

2017-10-10

# The Challenges of Taxing Income of Multinational Enterprises in Ethiopia: A Developing Country Perspective

Ayene, Mengesha

---

<http://hdl.handle.net/123456789/7891>

*Downloaded from DSpace Repository, DSpace Institution's institutional repository*

THE CHALLENGES OF TAXING INCOME OF  
MULTINATIONAL ENTERPRISES IN ETHIOPIA: A  
DEVELOPING COUNTRY PERSPECTIVE

AYENE MENGESHA SISAY

School of Law,  
Bahir Dar University

June, 2017

THE CHALLENGES OF TAXING INCOME OF  
MULTINATIONAL ENTERPRISES IN ETHIOPIA: A  
DEVELOPING COUNTRY PERSPECTIVE

Thesis

Submitted in Partial Fulfillment of the Requirements for the Degree  
of Master of Laws (LL.M.) at the School of Law, Bahir Dar  
University

By

Ayene Mengesha Sisay

Advisor

Aschalew Ashagre  
(LL.B., LL.M., Assistant Professor of Law PhD Candidate)

School of Law,  
Bahir Dar University

June, 2017

## Thesis approval page

The thesis titled ~~€~~ The Challenges of Taxing Income of Multi-national Enterprises in Ethiopia: A Developing Country Experience ~~by~~ Mr. Ayene Mengesha Sisay is approved for the degree of Master of Laws (LL.M.)

### Board of Examiners

	Name	Signature
Advisor	Aschalew Ashagre	_____
Internal Examiner:	_____	_____
External Examiner:	_____	_____

## Declaration page

Declaration I, the undersigned, declare that the thesis comprises my own work. In compliance with widely accepted practices, I have duly acknowledged and referenced all materials used in this work. I understand that non-adherence to the principles of academic honesty and integrity, misrepresentation/fabrication of any idea/data/fact/source will constitute sufficient ground for disciplinary action by the University and can also evoke criminal sanction from the State and civil action from the sources which have not been properly cited or acknowledged.

---

Signature

Ayene Mengesha Sisay

Name of Student

BDU0802516PR

University Id. Number

---

Date

## Acknowledgement

O Sovereign God, I give you thanks for your invaluable help throughout my life, and the Almighty God I owe all my life achievements to you.

My advisor, Mr. Aschalew Ashagre, spent his precious time reading the whole pages of this paper and gave me highly valuable comments and criticisms. Thus, I thank you so much Aschu!

I would like also to extend my deepest gratitude to the Vis Moot living legends! Maximillian Pika and Pierre Triple, guys I owe you so much. Had it not been the inclusions of those basic life principles you have taught me, this thesis could not have been accomplished within this short period of time. Thus, ich danke dir so sehr für alles

My special thanks shall also go to Dr. Baylie Damtie, President of Bahir Dar University and Mr. Aragaw Bizualem, Head of President's Office, for keeping me away from the administrative hassles at the legal service office in the course of conducting this research and Dr. Dawit Amogne, for the language editing

Last but not the least, I would like to thank my friends Dr. Yonas Tesfaye, Temesgen Sisay Beyene, Nega Mihret Yilma and my sister Mitu Amare Mengesha for their moral assistance and encouragement in the course of conducting this research.

## Table of Contents

Thesis approval page.....	ii
Declaration page.....	iii
Acknowledgement.....	iv
List of Tables.....	viii
List of Acronyms.....	ix
Abstract.....	x
CHAPTER ONE.....	1
INTRODUCTION.....	1
1.1. Background of the Study. . . . .	1
1.2. Statement of the Problem . . . . .	4
1.3. Objective of the Study. . . . .	5
a. General Objective . . . . .	5
b. Specific Objectives . . . . .	5
1.4. Research Questions . . . . .	6
a. Central Question . . . . .	6
b. Specific Questions . . . . .	6
1.5. Significance of the Study. . . . .	7
1.6. Review of Literature. . . . .	7
1.7. Scope and Limitations of the Study . . . . .	8
1.8. Methodology of the Study. . . . .	8
1.9. Organization of the Research . . . . .	9
CHAPTER TWO.....	10
GLOBALIZATION AND INTERNATIONAL TAXATION IN GENERAL .....	10
2.1. Introduction. . . . .	1.0
2.2. Globalization and National Fiscal Sovereignty . . . . .	1.0
2.2.1. New Medievalists Approach. . . . .	1.2
2.2.2. Liberal Internationalists Theory. . . . .	1.3
2.2.3. Transgovernmentalism. . . . .	1.4
2.3. The Problem of Double Taxation . . . . .	1.6
2.3.1. Citizenship Principle . . . . .	1.6

