Ethiopian Law on Transfer Pricing: A Critical Examination

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'Anything that can be priced can be mispriced' (Raymond Baker, *Capitalism's Achilles: Dirty money and how to renew the free market system*)

Abstract

Transfer pricing by multinational corporations is one of the darkest sides of international investment. Companies transfer large amount of profit untaxed out of a jurisdiction with the highest tax rate to countries with lowest corporate tax rate by mispricing their transactions. The OECD and UN came up with model conventions aimed at tackling this dilemma in member countries. Ethiopia, in its part, has introduced provisions governing transfer pricing in both the Customs and Income Tax Proclamations. The Proclamations require related companies to make their transactions at arm's length. Nonetheless, lack of directives and absence of comparable data, *inter alia,* are hindering the application of the laws on transfer pricing in the country, eventually, resulting in a loss of the very much needed tax revenue.

1. Introduction

This article aims at throwing some light on one of the hardly discussed subject matters of the Ethiopian tax system, that is, transfer pricing by multinational corporations (hereinafter, MNCs). The earlier tax laws of the country simply by-passed this matter without devoting a single

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provision governing the area. Given the economic and political realties at the time, the absence of legal regime dealing with the subject-matter is understandable, to say the least.

After the change of government in 1991, the country immediately embarked on decentralizing the economy and opening up many investment areas previously considered as government's only. In addition, the government has also lifted the restrictions on private ownership of properties. Encouraged by these and subsequent investment laws, many local and international companies have started to apply for new investment permits in Ethiopia. In the past ten years, around 6,000 foreign based companies have applied for investment permits at the Ethiopian Investment Authority.[1]

	Year	No. of Investment requests
1	2004	07
2	2005	294
3	2006	394
4	2007	567
5	2008	908
5	2009	945
6	2010	1270

Table 1 Source: Ethiopian Investment Authority (EIA)

[1] Data gathered from the Ethiopian Investment Authority. The data can be accessed from the data collection center of the Authority free of charge. The investors applied to the authority between July 2003-2013.

The volume of import has also increased from 4,932,925 metric tons in 2004/05 to more than 8 metric tons in 2009/2010.[2] With the increase of imports, the income from customs duty has also increased from 2,953.81 billion birr in 2005/06 to 5.854.66 billion birr in 2009/10, with annual average growth rate of 19.9.[3] The total revenue from foreign trade has also increased from 11.26 billion birr in 2005/06 to 35.71 billion birr in 2009/2010.[4] The country is profoundly benefiting from the recent increase in FDI. Nonetheless, I would argue, investment measures not complimented with the appropriate transfer pricing measures could result in a loss of desperately needed local tax revenue.

	Year	Volume of import(Metric Ton)
1	2004/05	4,932,925
2	2005/06	5,344,825.5
3	2006/07	4,665,454.28
4	2007/08	5,8511,904.23
5	2008/09	7,807,006,73
6	2009/10	8,492,485.84

Table 2 Source: Ethiopian Revenue and Customs Authority (ERCA)

In this article, the transfer pricing provisions of Ethiopia as provided in the Income and Customs Proclamations is critically examined. The writer has conducted literature review with a view of examining the transfer

[2] Ethiopian Revenues and Customs Authority, *Ethiopia: Foreign Trade and Federal Duty and Tax Revenue Collection (2005/06-2009/10), Statistical Bulletin* Vol.1p.16.
[3] Ibid. In addition to the customs duty goods imported into the country are subject to Excise tax (average rate of 30% for some goods the rate can be 100%), Value Added Tax (Flat rate of 15%) and Sur tax (10%).
[4] Ibid. Imports into Ethiopia are subject to the payment of Customs duty (the rate vary from good to good), Value Added Tax (15% flat rate tax for all imports of goods and services), Sur Tax (there is a 10% Sur tax on all imports) and Excise tax.

pricing principles and methods applicable in most jurisdictions around the world. Focus group discussions with the responsible departments in Ethiopian Revenue and Customs Authority, (hereinafter, ERCA) have also been conducted.

