station operated by such organisation would most likely not be so directly related.

(20) A cash indemnity allowance paid by an employer to an employee, but only to the extent that the allowance compensates the employee for shortfalls on money counts (sub-article (1)(n)). A cash indemnity allowance is paid to an employee to compensate them for any shortfall in money counts that they have to make up. The exemption is based on the notion that the allowance is actually making up for a loss and, therefore, is not income.

It is understood that, in practice, a record is kept throughout the year of each employee's shortfalls and, at the end of the year, an employee's allowance is applied against the total shortfall for the year. If the allowance exceeds an employee's total shortfall, the excess is paid to the employee. In this case, the excess is income. For this reason, the exemption applies only to the extent that the allowance compensates an employee for shortfalls on money counts.

(21) An amount that is specifically exempted from income tax under a law in force in Ethiopia (sub-article (1)(o)).

(22) Salary paid to domestic servants (sub-article (1)(p)).

(23) A payment made by a contractor engaged in petroleum operations to a sub-contractor (sub-article (1)(q)). The exemption applies only to payments to sub-contractors in the petroleum sector (and not the mining sector).

Sub-article (2) empowers the Council of Ministers to make Regulations for the exemption of any income for economic, administrative, or social reasons.

66. Acquisition of an Asset

This Article sets out when a person acquires an asset for the purposes of the ITP. It is relevant to the taxation of business assets under Schedule 'C' and taxable assets under Schedule 'D'.

A person acquires an asset when legal title to the asset passes to the person. This is consistent with the basic rule in Article 67(1), which provides that a person disposes of an asset when the person has sold, exchanged, or otherwise transferred legal title to the asset. In the ordinary case, a change in ownership of an asset through transfer of legal title will result in both a disposal and acquisition of the asset. Thus, in the case of a sale of an asset, the sale results in the seller disposing of the asset and the buyer acquiring the asset.

In the case of an asset that is a right or option, it is provided that a person acquires the asset when the right or option is granted to the person. "Right" and "option" are intended to have their normal legal meanings. The reference to "right" is a reference to any right recognised by law. The main example is a right granted by contract, but will also include a property right, such as an easement or lease.

Example 1

X Co is the manufacturer of a popular children's toy. X Co has entered into a contract with Addis appointing Addis as the exclusive distributor of the toy in Ethiopia for five years. Addis pays X Co 1,000,000 birr as consideration for the appointment. Addis' contractual rights are a business asset for the purposes of the ITP. Article 66 provides that Addis acquires the rights (i.e.

asset) when they are granted, i.e. when the contract is entered into.

An option is a contract that gives the holder a right to trade in a particular asset (such as shares, commodities, or immovable property) on a future date at a pre-agreed price. An option may be a "put" option under which the holder of the option has the right (but not an obligation) to sell property at a pre-agreed price or a "call" option under which the holder of the option has the right (but not an obligation) to buy property at a pre-agreed price. Options are often used to reduce trading risk.

Example 2

X Co is the owner of commercial premises. X Co grants A Co an option to purchase the premises for 10,000,000 birr. The option must be exercised within 2 years of grant and A Co pays X Co 100,000 birr as consideration for the option. This reflects the value to A Co of the option as it gives A Co an exclusive right to purchase the premises within the 2-year period. The option is a "call" option as A Co has a right (but not an obligation) to purchase the premises for a pre-agreed price within two years of grant (i.e. A Co can call upon X Co to transfer the property to A Co). The option is a business asset of A Co for the purposes of the ITP. Article 66 provides that A Co acquires the option (i.e. asset) when it is granted, i.e. when the contract is entered into.

A company that wishes to raise capital through an additional issue of shares will often grant existing shareholders an option to acquire further shares in the company. Similarly, as an incentive to employees, a company may grant options over shares in the company to employees under an employee share scheme (Article 66).

The acquisition rule for rights and options in this Article is consistent with the deemed disposal rule in Article 67(2). Thus, on the grant of a right or option, the grantor is treated as having disposed of the right or option (Article 67(2)) and the grantee is treated as having acquired the right or option.

67. Disposal of an Asset

This Article sets out when a person has disposed of an asset for the purposes of the ITP. The gain and loss rules in Articles 21(1)(b) and 22(1)(d) (business assets), and Article 59(3) and (4) (taxable assets), apply only when there has been a disposal of an asset.

The basic rule is in sub-article (1). Sub-articles (2)-(5) deal with special cases. Sub-article (1) provides that a person has disposed of an asset when the person has sold, exchanged (such as a barter transaction), or otherwise transferred legal title to the asset (such as by way of a gift). Sub-article (1) treats the loss or destruction of an asset (for example, as a result of a fire) as a disposal of the asset. When the asset is an intangible asset (such as a contractual right), sub-article (1) treats the asset as disposed when cancelled, redeemed, relinquished, or surrendered, or when the asset otherwise expires (such as the expiration of a licence).

Sub-article (2) applies when a person creates an asset in another person being an asset that the first-mentioned person did not own before it was created in the second-mentioned person. In this case, the first-mentioned person who created the asset is treated as having made a disposal of the asset to the second-mentioned person. An example of when sub-article (2) applies is the grant of a right or option. As discussed above, the right or option is an asset acquired by the recipient. The right or option is created by contract. Consequently, the right or option is not an asset that the grantor owns and then transfers to the grantee and, therefore, is not covered by sub-article (1). Sub-article (2) treats the grantor as having made a disposal of the right or option to the grantee at the time that the option is created.

Example 1

Assume the same facts as in Example 1 in the technical notes on Article 66. As stated above, the contractual rights are an asset and Addis acquires the asset on entering into the contract. From X Co's perspective, the contractual rights do not exist prior to the entering into of the distribution contract. Thus, X Co has created an asset (the contractual rights) in Addis being an asset that did not exist before the entering into of the distribution contract. Consequently, the contractual rights are an example of the application of Article 67(2).

Example 2

Assume the same facts as in Example 2 in the technical notes on Article 66. As stated above, the option is an asset and A Co acquires the asset on entering into the option contract. From X Co's perspective, the option did not exist prior to the entering into of the option contract. Thus, X Co has created an asset (the option) in A Co being an asset that did not exist before the entering into of the option contract. Consequently, the option is an example of the application of Article 67(2).

Sub-article (3) provides that the disposal of an asset by succession or under a will occurs at the time the asset is transmitted.

Sub-article (4) provides that a disposal includes the disposal of a part of an asset. This may include a physical separation and disposal (for example, a subdivision of a building) or any other part disposal possible in law such as a temporal disposal (for example, the grant of a right to property for a specified period).

Sub-article (5) applies when an asset of a person (referred to as the “owner”) is vested in a liquidator, trustee-in-bankruptcy, or receiver. It is provided that the vesting of the asset is not a disposal of the asset for the purposes of the ITP, and the acts done in relation to the asset by the liquidator, trustee-in-bankruptcy, or receiver are treated as having been done by the owner. This means that there is no separate disposal in relation to the taking of possession of the asset by the liquidator, trustee-in-bankruptcy, or receiver.

68. Cost of an Asset

This Article sets out the rules for determining the cost of assets for the purposes of the ITP. The Article is relevant in determining the amount of the gain or loss on disposal of a business asset under Articles 21(1)(b) and 22(1)(d), and on disposal of a taxable asset under Article 59(3) and (4). A gain on disposal of a business asset is calculated as the consideration for the disposal less the net book value of the asset at the time of disposal (Article 21(3)). A loss on disposal of a business asset is calculated as the net book value of the asset at the time of disposal less the consideration for the disposal (Article 22(3)). The cost of a business asset is the starting point in computing the net book value of an asset at the time of disposal (Article 69). A gain on disposal of a taxable asset is calculated as the consideration for the disposal less the cost of the asset at the time of disposal (Article 59(3)). A loss on disposal of a taxable asset is calculated as the cost of the asset at the time of disposal less the consideration for the disposal (Article 59(5)).

The basic rule is in sub-article (1), which provides that the cost of an asset is the sum of the following amounts:

(1) The total consideration given by the person for the asset (sub-article (1)(a)). This includes the fair market value

(Article 3 of TAP) of any consideration given in kind. The fair market value is determined at the time the asset was acquired (see Article 66). If the asset is constructed, produced, or developed (rather than purchased), the cost of the asset includes the cost of construction, production, or development.

(2) The total amount of any incidental expenditure incurred in acquiring or disposing of the asset (sub-article (1)(b)). Examples of incidental expenditure include professional fees (such as for the services of an agent, lawyer, valuer, auctioneer, or surveyor), and advertising costs (particularly on disposal).

(3) The total expenditure incurred to install, alter, renew, reconstruct, or improve the asset (sub-article (1)(c)).

Example

Serkalem purchased a warehouse for 5,000,000 birr and, in relation to the purchase, incurred 20,000 birr in legal fees. After two years, Serkalem adds another storeroom onto the premises for a cost of 500,000 birr. Serkalem then sells the warehouse. At the time of sale, the cost of the warehouse is 5,520,000 birr being the sum of:

* The purchase price (5,000,000 birr) (sub-article (1)(a)).