2.3.2.	Residence Principle . . . . .	1.6
2.3.3.	Source Principle . . . . .	1.7
2.4.	Methods of Relief from Double Taxation . . . . .	1.9
2.4.1.	Unilateral Measures . . . . .	1.9
2.4.2.	Double Taxation Treaties. . . . .	2.0
2.4.2.1.	Exemption Method /Principle/ . . . . .	2.0
2.4.2.2.	Tax Crediting Method /Principle/ . . . . .	2.1
2.5.	International Tax Competition. . . . .	2.2
2.5.1.	Arguments Surrounding International Tax Competition . . . . .	2.2
2.5.1.1.	Arguments against Limiting International Tax Competition . . . . .	2.3
2.5.1.2.	Arguments for Limiting International Taxation Competition. . . . .	2.4
2.6.	Global Tax Governance. . . . .	2.5
CHAPTER THREE.....		30
CHALLENGES OF TAXING MNEs IN DEVELOPING COUNTRIES.....		30
3.1.	Introduction. . . . .	3.0
3.2.	Illicit Financial Outflows from Developing Countries. . . . .	3.0
3.3.	Challenges of Taxing MNEs in Developing Countries . . . . .	3.4
3.3.1.	Base Erosion and Profit Shifting (BEPS). . . . .	3.6
3.3.1.1.	Transfer Pricing /Transfer Mispricing./ . . . .	3.7
3.3.1.2.	Hybrid Mismatch Arrangements. . . . .	4.0
3.3.1.3.	Special Purpose Entities (SPEs). . . . .	4.3
3.3.1.4.	Treaty Shopping . . . . .	4.4
3.3.1.5.	Thin Capitalization . . . . .	4.5
3.4.	Effects of Base Erosion Profit Shifting and other kind of Tax Arrangements on Developing Countries. . . . .	4.6
CHAPTER FOUR.....		48
TAXING MULTINATIONAL ENTERPRISES IN ETHIOPIA: LEGAL AND INSTITUTIONAL FRAMEWORK CHALLENGES.....		48
4.1.	Introduction.....	48
4.1.	Status of FDI and MNEs in Ethiopia . . . . .	4.8
4.2.	Legal and Institutional Framework Challenges of Taxing MNEs. . . . .	5.2
4.2.1.	The Legal Framework Challenges to Fight against BEPS by MNEs . . . . .	5.2



4.2.1.1. Challenges in Relation to Effective Transfer Pricing Legislation.....	52
4.2.1.2. Challenges in Relation to Absence of Anti-Hybrid Mismatch Rule.....	56
4.2.1.3. Challenges in Relation to Absence of Avoidance of Treaty Shopping Clause.....	57
4.2.1.4. Challenges in Relation to Absence of Detailed rules of Thin Capitalization....	59
4.2.1.5. Challenges in Relation to absence of General Anti-Base Erosion Rules.....	61
4.3.2. The Institutional Framework Challenges to Combat BEPS . . . . .	6.1.....
4.3.2.1. Challenges in Relation to Awareness of BEPS.....	62
4.3.2.2. Challenges in Relation to Lack of Capacity to Tax MNEs.....	63
4.3.2.3. Challenges in relation to Lack of Tax Cooperation and Exchange of Information	66
Challenges in Relation to Lack of Capacity to Follow up, Implement and Monitor MNEs	67
4.3.2.4. Challenges in relation to Lack of Resource and ICT Infrastructure.....	68
CHAPTER FIVE .....	70
CONCLUSION AND RECOMMENDATION .....	70
5.1. Conclusion. . . . .	7.0.....
5.2. Recommendation . . . . .	7.4.....
Bibliography .....	76
Annex .....	86

## List of Tables

Table one € Ethiopian Investment Commission, Summary of FDI Projects by Year and Investment Status, since 2007 May 09, 2017

Table Two - Ethiopian Investment Commission Summary of FDI Projects by Year, Capital inflow and Employment opportunity, since 2007 May 09, 2017

## List of Acronyms

Art.	Article
Arts.	Articles
BEPS	Base Erosion and Profit Shifting
EIC	Ethiopian Investment Commission
GIF	Global Financial Integrity
IFC	International Finance Corporation
IFF	Illicit Financial Flows
IMF	International Monetary Fund
ERCA	Ethiopian Revenue and Customs Authority
ITP	Income Tax Proclamation
LTO	Large Taxpayers Office
MFEC	Ministry of Finance and Economic Cooperation
MNC	Multinational Corporation
MNEs	Multinational Enterprises
MoFED	Ministry of Finance and Economic Development
NBE	National Bank of Ethiopia
No	Number
OECD	Organization for Economic Cooperation and Development
Proc.	Proclamation
SPEs	Special Purpose Entities
TNC	Transnational Corporation
UN	United Nations
UNCTAD	United Nation Conference on trade and Development
UNDP	United Nation Development Program

## Abstract

Nowadays, our world is more integrated, interdependent and interrelated more than ever before. Development of science and information technology has played a significant role to bring about this globalization process. MNEs have played their own part in increasing integration of international trade and economy. They have been a source of job opportunities, capital inflows, hard currency, tax revenue, transfer of technology, knowledge and skills for many developing countries. On the other hand, developing countries in order to make benefits out of MNEs and retain foreign capital to/in their own jurisdiction they have taken various tax reform and trade liberalization measures.

Benjamin Franklin said that nothing is certain except death and tax to emphasize the inevitability and unavoidably of payment of tax. However, this famous proverb does not seem to work for MNEs. Tax competition, lack of strong global tax governance, coupled with lack of effective anti-BEPS legislation and lack of capacity of tax authorities in developing countries have placed MNEs in a better position to avoid and/or evaded billions of dollars from the developing world each year.

