Interest-free Banking and Taxation in Ethiopia: A Critical Analysis

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Abstract

Barely a decade ago, Ethiopia adopted a directive that lay the ground for the operation of interest-free banking. The existing tax laws were developed within a framework of conventional financial transactions. Analyzing the Mudharabah and Murabaha services, this paper found out that there is a legal lacuna in the taxation of interest-free banking services in Ethiopia. In Mudharabah services, the status of the relationship between the bank and the customer, and the treatment of the profit gained from the contract on the income tax part as well as the VAT status of managerial service fee collected is not clear. In respect of Murabaha services, questions on whether profit received from Murabaha is treated as the interest in a conventional loan transaction or just as profit per se, the tax on the income status of the mark-up gain from the purchase or repurchase process of the Murabaha agreements as well as the VAT aspect thereof are not settled yet. Apart from other general solutions proffered, the article ends with a recommendation that a clear guideline/directive on interest-free banking be urgently put in place to take care of the tax aspect of these services in Ethiopia.

Keywords: Interest-free banking, *Mudharabah, Murabaha*, Income Tax, Value Added Tax

1. Introduction

In 2008, the Ethiopian Banking Business Proclamation No.592/2008 was amended to include a provision for Interest-free Banking (hereafter IFB). Following the amendment, in 2011, the National Bank of Ethiopia issued a directive, SSB/51/2011, to authorize the business IFB. The legislator's objectives are hammered out under the 'whereas' clause of the directive. Accordingly, the directive stamped down the objective affirming that there 'has been increasingly strong public demand for interest-free banking products in Ethiopia' which

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necessities to have a framework for this banking system, and hence such products have to be carried out safely and soundly.

The directive has outlined mandatory provisions, which are general and undetailed, about the general operational direction of IFB. Accordingly, only IFB windows are permitted[1], no fully-fledged interest-free banks were authorized, IFB entities need to follow Sharia law and IFB windows need to follow the same regulations as any other commercial bank except on the interest rate, which does not apply to IFB[2]. With the strict requirement for authorization, the directive prohibits that "banks shall not alter the maximum share of interest-free banking business in their consolidated balance sheet without prior approval of the National Bank." By setting up the major principles of the IFB, the directive leaves out the germane details of interest-free banking businesses *interalia*, mobilizing or advancing funds, to adhere to and in a manner consistent with Islamic finance principles.[3]

Following this, there are some legal issues unanswered under the current IFB legal frameworks which include but not limited to compatibility of the IFB and its compliance to sharia laws (standards of Islamic finance to use the word of the directive), the setting and frameworks of

[1] An IFB is simply a window within a conventional bank via which customers can conduct business utilizing only Shariah compatible instruments. According to Juan, Islamic banking in a country doesn't move on to the full-fledged level at the first inception. At the inception of the Islamic window, the products typically offered are safekeeping deposits—on the liability side of the bank—and Islamic trade-finance products for small and medium companies—on the asset side of the bank.. Then, after ascertaining the profitability of their Islamic business lines, they may expand to the level of considering segregating the window into a separate subsidiary and then to full-fledged Islamic banking industry. This has been a common practice in South East Asia and Western countries. In the Middle East, the tendency is establishing standalone Islamic banks. See, *Juan Solé, Introducing Islamic Banks into Conventional Banking Systems*,IMF Working Paper WP/07/175, July 2007, p.8.

[2] Almost seven years ago, *ZemZem*, a prospective new bank, asked to join the banking industry as a full-fledged interest-free bank, but was unable to start operations because of NBE's directives indicated that the service must be provided using a separate window along with other conventional banking services. Recently, however, the National Bank of Ethiopia (NBE) has issued the long-awaited directive on the formation of full-fledged interest-free banking (IFB) on June 18, 2019. So far, four share companies have passed the pre-application stage and received permissions from the central bank to open bank accounts and start selling shares. According to Fortune newspaper, four share companies have passed the pre-application stage and received permissions from the central bank to open bank accounts and start selling shares. While Zad, Zemzem, Hijira and Nejashi are in the process of formation, two others, Kush and Huda, have initiated a process to organize an interest-free bank. *Fortune Newspaper,* Published on Jul 13, 2019,VoL 20, NO 1002Available at Interest Free Banking available at https://addisfortune.news/central-bank-relaxes-interest-free-banking-rules/ accessed September, 2019.

[3] See *Licensing and Supervision of Banking Business Directives to Authorize the Business of Interest Free Banking Directives Number SBB/51/2011*, Article 2(2.2.).

Supervisory Board,[4] the jurisdiction of courts in disputes related to IFB, and the tax treatment of IFB. However, it is not the purpose of this paper to address these issues. Instead, this article will stick to the tax aspect of IFB in Ethiopia taking the Ethiopian value-added tax and Income tax laws.

Taxation systems differ from country to country as to the taxation of IFB. Usually, Islamic banking presents a challenge for tax systems developed within the framework of conventional financial transactions. This article will explore, then, the legal mantra surrounding the taxation of IFB in Ethiopia taking VAT and Income tax laws. This article inquires whether there are compatible tax provisions to IFB services. Accordingly, this article discusses some of the generic challenges that IFB transactions pose for tax systems. It then discusses how these challenges are being addressed by the Ethiopian tax laws.

So far, the majority of commercial banks are providing IFB services.[5] Time and space will not allow covering all the IFB services and the respective tax aspect of these services. Hence *Mudharabah and Murabaha*IFB services, which are common in banks introduced IFB in Ethiopia, are taken as a case study for this article.

Methodologically, this article employs primarily a document-based analysis of the legal and policy frameworks connected to financial services in Ethiopia. To substantiate this, an interview has been made with concerned experts at the Ministry of Revenue and Ministry of Finance. From the banking sector, an interview was conducted with legal as well as financial experts of NIB Bank and Commercial Bank of Ethiopia. Besides, the experiences of other countries with a similar tax setup have been taken into account while addressing the taxation of IFB in Ethiopia.

The structure of this paper is as follows. It begins with brief introductory concepts and a description of interest-free banking. The next part contains a discussion on taxation of

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[4] Advisory board is a common trend in countries that have IFB. Having an adequate Shari'a Advisory board guarantees a product is compliant with Shari'a principles. In Ethiopia, no directive or guidelines supervises and authenticates the Shari'a validity of an IFB product. In fact, there are reports that Banks that are rendering IFB services have advisory board to watch over its compliance to Shari'alaws. Therefore, there is a need to address how IFB products can be controlled at the product development stage but also monitored on a regular basis to ensure that they continuously comply with Shari'a principles.