* The legal fees relating to the purchase (20,000 birr) (sub-article (1)(b)).

* The cost of the capital improvement (500,000 birr) (sub-article (1)(c)).

Sub-article (2) provides for the cost of a business intangible. Sub-article (2)(a) provides that the cost of a business intangible under Article 25(7)(a)(1)-(3) (such as an industrial or intellectual property right, or a contractual right) is the total expenditure incurred in acquiring, creating, improving, or renewing the business intangible, and any incidental expenditure incurred in acquiring or disposing of the business intangible.

Example

Assume the same facts as in Example 1 in the technical notes to Article 66. Addis' rights under the contract are a business intangible within Article 25(7)(a)(3) of the definition and the cost of the intangible is 1,000,000 birr.

For a business intangible within Article 25(7)(a)(4) definition (i.e. expenditure that provides an advantage or benefit to the business of more than one year but which does not involve the acquisition of any asset), sub-article (2)(b) provides that the cost of the business intangible is the amount of the expenditure.

Sub-article (3) applies to an asset acquired by way of gift. It is provided that the cost of the asset is the fair market value of the asset at the time of acquisition (determined under Article 66). The fair market value of an asset is determined under Article 3 of TAP. This aligns with the consideration rule for gifts under Article 70(2).

Sub-article (4) provides that the cost of a business asset does not include any amount that is allowed as a deduction under the ITP, such as article 22(1)(a) (ordinary business expenses). Consequently, for example, an amount that is both deductible under Article 22(1)(a) and includible in the cost of a business asset under sub-article (1) or (2) is treated as a deductible expenditure. This is particularly relevant to the incidental expenditures of acquiring and disposing of an asset, as these expenditures may be deductible under the general principle in Article 22(1)(a). Sub-article (4) ensures that a person does not obtain a double benefit, i.e. both a deduction for an expenditure and inclusion of the amount of the expenditure in the cost of a business asset.

Sub-article (5) provides that the cost of an asset includes any amount given for the grant of an option to acquire the asset.

Example

Assume the same facts as in Example 1 in the technical notes to Article 66. If A Co exercises the option, then A CO has paid two amounts to acquire the commercial premises: (i) the exercise price of 10,000,000 birr; and (ii) the option price of 100,000 birr. Consequently, the acquisition cost of the premises is 10,100,000 birr, being the sum of the option price and the exercise price.

If X Co decides not to exercise the option and the option expires, then X Co has made a loss equal to the option price of 100,000 birr on expiration (i.e. disposal) of the option.

Sub-article (6) provides that the cost of an asset of a person is not reduced by an impairment write down in relation to the asset made in the financial accounts of the person. An "impairment write down" is the write down of the value of an asset in the financial accounts of a taxpayer because the fair market value of the asset is less than the cost of the asset. This is particularly relevant to intangible assets, such as goodwill. The effect of sub-article (6) is that the financial accounting rule requiring the write down of the value of impaired assets does not apply for the purposes of tax. Consequently, any loss in value in an intangible asset is recognised for tax purposes only on disposal of the asset.

Sub-article (7) applies to part disposals and provide for apportionment of the original cost of the undivided asset between the divided parts in proportion to the fair market value (see Article 3 of TAP) of the parts at the time of the asset's acquisition (see Article 66). Other criteria, such as the relative size of the parts, are not relevant to this apportionment.

Sub-article (8) excludes from the cost of an asset of a person any grant, subsidy, rebate, commission, or other assistance received or receivable by the person in respect of the acquisition of the asset unless the amount is included in the person's income taxable under the ITP.

Sub-article (9) empowers the Council of Minister to make regulations to provide further rules for determining the cost of an asset.

69. Net Book Value of a Business Asset

This Article sets out rules for determining the net book value of a business asset for the purposes of the ITP. It is relevant in computing the gain or loss arising on disposal of a business asset. A gain on disposal of a business asset is calculated as the consideration for the disposal less the net book value of the asset at the time of disposal (Article 21(3)). A loss on disposal of a business asset is calculated as the net book value of the asset at the time of disposal less the consideration for the disposal (Article 22(3)).

Sub-article (1) provides that the net book value of a business asset is the cost of the asset reduced by any depreciation deductions allowed in respect of the asset.

Example 1

ABC Plc acquires an item of plant on 1 July 2017 for 1,000,000 birr. The effective life of the plant for financial accounting purposes is 5 years and ABC uses straight-line depreciation in its financial accounts. Thus, the annual depreciation rate is 20% straight-line. The plant is used in ABC's business for the 2017/2018 and 2018/2019 tax years and ABC claims a depreciation deduction for those years under Article 22(1)(c) as calculated in accordance with Article 25. The amount of the depreciation deduction is 200,000 birr (1,000,000 birr x 20%) for each year. At the end of the 2018/2019 tax year, the net book value of the plant is 600,000 birr (1,000,000 birr - 400,000 birr). This recognises the fact that 400,000 birr of the cost of the plant has been allowed as deduction under the depreciation provisions.

If a business asset has been used partly to derive business income and partly for some other purpose (such as a private purpose or to derive exempt income), the reduction in cost in calculating the net book value of the asset is the full decline in value calculated without taking account of the deduction adjustment in Article 25(4).

Example 2

Assume the same facts as in Example 1 except that ABC Plc uses the plant 75% of the time to derive business income and 25% of the time to derive exempt income. The effect of Article 27(4) is that the depreciation deduction allowed for each year is only 150,000 birr (200,000 birr x 75%). However, the net book value of the asset is calculated by reference to the full decline in value. Thus, the net book value is still 600,000 birr.

Sub-article (1) applies to all business assets. However, if the business asset is not a depreciable asset or business intangible, the net book value of the asset is equal to the asset's cost determined under Article 68.

Sub-article (2) applies when a person disposes of part only of a business asset and Article 68(7) applies to allocate the cost of the asset between the part disposed of and the part retained.

In this case, the net book value of the part of the asset disposed of is the cost of allocated to the disposed asset reduced by the depreciation deductions related to the allocated cost.

70. Consideration for the Disposal of an Asset

This Article sets out the rules for determining the consideration for the disposal of an asset. The Article is relevant mainly in computing the gain or loss arising on disposal of a business asset under Articles 21(1)(b) and 22(1)(d), and on disposal of a taxable asset under Article 59(3) and (4). A gain on disposal of a business asset is calculated as the consideration for the disposal less the net book value of the asset at the time of disposal (Article 21(3)). A loss on disposal of a business asset is calculated as the net book value of the asset at the time of disposal less the consideration for the disposal (Article 22(3)). A gain on disposal of a taxable asset is calculated as the consideration for the disposal less the cost of the asset at the time of disposal (Article 59(3)). A loss on disposal of a taxable asset is calculated as the cost of the asset at the time of disposal less the consideration for the disposal (Article 59(5)).

Sub-article (1) sets out the basic rule that the consideration for the disposal of an asset by a person is the total amount received or receivable by the person for the asset including the fair market value of any consideration received in kind. The fair market value of consideration in kind is determined under Article 3 of TAP at the time of disposal (as determined under Article 67).

Sub-article (2) applies when a person disposes of an asset by way of gift. In this case, sub-article (2) provides that the consideration for the disposal is the fair market value of the asset at the time of disposal determined under Article 67. The fair market value of an asset is determined under Article 3 of TAP. Sub-article (2) does not apply to a gift of an asset by way of a donation to an Ethiopian charity or Ethiopian Association. In this case, the consideration will be zero.

Sub-article (3) provides that the consideration for the disposal of an asset by a person includes the consideration for the grant of an option in relation to the asset by the person but only if the person has not been subject to tax in respect of any gain made on the grant of the option. An option over a business asset is itself a business asset and, therefore, the grant of the option will give rise to a gain equal to the option price (less any incidental costs in granting the option). Sub-article (3) ensures that the option price is not taxed again as part of the consideration for the business asset to which option relates.

Example

A grants B an option to acquire commercial premises owned by A that has a net book value of 2,000,000 birr. The exercise price under the option is 5,000,000 birr and the price paid for the option is 250,000 birr. B subsequently exercises the option.

A has made two gains:

(1) A capital gain of 250,000 birr on grant of the option. The consideration received is 250,000 birr and there is zero cost.

(2) A capital gain of 3,000,000 birr on disposal of the commercial premises. The consideration received is 5,000,000 birr and net book value is 2,000,000.

As the gain on grant of the option is separately included in business income, the consideration received for the option is not included as part of the consideration received for the commercial premises.

Sub-article (4) applies when the disposal of an asset is as result of the asset being lost or destroyed (see Article 67(1)). In this case, the consideration for the disposal of the asset includes any compensation, indemnity or damages received or receivable as a result of the loss or destruction of the asset. This includes amounts paid under an insurance policy, as a result of a settlement of a lawsuit, or under a judicial decision. In the absence of sub-article (4), a person might argue that the amounts were received because of the insurance policy, judicial decision, or settlement and not the disposal of the asset. Sub-article (4) looks through the intermediate stage and treats the amounts as received or receivable in consequence of the loss or destruction of the asset that gave rise to a right to payment under the insurance policy, judicial decision, or settlement.