Following the downfall of the socialist regime in 1991, Ethiopia, has taken numerous economic structural reform measures such as; decentralizing the economy, opening up many investment areas to the private sector, lifting the restriction on the private sector, inclusion of incentive packages in investment laws and other trade liberalization measures. As a result, the number of FDI inflow is increasing from time to time. Thus, this has made the country to be one of the top 10 investment destinations in Africa by recording a continuous increase of 12% per annum.

Therefore, the country in order to benefit from FDI and MNEs, particularly, tax benefits, it needs to have effective legal and institutional framework that can enable it to properly exercise its taxing rights over MNEs and save billions of dollars from being avoided and/or evaded. Because, it is clear that the country is facing those challenges of taxing MNEs that other developing countries are facing. Hence, this research has investigated both the legal and institutional frameworks of the country to know as to whether the country is in a good position to tax MNEs and won the fight against BEPS (transfer pricing, hybrid mismatch arrangements, treaty shopping, SPEs and thin capitalization).

The findings of this research shows that, except the transfer pricing regime, the country's tax system is suffering from absence of anti-hybrid mismatch rule, general anti-base erosion rule and detailed rule of thin capitalization. Similarly, most of avoidance of double taxation treaties does not have limitation benefit and purpose test clause, which are the common methods of avoidance of treaty shopping. In addition to the legal framework, the institutional framework is fraught with lack of; awareness of BEPS, capacity to tax MNEs, capacity to follow up and monitor activities of MNEs and implementation of BEPS legislation, tax cooperation and exchange of information, resource and ICT infrastructure. Therefore, for the country it is hardly possible to combat BEPS and subject MNEs in to its proper power of taxation the existing legal and institutional frameworks.

Hence, this researcher has recommended for; the revision of the transfer pricing directive in the light of the new ITP, the enactment of anti-hybrid mismatch and general anti-base erosion rules, detailed rules of thin capitalization, and inclusion of limitation on benefit and purpose test clauses in avoidance of double taxation treaties so as to avoid treaty shopping. Concerning institutional framework reform measures, the researcher recommend that, raising the awareness of responsible experts and officials about BEPS, equip the tax authority and MFEC with well-trained experts on the area of BEP, enhancing the capacity of the ERCA and MEFC to follow up and monitor the activities of MNEs by allocating resource needed, ERCA should also sign tax cooperation and exchange of information agreements with other tax authorities concerning BEPS, and the authority must have documentation data base in order to mitigate the challenge related to lack of comparable data.

# CHAPTER ONE

## INTRODUCTION

### 1.1. Background of the Study

Globalization has made our world interdependent, interconnected and integrated more than any time before in the history of human kind. Development of science and technology, particularly, information communication technology has played a pivotal role in this increasing interdependence and integration process. This globalization process has also enabled MNEs to take part in trade and investment activities globally, has also opened up opportunities for them to greatly reduce the taxes they pay.<sup>4</sup>

In return MNEs have played a significant role in globalization of trade and investment activities and they have become an important source of revenue for developing countries. For instance, UNCTAD in its 2015 world investment report estimates the contribution of MNEs to government budget in developing countries at about \$730 billion annually, which represents on average about 23% of corporate payments and 10% total government revenues.<sup>5</sup> They have been also the source of job opportunities, transfer of technology, knowledge and skills.

Many developing countries have reformed their international tax systems in order to retain and attract MNEs in their jurisdiction to do business and also to promote overseas growth of their

---

<sup>1</sup> Sagit Leviner, *The Intricacies of Tax and Globalization*, *Colombia Journal of Tax Law*, Vol. 5 No. 207, 2011, p. 212 [Herein after referred as Sagit Leviner, *The Intricacies of Tax and Globalization*].

<sup>2</sup> Id.

<sup>3</sup> Multinational Enterprises (MNEs) also named as Multinational Corporations (MNCs) or Transnational Companies (TNCs) are companies that are involved in trade and investment activities crossing the boundaries of states.

<sup>4</sup> OECD Policy Brief, *Taxing Multinational Enterprises, Base Erosion and Profit Shifting (BEPS) Update* No. 3, October 2015, p. 1. [Here in after, referred as OECD Policy Brief *Taxing Multinational Enterprises, and BEPS*].

<sup>5</sup> United Nation Conference on Trade and Development (UNCTAD), *World Investment Report 2015: Reforming International Investment Governance*, 2015, p. 184. [Here in after, referred as UNCTAD, *World Investment Report 2015: Reforming International Investment Governance*].

See also David McNair and et al, *Transfer Pricing and Taxing Rights of Developing Countries*, Christian aid April 2010, p. 2. [Here in after, referred as David McNair, *Transfer Pricing and Taxing Rights of Developing Countries*]. MNEs have contributed for the global economic development accounting for 10% of world gross domestic product (GDP) in 2007.