[5] Two banks started IFB services as window services in 2013(Commercial Bank of Ethiopia and Cooperative bank of Oromia). This day, among the 17 privately and state-owned banks, 11 have secured a license to operate IFBs, and 10 of them have already commenced the service. *Fortune Newspaper, Published on Jul 13, 2019 [Vol. 20, NO 1002]* Available at https://addisfortune.news/central-bank-relaxes-interest-free-banking-rules/. Accessed on 16 July, 2019.

conventional financial services in Ethiopia taking income and value-added taxes into consideration. Followed to this, more in-depth consideration is given to the tax treatment of interest-free banking services under the VAT and Income Tax Laws of Ethiopia. Finally, the article ends with some concluding remarks.

2. Describing Interest-free Banking

Legal systems vary as to the nomenclature of Interest-free Banking. The name Islamic Banking, Islamic Finance, Sharia Compliant Banks, and Interest-free Banks have been usually used in countries that have IFB systems.[6] However, there is no consensus on the nomenclature of banking services provided according to the Sharia laws. For example, the term Interest-free Banking is criticized by some as misleading. Prohibition of interest (usury) being the distinguishing feature of Islamic finance, interpreting the Islamic financial system simply as free of interest, however, does not capture the true picture of the system as a whole. Because Islamic fiancé is supported by other principles of Islamic doctrine advocating social justice, risk sharing, the rights and duties of individuals and society, property rights, and the sanctity of contracts.[7] In other words, this banking service is not only meant to prohibit interest but it is abided by other Islamic principles like the prohibition of economic activities involving speculation (*gharar*); the obligation of paying the *zakat*; the discouragement of the production of goods and services which contradict the value pattern of Islam, and the prohibition to invest in activities forbidden by the *Qur'an*.[8]For this purpose, five religious features are required to be followed in this system:

> "ribais prohibited in all transactions; business and investment are undertaken on the basis of halal (legal, permitted) activities;maysir(gambling) is prohibited and transactions should be free from gharar(speculationor unreasonable uncertainty); zakat is to be paid by the bank to benefit society;all activities should be in line with

[6]Fuad Al-Omar & Mohammed Abdel-Haq, Islamic Banking: Theory, Practice & Challenges, Oxford University Press, Karachi: ZED Books, 1996.
[7]Hennie van Greuning and ZamirIqbal, *Risk Analysis for Islamic Banks*, The International Bank for Reconstruction and Development / The World Bank, 2008
[8]Claudio Porzio, Islamic Banking Versus Conventional Banking (pp91-106), in M. Fahim Khan *and* Mario Porzio,*(Ed), Islamic Banking and Finance in the European Union: challenge*, p.92.

> Islamic principles, with a special shari'aboard tosupervise and advise the bank on the propriety of transactions."[9]

That is why the expression "Islamic banking" suggests two competing forces at work. The noun "banking" suggests that there is a financial service like conventional banking. However, these services are required to comply with the Islamic principles of financial services.[10]However, the name to adopt depends on the nature of government and the religious reflections of each nation.[11]Having these conceptions, introducing IFB to a country -with conventional banking experience-with a tax system adorable of the conventional banking system- a new challenge to the existing tax law is expected.

3. Tax Framework of Conventional Banking Services in Ethiopia

3.1. Income Tax Laws

The banking business proclamation authorized only share companies to involve in the banking business.[12] As companies, therefore, they are subject to the income tax provisions which are devised to tax "Body" according to income tax proclamation (hereafter ITP).[13]Based on this, 'bodies' are subject to tax on schedule B, C, and D of the ITP.[14] Unless Banks are involved in rental services, which they can't, schedule B will not apply to banks. Hence, Schedule C and D

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[9]Latifa M. Algaoud and Mervyn K. Lewis, Islamic Critique of Conventional Financing, in M. Kabir Hassan and Mervyn K. Lewis, *Handbook of Islamic Banking,* Edward Elgar Publishing Limited, 2007, *p, 38*.

[10] Mahmoud A. El-Gamal, *Islamic Finance: Law, Economics, and Practice*, Cambridge University Press, 2006, p.64.

[11] It seems that the Ethiopian legal framework has adopted the Phrase Interest free banking to show its neutrality in the sense that IFB is introduced not in the religious sense but to offer optional banking service to the community in need of but not limited to those who follow the Religion of Islam.

[12] According the Banking business proclamation definition "bank" means a company licensed by the National Bank to undertake banking business or a bank owned by the Governmentand consequently, a company defined to include only " a share company as defined under the Commercial Code of Ethiopia, in which the capital is wholly owned by Ethiopian nationals and organizations wholly owned by Ethiopian nationals and registered under the laws of, and having its head office in, Ethiopia" see Banking Business Proclamation No. 592/2008, *Federal Negarit Gazette*, 14th Year, No 57, Article 2(1) and Article 2(5).

[13] Unlike the previous tax frameworks, the current income tax Administration, presumed to apply to all Tax laws in the country including the income tax proclamation, defined 'body' as "a company, partnership, public enterprise or public financial agency, or other body of persons whether formed in Ethiopia or elsewhere." Tax Administration Proclamation No. 983/2016, *Federal NegaritGazeta*, 22th year, No. 103, Article 2(5).

[14] The Ethiopian Income tax law follows a scheduler income tax system and accordingly adopts five schedules which are applicable to separated source of income. Schedules A is levied on Employment income, Schedule B for Rental income, Schedule C for Business income, Schedule D for "other" incomes and Schedule E for Exempted income. Schedule A of the ITP exclusively applies to employment income whereas schedule B, C, and D applies to 'Body' and other persons defined under the tax administration proclamation. See Income Tax Proclamation No. 979/2016, *Federal NegaritGazeta*, 22th year, No. 104.

of the income tax law seem the most important provisions applicable to companies rendering banking services. Though all provisions of Schedule C seem relevant to any company, for this article, only provisions which could create a difference in the conventional and interest-free banking in general and the two IFB services, *Mudharabahand Murabaha*, in particular, are discussed.[15] Accordingly, the income tax rate for companies is 30 percent.[16] This is calculated by "the total business income of the taxpayer for the year reduced by the total deductions allowed to the taxpayer for the year."[17] Another essential legal provision in the proclamation is the deductible expenses part. Generally, the proclamation allows a taxpayer to deduct "any expenditure to the extent necessary incurred […] in deriving, securing, and maintaining amounts included in business income." Coupled with this general limp of deduction, 'the cost of trading stock disposed of", "the amount by which the depreciable assets and business intangibles of the taxpayer declined in value during the year through use in deriving business income" and a loss in the disposal of a business asset are included.[18]Specific to interest, the proclamation provided that interest incurred by a taxpayer is deductible if the benefits of the debt or other instruments or agreements that give rise to the interest are used to derive business income.[19]