The article has five sections. The first section provides for an introduction to this article followed by the second section which sketches the relevance of the concept of transfer pricing to the Ethiopian tax system. Section three outlines the basic precepts of transfer pricing and transfer pricing methods existing in the Ethiopian Income Tax Proclamation. The fourth section deals with the provisions of the Customs Proclamation governing the subject-matter, but from a different perspective. The convergence-divergence nature of the Income Tax and Customs Proclamation in terms of regulating transfer pricing is dealt with in the fourth section. The main pitfalls of the current tax system in regulating transfer pricing is also discussed in the fourth section followed by conclusion.

2. Transfer Pricing: Basic Concepts and Methods

Recent developments in technology, transportation and communication have resulted in the growth of MNCs around the world. It is estimated that there are now more than 82,000[5] MNCs each with an average of 10 affiliates around the world.[6] Value added activities of MNCs amount to 11% of the world gross domestic products (GDP).[7] MNCs transact with

[5] UNCTAD Word Investment Report 2010 available at http://unctad.org/en/Docs/wir2010_en.pdf accessed on August 31, 2013.
[6] Ibid.
[7] Ibid.

each other extensively; it is even estimated that 60% of the international trade is between MNCs.[8] MNCs charge each other for the services or goods one receives from the other; the price at which they transact is referred to as transfer price. Transfer pricing, therefore, is the pricing of goods and services for transactions among MNCs.[9] It generally '*refers to the setting of prices for transactions between associated enterprises involving the transfer of property or services'.*[10]

In efficient market system, sale between two enterprises is based on market profitability. The company selling the item or rendering a particular service will not sell the items or render the services unless it gets a profit from the transaction. At times, companies provide goods or render services to a party at a price that it would not be willing to give to other clients. This by itself is not a problem. Companies may sale their items at lower or higher prices due to various justifiable economic reasons, more frequently than not, however, MNCs sell their products at a lower price or purchase a product from the subsidiary at a hugely inflated prices solely to reduce their tax obligations.[11] These kinds of acts

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[8] Ibid.

[9] Alexandre Tadeu Seguim, New Transfer Pricing Rules in Brazil, 19 NW. J. INT'L L. & BUS. 393, 395 (1999); see Susan C. Borkowski, Advance Pricing (Dis)Agreements: Differences in Tax Authority and Transnational Corporation Opinions, 22 INT'L TAX J. 23 (1996).

[10] UN Practical Manual On Transfer Pricing for Developing Countries, Department of Economic and Social Affairs(2013).2.

[11] *Death and taxes :the true toll of tax dodging* ,A Christian aid Report (2008)5, Glen Rectenwald, *A Proposed Framework For resolving The transfer Pricing Problem: Allocating the tax base of Multinational entities based on real economic Indicators of benefit and burden* , DUKE JOURNAL OF COMPARATIVE & INTERNATIONAL LAW [Vol 223,2012)423, Robert Z. Aliber ,*Transfer Pricing A taxonomy of Impacts on Economic welfare ,in Alan M.Rugman and Lorriane Edne*n(ed), Multinationals and Transfer Pricing(1985)82, Marc M. Levey et el ,*Transfer Pricing Rules and Compliance Handbook*(2007)2.

'*impact on the legitimate tax revenues of countries where economic activity of the MNC takes place, and therefore the ability of such countries to finance development.*[12] For instance, it is estimated that Ethiopia has lost around 10 million Euros in tax revenues due to mispricing by MNCs.[13]

Many countries around the world use the *arm's length* as the main method in order to regulate transfer pricing.[14] Brazil,[15] notably, however, introduced a unique system to determine prices. In addition, there is a growing suggestion from group of economists for the adoption of a *formulary* approach, especially in developing countries.[16]

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[12] UN manual Cited supra note 7 at 3.

[13] *False profit: Robbing the poor to keep the rich tax free* ,A Christian Aid Report(2009)22, U.S. researcher Raymond Baker estimates that up to $500 billion in capital flows out of developing countries through transfer pricing abuses. See Raymond Baker, Capitalism's Achilles: Dirty money and how to renew the free market system(2005)172.

[14] John Braithwaite, Markets in Vice, Markets in Virtue(2005)89-91, Karl Wündisch(ed.), *International Transfer Pricing in the Ethical Pharmaceutical Industr*y(2003)105-108, Michelle Markham, *The Transfer Pricing of Intangibl*es(2005)20-23, Brian J. Arnold and Michael J. McIntyre, *International Tax Primer*(2002)60-62.