Example

A Plc is the owner of an item of plant that cost 1,000,000 birr. The plant is completely destroyed by a fire. The plant is treated as disposed of under Article 67(1). The plant was insured and A Plc receives 1,000,000 birr pay-out under the insurance policy from the insurance company. The insurance payment is treated as the consideration received for the disposal of the plant.

Sub-article (5) requires a person to apportion any undivided consideration received or receivable in respect of two or more assets disposed of in a single transaction in proportion to their respective fair market values (see Article 3 of TAP) determined at the time of the disposal (see Article 67).

Sub-article (6) applies when a taxpayer is unable to provide documentary evidence of the consideration received or receivable for the disposal of an asset. In this case, the consideration is the fair market value of the asset at the time of disposal. The fair market value of an asset is determined under Article 3 of TAP and the time of disposal is determined under Article 67.

71. Deferral of Recognition of Gain or Loss

This Article specifies four cases when the recognition of a gain or loss arising on an actual disposal of an asset is deferred until a later time.

The first case is when an asset is transferred between spouses as part of a divorce settlement (sub-article (1)(a)). While the transfer of the asset is a "disposal" (as there is a change in ownership of the asset (Article 67)), the transfer is ignored for all purposes the ITP. Importantly, the deferral rule applies only when the transfer is part of a divorce settlement. The normal operation of the ITP applies to other transfers of assets between spouses. Further, sub-article (2) provides that sub-article (1)(a) does not apply if the recipient spouse is not subject to tax under the ITP in respect of a subsequent disposal of the asset. This may happen, for example, when the recipient spouse is either: (i) exempt from tax generally; or (ii) not taxed in respect of the particular asset (i.e. the asset is not a business or taxable asset of the recipient). This could also happen when the recipient spouse is a non-resident who may be able to subsequently dispose of the asset in a way that does not give rise to Ethiopian source income.

Sub-article (3) provides that the recipient spouse is treated as having acquired the asset for an amount equal to the cost of the asset to the transferor spouse at the time of the transfer. In other words, the recipient spouse is treated as having taken over the cost of the transferor spouse for the asset.

Example 1

H and W are husband and wife who have divorced. Under the divorce agreement, H is required to transfer shares to W. H acquired the

> shares for a cost of 1,000,000 birr. At the time of the transfer, the shares have a fair market value of 2,000,000 birr. Two years later, W sells the shares for 3,000,000 birr.
>
> The transfer of the shares is the disposal of a taxable asset by H. As the transfer is for no consideration, Article 70(2) treats H as having received the fair market value of the transferred shares at the time of the transfer as the consideration for transfer of the shares. Consequently, H would make a gain of 1,000,000 birr (2,000,000 birr – 1,000,000 birr) in respect of the transfer. Despite this, Article 71(1)(a) provides that no gain arises in respect of the disposal. Instead, under Article 71(3), W takes over H's cost at the time of the transfer (1,000,000 birr) and taxation of the gain that has accrued in respect of the shares is deferred until W subsequently disposes of the shares. Consequently, when W subsequently sells the shares, W makes a gain of 2,000,000 birr (3,000,000 birr – 1,000,000 birr) – this represents 1,000,000 birr of deferred gain that accrued while H owned the asset and 1,000,000 birr of gain that accrued while W owned the asset.

Consequently, the effect of sub-article (1)(a) and (3) is that recognition of the gain (or loss) that has accrued prior to the date of the transfer between spouses is deferred until the recipient spouse subsequently disposes of the asset.

If the transferred asset is a depreciable asset or business intangible of the transferor spouse, sub-article (7)(a) provides that the recipient spouse is treated as having acquired the asset for an amount equal to the net book value of the asset to the transferor spouse at the time of the transfer. In other words, the recipient spouse takes over the deprecation position of the transferor spouse in relation to the asset. Consequently, the recipient spouse will continue to depreciate the asset accordingly, and Articles 25 and 59 apply in the normal way to the recipient spouse on a subsequent disposal of the asset.

Example 2

H and W are husband and wife who have divorced. Under the divorce agreement, H is required to transfer a depreciable asset to W, who will use the asset in her own business. H acquired the asset for a cost of 1,000,000 birr and the net book value of the asset at the time of the transfer is 500,000 birr. At the time of the transfer, the asset has a fair market value of 850,000 birr. Two years later, W sells the asset for 750,000 birr.

The transfer of the asset is a disposal of a business asset. As the transfer is for no consideration, Article 70(2) treats H as having received the fair market value of the transferred asset at the time of the transfer as the consideration for transfer of the asset. Consequently, H would make a gain of 350,000 birr (850,000 birr – 500,000 birr) in respect of the disposal. Despite this, Article 71(1)(a) provides that no gain arises in respect of the disposal and, therefore, taxation of the gain is deferred until W subsequently disposes of the asset. Instead, under Article 71(3) and (7)(a), W takes over H’s net book value of the asset at the time of the transfer (500,000 birr) and W continues to depreciate the asset from that base. Assume that the net book value of the asset at the time that W subsequently sells the asset is 250,000 birr. W makes a gain of 500,000 birr (750,000 birr – 250,000 birr). As the original cost of the asset was 1,000,000 birr, this gain represents recaptured depreciation deductions. The gain of 500,000 birr taxed to W can be broken down into 250,000 birr of depreciation deductions allowed to H that have been recaptured on the subsequent sale of the asset by W and 250,000 birr of depreciation deductions allowed to W that have also been recaptured on the subsequent sale of the asset.

It is noted that if the transferred asset is a depreciable asset of the transferor spouse but not a depreciable asset of the recipient spouse, then sub-article (2) provides that sub-article (1) does not apply to the transfer. Consequently, Articles 25 and 59 will apply in the normal way to the transferor spouse to the transfer of the asset.

The second case is when an asset is transmitted on the death of a taxpayer to the executor or beneficiary of the person's estate (sub-article (1)(b)). Sub-article (2) provides that sub-article (1)(b) does not apply if the recipient (executor or beneficiary) is not subject to tax under the ITP in respect of a subsequent disposal of the asset. For example, the asset is transmitted to a beneficiary of the deceased asset and the asset is not a business or taxable asset of the beneficiary. If sub-article (1)(b) applies, recognition of any gain or loss up to the date of the death of the deceased is effectively deferred until the executor or beneficiary subsequently disposes of the asset. The same cost and net book value rules as applicable to transfers between spouses on divorce apply also to the transmission of the asset (sub-articles (3) and (7)(a)).

The third case is when an asset (referred to as the "replaced asset") is lost or destroyed, or compulsorily acquired under any law (sub-article (1)(c)). Again, there is an actual disposal of the asset (see Article 67(1)), but the disposal is ignored for all purposes of the ITP. There are two conditions that must be satisfied for the non-recognition rule to apply. First, the consideration for the disposal must be reinvested in an asset of a like kind (referred to as the "replacement asset"). Second, the replacement asset must be acquired within one year of the disposal of the replaced asset or within such further time as the Authority allows.

The fourth case is when a person disposes of a depreciable asset (referred to as the "replaced asset") and acquires a new depreciable asset (sub-article (1)(d)). There are two conditions that must be satisfied for the non-recognition rule to apply. First, the person must acquire a depreciable asset of a like kind (referred to as the "replacement asset"). Second, the replacement asset must be acquired within six months of the disposal of the replaced asset or within such further time as the Authority allows. The non-recognition rule is intended as an incentive for business taxpayers to regularly upgrade their depreciable assets, such as plant and equipment.

Sub-articles (4), (5), and (6) apply for the purposes of the non-recognition rules in sub-article (1)(c) or (d). The effect of these sub-articles is that the cost (or net book value in the case of a depreciable asset or business intangible (sub-article (7)(b)) of the replaced asset is "rolled over" into the replacement asset. The cost of the replacement asset is increased by any amount paid for the asset that is in addition to the proceeds of disposal of the replaced asset (sub-article (4)) or is reduced by any part of a gain made on disposal of the replaced asset that is not used in acquiring the replacement asset (sub-article (5)). Sub-article (6) applies when the excess under sub-article (5) is not fully utilised because of the limitation that the cost of the replacement asset cannot be reduced below zero. In this case, the unutilised part of the excess is included in the taxpayer's business income.

Example 3

X Plc has an item of plant that cost 1,000,000 birr that is destroyed by a fire. At the time of the fire, X Plc had been allowed depreciation deductions of 200,000 birr and, therefore, the net book value of the plant at that time is 800,000 birr. X Plc receives 1,000,000 birr as an insurance payment for the asset. X Plc buys a replacement asset for 1,100,000 birr. In this case, the full amount of the insurance payment has been used to acquire the replacement asset.