<sup>6</sup> David McNair, *Transfer Pricing and Taxing Rights of Developing Countries*, p. 2.

resident companies<sup>7</sup>As a result, they have effectively reduced those problems associated with double taxation of MNEs. Hence, limited range of taxable activities coupled with narrow tax bases has made the revenue from taxing MNEs a significant one for developing countries<sup>8</sup>

However, MNEs are not living up to the expectations of developing countries and developing countries are not getting what they should have earned from taxing MNEs due to lack of effective tax laws, harmful tax competition, lack of global tax governance and lack of capacity of tax authorities to properly exercise their taxing rights over MNEs<sup>9</sup>.

As a result, developing countries are losing billions of dollars as a result of illicit financial outflows and tax evasion activities of MNEs. Global Financial Integrity (GFI) estimates the IFFs from developing countries in the 2004-2014 to be \$620 billion - \$970 billion<sup>10</sup> The real growth of illicit flows by regions over these ten years is also estimated to be; 1) Middle East and North Africa (MENA) 24.3 %; 2) Developing Europe 23.1%; 3) Africa 21.9%; 4) Asia 7.85%, and 5) Western Hemisphere 5.18%. This illicit outflow is approximately ten times the amount of official development assistance going in to developing countries. This means for every \$1 in economic development assistance that goes to developing country, \$10 is lost via illicit outflows.<sup>12</sup> Of all parts in Africa, the Sub-Saharan has suffered the biggest loss with outflows from the region averaging 5.7% of GDP annually<sup>13</sup>.

Of all this illicit financial outflows from developing countries in the form of tax avoidance by MNEs is estimated to be \$660 and \$870 billion each year<sup>14</sup>. Other reports also show that

---

<sup>7</sup> Prafula Fernandez and Jeff Pope, International Taxation of Multinational Enterprises (MNEs) Revenue Law Journal, Vol. 12, No.1 January 2002, p. 106. Here in after, referred as Prafula Fernandez and Jeff Pope International Taxation of Multinational Enterprises

<sup>8</sup> Dirk Willem- te Velde, Typical Tax Findings and Challenges in Developing Countries Chapter in; Taxation and Developing Countries Training Notes September 2013, p. 9. Here in after, referred as Dirk Willem- te Velde Typical Tax Findings and Challenges in Developing Countries.

<sup>9</sup> David McNair, Transfer Pricing and Taxing Rights of Developing Countries.

<sup>10</sup> Global Financial Integrity, Illicit Financial Flows to and from Developing Countries: 2006-2014 April 1 2017, p. VII. [Here in after referred as Global Financial Integrity, Illicit Financial Flows to and from Developing Countries]

<sup>11</sup> José Luis Escario Díaz-Berrio, the Fight against Tax Havens and Tax Evasion Progress since the London G20 summit and the challenges ahead. Fundación Alternativas, 2011, p. 20. Here in after, referred as José Luis Escario Díaz-Berrio, the Fight against Tax Havens and Tax Evasion Progress

<sup>12</sup> Id.

<sup>13</sup> European Union, Policy Department DG External Policies, Tax Revenue Mobilization in Developing Countries: Issues and Challenges April 2014, p. 15. Here in after, referred as European Union Tax Revenue Mobilization in Developing Countries

<sup>14</sup> Id.

developing countries could lose as much as \$285bn each year because of tax evasion and avoidance by MNEs through tax havens and this equal to 5% of their GDP.<sup>15</sup>

Justice Network Africa (JNA) stated that African countries could be losing \$50 billion from MNEs<sup>16</sup>, which is three times the amount they receive in aid from the developed world. It has been also documented that the number of tax havens has risen from 25 in the 1970s to around 72 at present.<sup>18</sup> The report released from OXFAM International on June of 2015 demonstrates that Africa has lost \$11 billion through the tricks used by MNEs to reduce tax bills.<sup>19</sup>

Therefore, the big challenge for developing countries would be enforcing their legitimate taxing rights while ensuring an open, transparent, investment friendly and fair environment for investors.<sup>20</sup>

The Ethiopian government sees Foreign Direct Investment (FDI) as one of the most important strategic tool for the economic development of the country. The sector has shown a considerable amount of growth, for example, of the total investment projects licensed in, 2012 FDI's share is about 15.80%. This has made the country to be one of the top 10 investment destinations in Africa recording 00% change in FDI inflow with a continuous increase of more than 12% per annum.<sup>21</sup>

However, despite all this growth of FDI, we are hearing different tax abuses by many foreign companies in the country. For instance, one of the business papers, Addis Fortune, has reported the involvement of Indian, Israeli, Chinese and United Arab Emirates (UAE) companies

---

<sup>15</sup> Petr Janský and Alex Prats, Multinational Corporations and the Profit Shifting Lure of Tax Havens, Christian Aid Occasional Paper Number 1, March 2013, p.5. Here in after referred as Petr Janský and Alex Prats].

<sup>16</sup> Tax Justice Network Africa, Tax and International Financial Architecture, Here in after referred as Tax Justice Network - Africa], available at, <<http://www.taxjusticeafrica.net/en/programmes/international-taxation>> [Last Accessed 24/01/2017].