[15] Marcos Aurélio Pereira Valadão,Transfer Pricing in Emerging Economies :Brazilian Case,Avilable at http://www.un.org/esa/ffd/tax/2012EgmTax/Presentation_PereiraValadao.pdf,Accessed on May,21,2013, Brazil-Changes to Transfer Pricing rules(2013)available at http://www.kpmg.com/global/en/issuesandinsights/articlespublications/taxnewsflash/pages/brazil-changes-to-transfer-pricing-rules-2013.aspx accessed on May 22, 2013, Attaining Falaco, Brazilian transfer pricing –A Practical Approach Could this be a model for Developing Countries ,A presentation available at http://www.taxjustice.net/cms/upload/pdf/Tatiana%20Falcao%201206%20Helsinki%20ppt.pdf,accessd on May22,2013.

[16] Reuven S.Avi-Yonah and Kimberly Clausing, *A Proposal To Adopt Formulary Apportionment For Corporate Income Taxation: The Hamilton Projec*t , Working Paper No.85 of June 2007, University of Michigan Law School ("The Hamitlon Project"), Reuven S. Avi-Yonah, *et al* , *Allocating Business Profits for Tax Purposes: A Proposal to Adopt a Formulary Profit Spl*it, University of Michigan Law School Program in Law and Economics working paper ,available at http://law.bepress.com/umichlwps-olin/art95 accessed on June 12 ,2012.

In Ethiopia, article 29 of the Income tax Proclamation regulates MNCs intra trade. The article reads: [17]

> *'Where conditions are made or imposed between persons carrying on business in their commercial or financial relations which differ from those which would be made between independent persons, the Tax Authority may direct that the income of one or more of those related persons is to include profits which he or they would have made but for those conditions. The Tax Authority shall do so in accordance with the directives to be issued by the Minister.'*

According to the above provision, ERCA can use either one of the following approaches to regulate MNCs intra trade.

2.1. The Arms' Length Method

As provided in article 29(1) of the proclamation, the arm's length approach is the primary approach that would be made applicable in case of MNCs intra trade.

The arm's length approach, as enunciated in the OECD and UN guidelines, is the most widely practiced method around the world. The arm's-length principle states that the amount charged by related party to another for a given product must be the same as if the parties were not related. An arm's-length price for a transaction is, therefore, the price of that transaction on the open market. The principle prohibits the regulation

[17] Income Tax Proclamation No.286/2002,art.29.

of the price for a particular item by anything other than market forces. In this regard, article 9 of the OECD Model Tax Convention states the following:

> *'[Where] conditions are made or imposed between the two [associated] enterprises in their commercial or financial relations which differ from those which would be made between independent enterprises, then any profits which would, but for those Conditions, have accrued to one of the enterprises, but, by reason of those conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly.'*[18]

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[18] Michelle Markham,cited supra note 14,at110, Wagdy Moustafa Abdallah,*Critical Concerns in Transfer Pricing and Practice*(2004)150, Michael C. Durst, Making Transfer Pricing Work for Developing Countries, December 10,2013 ,available at http://www.taxjustice.net/cms/upload/pdf/Durst_2010_developing_countries.pdf,acessed on may 18,2013. See also Michael C. Durst, *It's Not Just Academic: The OECD Should Reevaluate Transfer Pricing Laws,' Tax Notes International* , Jan. 18, 2010, p. 247, Doc 2009-26892 , or 2010 WTD 11-14 ; and Durst, *The President's International Tax Proposals in Historical and Economic Perspective*, Tax Notes International, June 1, 2009, p. 747, Doc 2009-11696 , or 2009 WTD 103-14, Robert Feinschreiber and Margaret Kent, *Asia-Pacific Transfer Pricing Handbook*(2012)485, Robert Feinschreiber, *Transfer Pricing Methods: An Applications Guide*(2004)70, Marc M. Levey et al , *Transfer Pricing Rules and Compliance Handbook*(2007)160, Alan Paisey and Jian Li, *Transfer Pricing: A Diagrammatic and Case Study Introduction, with Special Reference to China*(2012)108, Erik Wintzer, *Transfer Pricing for Multinational Enterprises: An Integrated Approach* (2007)22, See also Article 9 paragraph 1 of the OECD Model Tax Convention , available at http://www.oecd.org/tax/transfer-pricing accessed on June 12 ,2013, The UN Model Convention Article 9(1) states the following

"Where: (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or, (b) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State, and in either case conditions are made or imposed between the two enterprises in their commercial or financial relations which differ from those which would have been made between independent enterprises, then any profits which would, but for those conditions, have accrued to one of the enterprises, but, by reason of these conditions, have not so accrued, may be included in the profits of that enterprise and taxed accordingly

The OECD empowers local tax authorities to adjust profits when the price charged by related companies differs from those which might have been charged by unrelated parties for the same transaction. Both model laws treat related MNCs as if they were unrelated independent entities.