The other important article of the proclamation related to financial services is the taxation of interest on deposits. Under schedule D of the ITP, 5 and 10 percent tax rates are imposed on the gross amount of interest on saving deposits in financial institutions and others respectively.[20] These are the provisions that are directly linked to financial services whether they are conventional or interest-free banking services. The ITP inserted a way out article if an income doesn't fall within the four schedules of the income tax proclamation. Thus, any income derived

[15] Under the income tax proclamation Business is defined broadly to include:

> "a. Any industrial, commercial, professional, or vocational activity conducted for profit and whether conducted continuously or short-term, but does not include the rendering of services as an employee or the rental of buildings
>
> b Any other activity recognized as a trade under the commercial code; or
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> c. Any activity, other than the rental of buildings, of a share company or private company whatever the objects of the company" see Article 2(2) of the Income Tax Proclamation.

[16] Ibid, Article 19(1) of the Income Tax Proclamation

[17] Ibid, Article 20(1) of the Income Tax Proclamation. Accordingly, Business income includes "the gross amounts derived by the taxpayer", "a gain on disposal of a business asset" and other amount included as a business income under the proclamation.

[18] Ibid, Article 25(1)

[19] Ibid, Article 23.

[20] Ibid, Article 56.

but not taxable under the schedules of the ITP will be subjected to an income tax rate of 15 percent on the gross amount of the income. [21]

Before leaving this topic, the term interest needs to be clarified. To begin with, the breakthrough directive on IFB doesn't define the word interest. However, the definitional part of the directive signaled that "interest-free banking business refers to banking business …[that] avoids receiving or paying interest." As part of this, under part 7.1 of the directive, banks are bounded to comply mutatis mutandis with all regulatory and supervisory requirements except the National Bank's directives on the interest rate. The definition of interest is not clear here and thence we need to refer to other definitions in the tax laws.

Unlike the former Income Tax Proclamation, the current ITP has included a definitional sub-article designed to avoid previous ambiguity on the term.[22] Accordingly, Article 2(16) of the proclamation defined interest as *"a periodic or lump sum amount, however, described as consideration from the use of money or being given time to pay, and includes a discount, premium, or other functionally equivalent amounts."* The definitional part of this article has limited itself to the literal meaning of interest as the usual trend of defining interest in conventional banking services.

To search further and as part of the broader legal framework of the tax system, definition of interest under the Model Double Taxation avoidance treaty prepared by the then Ministry, Ministry of Finance and Economic Development and Tax treaty between Ethiopia and the UK ha presented below respectively. The anti-tax avoidance treaty defined interest as:

> income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty

[21] Ibid Article 63. This article is aimed at narrowing the possible gaps of the scheduler system which divided taxable incomes into four schedules.
[22] Ibid, article 2(16).

> charges for late payment shall not be regarded as interest for the purpose of this Article.[23]

A similar definitional article is inserted in the Double Taxation Avoidance Treaty between Ethiopia and the United Kingdom. Accordingly, interest is defined as:

> income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges from late payment shall not be regarded as interest for the purpose of this article. The term shall not include item which is treated as a dividend under the provisions of article.[24]

Based on these definitions, it is possible to discern that the definition of interest in the Ethiopian legal system is compatible with the conception of the term in conventional banking services. In some jurisdictions, interest is defined broadly to include payments: 'in the nature of interest', 'in substitution of interest' or dividends paid in respect of non-equity shares to accommodate IFB services.[25]

3.2. Value Added Tax (VAT)

Taking deposits and making loans are core banking services. In recent years, there has been an explosion in the number of different financial products offered by financial institutions and brokerage companies, some combining financial and nonfinancial products into a single product, or combining multiple financial products in a single product.[26]Colloquially, services commonly identified as financial services fall into three broad groups: "loan intermediary services provided to lenders (including persons making deposits in financial institutions) and borrowers; insurance

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[23]*Ministry of Finance and Economic Cooperation (Formerly Ministry of Finance and Economic Development) Model Convention on Double Tax Avoidance Treaties,* Article 11(4).

[24]*Convention Between the Government of the Federal Democratic Republic of Ethiopia and the Government of United Kingdom of Great Britain and Northern Ireland for the avoidance of double taxation and the prevention of Fiscal evasion with the Respect to taxes on income and capital gains*, available at the Ministry of Finance and Economic cooperation. Article 11.

[25] See the Australian law in Salim Farrar, Accommodating Islamic Banking and Finance in Australia, *UNSW Law Journal Volume 34(1)*, March 2012, P.433

[26] Alan Schenk and Oliver Oldman (2001), *Value Added Tax: A Comparative Approach,* Cambridge University Press, 2007, pp.305-307.

and gambling pooling services; and the provision of intangible investment instruments."[27] With some very limited exceptions, almost all jurisdictions treated all these financial services as exempt supplies not subject to VAT.[28]

The primary debate in the financial sector is what constitutes value-added in these sectors, i.e. how to determine the tax base.[29] Charges for services often do not reveal their full price except for specific services such as the provision of safe deposit. The charges for many services are reflected in the interest rates charged on loans and paid to depositors. Thus, the difficulty lies essentially in distinguishing a tax upon the financial services from a tax upon the return of the capital.[30] Taxation of the full amount of interest charged would amount to taxing the depositors for the use of capital in addition to the value of services rendered by the financial institution.

Besides, the difficulty arises for services charged in the margin between the return paid to lenders and that charged to borrowers.[31] The aggregate value-added created can be identified to the extent that the financial services are used by registered firms but it needs further to allocate the aggregate value added between the two sides of the transaction. This margin-based income comes not only from the acceptance of deposits and the granting of credit but also includes

[27] Robert F. Van Brederode and Richard Krever, Theories of Consumption and the Consequences of Partial Taxation of Financial Services in Robert F. van Brederode, Richard Krever (eds.) - *VAT and Financial Services: Comparative Law and Economic Perspectives*, 2017, Springer Singapore.

[28] New Zealand is the only jurisdiction to have adopted zero rated treatment for intermediary loan supplies. See MariePallot and Thomas Allen, Loan Intermediary Services: New Zealand, in Robert F. van Brederode, Richard Krever (eds.) *VAT and Financial Services: Comparative Law and Economic Perspectives*, 2017, Springer Singapore.