X Plc has made a 200,000 birr gain on disposal of the plant (1,000,000 birr - 800,000 birr), but Article 71(1)(c) applies and X Plc is not taxed in respect of the gain. As the cost of the replacement asset exceeds the consideration received for the replaced asset, Article 71(4) applies. The amount of the excess is 100,000 birr. Consequently, the cost of the replacement asset is 900,000 birr (being the net book value of the replaced asset at the date of disposal (i.e. 800,000 birr) plus the excess (100,000 birr)). If X Plc subsequently sells the replacement asset for 1,100,000 and the net book value of the asset at the time of sale is 800,000 birr, the taxable gain is 300,000 birr (1,100,000 birr - 800,000 birr). This represents 200,000 birr of recaptured depreciation deductions in relation to the replaced asset and 100,000 birr of recaptured depreciation deductions in relation to the replacement asset.

Example 4

Suppose the same facts as in Example 3 except that the replacement asset cost 900,000 birr. In this case, only 900,000 birr of the 1,000,000 birr insurance payment has been used to acquire the replacement asset.

Again, X Plc has made a 200,000 birr gain (1,000,000 birr - 800,000 birr) on disposal of the plant, but Article 71(1)(c) applies and X Plc is not taxed in respect of the gain. As the consideration received for the replaced asset exceeds the cost of the replacement asset, sub-Article 71(5) applies. The amount of the excess is 100,000 birr and constitutes that part of the insurance payment that has not been reinvested in the replacement asset. Consequently, the cost of the replacement asset is 700,000 birr (being the net book value of the replaced asset (800,000 birr) reduced by the part of the insurance proceeds that have not been reinvested (100,000 birr)). If the replacement asset is subsequently sold for 800,000 birr and the net book value of the replacement asset at the time of sale is 500,000 birr, the taxable gain is 300,000 birr (800,000 birr - 500,000 birr). This represents 100,000 birr of recaptured depreciation deductions in relation to the replaced asset and 200,000 birr of recaptured depreciation deductions in relation to the replacement asset.

Example 5

Assume the same facts as in Example 3 except that the net book value of the replaced asset at the time of disposal is 100,000 birr and the insurance payment is 200,000 birr. X Plc has managed to acquire a second-hand item of plant of the same type in good condition for 80,000 birr. Article 71(5) applies in this case because the consideration for the replaced asset (insurance payment of 200,000 birr) exceeds the cost of the replacement asset (80,000 birr). The amount of the excess is 120,000 birr, which exceeds the cost of the replacement asset. In this case, the effect of Article 71(5) and (6) is that cost of the replacement asset is reduced to zero and remaining part of the excess (40,000 birr) is included in X Plc's business income. As the cost of the replacement asset is reduced to zero, X Plc is not allowed any depreciation deductions in respect of the asset.

72. Registration of Transferred Assets

This article provides for a rule relating to the registration of a transferred asset.

The Article provides that any person authorised by law to accept, register, or in any way approve the transfer of an asset must not accept, register, or approve the transfer unless satisfied that any tax payable under ITP in respect of the transfer of the asset has been paid.

73. Recovered Expenditure

This Article provides for the tax treatment of recovered deductions.

This Article applies when a taxpayer has been allowed a deduction for an expenditure incurred, or bad debt written off, in a tax year and, subsequently, the taxpayer has received, in cash or in kind, an amount as a reimbursement or recovery of, or an indemnity for the expenditure or bad debt. In this case, the Article provides that the amount received is treated as income derived by the taxpayer in the tax year in which it is received and the income has the same character as the income to which the deduction related. For example, if the expenditure related to the derivation of business income, the reimbursed expenditure is treated as business income. The effect of the Article, therefore, is to reverse the deduction that had previously been allowed to the taxpayer for the reimbursed or recovered expenditure.

74. Cessation of Income Earning Activity

This Article applies to income derived after the source of the income has ceased.

Sub-article (1) applies when a person derives an amount in a tax year from a business, activity, or investment that had ceased before the amount was derived. Sub-article (1) provides that, if the amount had been derived before the business, activity, or investment ceased it would have been income subject to tax under the ITP, then the ITP applies to the amount on the basis that the business, activity, or investment had not ceased at the time the amount was derived.

Sub-article (2) applies a similar rule in relation to the deduction of expenditures.

The Article overcomes any argument that an amount derived by a taxpayer is a non-income receipt if the original source of the income has ceased to exist.

75. Amounts-in-kind

This Article provides rules relating to amounts-in-kind.

The Article provides that the value of an amount derived or incurred as a benefit-in-kind is the fair market value of the benefit at the time that the benefit is derived or incurred and determined ignoring any restriction on transfer. Article 3 of TAP applies in determining the fair market value of a benefit-in-kind.

The requirement to ignore any restriction on transfer in determining the fair market value of a benefit-in-kind is intended to avoid any argument that a benefit that is not convertible to cash has no value.

The application of the Article is expressed to be subject to Article 12(4), which provides that the valuation of employee fringe benefits is to be made according to the regulations.

76. Apportionment of Expenditures

This Article provides for the apportionment of expenditures.

Sub-article (1) provides that the Article applies in two classes of case. Paragraph (a) applies when expenditure is incurred to derive more than one class of income. Sub-article (2) treats the following as classes of income for the purposes of the Article: (i) employment income (Schedule 'A'); (ii) income from the rental of buildings (Schedule 'B'); (iii) business income (Schedule 'C'); (iv) each amount taxable under Schedule 'D' is a separate class of income; and (iv) exempt income (Schedule 'E').

An example when paragraph (a) applies is if expenditure is incurred partly to derive business income and partly to derive exempt income. Article 22(1)(a) allows a deduction for the expenditure only to the extent to which it is incurred in deriving business income. Article 21(2) provides that business income does not include exempt income.

Paragraph (b) applies when expenditure is incurred partly to derive a class of income and partly for another purpose (such as a private purpose). An example is expenditure incurred partly to derive business income and partly for private purposes. Article 22(1)(a) allows a deduction for the expenditure only to the extent to which it is incurred in deriving business income. Article

27(1)(l) makes it clear that no deduction is allowed for personal consumption expenditure.

When the Article applies, sub-article (1) requires taxpayers to apportion expenditures on any reasonable basis taking account of the relative nature and size of the activities or purposes to which the expenditures are incurred. For example, if the taxpayer could show that 80% of an employee's time was spent on work relating to deriving business income and the other 20% was spent on work relating to deriving exempt income, it would be reasonable to apportion 80% of the employee's salary costs to deriving business income. On the other hand, if the employee's work led to the derivation of income that comprised 20% exempt income and 80% business income but the employee spent 75% of his or her time on the work related to the derivation of the exempt income, the employer should attribute the employee's salary to the time spent on work related to each type of income, not to the absolute amount of income. This is because the employer is paying for the employee's time and it appears that deriving one type of income is more time consuming than deriving another type of income.

77. Currency Translation

This Article provides for the currency of account for the purposes of the ITP.

Sub-article (1) provides that all amounts (income, gains, expenditures, costs, and tax credits) taken into account under the ITP must be expressed in Ethiopian birr.

Sub-article (2) provides for the translation of foreign currencies to Ethiopian birr. A foreign currency amount is to be translated to Ethiopian birr at the National Bank of Ethiopia exchange rate applying between the foreign currency and birr on the date the amount is taken into account for the purposes of the ITP. Income is taken into account on the date derived and expenditures are taken into account on the date incurred.

Sub-article (3) provides for the recognition of foreign exchange gains and losses. It is provided that all gains and losses arising from transactions in foreign currency are brought to account for tax purposes as additions to taxable income or deductible losses in the tax year that they are realised. This means that foreign exchange gains and losses are recognised when they are realised and not as they accrue.

Sub-article (4) empowers the Authority to issue a Directive to deal with the following: (i) calculation of foreign exchange gains and losses; and (ii) the conversion of foreign currency amounts to birr.

78. Income Splitting

This Article provides rules to counter income-splitting practices.

This Article applies when a person attempts to split income with a related person (see Article 4 of TAP). When this occurs, sub-article (1) obliges the Authority to adjust the income and tax credits of both persons so as to prevent any overall reduction in tax payable as a result of the splitting of income. The reference to "income" is intended as a reference to taxable income (i.e. income net of expenses).

Sub-article (2) identifies the circumstances when a person is treated as having attempted to split income. These are:

(1) A person has transferred income, or a right to income, either directly or indirectly to a related person and the reason or one of the reasons for the transfer is to lower the total tax payable in respect of the income of the transferor and transferee. If there are multiple reasons for the transfer, the lowering of tax liabilities need only be one of the reasons for the transfer. In any other words, it need not be the primary reason.

(2) A person transfers property (including money) either directly or indirectly to a related person with the result

that the related person receives or enjoys the income from the property and the reason or one of the reasons for the transfer is to lower the total tax payable in respect of the income of the transferor or transferee. Again, if there are multiple reasons for the transfer, the lowering of tax liabilities need only be one of the reasons for the transfer. In any other words, it need not be the primary reason.

Sub-article (3) obliges the Authority to have regard to any consideration given by the transferee for the income, right to income, or property transferred in determining whether a person is attempting to split income. If the transferee has given fair market consideration for the transfer, this is likely to indicate that the purpose of the transaction is not to split income.