Transfer pricing rules are intended to govern transactions among related parties.[19] As a result, relatedness or otherwise of it, is a central concept to the operation of transfer pricing. Therefore, tax evasion arrangements between unrelated parties, *albeit* showing clear pricing differences from the ordinary market, are not subject to article 29.[20]

According to the Income Tax Proclamation, a related person, for natural person includes any relative of the natural person.[21] Relative, on the other hand, encompasses the spouse of the person; or an ancestor, lineal descendant, brother, sister, uncle, aunt, nephew, niece, stepfather, stepmother, stepchild, or adopted child of that person or of the spouse, and in the case of an adopted child the adoptive parent.[22] All these individuals are considered related according to the law. As a result, transactions among enterprises owned by these individuals will be the subject of the law. For instance, an enterprise owned by two brothers

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[19] In the UN model tax convention the term used in order to refer to these groups of taxpayers is 'associated enterprise'. The model has defined associated enterprises as (a) an enterprise of a Contracting State participates directly or indirectly in the management, control or capital of an enterprise of the other Contracting State, or, (*b*) the same persons participate directly or indirectly in the management, control or capital of an enterprise of a Contracting State and an enterprise of the other Contracting State.

[20] A transfer pricing rule resembling to that introduced by Brazil will give an opportunity to tax authorities to tackle profit moving scheme even when the parties are unrelated.

[21] Income Tax Proclamation Cited supra note 17, art.2(4)

[22] Ibid.

shall be considered related; hence, they could be subject to transfer pricing procedures.

In addition, a trust and in respect of which a relative is or may be a beneficiary is considered related persons.[23] For instance, 'A' who is the brother of 'B' may be beneficiary of a particular trust, therefore, any dealing between the trusts and 'A' could be considered as a related party transaction. A partnership, joint venture, or unincorporated association or body or private company; and any member thereof irrespective of the degree of control shall be considered related persons.[24]

In the case of a share company a person that controls 10% or more of the right to vote, or the rights to distributions capital or profits, either directly or through one or more interposed companies, partnerships, or trusts is considered a related person.[25] The writer argues that a 10% threshold for establishing relatedness is a very low standard for starter country like Ethiopia. This will create a cumbersome task on tax auditors as it requires them to check the books and accounts of many related companies.

When MNCs transact each other, they structure their transactions in such a way as to ensure that profits are located in a jurisdiction with the most desirable tax consequences. As a result of this, transfer pricing is basically viewed as a transaction between related and non-related parties. Consequently, the presence of a resident and nonresident company is considered to be an indispensable part of transfer pricing rules in most

[23] Ibid.
[24] Ibid.
[25] Ibid.

countries. The Ethiopian law, however, does not require the presence of nonresident party in the transaction. The rules governing transfer pricing can even be made applicable to transaction made between two non related parties.

3. Advance Pricing Agreement (APA)

An advance pricing agreement (hereinafter, APA) is an agreement between the tax authority and MNC regarding the pricing of goods. A typical APA includes the set of criteria for the determination of the arm's length transfer pricing, transactions within the scope of the agreement and time within which the agreement applies.[26] APA is considered by many to be a more co-operative approach to addressing transfer pricing compliance.[27] In addition, APA is further credited for relieving the taxpayer and the tax authority of costs related to tax audits. The Income Tax Proclamation also contains the following provision regarding APA:

> *'In order to ensure the just and efficient application of this Article, the Tax Authority may make agreements in advance with persons carrying on entrepreneurial activities, subject to conditions if necessary that specified conditions between*

[26] OECD Tax and Development Center, Advance Pricing Arrangements Approach to Legislation (2012)2.