[29] Glenn P. Jenkins, *Value Added Taxation: The Policy Issues*, Harvard Institute for International Development (1994), p.24.

[30] Ibid.

[31] Alan Schenk and Howell Zee, *Financial Services and the Value Added Tax in* HoweellH.Zee (ed.), *Taxing the Financial Sector: Concepts, Issues and Practices,*2004, pp. 61-63. The function of financial intermediation can be divided into four distinct types:
1) intermediation between suppliers and users of financial capital (deposit-taking intermediation);
2) intermediation between persons with different exposures and/or tastes for risk (risk intermediation);
3) intermediation between persons with exposure to similar risks (the insurance function); and
4) Intermediation between buyers and sellers of commodities, currencies, and/or debt and equity securities (brokerage services). See Tim Edgar, "Exempt Treatment of Financial Intermediation Services under a Value-Added Tax: An Assessment of Alternatives", *Canadian Tax Journal*, *Vol*. 49, No.5, 2001, p.1137. This intermediation process might not problematic if it is to the final consumers. The problem is when there is another registered firm. Hence, the administrative difficulty VAT on financial services lead to the exemption of financial intermediation. See also Alan D. Tait, *Value Added Tax: International Practice and Problems*, 1988, p. 92.

trading in equities, debts, and other instruments, as well as foreign exchange transactions.[32] A unique and identifiable margin relating to an individual transaction between a single borrower and a single lender might be hypothetically conceivable but practically it is not workable.

The difficulty of taxing financial services is not measuring the value-added tax created or considerations received by the service provider.[33] However, quantifying the consideration on the transaction by transaction basis is no straight forward which is necessary for drawing upon invoice recording, the services supplied and giving the recipients of the services the right to deduct the corresponding tax as input tax.

Concerning the invoice credit method which the Ethiopian VAT laws adhered to, the operational requirement cannot readily be satisfied in the financial institutions because the invoice credit method works by charging tax at each level in a chain of transactions which is then invoiced to the individual purchasers. Some recent technological changes like internet banking cause a mix of activities and relationships more complex which is not easier to measure them.[34] Unlike conventional financial services, on the contrary, the complication of value addition seems not apparent in the IFB because there no interest and loan with interest services in the sector.

Hence, in principle, under the Ethiopian Value Added Tax Proclamation (hereafter VATP), financial services are exempted[35]. The Value Added Tax Regulation (hereafter VATR) has listed down the financial services which are exempted. Exemptions of these financial services are justified to avoid problems of complex administration. The fact remained behind the exemption or otherwise of financial sectors is administrative difficulty embodying this sector to the value-added tax base.

However, the dichotomy of exempting financial services doesn't imply that all services of financial institutions are exempted. That is why the VATP has employed the phrases 'exempted

[32]Arthur Kerrigan, the Elusiveness of Neutrality: Why Is It so Difficult to Apply VAT To Financial Services? 2010, Munich Personal Repec Archive paper number 22748, available at http://mpra.ub.uni-muenchen.de/22748/, p.2 accessed on May 23, 2018.

[33] Ibid.

[34] Readers are advised to consult TaddesseLencho's article on the exemption of financial services pinpointed the applicability of VAT on Foreclosure. TaddeseLencho, *To Tax or Not To Tax: Is That Really the Question? VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia*, Mizan Law Review, Vol. 5, No.2, December, 2011, pp. 264-310.

[35] Value Added Tax Proclamation No. 285/2002, *Federal Negarit Gazette*, 8th year, No. 33, Article 8(2)(b)

transactions', 'supply of goods', or 'rendering services' in the exemption part of the proclamation. Based on this presupposition, the VATR clearly outlined services which are exempted,[36] non-exempted services [37], and zero-rated services.[38]At the same time, the regulation distinguished services related to export or at least services that possibly fall in the realm of zero-rating to be treated as zero-rating financial services.[39]

4. Tax Treatment of Interest-free Banking Services

4.1. Experiences of other Countries

Inherent in evaluating changes to the tax law is the need to ensure that facilitating Islamic banking does not distort the operation of the market. In this case, the stand of legislations differs based on the nature of tax laws of countries(form or Substance) and the nature of the tax legislation(whether the adjustments can be made with the existing tax frameworks rather than the development of specific provisions directed solely at Islamic finance.)[40]Experiences of different jurisdictions based on these classifications is presented below.

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[36] See Council of Ministers Value Added Tax Regulations No. 79/2002, *Federal Negarit Gazette*, 9th year, No. 19, Article 20(2) which lists exempted financial services.

[37] The Regulation listed down services which are not exempted "whether or not they are rendered in connection with an exempt financial service". These are: Legal, accounting and record package services, actuarial, notary, and tax agency services (including advisory services) when rendered to a supplier of financial services or to a customer of that supplier of financial services; Safe custody for cash, documents or other items; Data processing and payroll services; Debt collection or factoring services; (e) Management services, such as management of a superannuating fund; (t) Trustee, financial advisory, and estate planning services, and (g) Leases, licenses, and similar arrangements relating to property other than a financial instrument. Article 20(6) of the VATR.

[38] The regulation used the word services not financial services in the sub article that listed down services which are not exempted or zero-rated. Services that are zero-rated are related to exports compatible with the main exemption limb of the proclamation under Article 7(2) (a) of the VATP. Zero rating (also referred to as 'exempt with credit' or GST-free in some jurisdictions) has the result that financial services will be totally relieved from tax. No VAT will be due on the supply of these services, whereas full input tax credits will be granted to financial institutions regarding their purchases. However, definition complexities may remain when determining which services are subject to the zero rate competing with the exemption, particularly given the rapid pace of product innovation in the financial sector industry. (See Robert Supra note 26, p.24). In some Jurisdictions like New Zealand Zero rating of financial services is reserved for services to registered businesses and only those business customers for which taxable supplies constitute at least 75% of total supplies made.(Ibid, p.25)

[39] As per article 20(9) of the VATR, Zero-rated exports of financial services includes the following:
"(a) financial services rendered in connection with an export of goods;
(b) financial intermediation services rendered in connection with a loan to an unregistered, non-resident person to finance the export of goods; and
(c) fees imposed by an Ethiopian bank on banking services rendered to a non-resident who is outside Ethiopia when the banking services are rendered"

[40] Review of the taxation treatment of Islamic finance: Discussion Paper, Australian government (the board of taxation), 2010 available at http://www.ag.gov.au/ccaaccessed on December, 2018.