79. Transfer Pricing

This Article provides for transfer pricing rules. The effect of the Article is that pricing in transactions must be based on arm's length principles. If they are not, the Authority has power to allocate income, gains, deductions, losses, and tax credits between the parties to the transaction so as to reflect the outcome that would have been achieved in an arm's length transaction (i.e. a transaction between independent persons dealing with each other at arm's length (sub-article (6)).

Non-resident persons, in particular, may use transfer pricing as a means of reducing the amount of Ethiopian source income derived. For example, a non-resident parent company may supply goods or services to an Ethiopian subsidiary for a price that is greater than the arm's length price so as to reduce the taxable income (and, therefore, Ethiopian tax liability) of the Ethiopian subsidiary. Similarly, a foreign head office of a non-resident company may allocate income and expenditures to an Ethiopian permanent establishment of the company in such a way as to reduce the non-resident's taxable income in Ethiopia. For this reason, sub-articles (2) and (3) provide that cross-border transfer pricing adjustments must be made in accordance with a Directive issued by the Minister.

Sub-article (4) provides that the Directive referred to in sub-article (2) may apply also to transactions that take place wholly in Ethiopia (i.e. to purely domestic transactions).

Sub-article (5) provides that a taxpayer must include details of transactions with related persons during a tax year with the taxpayer's tax declaration for the year. A taxpayer who fails to do so is liable for an administrative penalty under Article 114(6) of TAP.

80. Tax Avoidance Schemes

This Article provides for a general anti-avoidance rule applicable to taxes imposed under the ITP.

Sub-article (1) provides that the Article applies when the Authority is satisfied of the following:

(1) A scheme has been entered into or carried out. The concept of a "scheme" is defined broadly in sub-article (4) and is not limited to express, legally enforceable agreements, and can include a unilateral course of action.

(2) A person has obtained a tax benefit in connection with the scheme. The concept of a "tax benefit" is explained in sub-article (4). The following are a "tax benefit" for the purposes of the Article: (i) a reduction in a liability of a person to pay tax; (ii) a delay in the arising of a liability of a person to pay tax; and (iii) any other avoidance of a liability of a person to pay tax.

(3) Having regard to the substance of the scheme, it would be concluded that a person, or one of the persons, who entered into or carried out the scheme did so for the sole or dominant purpose of enabling the person referred to in (2) above to obtain the tax benefit. Importantly, the

person who has the requisite purpose and the person who obtained the tax benefit need not be the same person. In other words, the Article can apply when a person enters into a scheme with the sole or dominant purpose that another person obtains a tax benefit under the scheme.

When the requirements in sub-article (1) are satisfied, sub-article (2) empowers the Authority to determine the liability of the person who obtained the tax benefit and the tax liability of any other person related to the scheme as if the scheme had not been entered into or carried out. In determining a person's tax liability as if the scheme had not been entered into or carried out, sub-article (2) enables the Authority to "rewrite" a transaction by treating particular events as if they did or did not happen and at particular times or involving particular third party actions. Sub-article (2) also empowers the Authority to make corresponding adjustments to the tax liability of any other person affected by the scheme. For a corresponding adjustment to be made in relation to a person, the person need not be a party to the scheme, it is required only that they are affected by the scheme.

Sub-article (3) obliges the Authority to notify a person whose liability has been determined or adjusted under the Article by serving a notice of assessment on the person to give effect to the determination or adjustment. An assessment made under this Article is a "tax assessment" for the purposes of the TAP (see the definition of "tax assessment" in Article 2(32) of TAP). This means, for example, that the assessment can be amended under Article 28 of TAP and can be the subject of an objection under Article 54 of TAP.

81. Application of Tax Administration Proclamation

This Article provides for the application of TAP for the purposes of administering the taxes imposed under the ITP.

It is provided that TAP applies for the purposes of the administration of the ITP but subject the application of Part

Nine of the ITP. TAP provides for harmonised procedural and administrative rules applicable to taxes imposed in Ethiopia. For this reason, the ITP is a "tax law" for the purposes of TAP (Article 2(36)(b) of TAP). However, the application of TAP for the purposes of the ITP is subject to Part Nine of the ITP. Part Nine provides for procedural and administrative rules that are specific to the taxes imposed under the ITP. Thus, the legislative structure is that any procedural or administrative rules that are specific to the taxes imposed under the ITP are provided for in the ITP, while any generic procedural or administrative rules are provided for in TAP. For example, the obligation to file a tax declaration is in the relevant law requiring the tax declaration as the due date for filing tax declarations can differ from tax to tax (see Article 83 of the ITP). However, general rules relating to tax declarations, such as extensions of time of file tax declarations, are provided for in Part Five of TAP.

As the ITP is a "tax law" for the purposes of TAP, the following applies:

(1) The taxes imposed under the ITP (employment income tax, rental income tax, business income tax, the Schedule 'D' taxes, and withholding tax) are "taxes" for the purposes of TAP (Article 2(31) of TAP).

(2) A person liable for tax under the ITP is a "taxpayer" for the purposes of TAP (Article 2(41) of TAP).

(3) Any tax imposed under the ITP that is not paid by the due date is "unpaid tax" for the purposes of TAP (Article 2(42) of TAP).

82. Record-keeping

This Article specifies the record-keeping obligations of a taxpayer subject to tax under ITP.

Sub-articles (1), (2) and (3) set out the record-keeping obligations of taxpayers liable for business income tax (Schedule 'C'). Sub-article (1) applies to Category 'A' taxpayers and states a general obligation that they must keep books of account prepared in accordance with the financial accounting standards (i.e. IFRS). Paragraphs (a)-(e) specify documents that Category 'A' taxpayers must keep. Most of these documents will be covered by the general obligation to keep books of account in accordance with the financial accounting standards.

Sub-article (2) applies to Category 'B' taxpayers and sets out a list of documents that such taxpayers are required to keep. The record-keeping requirement is consistent with the simplified tax system applicable to Category 'B' taxpayers under Article 33.

Sub-article (3) applies to Category 'C' taxpayers and requires that such taxpayers must keep documents as may be required under the Regulations.

Sub-article (4) sets out the record-keeping obligations of Category 'A' and 'B' taxpayers liable for rental income tax (Schedule "B"). Simplified record keeping of expenditures applies to taxpayers that are subject to Article 15(5)(b) (notional deduction rule).

Sub-article (5) applies to a taxpayer liable for tax under Article 59 in relation to the disposal of a taxable asset. Such a taxpayer is required to keep: (i) a record of the acquisition date of the taxable asset; (ii) the cost of acquisition of the asset; (iii) the costs of improvements (if any) to the asset; (iv) the consideration received on disposal of the asset.

Sub-article (6)(a) provides that the Authority may disallow a taxpayer a deduction for expenditure when the taxpayer cannot properly substantiate the incurring of the expenditure. Further, sub-article (6)(b) provides that the Authority may disallow the inclusion of expenditure in the cost of an asset if the person cannot properly substantiate the incurring of the expenditure. This applies to a business asset under Schedule 'C' or a taxable asset under Article 59. The amounts included in the cost of an asset are specified in Article 68.

A taxpayer required to keep documents under the Article must keep the documents in accordance with requirements in Article 17 of TAP. In particular, Article 17 of TAP requires that that the documents are:

(1) Kept in Amharic or English.

(2) Kept in Ethiopia.

(3) Kept in such manner so as to enable a person's tax liability under the ITP to be readily ascertained.

(4) Kept for the longer of: (i) the record-keeping period specified in the Commercial Code (10 years at the date of enactment); or (ii) five years from the date that the tax declaration for the tax period to which the documents relate was filed with the Authority. This applies to Category 'A' taxpayers.

A person who fails to keep records as required under this Article 82 and in accordance with the requirements of Article 15 of TAP may be liable for a penalty under Article 102 of TAP. Further, a taxpayer who fails to keep records as required under this Article may not be able to satisfy the burden of proving that a tax assessment is incorrect under Article 59 of TAP should they wish to challenge the assessment.

83. Tax Declarations

This Article provides for the filing of tax declarations.

Sub-articles (1), (2), and (3) apply to employees liable for employment income tax. Sub-article (1) provides that an employee is not required to file a tax declaration for a calendar month unless either of the following applies:

(1) The employee has more than one employer during the month.

(2) The employer has a self-withholding obligation under Article 93. This applies when the employee is employed by an international organisation or works in an embassy,

diplomatic mission, or other consular establishment in Ethiopia of a foreign government and the international organisation or foreign government does not withhold tax as required under Article 88.

If an employee is required to file a tax declaration, sub-article (2) provides for the filing of quarterly tax declarations. Each quarterly tax declaration covers the employment income tax payable by the employee for the three calendar months of the quarter. An employee must file a quarterly tax declaration within 30 day after the end of the quarter.

Sub-article (3) applies when an employee is not required to file a tax declaration (see sub-article (1)). In this case, the withholding tax receipt provided by the employer to the employee under Article 96 for a month is treated for the purposes of the ITP and TAP as a tax assessment of the amount of tax payable by the employee for the month being that amount as set out on the receipt.