<sup>17</sup> OECD Policy Brief, Taxing Multinational Enterprises, and BEPS,

<sup>18</sup> José Luis Escario Díaz, p17.

<sup>19</sup> OXFAM International, Multinational companies cheat Africa out of billions of dollars published, 2 June 2015, [Here in after referred as, OXFAM International], available at, <<https://www.oxfam.org/en/pressroom/pressreleases/2015/62/multinational-companies-cheat-africa-out-billions-dollars>> [Last Accessed, 24/01/2017].

<sup>20</sup> David McNair, Transfer Pricing and Taxing Rights of Developing Countries, p.1.

<sup>21</sup> Ethiopian Investment Commission, Ethiopia: A Preferred Location for Foreign Direct Investment in Africa Investment Guide to Ethiopia, 2015, p. 6.

<sup>22</sup> Ethiopian Investment Commission, Economic Indicators available at, <<http://www.investethiopia.gov.et/why-ethiopia/economic-indicators>> [Last Accessed, 26/01/2017]

in tax evasion activities<sup>23</sup> There are also a lot of pending tax evasion cases by MNEs at different level of courts such as Total Ethiopia, ZTE and Add Potashi which are related with BEPS.<sup>24</sup> This is a good alarm for the Ethiopian government to check and strengthen its tax system that could regulate MNEs in the country. However, if the harm outweighs the benefit it will have a negative impact on the integrity of the entire tax system. The experience of many developing countries shows that, in order to effectively combat tax abuses by MNEs, legal and institutional frameworks have an irreplaceable role.

## 1.2. Statement of the Problem

Taxing MNEs requires carefully crafted tax legislation and well trained persons that properly understand and implement it. It also requires a tax authority which is equipped with state art of technologies to follow and trace transactions of MNEs. However, developing countries are not fortunate enough to possess those well trained experts and vibrant tax authorities. To the contrary, MNEs have well trained persons who could easily manipulate loopholes in the tax legislation and lack of capacity of the tax authorities of developing countries. Due to this, developing countries are losing billions of dollars. Base Erosion and Profit Shifting (BEPS) activities and other aggressive tax planning strategies of MNEs takes the lion share in this regard.

Therefore, the magnitude of the problem of taxing MNEs is very broad and the negative effect is multi-dimensional. It affects everyone; governments, individual taxpayers, business communities and even MNEs themselves.<sup>25</sup> Particularly, for governments in developing countries the impact is very serious. It reduces their incomes and raises the cost of ensuring compliance.<sup>26</sup> It undermines their legitimacy, as this would be considered as the manifestation of their inability to protect their fellow citizens. It has also the effect of undermining the tax system's integrity and eroding the trust of citizens.<sup>27</sup>

---

<sup>23</sup> Addis Fortune, News Paper Tax Fraud by Foreign Companies in Ethiopia, Vol. 16, No. 801, Sep 07, 2015, available at <<http://addisfortune.net/articles/tax-fraud-by-foreign-companies-in-ethiopia/>> [Last accessed 26/01/2017], [Here in after Addis Fortune, News Paper Tax Fraud by Foreign Companies in Ethiopia]

<sup>24</sup> Since these cases are pending and under investigation the researcher is unable to reproduce the substance thereof, however, just simply used to show the extent of problem of BEPS in the country.

<sup>25</sup> OECD Policy Brief Taxing Multinational Enterprises, and BEPS, §. 1.

<sup>26</sup> Id.

<sup>26</sup> David McNair, Transfer Pricing and Taxing Rights of Developing Countries, p. 9.

<sup>27</sup> OECD Policy Brief Taxing Multinational Enterprises, and BEPS, §. 1.



If MNEs don't pay their fair share of tax, the ultimate tax burden will be pushed to individual tax payers as collecting taxes from wage income is pretty much easier.<sup>28</sup> Other domestic companies which do not have access to evade tax will be kicked out from the market as they could not compete. Ultimately, it undermines voluntary compliance by all taxpayers upon which modern tax administration depends.<sup>29</sup> It will also create a serious reputational risk against the MNEs themselves.<sup>30</sup>

The Ethiopian government sees FDI as one of the important vehicle for the development of the country. MNEs are the key actors in FDI. Therefore, it is obvious that Ethiopia as a developing country would face the challenges of taxing MNEs. The country is also experiencing the involvement of some MNEs in tax evasion and avoidance activities.<sup>31</sup> Therefore, this research has explored whether there are adequate legal and institutional frameworks to manage the case of taxing MNEs and tackling the problem of BEPS.

### 1.3. Objective of the Study

This study has the following general and special objectives

#### a. General Objective

This study has a general objective from which other specific objectives are derived. The general objective of this study is to identify the legal and institutional frameworks and challenges of the Ethiopian tax system to tax MNEs and to evaluate as to whether these challenges can possibly be tackled by the existing legal and institutional frameworks.

#### b. Specific Objectives

This study has the following specific objectives

---

<sup>28</sup> José Luis Escario Díaz-Berrio, *The Fight against Tax Havens and Tax Evasion Progress*, P. 19.