Countries differ on the treatment of taxing the IFB based on their inclination to the form or substance dichotomy. In the tax literature, the phrase 'form and substance' is often discussed in the context of tax avoidance. There the question often arises whether the legal form of the transaction or the economic substance of the transaction is relevant in determining the tax treatment.[41] In this context, "form" is used to describe putting significant emphasis upon the legal form of a transaction i.e. how is the transaction classified from a legal perspective. In contrast, "substance" is used to denote an approach of basing the tax treatment primarily upon the economic reality or the real legal nature of a transaction. So if a country favors applying the substance-over-form doctrine, one looks to the objective economic realities of a transaction rather than to the particular form the parties employed and does not regard the simple expedient of drawing up papers as controlling for tax purposes where the objective economic realities are to the contrary.[42] The substance over form also impels many more specialized doctrines in the literature including the economic substance and step transaction doctrines. the point of economic substance doctrine is to look beyond the form of a transaction and to determine whether its substance is of such a nature that it should be recognized to protect the intent of the legislature or purpose embodied in the laws whereas the step transaction allows a court to treat a series of closely related transactions as one for tax purposes and to disregard the independent tax effects of intermediate steps.[43]

Then the effect of inclination of countries towards form or substance may have an implication on the adaptability of tax legislations to IFB services. It has been said that:

> Whether or not a conventional tax system is able to cope with Islamic finance transactions without a need for specific legislation will depend broadly on the extent to which it follows the economic substance or the legal form of transactions: the closer the alignment of conventional tax rules with economic substance, the less adjustment is likely to be needed for Islamic finance transactions. The U.K. is an example of a country which has needed to introduce

[41] Dar, H. A. and Moghul, U. E. (eds), *The Chancellor Guide to the Legal and Shari'a Aspects of Islamic Finance,* 2009, (Chapter five). London: Chancellor Publications Limited.
[42] Ibid
[43]Philip Sancilio,Clarifying (Or Is It Codifying?) The "Notably Abstruse": Step Transactions, Economic Substance, and the Tax Code, Columbia Law Review, Vol, 113, 138, No. pp.143-162.

> — and has done so — significant changes to overcome obstacles for Islamic finance within its general tax system.*[44]*

If we took changes within the existed tax formworks or new frameworks, countries differ based on the approaches in implementing tax changes to facilitate IFB. Countries that adopt a total absorption method stand for measures that commonly supplant conventional finance law with Sharia commercial and tax law.[45] Whereas countries that adhere to the dual model method "recognizes the integrative duality of financial systems in which Islamic finance exists parallel with conventional finance."[46] A parallel tax system is required to be adopted in this modality. Another modality of tax treatment is the integrative approach which targets selective changes to tax law and financial laws to facilitate the development of Islamic finance within the economy. In this modality, legal impediments inherent in tax and financial regulations are separated for special consideration to allow integration of Islamic financial practices within conventional banking to maintain the integrity of existing prudential laws *ex-ante*.[47]Based on these categorizations, countries may follow any of these systems taking the specific realities of their tax policy or frameworks. In the UK, the legislation which is set out in the Finance Act 2005 does not mention the Sharia or use any Islamic finance terms or it does not make provision specifically for Islamic financing or Shari'a compliant' transactions nor will one find words such as *Murabahah* or *Mudarabah*. Instead, the legislation creates a freestanding set of definitions for use in UK tax law which is entirely neutral regarding religion.[48] For transactions that fall within

[44] Organization for Economic Co-operation and Development (OECD), Background paper, International Tax Dialogue (ITD) Global Conference on Financial Institutions and Instruments – Tax Challenges and Solutions, 2009.
[45] A total absorption model refers specifically to the commitment by a country to initiate efforts to completely Islamize its banking systems. Countries such as Sudan and Iran have adopted this approach and associated measures to completely supplant conventional finance law with Shari'ah commercial law. See, Brett Freudenberg and MahmoodNathie, Islamic Finance in Australia:Methods of Tax Reform, *Asia Pacific Journal of Taxation,* Vol. 15 No. 1, Spring/Summer, 2011. P.79
[46]Ibid, p.80.
[47]Ibid, p, 81. This modality can be implemented using different mechanisms. The first method is Listing Method. This involves identifying and then "listing" all requirements that may impede the introduction of Islamic finance. Tax and regulatory reform is then targeted in terms of priority and necessity. This could include widening definitions or clarification of terms applicable for conventional services. The second method is called exceptions method. This method assumes that Islamic financial instruments and practices substantially conform to their conventional equivalents albeit with important *exceptions* that may require special attention. Legislators therefore need only to address "exceptional" issues and only in situations where deviations from acceptable norms and standards are significant.
[48] See, *the Development of Islamic Finance in The UK: The Government's Perspective.* Available at http://www.hmtreasury.gov.uk/d/islamicfinance101208.pdf accessed on may, 2019.

these definitions, the legislation specifies how to determine the finance cost and how that finance cost is treated by both the payer and the recipient.

In some other countries, they have specific laws that addressed the taxation of IFB in their respective laws. In Australia, for instance, the Australian *Income Tax Assessment Act* has extended the definition of 'interest' to include payments: 'in the nature of interest', 'in substitution of interest' or dividends paid in respect of non-equity shares which possibly accommodates the taxation of IFB parallel to interest in the conventional banking services. As result, the majority of IFB based on deferred payments and tend to shadow their price rates (profit margins) are likely to be deemed 'interest' and thus subject to the tax rate specified in the laws of the country.[49]

Within this spectrum, Malaysia, a key global player in Islamic finance, has enacted tax legislation to ensure that IFBservices are taxed in the same manner as conventional arrangements. For tax purposes, the profits of Islamic financial arrangements and the payment of profits are generally treated as interest. Malaysian tax legislators introduced different amendments to address the tax treatment of Islamic financial instruments.[50]

In South Africa, the existed tax laws are amended to level the playing field for conventional and Islamic banking. Accordingly, the amended law incorporated definitions on sharia arrangements; *Mudaraba*,*Murabaha*, and diminishing *Musharaka.* Specific articles are extended to accommodate the tax aspect of interest-free banking services.[51]

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[49]Salim Farrar, Accommodating Islamic Banking and Finance in Australia, *UNSW Law Journal Volume 34, No.1*, March 2012.