Sub-articles (4) and (5) apply to Category 'A' and 'B' taxpayers for the purposes of both Schedules 'B' and 'C'. Sub-article (4)(a) provides that a Category 'A' taxpayer must file a tax declaration for a tax year within 4 months after the end of the year and sub-article (4)(b) provides that a Category 'B' taxpayer must file a tax declaration for a tax year within 2 months after the end of the year.

For an individual, Article 2(21)(a) provides that the tax year is the one-year period from the 1st Hamle to 30th Sene. However, the Authority may, on application by an individual, grant the individual permission to use a different one-year period as the individual's tax year. For a body (defined in Article 2(5) of TAP), Article 2(21)(b) provides that the tax year is the accounting year of the body, i.e. the one-year period ending on the date of the annual balance of the financial accounts of the body (Article 28). For example, if a company (i.e. a Category 'A' taxpayer) uses the period 1 January – 31 December as its accounting and tax year, the tax declaration for the year is due by 30 April of the following year.

Sub-article (5)(a) provides that the tax declaration of a Category 'A' taxpayer for a tax year must be accompanied by the taxpayer's profit and loss statement and balance sheet for the year. Sub-article (5)(b) provides that the tax declaration of a Category 'B' taxpayer for a tax year must be accompanied by the taxpayer's profit and loss statement for the year. In the case of a Category 'B' taxpayer, this reflects the simplified record keeping required of Category 'B' taxpayers (see Article 82(2)).

Sub-article (6) provides that a Category 'C' must file a tax declaration for a tax year within the period 7th day of July to 6th day of August following the end of the tax year.

Sub-article (7) applies to a taxpayer liable for a Schedule 'D' tax that is not discharged by final withholding. This applies to the taxes on income from the casual renting of property (Article 58), gains on disposal of taxable assets (Article 59), windfall profits (Article 60), undistributed profits of bodies (Article 61), repatriated permanent establishment profits (Article 62), and other income (Article 63). Reporting of these Schedule 'D' taxes is done on a transaction basis. Sub-article (7) requires the tax declaration to be filed within two months after the date of the transaction giving rise to the Schedule 'D' income.

For example, if the Schedule 'D' income is a gain on disposal of a taxable asset that is taxed under Article 59, the tax declaration in relation to the transaction (i.e. disposal) must be filed within two months after the disposal occurred as determined under Article 67. If the Schedule 'D' income is undistributed profits of a body for a tax year liable for tax under Article 61, sub-article (7) applies on the basis that the tax declaration for a tax year must be filed within 2 months after the end of the tax year (the transaction being the tax year during which the undistributed profits were derived). The mechanics of this may be further elaborated in the Regulations.

Tax declarations must be filed in the approved form (i.e. the form approved by the Authority for such declarations (see Article 79 of TAP)) and in the manner provided for in Article 80 of TAP.

Tax declarations required to be filed under the Article are self-assessment declarations for the purposes of TAP (Article 2(29)(a) of TAP). Under Article 25 of TAP, a taxpayer who has filed a tax declaration for a tax year is treated as having made a self-assessment of the tax payable by the taxpayer for the year. The self-assessed liability is the amount of tax specified in the declaration.

Part Five of the TAP provides for general rules applicable to tax declarations filed under this Article. A person who fails to file a tax declaration by the due date may be liable for a penalty under Article 104 of TAP. Further, a person who files a fraudulent tax declaration may be prosecuted for an offence under Article 118 of TAP.

84. Payment of Tax

This Article provides for the payment of tax imposed under the ITP.

As the taxes imposed under the ITP are self-assessed taxes, the tax payable for a tax period is due at the time that the tax declaration for the period is due. This is provided for in sub-article (1) (employee tax declaration), sub-article (2) (Category 'A' and 'B' taxpayer) and sub-article (3) (Schedule 'D' tax).

Sub-article (4) provides that a Category 'C' taxpayer must pay tax during the period 7th day of July to the 6th day of August each fiscal year in accordance with the standard assessment applicable to the taxpayer (see Article 49).

A taxpayer who fails to pay tax by the due date is liable for late payment interest under Article 37 of TAP. In addition, the person may be liable for late payment penalty under Article 105 of TAP. Late payment interest is compensating the Government for being out of funds due to the late payment of tax and late payment penalty is punishing the taxpayer for the wrongdoing associated with paying tax late.

Tax payable under the Article that is not paid by the due date is "unpaid tax" for the purposes of TAP (Article 2(42) of TAP). The Authority can use the measures in Chapter Three of Part Seven of TAP to collect any unpaid tax under the Article.

85. Advance Payment of Tax in Relation to Imports

This Article provides for the payment of tax on imports of goods as an advance payment of business income tax.

Sub-article (1) applies to a taxpayer liable for tax under Schedule 'C' (business income tax). If the taxpayer imports goods for commercial use, the taxpayer must make an advance payment of business income tax to the Authority equal to 3% of the CIF value of the goods. "Commercial use" has it ordinary meaning, namely the use for profit making purposes, directly or indirectly, in the taxpayer's business. Sub-article (4) empowers the Minister to issue a Directive defining "commercial use" for the purposes of this Article.

Sub-article (2) requires that the advance tax payable under sub-article (1) must be paid before the goods are released from Customs control. The tax is credited against the taxpayer's business income tax liability for the tax year in which the import occurred.

Sub-article (3) applies if the total amount of advance payments of tax credited under sub-article (2) for a tax year exceeds the business income tax liability of the taxpayer for the year. In this case, the excess is applied in accordance with Article 49 of TAP as follows:

(1) The excess is first applied in payment of any tax (other than withholding tax) owing by the taxpayer under the ITP (Article 49(1)(a) of TAP). The exclusion of withholding tax means that the excess can be applied only against a primary tax liability of the taxpayer.

(2) The balance (if any) is then applied in payment of any tax owing by the taxpayer under any other tax law (Article 49(1)(b) of TAP). For example, it may be applied against any VAT liability of the taxpayer owing under the Value Added Tax Proclamation.

(3) The remainder (if any) must be refunded to the taxpayer within ninety days of the date that the taxpayer filed the tax declaration for the year to which the tax credit relates (Article 49(1)(c) of TAP). A refund of the remainder is made only on written application of the taxpayer. Article 49(1)(c) of TAP is subject to Article 49(2) of TAP, which provides that the amount of the refund can be carried forward for credit against any future tax liability of the taxpayer. A refund is carried forward under Article 49(2) of TAP only with the written agreement of the taxpayer.

86. Instalment of Tax

This Article provides for a current payments system for taxpayers liable for business income tax and rental income tax.

Sub-article (1) allows a Schedule 'C' taxpayer to pay an instalment of business income tax for a tax year on the last day of the month following the end of the sixth month of the year.

Sub-article (2) provides that the amount of the instalment of tax for a tax year payable by a taxpayer is 50% of the amount of the business income tax payable by the taxpayer for the previous tax year. This is subject to two variations:

(1) If a taxpayer did not have a business income tax liability for the previous year, the amount of the instalment is 50% of the amount of the taxpayer's business income tax payable in the most recent tax year in which the taxpayer had a business income tax liability (sub-article (3)).

(2) The amount of an instalment payable by a taxpayer for an instalment period as determined under sub-article (2) of this Article shall be reduced, but not below zero, by any advance tax paid under Article 85 or any withholding tax paid under Article 92 in respect of the business income derived by the taxpayer during the instalment period (sub-article (4)). Sub-article (8) provides that "instalment period" means the period of six months ending on the sixth month of the tax year. The reductions reflect the fact that advance tax and withholding tax are the equivalent of instalments of tax.

Sub-article (5) provides that an instalment of tax paid by a taxpayer for a tax year is credited against the business income tax liability of the taxpayer for the year. Sub-article (6) provides that, if the amount of the instalment of tax credited under sub-article (5) for a tax year exceeds the business income tax liability of the taxpayer for the year, the excess is applied in accordance with Article 49 of TAP as follows:

(1) The excess is first applied in payment of any tax (other than withholding tax) owing by the taxpayer under the ITP (Article 49(1)(a) of TAP). The exclusion of withholding tax means that the excess can be applied only against a primary tax liability of the taxpayer.

(2) The balance (if any) is then applied in payment of any tax owing by the taxpayer under any other tax law (Article 49(1)(b) of TAP). For example, it may be applied against any VAT liability of the taxpayer owing under the Value Added Tax Proclamation.

(3) The remainder (if any) must be refunded to the taxpayer within ninety days of the date that the taxpayer filed the tax declaration for the year to which the tax credit relates (Article 49(1)(c) of TAP). A refund of the remainder is made only on written application of the taxpayer. Article 49(1)(c) of TAP is subject to Article 49(2) of TAP, which provides that the amount of the refund can be carried forward for credit against any future tax liability of the taxpayer. A refund is carried forward under Article 49(2) of TAP only with the written agreement of the taxpayer.