[27] Diane M. Ring, *On the Frontier of Procedural Innovation: Advanced Pricing Agreements and the Struggle to Allocate Income for Cross-Border Taxation*, 21 Mich. J.of Int. Law (2000) 143, Anuschka Bakker and March M.Levy (ed), *Transfer pricing and Dispute Resolution: Aligning strategy and Execution*(2011)116, Carlo Romano, *Advance Tax Rulings and Principles of Law: Towards a European Tax Rulings System?*(2002)38, Alan Paisey and Jian Li cited supra note 18 at 108.

related persons do not differ from those which would be made between independent persons.'[28]

In the Ethiopian context, ERCA is given the power to make advance-pricing agreements with MNCs. However, in countries like Ethiopia where there exists a very ineffective auditing system, MNCs will have little incentive to enter into an APA with tax authorities. As a result, not even single MNC has applied for an APA to this date.

In addition to Article 29 of the Income Tax Proclamation, ERCA may also use other provisions, introduced by the law with the main purpose of achieving other objective, to complement the application of Article 29. These scattered provisions and the extent of their applicability in regulating transfer pricing are discussed in the next sub section.

3.1. Thin Capitalization[29]

Debt financing is one of the fund-raising schemes available to traders, equity financing being the other. According to Ethiopian tax law, Schedule 'C' taxpayers, while calculating their taxable income, are given the right to deduct interest payment on their debt from their gross income.[30]

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[28] Income Tax Proclamation Cited supra note 17, art.29(2).

[29] Thin capitalization is when large proportion of the capital of the company is through debt financing rather equity financing.

[30] Ethiopia follows a scheduler approach to the taxation of income. Accordingly, there are four schedules each taxing a distinct and separate type of income. Schedule `A` is used for income from employment, `B` for incomes from rental of building, `C` for incomes from business and the rest of incomes will be taxed using schedule D.

When it comes to loans from foreign institutions, however, the law has made it crystal clear that such loans can only be deducted if it fulfills some requirements. First, the lending institution must secure permission from the National Bank of Ethiopia. Furthermore, prior to granting the loan, the lending institution must inform the tax authority about the modality of the loan. And finally, *'the borrower ... withholds 10% from the gross interest payable to the lender and transfers same to the Tax Authority within two months of the end of the fiscal year'.* [31]

These requirements give ERCA a golden opportunity to examine, *inter alia,* the nature of the loan, the modality of repayment, the interest to be paid, the relationship of the parties, etc. As a result, ERCA will have an ample opportunity to keep at bay the possibility of related parties giving loan to each other and moving large amount of money as interest payment. In addition, the 10% withholding obligation on the local taxpayer reduces the amount of untaxed profit leaving the country even when the loan agreement is undetected mispricing arrangement, *albeit* by 10%.[32]

3.2. Services Rendered by a Head Company to the Subsidiary

One of the transfer pricing schemes by the MNCs is in the form of fee called consultancy fee. According to this scheme, subordinate companies transfer large amount of fund as a consultancy fee to the head company or to affiliates controlled by the head company. For example, a resident

[31] Income Tax Regulation No.78/2002, art.10.

[32] A resident company that failed to withhold the 10% from the nonresident company shall be prohibited from deducting the amount paid as interest as the end of the tax year. In addition, there will be a penalty for failure to withhold the stated amount.

horticulture exporting company may enter into a market assessment service contract with a related nonresident company.

Receiving services from nonresident unrelated party has not been outlawed by the proclamation. The law rather made it difficult for MNCs to transfer funds untaxed by using this scheme. Accordingly, a business located and operating in Ethiopia as a branch, subsidiary or associated company of a business located and operating abroad must prove the following in order to deduct the cost of service to nonresident company from its gross income. First, the payment in question was made for services actually rendered.[33] Second, the company is required to prove that the service was necessary for the business and could not be performed by other persons or bodies or by the business itself at a lower cost.[34] This has never been a problem to MNCs as they normally present a cooked data to present that the services were in fact rendered.[35]

3.3. Regulation of Commission Work

Commission work is the other area of concern. A related company residing outside the country may demand payment from the company in Ethiopia for commission works it has carried in favor of the company residing in Ethiopia. Regarding this matter, the law laid down stringent criterias that must be fulfilled for such payments to be considered deductible. Accordingly, companies are required to prove that a service is in fact rendered. This requires companies to present