<sup>29</sup> Patrick Love, *BEPS: why you're taxed more than a multinational*, available at, <<http://oecdinsights.org/2013/02/13/beps-why-youre-taxed-more-than-a-multinational/>> [Last Accessed 23/1/2017]

<sup>30</sup> OECD Policy Brief, *Taxing Multinational Enterprises, and BEPS*, 1.

<sup>31</sup> Addis Fortune, *News Paper Tax Fraud by Foreign Companies in Ethiopia*, Vol. 16 , No.801, Sep 0, 2015, available at, <<http://addisfortune.net/articles/tax-fraud-by-foreign-companies-in-ethiopia/>>, [Last accessed 26/01/2017].

There are also a lot of pending tax evasion cases by MNEs at different level of courts such as Total Ethiopia, ZTE and Alena Potashi which are related with BEPS

- o To examine the impact of tax competition and global tax governance on fiscal national sovereignty of developing countries.
- o To explore and identify the challenges of taxing MNEs in developing countries in general and Ethiopia in particular.
- o To survey the nature and elements of Base Erosion and Profit Shift (BEPS) techniques of MNEs.
- o To scrutinize the sufficiency of the Ethiopian legal and institutional framework to overcome the challenges of taxing MNEs, thus, combatting BEPS

#### 1.4. Research Questions

Based on the above statement of problem and objective of the study, this research addresses the following central and specific research questions.

##### a. Central Question

What are the challenges of taxing MNEs and whether the legal and institutional framework of the Ethiopian tax system is capable to overcome these challenges?

##### b. Specific Questions

This study has also addresses the following specific research questions.

- o How has globalization affected international taxation of developing countries and what are the contributing factors from the part of developing countries?
- o What are the legal and institutional framework challenges of taxing MNEs in developing countries such as Ethiopia?
- o What are the legal and institutional framework challenges of Taxing MNEs in Ethiopia?
- o Is the Ethiopian tax system sufficient enough to fight against BEPS activities of MNEs, like transfer pricing, hybrid mismatch arrangements, treaty shopping, special purpose entities and thin capitalization?
- o Do ERCA and other relevant institutions such as MFEC, EIC have the institutional capacity to tax MNEs and fight BEPS?

## 1.5. Significance of the Study

Globalization has made our world more connected and interdependent more than ever. Technological innovations and communication technologies have made it easier cross border communications. Countries have liberalized trade and economic activities. This has enabled MNEs to do business crossing the boundary of different sovereign nations. Developing countries have also opened their doors at the expense of their national fiscal sovereignty to make some benefits out of FDI. Tax revenue is one of the important benefits that developing countries derive from MNEs. However, these days developing countries are not getting what they should earn from taxing MNEs, due to tax planning strategies of MNEs and lack of sufficient legal and institutional capacities.

Therefore, a research that tries to identify those challenges of taxing MNEs and make an assessment as to whether the Ethiopian legal and institutional framework is sufficient enough to overcome those challenges is a worthwhile and a timely one. The research can serve as a board for further researches by academicians as well as practitioners. It will have also a meaningful contribution to policy and lawmakers. More importantly, it adds an input in the creation of vibrant taxing authority in the country.

## 1.6. Review of Literature

Undeniably there are a number of researches conducted on BEPS techniques of MNEs and developing countries by international organizations like; United Nations (UN), International Monetary Fund (IMF) and Organization for Economic Cooperation and Development (OECD) and individual scholars. However, to the best of the researcher's knowledge there is no research conducted in the Ethiopian context. This makes the research the first of its kind on the subject matter.

However, there are attempts to conduct research on some of the elements of BEPS, specifically, on transfer pricing. For instance, Yosef A. Gebreegziabher, has written an article on transfer pricing titled as "Ethiopian Law on Transfer Pricing: A Critical Examination". In this article Mr. Yosef has tried to examine the transfer pricing regime of the country and figured out the most important issues which are not incorporated in the then ITP. But, there are a lot of development

in the transfer pricing legal regime of the country after this article is written. For example, the transfer pricing directive is issued and the new ITP is promulgated.

There is also a thesis written by Kalkidan Negashi titled Taxation of Multinational Enterprises in Ethiopian Law at Addis Ababa University in 2005. In this thesis the researcher has tried to make a look at tax jurisdictions issues not in relation to BEPS.

## 1.7. Scope and Limitations of the Study

The research is only limited to assessment of the modicum of the Ethiopian legal and institutional frameworks to overcome the challenges of taxing MNEs in relation to BEPS such as; transfer pricing, hybrid mismatch, SPEs, treaty shopping and thin capitalization.

While conducting this research, one of the limitations of the research, as the researcher has to accomplish the research within two months. Additionally, as the research was one of the participants in 24<sup>th</sup> Willem C. Vis International Commercial Arbitration Moot Competition, held in Vienna, Austria, representing Bahir Dar University, School of Law, it has forced the research to be a little bit busy. Lack of willingness of some experts of ARCA, MFEC and EIC to be interviewed was the other challenge in the course of conducting this research.