Sub-article (7) provides that the Article applies to a Schedule 'B' taxpayer on the basis that a reference in this Article to "business income tax" is treated as a reference to "rental income tax". Thus, a taxpayer liable for rental income tax for a tax year may pay an instalment of tax on the last day of the month following the end of the sixth month of the year.

87. Collection of International Air Transportation Income Tax

This Article provides for the reporting and collection of business income tax payable by a non-resident airline operator under Article 50 on a quarterly basis.

Sub-article (1) provides that a non-resident airline operator liable for business income tax under Article 50 must file a tax declaration with the Authority for each quarter by the last day of the month following the end of the quarter. Sub-article (4) provides that "quarter" means the period of three months ending on 31st March, 30th June, 30th September, and 31st December of each year.

A tax declaration under sub-article (1) is treated as a "tax declaration" for the purposes of TAP (Article 2(35)(a) of TAP).

A tax declaration under sub-article (1) must be filed in the approved form (i.e. the from approved by the Authority for tax declarations to be filed by non-resident airline operators (see Article 79 of TAP)) and in the manner provided for in Article 80 of TAP.

A tax declaration filed under the Article is a self-assessment declaration for the purposes of TAP (Article 2(29)(a) of TAP). Under Article 25 of TAP, a non-resident airline operator who has filed a tax declaration under sub-article (1) for a quarter is treated as having made a self-assessment of the tax payable for the quarter. The self-assessed liability is the amount of tax specified in the declaration.

Part Five of the TAP provides for general rules applicable to a tax declaration filed by a non-resident airline operator. A non-resident airline operator who fails to file a tax declaration by the due date may be liable for a penalty under Article 104 of TAP. Further, a non-resident airline operator who files a fraudulent tax declaration may be prosecuted for an offence under Article 118 of TAP.

Sub-article (2) provides that the tax under Article 50 payable by a non-resident for a quarter is due by the due date for filing the tax declaration for the quarter, i.e. by the last day of the month following the end of the quarter.

Sub-article (3) provides that, if the tax payable by a non-resident airline operator for a quarter is not paid within three months of the due date, the Authority may issue to the Ethiopian Civil Aviation Authority with a certificate specifying the name of the non-resident airline operator and the amount of tax due, and the Ethiopian Civil Aviation Authority must refuse clearance from any airport in Ethiopia to any aircraft owned or chartered by the non-resident airline operator until the tax due has been paid. This is in addition to any recovery action that can be taken under Chapter Three of Part Seven of TAP.

A non-resident who fails to pay tax by the due date in sub-article (2) is liable for late payment interest under Article 37 of TAP and may be liable for late payment penalty under Article 105 of TAP.

88. Withholding of Tax from Employment Income

This Article provides for the withholding of tax by employers from payments of employment income.

Sub-article (1) obliges an employer paying employment income to an employee subject to employment income tax under Article 10 to withhold tax from the gross amount of each payment of employment income made to the employee at the rate or rates applicable to the employee under Article 11. The obligation to withhold tax is imposed on an "employer", which is defined in Article 2(8) to mean a person who engages or remunerates an employee. In broad terms, the person remunerating an employee must withhold employment income tax from each payment of employment income made to the employee.

Sub-article (2) applies when an employer is aware that an employee has more than one employment and that the other employer, or none of the other employers, are withholding tax based on the aggregated employment income. In this case, the employer must withhold tax based on the aggregated employment income.

Sub-article (3) provides that the obligation of an employer to withhold tax from a payment of employment income to an employee under sub-article (1) has priority over any obligations of the employer to withhold any other amount from a payment of employment income to an employee.

89. Withholding of Tax from Payments to Non-residents

This Article provides for the withholding of tax from certain payments to non-residents that are subject to tax under the ITP.

Sub-article (1) applies to the following amounts:

(1) A payment made by a contractor (Article 36(1)) or a licensee (Article 36(11)) to a non-resident subcontractor taxable under Article 37(4). The rate of withholding is the rate set out in Article 37(4).

(2) A payment made by a resident of Ethiopia or an Ethiopian permanent establishment of a non-resident to a non-resident of Ethiopian-source dividends, interest, royalties, management fees, technical fees, or insurance premiums taxable under Article 51. This includes any recharged technical fees and lease payments (i.e. royalties) to which Article 52 applies. The rate of withholding is the relevant rate applicable to the income under Article 51(2).

(3) Any repatriated permanent establishment profit of a non–resident body taxable under Article 62. The rate of withholding is the rate set out in Article 62(1).

(4) A payment made by a resident of Ethiopia or an Ethiopian permanent establishment of a non-resident to a non-resident of Ethiopian-source income taxable under Article 63. The rate of withholding is the rate set out in Article 63.

A person obliged to withhold tax under sub-article (1) must withhold tax from the gross amount paid or distributed.

Sub-article (3) provides for withholding in relation to the undistributed profit of a body that is taxable to a non-resident under Article 61. The rate of withholding is the rate set out in Article 61.

The rate of withholding tax coincides with the relevant primary rate of tax as follows:

(1) An insurance premium or royalty – 5%.

(2) A dividend, interest, subcontractor payment, undistributed profits, or repatriated permanent establishment profits - 10%.

(3) A management, technical fee, or other income – 15%.

Sub-article (2) provides that a resident of Ethiopia or a permanent establishment in Ethiopia of a non-resident making a payment to a non-resident entertainer that is income of the non-resident entertainer subject to tax under Article 53 must withhold tax from the gross amount paid at the tax rate specified in Article 53(1), namely 10%.

"Permanent establishment" is defined in Article 4, "resident of Ethiopia" and "non-resident" are defined in Article 5, and Article 6 provides for the determination of Ethiopian-source income.

90. Withholding of Tax from Dividends, Undistributed Profits, Repatriated Profit, Interest, and Royalties

This Article provides for the withholding of tax from dividends, interest, and royalties paid to a resident of Ethiopia that are subject to tax under Articles 54, 55, and 56, and from undistributed profits that are subject to tax under Article 61.

Sub-article (1) provides that a resident of Ethiopia or permanent establishment in Ethiopia of a non-resident paying a royalty to a resident that is subject to tax under Article 54 must withhold tax from the gross amount of the royalty. Tax must be withheld at the rate applicable under Article 54 (i.e. 10% of the gross amount of the royalty).

Sub-article (2) provides that a resident body (defined in Article 5(5)) paying a dividend to a resident of Ethiopia that is subject to tax under Article 55 must withhold tax from the gross amount of the dividend. Tax must be withheld at the rate applicable under Article 55 (i.e. 10% of the gross amount of the dividend). Sub-article (2) applies also to undistributed profits taxable under Article 61 in respect of a resident member with tax withheld at the rate specified in Article 61 (i.e. 10% of the amount of undistributed profits)

Sub-article (3) provides that a resident of Ethiopia or permanent establishment in Ethiopia of a non-resident paying interest to a resident that is subject to tax under Article 56 must withhold tax from the gross amount of the interest. Tax must be withheld at the rate applicable under Article 56 (i.e. 10% of the gross amount of the interest).

"Permanent establishment" is defined in Article 4, and "resident of Ethiopia" and "non-resident" are defined in Article 5.

91. Withholding of Tax from Income from Games of Chance

This Article provides for the withholding of tax from winnings from games of chance subject to tax under Article 57.

The Article obliges the person paying winnings from a game of chance to withhold tax from gross amount of the winnings at the rate specified in Article 57 (i.e. 15% of the gross amount of the winnings).

92. Withholding of Tax from Domestic Payments

This Article provides for the withholding of tax from certain domestic payments for goods or services.

Sub-article (1) sets out the withholding obligation. It applies to payments made for the supply of goods or services in Ethiopia by the following withholding agents: (i) a body having legal personality (such as a body corporate); (ii) a government agency; (iii) a non-profit organisation; (iv) a non-governmental organisation; or (v) other persons as specified in a Directive issued by the Authority. The obligation to withhold does not apply to payments made by a micro-enterprise.

The rate of withholding is 2% of the gross amount of the payment made for the supply of goods or services. Sub-article (4) provides that the withholding rate is 30% of the gross amount of the payment if the supplier in a transaction to which sub-article (1) applies has failed to provide their TIN to the withholding agent. When sub-article (4) applies, sub-article (5) provides that the 30% withholding tax payable is a final tax on the income derived by the supplier from the supply and the withholding tax cannot be waivered by either a Directive or an administrative decision.

Sub-article (1) sets out the following thresholds for the application of the withholding obligation:

(1) The withholding obligation applies to a supply of goods only when the payment for the supply involves more than 10,000 Birr in one transaction or supply contract.

(2) The withholding obligation applies to a supply of services on when the payment for the supply involves more than 3,000 Birr in one transaction or supply contract.

In determining the thresholds in sub-article (1), sub-article (2) provides for the aggregation of the payments for separate supplies when it would reasonably be expected that the goods or services would ordinarily be supplied in a single supply. In this case, sub-article (3) provides that the Authority may determine the amount of any unpaid withholding tax and, by notice in writing, recover the unpaid withholding tax from either the supplier or purchaser.