[50]WalidHegazy, *Islamic Finance in Malaysia:A Tax Perspective***,** Proceedings of the Second Harvard University Forum on Islamic Finance: Islamic Finance into the 21st CenturyCambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University, *1999.Pp.215-224.*

[51] Omar Salah and Christa Rautenbach, Islamic Finance: A Corollary to Legal Pluralism or Legal Diversity in South Africa and the Netherlands? *The Comparative and International Law Journal of Southern Africa,* Vol. 48, No. 3, November 2015, pp. 488-515, p.508. According to this article, in South Africa, the *Mudharabah*Agreement is taken to be equivalent with conventional savings account and hence an amount received by or accrued to a client in terms of a *Mudharabah*agreement, is regarded as interest. Accordingly, theIncome Tax law allows for a basic interest exemption. Any profit earned by a natural person in termsof a *Mudharabah*agreement is regarded as interest and qualifies for the sameinterest exemptions as its conventional counterpart.

4.2. The Ethiopian Tax Laws

The main attribute of interest-free banking is that no interest is imposed on the services whereas, in conventional banking services interest is subject to income tax Under the VAT laws, financial services are exempted not because they are necessities but simply because it is difficult to impose a value-added tax on the intermediaries. Such intermediaries are not a challenge for interest-free banking. So the next issue will be, then, how do the income tax laws and VAT laws treat interest-free banking.

So far, almost all commercial banks have received licenses for IFB windows from NBE. Besides, these banks are delivering IFB services at a full-fledged level. IFB services may be grouped into Deposit Account Services and Trade partnership/investment financing. Under the deposit account services, *WadiahAmanah*, *Amanah,* and *Mudharabah*are the most common services.[52]With the trade partnership/investment IFB services, *Murabaha,* *Musharakah,* Salam, *Istisna*and*Ijara* are the most common services in Ethiopia.[53]Since time and space will not allow addressing all these services, to show the tax loopholes or tax challenges of these services, *Mudharabah* and *Murabaha* IFB services are taken as case studies. The analysis limits itself to VAT and Income tax laws only.

4.2.1. *Mudharabah*

Mudharabah[54]is a contract conducted between two parties, a capital owner [depositor] and an investment manager [financial institution].[55] In other words, the *Mudharabah* is a deposit account for customers who wish to maintain a regular (or irregular) saving pattern. Under the Sharia principles, this type of account is based on a profit or loss sharing concept, with a risk that

[52] A simple look at the websites of Ethiopian commercial banks signifies that these are the most shared customer deposit account services even though some banks add special account within these services while others are rendering limited services. A detailed definitions and classifications are available in the website of Commercial Bank of Ethiopia, available at *www.combanketh.et* accessed on July, 2018

[53] Id.

[54] In this article from the list of *Mudharabah* services, profit sharing saving account is taken for analysis. This IFB services is a type of investment partnership where a customer deposits money for unspecified length of time and the Bank shares both the profit and loss with her/him. The customer may withdraw his/her deposit at any time, but the Bank may impose some restrictions on the amount to be taken out as this arrangement is both profit and loss sharing partnership.

[55]Said M. Elfakhani, Imad J. Zbib and Zafar U. Ahmed, Marketing of Islamic Financial Products in M. Kabir Hassan and Mervyn K. Lewis, *Handbook of Islamic Banking(*116-127, Edward Elgar Publishing Limited, 2007, *p,119.*

customers may lose their initial capital saved with the Islamic finance provider.[56] The financial institution pools its customers' funds with its funds to invest in Sharia-compliant investments assets and charges a fee (management fee),[57] which is often explicitly identified along with other profit components. Each month, the bank calculates the actual profit and credits its customers' accounts based on previously agreed profit-sharing ratios. As noted, in the case of losses, customers may lose some or all of their initial capital.[58]If there are profits from the bank's operations, those profits are shared between the bank and the customer on an agreed basis. Presumably, the customer obtains a return similar to market interest rates while the bank keeps any excess return as a reward for organizing the transactions.

- **Income tax and VAT Issues**

It is crystal clear that the profit from the *Mudharabah* contract is part and parcel of the business income, on the bank side, under schedule C of the ITP. The *Mudarib* fees, profit, and loss from the *Mudharabah* should be included in the financial institution's business income. It will be necessary to examine the legal nature of the relationship between the financial institution and the customer. Unlike the trend of treating this relationship as a partnership in some jurisdiction, in the Ethiopian case, the relationship does not fulfill the legal requirement of partnership or any other business organization in the commercial code[59] or the definition of the body in the tax administration proclamation or there is no way that the customer is considered as a shareholder of the banks. If this is so then, there is no possibility that the profit distributed by the bank to the

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[56] Id.

[57] According to the model *Mudharabah* Agreement prepared by the commercial bank of Ethiopia, the managerial fee is defined as fees payable to the bank because of the profitable investment it endeavors.

[58] A sample contract prepared for a customer deposits money for unspecified length of time by the commercial bank of Ethiopia in one of its article reads as follows "ደንበኛውበዚህስምምነትመሰረትገንዘብማስቀመጡብቻያስቀመጠውንገንዘብሙለበሙለስለመከፈለወይምትርፍስለመጋራቱዋስትናሆኖየማይቆጠርመሆኑንተስማምታል" which indicates saving by itself doesn't guarantee repayment of the money (Draft agreement prepared by the Commercial bank of Ethiopia article 6).

[59] In the commercial code of Ethiopia, a business organization is defined as "any association arising out of a partnership Agreement" and Partnership agreement is in turn defined as "a contract whereby two or more persons **who** intend to join together and to cooperate undertake to bring togethercontributions for the purpose of carrying out activities of an economic nature and of participating in the profits and loss arising out thereof, if any." Since formation of any business organization other than a joint venture is mandatorily required to be made in writing and fulfill the requirements under the Ethiopian commercial code, it seems not legible to treat*Mudharabah* contract as partnership. The Commercial Code of the Empire of Ethiopia, proclamation No.166/1960, *NegaritGazeta* Gazette Extraordinary, Article 210, 210 and 211.

Customer could be considered as a dividend[60] to tax under Schedule D of the ITP. The last resort we have in the tax law is the definition of interest in the ITP.

As it is described in the preceding topics, article 2(16) of the income tax proclamation defined interest as “a periodic or lump sum amount, however, described as consideration from the use of money or being given time to pay, and includes a discount, premium, or *other functionally equivalent amounts*” (emphasis added). The “other functionally equivalent amount” phrase of this definition might be interpreted as the ‘interest in substance’ conception in other counters. In the UK, for instance, for corporation taxes, interest applies to interest paid on securities paid on “securities under which the consideration is given [..]is dependent on the results of the company business” which this provision would most likely apply to the profit-sharing payments which the bank makes to its customer under the*Mudharabah* contract.[61] In the Australian tax laws, there is an extended definition of ‘interest’ to include payments ‘in the nature of interest’, ‘in substitution of interest’, or dividends paid in respect of non-equity shares to avoid ambiguity created by these relations.