## 1.8. Methodology of the Study

In conducting this research, qualitative research methodology has been employed. Some of the research questions are addressed using a qualitative approach. In so doing, relevant laws of Ethiopia and primary sources are analyzed. The contribution of other countries' laws, experience and research findings and recommendation of international organizations have been vital in the course of analysis of conducting this research. Books, articles, secondary sources such as policy and other documents from EIC and MFEC have been also consulted.

Moreover, since the research also includes an assessment of the institutional framework of the country's tax system, an empirical qualitative data is important to profoundly conduct this research. The research questions require the investigation of reality on the ground as to the awareness of BEPS, the capacity of the tax authority to tax, follow up and monitor MNEs, and the experience of the tax authority in relation to tax cooperation and exchange of information. Hence, primary data were collected

To collect the data, semi-structure interview questions were used since BEPS are technical and many of the respondents are not familiar with some of the elements of BEPS. Structured interview questions are used. Tax and legal experts from ERCA, MFEC and EIC were interviewed.

## 1.9. Organization of the Research

This study has five chapters. The first chapter is an introductory chapter devoted to the presentation of the proposal. The second chapter deals with globalization and international taxation in general. This chapter discusses the impact of globalization on fiscal sovereignty of national governments, the problem of double taxation and the relief methods thereof, international tax competition and problems in relation to global tax governance.

The third chapter is entirely devoted to the discussion of challenges of taxing MNEs which are peculiar to developing countries, so doing it discusses illicit financial outflows, elements of BEPS such as transfer pricing, hybrid mismatch arrangements, SPEs, treaty shopping, and thin capitalization with the effects thereof. The fourth chapter is specifically allocated to the discussion of the challenges of taxing MNEs in Ethiopia.

This chapter single outs the underlining legal and instructional framework challenges in the fight against BEPS. The normative framework includes the present challenges in relation to; effective transfer pricing legislation, absence of anti-hybrid mismatch rule, absence of general anti-base erosion rule and absence of debt rule of thin capitalization. The institutional framework challenges relates to; awareness of BEPS, lack of capacity to tax MNEs, lack of capacity to follow up, implement and monitor the activities of MNEs, lack of tax cooperation and exchange of information and lack of resource and ICT infrastructure. The last chapter is devoted to conclusion and recommendation.

## CHAPTER TWO

### GLOBALIZATION AND INTERNATIONAL TAXATION IN GENERAL

#### 2.1. Introduction

This chapter discusses globalization and international taxation in general. It begins with highlighting the conceptual underpinnings of globalization and its impact on national as well as fiscal sovereignty of national governments. It also discusses the problem of double taxation the relief methods thereof. International tax competition with the arguments surrounding thereof is also at the heart of the discussion of this chapter. The remaining part of the chapter is left to the presentation of issues in global tax governance, one of the pressing issues in this highly interconnected and interdependent world.

#### 2.2. Globalization and National Fiscal Sovereignty

Globalization is one of the fuzziest terms which cannot be defined easily and which cannot be agreeable as there are a lot of political, economic, and social motives behind any attempts to define it. However, though globalization has broad meanings, it refers to the increasing internationalization of markets for goods and services, the means of production, financial systems, competition, corporations, technology and industries, associated with increased integration and liberalization of markets around the world and the process of increasing connectivity and uniting the world market and business.<sup>32</sup>

As per tax law comparatists, our world becomes more globalized after the mid-1980s<sup>35</sup> following the emergence of the internet which has made it easier for people to travel, communicate and do business internationally.<sup>36</sup> Information revolution and technology innovation of the last two

---

<sup>32</sup> UNCTAD et al., 2002, Glossary, p. 170.

<sup>33</sup> Sagit Leviner, *The Intricacies of Tax and Globalization*, 212.

<sup>34</sup> Brian J Taylor, *The Impact of Globalization on Taxation* [Last accessed 5/4/2017], available at <<http://ezinearticles.com/?The-Impact-of-Globalization-on-Taxation&id=6140542>> [Here in after Brian J Taylor, *The Impact of Globalization on Taxation*]

<sup>35</sup> Sagit Leviner, *The Intricacies of Tax and Globalization*, 212.

<sup>36</sup> Brian J Taylor, *The Impact of Globalization on Taxation*.

decades has a paramount importance in the development of globalization and for increasing need of cross border relationships<sup>37</sup>.

Nevertheless, globalization should not be only construed with markets and business, because it encompasses and touches every parts of national performance including innovation, technological progress, laws and rules and even social and cultural norms.<sup>38</sup>

It is undeniable that our world is highly integrated, interdependent and connected more than ever before due to globalization. But, globalization is the subject of heated debates among scholars. It is hardly possible to categorize the fans and people who dislike globalization by their geographical location, level of civilization, or political thinking. We have heard of politicians, ordinary citizens, academicians, and business mans from both the developed and the developing world propagating the same ideas in favor of or against globalization.<sup>39</sup>

If we just begin from the positive arguments, the adherents of globalization argue that globalization has given rise to new industries and more jobs in developing countries<sup>40</sup>. They further argued that, both institutional factors (multilateral liberalization of exchange, economic integration) and technological factors (development of internet and telecommunication techniques) helped developing countries to make benefit out of it.<sup>41</sup>

The negative arguments regarding globalization emanate from both the developing and the developed world. People from the developed world argue that globalization has outsourced manufacturing jobs that used to be done by their own citizens<sup>42</sup>. They also tend to fear that could endanger their jobs and way of living.<sup>43</sup> People from developing world also fear that globalization may lead to loss of control over economic and political decisions and may be a

---

<sup>37</sup> Insop Pak International Finance and State Sovereignty: Global Governance in the International Tax Regime Annual Survey of International & Comparative Law, Vol. 10 Issue (No.) 1, 2004, p. 203. Here in after, Insop Pak, International Finance and State Sovereignty

<sup>38</sup> Sagit Leviner, The Intricacies of Tax and Globalization, 212.