[33] See article 8(6) of the Income Tax Regulation.
[34] Ibid.
[35] In the chapter dealing with the Dirty Money User manual, Baker, from his rich experience working with MNCs has discussed ways of easily by passing requirements like this. See Baker Cited Supra note 13at p.24

objective evidence showing the completion of the work. Furthermore, the amount paid as a commission must correspond to the normal rate used by other businesses engaged in similar trade.[36]

3.4.Transfer of Business Assets

The taxpayer may sell a property purchased for business purposes at a later date. Such transfer may attract a loss or a gain. In this regard, the Income Tax Proclamation recognizes the loss by the taxpayer.[37] Accordingly, a taxpayer is entitled to a deduction for losses incurred while transferring business assets. The law, however, does not recognize losses incurred when the transfer is between related parties.[38] The non-recognition of such loss mitigates transfer of properties that aim at avoiding tax obligations among MNCs.

3.5. Loss on Transfer of Certain Investment Property

An income derived from transfer of investment property is subject to the payment of income tax.[39] A taxpayer may record loss or gain from the transfer of the property. The gain is subject to tax at 15% flat rate. On the other hand, when the taxpayers' record is loss, the loss is offset against gains derived from properties that are subject to the same schedule. For instance, a person that losses ETB 10,000 on transfer of shares can deduct this amount from the income s/he get by selling another set of shares at other times. This loss carry forward rule,

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[36] Id.art.8 (5).

[37] Income Tax Proclamation supra note 17, art .24.

[38] See art.24(6)of the Income Tax Proclamation.

[39]Id., art.37. Shares of Companies and building used for factories and offices are the properties that will be subject to the payment of the tax.

however, does not apply to losses recorded between related parties.[40] This rule restricts the possibility of transferring shares between related companies, which is mostly not motivated by economic reasons.

4. Transfer Pricing in the Customs Proclamation

A customs duty is levied on all imports into the country unless the goods are specifically exempted. The customs value of the goods is the base of the duty. Consequently, the amount of customs duty from each item depends on the customs value for the good, higher customs value results in higher tax revenues to the tax authorities and the vice versa results in lower tax revenue.

According to the Customs Proclamation, transaction value is the primary valuation method used to determine the customs value of imported goods.[41] The transaction value is defined in the Proclamation as 'the price

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[40] Id. art.37(6)of the Income Tax Proclamation.

[41] Customs Proclamation No. 622/2009, art.33(1). See also Winham, Gilbert R., *International Trade and the Tokyo Round Negotiation* (1986).106,Sheri Rosenow and Brian J. O'Shea,*A Handbook on the WTO Customs Valuation Agreement*(2010)5, Nuschka Bakker, Belema Obuoforibo, *Transfer Pricing and Customs Valuation: Two Worlds to Tax as One*(2009)62, Ainsworth, RT 2007, IT-APAS: harmonizing inconsistent transfer pricing rules in Income Tax Customs VAT, *Boston University School of Law, Working Paper Series*, Law and Economics, No. 07-23(2007),http://papers.ssrn.com/sol3/Delivery.cfm/SSRN_ID1013518_code355514.pdf ?abstractid=1013518&mirid=1,accessed on April 11,2012. Rajkarnikar, P., 2007 "Implementation of the WTO customs valuation agreement in Nepal: An ex-ante impact assessment", pp. 195-220, Chapter VI in ESCAP, *Trade facilitation beyond the multilateral trade negotiations: Regional practices, customs valuation and other emerging issues – A study by the Asia-Pacific Research and Training Network on Trade*, (United Nations, New York) Available online at: http://www.unescap.org/tid/artnet/pub/tipub2466.pdf accessed on July 10,2012,Dominik Lasok, *The Trade and Customs Law of the European Union*,3rd ed(1998)278, Junji Nakagawa, *International Harmonization of Economic Regulation*(2011)31,Hironori Asakura, World *History of the Customs and Tariffs* (2003)282.

actually paid or payable for the goods.'[42] As explained in the interpretive note to article 1 of GATT, such payment need not be made in the form of money. Other forms of payment such as payment through letter of credit or other form of negotiable instruments are also considered proper modes of payment.[43]