All in all, from the income tax perspective, the *Mudharabah* service may have the following tax implications. If we took the ‘substance’ of the service, it seems equivalent to a savings account. Like a conventional savings product, the purpose of *Mudharabah*serviceis to offer investors an agreed return on their investment. The bank pools the money with that of other investors and it is subsequently invested in *shari'a*-compliant transactions. The income is then shared between the client and the bank following the agreement and after deduction of bank charges. Any profit earned by a natural person in terms of a *Mudharabah*agreement may be regarded as interest and qualifies for the same tax rate as a conventional banking counterpart.

Besides, within this thinking, if the tax laws are not clear in this matter, IFB services may pose challenge for the VAT laws. In fact, according to the VATR “transactions concerning money…, deposit, savings, and current accounts, payments, transfers, debts, cheques, or negotiable

[60] Article 2(7) (C/ of the ITP has defined dividend broadly to include “the amount of loan payment for an asset or services, value of any asset or series provided, or any debt obligation released, by a body to, or in favor of, a member or related person of a member to the extent that the transaction is *in substance*, a distribution of profit”(emphases mine).

[61] Dar, H. A. and Moghul, U. E. (eds), *The Chancellor Guide to the Legal and Shari’a Aspects of Islamic Finance,* 2009, (Chapter five). London: Chancellor Publications Limited.

instruments, other than debt collection and factoring” are exempted.[62] However, the bank has agreed in advance that it will invest the money in the permissible activities. Unless these investments are non-taxable transaction under the law, there is no law which proscribes imposition of VAT on these activities.

Furthermore, taking the model*Mudharabah* contract prepared by the commercial bank of Ethiopia, the Bank is entitled to collect a ‘Managerial service fee’ for the profitable investment it undertakes. In this case, issues could arise that this fee may be considered as to manager’s fee and, therefore, subject to VAT. It may fall under “management services” stipulated in Article 20(6) (e) which are not exempted. Following the introduction of the IFB services in Ethiopia, the concerned authority was expected to hammer out guidelines or directives to address the taxation issues of IFB. This far, however, there is no guideline/ directive for this matter.[63] For all these purposes, it seems that the law needs amendment or some other arrangement to consider these transactions.

4.2.2. *Murabaha*

In conventional banking, when a person needs capital to finance a business he makes a request to the bank for a loan. Bank issues loan at a certain interest rate after making risk assessment and calculating the time value of money. In this way, the person receives the money to finance capital and pays back the actual loan with interest over a certain period in monthly installments. Islamic banks have different procedures and processes to execute a transaction similar to the one mentioned above. Of these services of the IFB, is *Murabaha* contract is commonly cited. *Murabaha* means “sale on profit”. It is technically a contract of sale in which the seller declares his cost and profit."[64] In other words, it is a contract between a buyer and a seller in which the seller sells the commodity to the buyer at an agreed price.[65]

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[62] See VATR Article 20(2) (b).

[63] Interview made with Tax policy experts at the Ministry of Finance and Interview made with Legal office head of Ministry of Revenue, September, 2019.

[64] Fuad Abdullah and Mohammed Kayed, *Islamic Banking: Theory, Practice and Challenges*, Zed Books, 1996, Glossary part.

[65] The same conception is provided at the website of the commercial bank of Ethiopia. Accordingly, *Murabaha* “involves a request from a customer to the Bank or by the initiative of the Bank to purchase and then on sell to the customer certain goods and/or assets not banned by Shari’a.” The sale by the Bank to the customer is at cost plus on an agreed margin. Payment by the customer is in one or more pre-determined instalments at agreed points in time.

In *Murabaha*, a bank acquires a specified product to resell it to one of its customers for a price that reflects the cost of acquiring the product plus a reasonable amount of profits for the bank. The sale by the Bank to the customer is at cost plus on an agreed margin. Payment by the customer is in one or more pre-determined installments at agreed points in time. Ownership of the goods passes to the customer upon delivery by the Bank. The contract is valid on the condition that the price, costs, and, profit margins of the seller are stated at the time of the agreement.[66]

The main difference between *Murabaha* and the corresponding conventional bank service is that in the latter the bank advances cash based on a loan against which it earns interest. In the case of IFB, the bank first purchases[67] an item, and by taking its possession assumes the risk of that item. Thereafter, the bank sells it for a specified profit. In the case of conventional banking, the bank collects principal plus interest on debt documented as a loan. In contrast, the *Murabaha* model of Islamic finance is predicated on the permissibility of charging a credit price that is higher than the spot price of a property.[68]

- **Income Tax and VAT Issues**

From the financial institution's perspective, the *Murabaha* service will not pose a tax challenge to the current income tax laws. The question of whether the profit received from *Murabaha* is treated as the interest in a conventional loan transaction or just as profit *per se, however,* persists. In the UK for example, the approach followed by the legislators was to look into the economic substance of the transaction rather than its legal form. In other words, the profit derived from

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Ownership of the goods passes to the customer upon delivery by the Bank. Such a sale contract is valid on condition that the price, other cost and the profit margins of the seller are stated at the time of the agreement of sale. The asset/good remains as a mortgage with the Bank until the default is settled. The Bank may ask for collateral, if necessary, for this financial service. Services included under the *Murabaha* banking services are:

- *Murabaha* fixed-time financing(For production inputs, purchase of machinery or short-term project)
- *Murabaha* revolving financing (For purchase of production inputs)
- *Murabaha* LC financing (For purchase of production inputs from abroad or for buying machinery)
- *Murabaha* pre-shipment and Murabaha post-shipment financing (for purchase of goods to be exported)

See interest free banking in the website of the commercial bank of Ethiopia at www.combanketh.et accessed on *July, 2018*

[66] WalidHegazy, supra note 49, p.224.

[67] This can be done by the client himself as agent of the bank to purchase on its behalf.