Sub-article (6) permits the Minister for finance, by Directive, to change the thresholds specified in in sub-article (1).

93. Self-withholding

This article provides for self-withholding by the recipient of certain income subject to withholding tax.

Sub-article (1) applies to an employee employed by an international organisation or working in an embassy, diplomatic mission, or other consular establishment in Ethiopia of a foreign government. "International organisation" is defined in Article 2(15) of TAP.

Sub-article (1) requires the employee to withhold tax from the employment income paid by the international organisation or foreign government to the employee as required under Article 88. The reason for the self-withholding rule is that an international organisation or foreign government may be exempted from the withholding obligation by international agreement.

Sub-article (2) provides that sub-article (1) applies only when the international organisation or foreign government does not withhold tax as required under Article 88. While, under an international agreement, an international organisation or foreign government may not be required to withhold tax, the international organisation or foreign government may choose to do so by agreement with the Government of Ethiopia. In this case, the self-withholding rule does not apply and the normal withholding rule in Article 88 applies.

Sub-article (3) provides for self-withholding by a resident of Ethiopia when the payer of royalties, interest, or winnings from a game of chance is a non-resident without a permanent establishment in Ethiopia or the payer of dividends is a non-resident body. Self-withholding applies in this case because the payer of the royalty, dividend, interest, or winnings is a non-resident outside Ethiopia's jurisdiction to enforce the withholding obligation applying under Articles 90 and 91.

Self-withholding is at the rate specified in Articles 54, 55, 56, or 57, as the case may be.

94. No withholding from Exempt Income

This Article provides that there is no withholding from an amount that is exempt income of the recipient. Amounts that are exempt income are specified in Schedule 'E'.

95. Time of Payment of Withholding Income

This Article states the time at which the obligation to withhold tax under Part Ten arises.

The obligation to withhold tax under Part Ten arises in relation to the payment of the relevant amount. The article provides that withholding income (i.e. income subject to withholding tax (Article 2(27)) is treated as having been paid by a withholding agent to a person if any of the following applies:

(1) The withholding income is actually paid to the person. This would be the normal case.

(2) The withholding income is applied on behalf of the person either at the instruction of the person or under any law.

(3) The withholding income is reinvested, accumulated, or capitalised for the benefit of the person. This is particularly relevant for dividends.

(4). The withholding income is credited to an account for the benefit of the person. For example, the obligation to withhold tax arises on the crediting of an amount (e.g. interest) to an inter-company loan account.

Generally, the primary liability for tax in relation to withholding income arises when the recipient receives the income. To ensure that the primary liability and the withholding obligation arise at the same time, the concept of "paid" under the Article aligns with the concept of "received" as defined in Article 2(19).

96. Withholding Tax Receipt

This Article provides for the issuing of withholding tax receipts.

The Article requires a withholding agent to provide the recipient of withholding income with a withholding tax receipt in the approved form (i.e. the form approved by the Authority for such certificates (Article 79 of TAP)). The withholding tax receipt must be provided at the time of withholding the tax from the withholding income.

97. Payment of Withholding Tax

This Article provides for the payment of withholding tax.

Sub-article (1) provides that tax that a withholding agent is required to withhold from a payment of withholding income must be paid to the Authority within 30 days after the end of the month in which the withholding income was paid.

Sub-article (2) provides that a withholding agent required to pay withholding tax under sub-article (1) must file a monthly withholding tax declaration with the payment. This means that a monthly withholding tax declaration is also due within 30 days after the end of the month in which the withholding income was paid. The monthly withholding tax declaration must be in the approved form, i.e. the form approved by the Authority for such declarations (Article 79 of TAP).

The obligations under sub-articles (1) and (2) arise for tax that a withholding agent is required to withhold from withholding income. In other words, it arises regardless of whether the tax is actually withheld.

The liability for withholding tax arises by operation of the ITP (particularly under the relevant Article requiring withholding). There is no obligation on the Authority to raise an assessment of withholding tax.

"Withholding tax" is a tax for the purposes of the TAP (Article 2(31)(a)) and, therefore, the Authority can rely on the recovery provisions in Chapter Three of Part Seven of TAP to collect unpaid withholding tax. Further, a withholding agent who fails to pay withholding tax by the due date specified in sub-article (1) may be liable for late payment interest under Article 37 of TAP and late payment penalty under Article 105 of TAP.

A monthly withholding tax declaration is a tax declaration for the purposes of TAP (Article 2(35)(b) of TAP). This means that, to the extent relevant, Part Five of TAP applies to monthly withholding tax declarations. A withholding agent who fails to file a monthly withholding tax declaration by the due date may be liable for a late filing penalty under Article 104 of TAP.

Sub-article (3) imposes a personal liability on a withholding agent who fails to withhold tax as required under Part Ten or who withholds the tax but fails to remit the withheld tax to the Authority.

Sub-article (4) provides that a withholding agent personally liable for withholding tax under sub-article (3) that has not been withheld from a payment of withholding income has a legal entitlement (a "cause of action") to recover any withholding tax paid from the recipient of the withholding income.

98. Credit for Withholding Tax

This Article provides a tax credit for withholding tax.

Sub-article (1) provides that a taxpayer deriving withholding income is entitled to a tax credit for any tax withheld from the income. However, no tax credit is allowed for income subject to final taxation under Article 10(5) (employment income referred to Article 83(1)) or Article 64(2) (i.e. Schedule 'D' income). Consequently, a tax credit is allowed in respect of tax withheld from employment income under Article 88 when Article 83(2) applies to the employee and tax withheld from a domestic payment under Article 92. The tax credit is applied against the employment income tax payable under Article 10 or business income tax payable under Article 18, as the case may be.

Sub-article (2) provides that, if the amount of the tax credit allowed under sub-article (1) is less than the total tax liability of the taxpayer for the year in relation to the withholding income, the taxpayer must pay the difference by the due date for filing the taxpayer's tax declaration for the year (see Article 83).

Sub-article (3) provides that, if the amount of the tax credit allowed under sub-article (1) exceeds the total tax liability of the taxpayer for the year, the Authority must apply the excess in accordance with Article 49 of TAP as follows:

(1) The excess is first applied in payment of any tax (other than withholding tax) owing by the taxpayer under the ITP (Article 49(1)(a) of TAP). The exclusion of withholding tax means that the excess can be applied only against a primary tax liability of the taxpayer.

(2) The balance (if any) is then applied in payment of any tax owing by the taxpayer under any other tax law (Article 49(1)(b) of TAP). For example, it may be applied against any VAT liability of the taxpayer owing under the Value Added Tax Proclamation.

(3) The remainder (if any) must be refunded to the taxpayer within ninety days of the date that the taxpayer filed the tax declaration for the year to which the tax credit relates (Article 49(1)(c) of TAP). A refund of the remainder is made only on written application of the taxpayer. Article 49(1)(c) of TAP is subject to Article 49(2) of TAP, which provides that the amount of the refund can be carried forward for credit against any future tax liability of the taxpayer. A refund is carried forward under Article 49(2) of TAP only with the written agreement of the taxpayer.

99. Power to Issue Regulations and Directives

This Article enables the issuing of Regulations and Directives necessary for the implementation of the ITP.

100. Repealed and Inapplicable Laws

This Article provides for the repeal of the following Proclamations:

(1) The Income Tax Proclamation No. 286/2002 and all amendments thereto

(2) The Mining Income Tax Proclamation No 53/1993 and all amendments thereto

(3) The Petroleum Operations Income Tax No 296/1986 and all amendments thereto

Sub-article (2) provides that no other law may, in so far as it is inconsistent with the ITP, is applicable with respect to matters provided for by the ITP.

101. Transitional Provisions

This Article provides for transitional provisions consequent upon the repeal of the ITP 2002. Further transitional provisions may be provided for in the Regulations.

Sub-article (1) provides that the repealed laws continue to apply for a tax year preceding the tax year in which the ITP enters into force. This is subject to TAP providing otherwise.

Sub-article (2) provides that a reference in the ITP to a previous tax year includes, when the context requires, a reference to a tax year under the repealed law.

Sub-article (3) provides that a reference in Article 73 to a previously deducted expenditure, loss, or bad debt includes a reference to expenditure, loss, or bad debt deducted under the repealed law.

Sub-article (4) provides that a profit and loss or income statement to be prepared under the ITP must be prepared in accordance with the schedule to be set by the Ethiopian Accounting and Audit Board. However, it is provided that the repealed laws continue to apply until the schedule becomes operative.

Sub-article (5) provides that the Authority is to determine within one year from the effective date of the ITP, the date from when the category of taxpayers provided for in Article 3 begins to apply. The provisions in the repealed law relating to the category of taxpayers continues to apply until that time.

Sub-article (6) provides that the Regulations and Directives issued under the Repealed laws continue to apply to the extent that they are not inconsistent with ITP and until they are replaced by new Regulations and Directives.

102. Effective Date

This Article provides that the ITP applies to tax years commencing on or after the 8th day of July, 2016.

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