However, the transaction value, which is the primarily chosen method of valuation in GATT and Customs Proclamation, may not be accepted by the customs authorities due to various justifiable reasons. Whenever this happens, the customs value of a good is determined using the transaction value of identical goods.[44] Nevertheless, when goods identical to the product being assessed do not exist in the market, the transaction value of similar goods shall be taken as a third alternative transactional value of the good.[45] Moreover, if the above methods fail customs authorities may use the deductive, the computed or the fallback method in order to determine the customs value when the other systems fail to produce the needed result.[46]

When the parties involved in international trade are related parties, the transaction value must pass either the circumstances of sale test or test

[42] Ibid. See also article 1(1) of the Agreement *on Implementation of Article VII of the General Agreement on Tariffs and Trade 1994.*

[43] Interpretative note to article 1(1) of the Agreement.

[44] Customs Proclamation Cited supra note 41 , Art.34, the identical goods must be of those sold for export to Ethiopia at the same commercial level and in substantially the same quantity at or about the same time as the goods being valued. When information is not available on identical good of substantially the same quantity at about the same time, the transaction value of identical goods sold at a different commercial level or in different quantities by making adjustments to take account of differences attributable to the commercial level or to the quantity.

[45] Id. art.35.

[46] Id. arts.36-38.

value in order to be accepted as the customs value for the good.[47] If the importer fails to prove either one of the test, ERCA can determine the customs value of the goods. However, concerning the issue as to how ERCA determines the customs value is concerned, nothing is provided in the Proclamation. Yet, obviously, it ERCA determines it based on estimation.

4.1. The Circumstances of Sale Test

As provided in Article 33(5) of the Proclamation, the transaction value between a related buyer and seller may be accepted as customs value if examination of the circumstances of the sale of the imported merchandise indicates that the price has not been influenced by the relationship of the parties involved.[48] The Customs Proclamation nonetheless failed to specify what circumstances to look at and how to look at those matters. It is unfortunate that the valuation directive that was supposed to cover this matter has completely overlooked the matter.[49] ERCA however can use the interpretive note to paragraph of the GATT as guidance. The interpretative note provides that during transaction among related parties, the customs authorities, among others things should look at whether:

> "[t]*he price was settled in a manner consistent with the normal pricing practices of the industry in question…[t]he*

[47] A buyer and a seller shall be deemed to be related if they met one of the following requirements; one of them is an officer or director of the other's business or the two businesses b) they are legally recognized partners in business or the two businesses have employer-employee relationship. In addition if one of the business owns at least 10 % of the shares of the other's business or one of them directly or indirectly or both of them are directly or indirectly controlled by a third party or both of them directly or indirectly or related by consanguinity or affinity up to the second degree.

[48] Id. art.33 (5).

[49] See Customs Valuation Directive 70/2004, available at http://www.erca.gov.et/docs/1564.pdf.acessed on May 12,2013.

> *price was settled in a manner consistent with the way the seller settles prices for sales to buyers who are not related to it; or [t]he price is adequate to ensure recovery of all costs plus a profit that is equivalent to the firm's overall profit realized over a representative period of time in sales of merchandise of the same class or kind"*[50]

4.2. Test Value

Under test value, the transaction value between related parties is tested using specified standard values. This method requires importers to prove that their transaction closely approximates to :

- ✓ the transaction value in sales, between buyers and sellers who are not related, of identical or similar goods for export to Ethiopia during the same period or
- ✓ The customs value of identical or similar goods the customs value of which is determined according to the computed value method or the customs value of identical or
- ✓ Similar goods the customs value of determined according to the fallback method. [51]

5. Income Tax *vs*. Customs Duty: Divergence or Convergence?

Rules regulating transactions among related parties exist in both the Income and the Customs Proclamations. The Customs Proclamation primarily targets to increase transfer price between related parties so as to generate the maximum revenue possible. On the contrary, the Income

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[50] Interpretive Note to article 2 of the GATT.
[51] Customs Proclamation cited supra note 41, art..33(5).