[68] Mahmoud A. El-Gamal, Islamic Finance: Law, Economics, and Practice, Cambridge University Press, 2006, p.64

Murabaha is treated the same way as interest in a conventional loan transaction. *Murabaha*, therefore, has been treated as if it was an interest-bearing instrument and consequently the tax treatment is equivalent to that of interest-bearing products.[69]

If the issue is the timing of recognizing the profit where the term is more than a year, uncertainty may arise regarding when a financial institution would be required to include in taxable income-the gain on sale of the asset—at the time of sale of the business assets or over the payment period. In a conventional loan scenario, the economically equivalent "interest" would be recognized over the term of the loan (for example, five years).[70] Generally, a taxpayer should include in the business income the difference between the cost of a good and the amount it was sold to the customer in the year of sale.

From the customer perspective, according to article 23(1) of the ITP, a taxpayer is entitled to deduct "for any interest incurred by the taxpayer in a tax year to the extent that 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." An important element that the law should address is whether the profit collected by the bank will be considered as interest so that it will fall beneath this article or not. In countries like Malaysia, "interest paid on borrowed money is a deductible expense if it is employed in the basis period in the production of gross income or laid out on the purchase of assets used, or held, for the production of gross income."[71]

As it is pointed out above, in *Murabaha* the bank purchases the property from a third party for the benefit of its client, and the purchase is based on the terms and conditions agreed upon by its client and the third party. The bank then resells the property to the client with a mark-up agreed upon by the bank and the client. So according to the existed income laws, this income can be treated in two ways. First, the mark-up can be characterized as interest generated for the bank and interest incurred by the client so that the rate on interest in the schedule D of the income tax

[69]TareqMoqbel, The UK Islamic Finance Taxation Framework and The Substance VsForm Debate in Islamic Finance, Legal Ethics, Vol.18, No.1, 2015, pp.84-86.

[70] Under the Ethiopian Income Tax Proclamation, in long-term contracts, "a taxpayer accounting for business income tax on accrual basis shall include amounts in business income and claim deductions for expenditures arising under a long-term contract for a tax year based on the percentage of the contract completed during the year." Article 32.

[71]WalidHegazy, supra note 49, p.224.

and the deductible expense on interest under schedule C will apply. Second, if this marked margin/profit margin is formally considered as profit then it will be included in the profit and loss balance sheet of the bank and then the 30 percent rate on business income will apply.

On the VAT side, under the conventional arrangement, the sale of a good is subject to VAT regardless of the kind of institution. In the case of the *Murabaha*, the institution purchases and resells the good through an arrangement that is typically structured to generate a return in line with conventional financing rates. As there is a second transaction on an increased amount (i.e., the price of the good plus the profit), a higher VAT is exigible. However, in substance, if the profit amount could be viewed as a financing cost or interest and, thus, as a financial service, VAT would not arise. However, the demarcation among the exempted, taxable, and zero-rated financial services under the VATR does not appear to support this interpretation. As a result, there seems to have a legal foundation to impose VAT on this service. If so, consumers will face higher costs under a *Murabaha* than under a conventional financial instrument, increasing the risk that *Murabaha* products would be unattractive in the marketplace.

According to the experts in the Ministry of Finance and Ministry of Revenue, to this date, no guideline or directive is issued for this purpose. On an individual basis, however, the writer of this article has found out that the ministry, Ministry of Finance, on banks own request has sent a letter to avoid "double" VAT on *Murabaha*which states that banks are not required to collect VAT from their customers except the input tax from the sellers of the property.[72]VAT will not be imposed on the customer of the IFB and thence no output tax on the side of the bank while VAT will be imposed during the purchase of the property from the seller. This is how the Ministry of Finance's ruling aimed at avoiding the multistage nature of VAT. This does not, however, bring the equal treatment of the same transactions to get through the conventional and Interest-free Banking services. At least this policy choice disallows banks to offset the input tax imposed on the property by the seller. Besides, it is questionable on what legal ground and authority does the ministry exempted banks from collecting VAT from their customers. The VATP has empowered the Ministry to exempt 'other goods and services' through a directive. Plus, it is authorized to

[72] Advance ruling made to the NIB bank Share Company on issue of VAT collection from Interest Free Banking services.

pass binding private rulings upon the application of the taxpayers.[73]However, the issue of taxation or exemption of IFB needs a thorough policy decision, not private or public ruling, on all possible tax issues.

Conclusion

In conventional banking, when a person needs capital to finance a business, he makes a request to the bank for a loan. Bank issues loan at a certain interest rate after making risk assessment and calculating the time value of money. In this way, the person receives the money to finance capital and pays back the actual loan plus interest over a certain period in monthly installments. Islamic banks have different procedures and processes to execute a transaction similar to the one mentioned above. As Sharia does not allow trading of money and receiving money without efforts, therefore, Islamic banks do not lend money or deposit money with interest. They usually deal in commodities through buying and selling contracts which are known as *Murabaha*or deposit money using like *Mudharabah* contract.

On the deposit side, the usual trend of conventional banking is that upon receipt of funds from their customers, banks credited interest to their customers based on their agreements. However, in IFB, since interest is prohibited there are arrangements, like *Mudharabah and Murabaha*, and such financial services are required to be sharia-compliant.

On the other hand, in countries like Ethiopia, most tax laws are arranged to be compatible with conventional financial services. Thus, the introduction of Interest-free banking usually poses a challenge to the tax system until countries hammer out Guidelines or laws for that purpose. Accordingly, the core issue in the taxation of IFB products, in general, is that these transactions require additional steps when compared to their conventional counterparts to achieve the same economic benefits. Hence, if each step were to be considered separately, this would give rise to additional tax costs. In *Murabaha*, there are more transactions and documentation and hence, VAT may arise at each step of the *Murabaha* arrangement though there are some attempts to settle the issue from the ministry of Finance side. At the same time, the profit margin of the transaction poses a question of whether it should be treated as interest or profit *per se* for the

[73]VAT Proclamation, Supra note 35, article 8(4) and Tax Administration Proclamation, Supra note 13, article 71.

income tax purpose. In the *Mudharabah* financing, too, whether the profit or managerial service (depending on their agreement) is part of the definition of interest under the income tax laws or whether this service is treated as VAT Exempted in the VAT laws is questionable. Due to this, the resulting tax treatment, taxing or exempting the services, may put IFB at a competitive disadvantage or advantage compared to conventional banking services.

Therefore, this time, it could be deduced that the tax aspect of IFB is still a virgin area yet to be addressed by the Ethiopian tax laws. Neither the National bank directive nor any other tax law that regulates company activities in Ethiopia provides a solution for the tax aspect of the Islamic financial products. The current 'here and there' advance ruling of the Ministry of Finance may reduce the problem but it needs long-lasting legal solutions. The problem demands the enactment of a guideline or amendment of the existing tax laws in Ethiopia.