Tax Proclamation aims at reducing transfer pricing as low as possible so as to increase the taxable income of the resident company through reducing the legally allowed deductible items. This divergent nature of the two rules create additional cost on MNCs as it requires them to comply with both, at times contradictory formalities answering the same single question '*what is the arm's length price of a product?*'[52]

As it has been discussed in the previous section, the provisions of the Income Tax Proclamation that govern transfer pricing cannot be put into practice as it is due to lack of directives outlining the arm's length approach to be deployed. On the other hand, we can find provisions enough to govern customs valuations in the Customs Proclamation. This gives unique opportunity for the country in terms of integrating the customs and Income Tax Proclamation provisions governing the area. Accordingly, while drafting the arm's length methods to be applied in the country, ERCA must align it to customs valuation, lest importers will incur unnecessary compliance burdens, ultimately making the country a less desired destination for FDI.

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[52] In order to find a workable solution to this problem the World Customs Organization (WCO) and the OECD jointly hosted two international conferences on Transfer Pricing and Customs Valuation. The first conference took place at the WCO headquarters in Brussels in May 2006, and the second conference was held at the same venue in May 2007WCO/OECD CONFERENCE ON TRANSFER PRICING AND CUSTOMS VALUATION at http://www.oecd.org/document/39/0,2340,en_2649_201185_36541927_1_1_1_1,00.html, See also International Conference on Transfer Pricing and Customs Valuation at http://www.oecd.org/document/39/0,3343,en_2649_201185_36541927_1_1_1_1,00.html.Even though an agreement had not been reached on convergence of the two systems, delegates came to understanding that tax authorities must take the implications of one decision over the other.

6. Challenges in Controlling Transfer Pricing in Ethiopia

Flow of FDI into the Country is increasing every year, with the increase in investment the volume of import into the County is also increasing. These two factors make income and customs transfer pricing a huge risk to the national revenue unless tackled by appropriate legislative and administrative measures. Currently, nonetheless, the tax machinery has blatantly failed to address the problem due to the following reasons.

Firstly, the Customs Proclamation has incorporated detailed provisions governing transfer pricing, *albeit* with provisions which require further clarity.[53] The same cannot be said about the Income Tax Proclamation, however. The Proclamation has entrusted the Ministry of Finance and Economic Development the power of legislating a directive to further implement transfer pricing provisions. Yet, the Ministry has failed to come up with detailed directives governing this area.

Secondly, the primary step in the regulation of transfer pricing, *inter alia*, is the identification of those businesses considered to be related. Both the Income and the Customs [Proclamations] have incorporated their own tests in order to determine the relatedness or otherwise of companies. Yet again, the authority has not identified companies considered to be related; consequently, companies trade with each other without any restrictions.[54]

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[53] Under the circumstances of test, the law has to make it clear the circumstances that will be used in order to test a particular transaction.

[54] One Task force organized by the Ethiopian Customs and Revenue Authority is compiling data on enterprises suspected of being related.

Thirdly, controlling transfer pricing requires well-trained expertise and well organized system for documentation. Nonetheless, the department in the tax authority is under staffed compared to the MNCs that it strives to control.[55] In addition, the Income Tax Proclamation has not incorporated a single provision that requires companies to keep and submit documents when they transact with related parties.

Fourthly, the transfer pricing approach incorporated in the Income Tax Proclamation requires the availability of a comparable data. Obviously, for some items, comparable data is unavailable in the country due to absence of competing market forces. The authority, nonetheless, failed to organize a comparability data even in areas where more market forces exist.

Conclusion

The Ethiopian government has done a commendable work in making the country a desirable destination for investment. As a result, the flow of foreign investment in the country is rising. With increase in flow of international trade, the revenue from international trade is also increasing. Nonetheless, absence of clear transfer pricing rules and non-implementation of those scanty provisions that the Country has is resulting a huge loss in local revenue.

[55] Till August 2013, the department in the customs branch entrusted with this responsibility has only less than 5 personnel, whereas its income branch does not exist at all. Field observation conducted by the researcher.

An organized and clearly structured income and customs transfer pricing regulations, therefore, would enable the Country to collect revenues from international transactions. In order to realize this objective, the Country must first introduce a directive that clearly outlines the arm's length approach to be used by related parties. In addition, documentations that must be submitted when related parties enter into transactions must be clearly specified in the Income Tax Proclamation. The document submitted by taxpayers, in addition to its use to determine the arm's length or otherwise of transactions at hand, can also assist the authority in its assessment of the comparability of other businesses dealings in identical or similar matters. Furthermore, while drafting the directive, contradictions must be avoided between the provisions of the Customs Proclamation dealing with similar matter.

Author's Guide

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