<sup>39</sup> \_\_\_\_\_, Globalization Positive or Negative? P. 1. Here in after, Globalization, Positive or Negative, available at < [http://www.edu.gov.mb.ca/k12/cur/socstud/frame\\_found\\_sr2/bl/sd/](http://www.edu.gov.mb.ca/k12/cur/socstud/frame_found_sr2/bl/sd/)> [Last accessed 10/05/2017].

<sup>40</sup> Ibid.

<sup>41</sup> Prof. Pascal Salin Arguments in Favor of Globalization University Paris Dauphine, p. 2. Here in after referred as Pro. Pascal Salin Arguments in Favor of Globalization

<sup>42</sup> Globalization Positive or Negative? p. 1.

<sup>43</sup> Id.

threat to their tradition language and culture.<sup>44</sup> Most importantly, they fear that globalization may force poor countries of the world to do whatever the big countries tell them to do. As a result, their sovereignty will be washed away.<sup>45</sup>

This triggers another important issue, i.e. the impact of globalization on national sovereignty. Some people argue that globalization has entirely eroded states' sovereignty and even questions the very existence of it. In contrast, other scholars claim that globalization does not erode sovereignty rather it has transformed it. This diverse approach has produced the following views concerning sovereignty.<sup>46</sup>

### 2.2.1. New Medievalists Approach

The new medievalists view bases itself in medievalism which refers to a system of overlapping authority and multiple loyalty, held together by a duality of competing universalistic claims,<sup>47</sup> This is used to refer to the situation that Europe was in during the Middle Ages, which were characterized by a highly fragmented and decentralized network of sociopolitical relationships, held together by the competing universalistic claims of the Empire and the Catholic Church.<sup>48</sup>

In the same fashion, new medievalists claim that currently sovereignty is weakened as in the medieval times, because the current world is also characterized by a complicated web of social identities, held together by the antagonistic organizational claims of the nation state system and the transnational market economy.<sup>49</sup> New medievalists proclaim the end of nation state under traditional international law which is associated with exclusive territorial jurisdiction since the Treaty of Westphalia in 1648.<sup>50</sup>

---

<sup>44</sup> Prof. Pascal Salin, Arguments in Favor of Globalization.

<sup>45</sup> Globalization Positive or Negative? P. 2.

<sup>46</sup> Ibid.

<sup>47</sup> Jorg Friedrichs, The Meaning of New Medievalism, European Journal of International Relations, available at <<http://journals.sagepub.com/doi/abs/10.1177/135406610100700401>> Here in after, referred as Jorg Friedrichs, The Meaning of New Medievalism [Last accessed 04/05/2017]

<sup>48</sup> Ibid.

<sup>49</sup> Ibid.

<sup>50</sup> Insop Pak, International Finance and State Sovereignty 184.



The Westphalia logic provides that the state is the ultimate power within its territory and its existence is recognized by other states.<sup>51</sup> New medievalists strictly oppose this logic and argue that since the sovereignty of states is taken away by non-state actors, we should emphasize their role with multiple allegiances and global networks. They also call for the development of a complex and varied international order with multiple layers and actors as a solution for the present turmoil that our world is facing.<sup>52</sup>

### 2.2.2. Liberal Internationalists Theory

Liberal Internationalist theory is a foreign policy principle that tries to address the issue of how best to organize and reform the international system and international relations between states and non-state actors.<sup>53</sup> It underlines the benefits and importance of international progresses, interdependence, cooperation, diplomacy, multiculturalism, and support for international structure and organizations.<sup>54</sup>

Liberal internationalists believe in the power of cooperation and interdependence by the instrumentality of international law and international commerce.<sup>55</sup> They have also a strong faith in the decency and effectiveness of international institutions with a superior political structure constituted by a legally binding treaty with expanding power of governance.<sup>56</sup>

This theory has been successful so far and greatly influenced the current globalization process and contributed a lot in eroding the sovereignty of so many nation states. The United Nations, other international organizations and conventions and treaties are some of the fruit of this theory.<sup>57</sup>

---

<sup>51</sup> Ladin idil OZTIG, Globalization and New Medievalism: A Reconsideration of the Concept of Sovereignty Heinonline, 6 Rev. Int'l. & Pol. 125 2010, abstract page here in after Ladin idil OZTIG, Globalization and New Medievalism.

<sup>52</sup> Insop Pak International Finance and State Sovereignty 185.

<sup>53</sup> Duncan Bell, Liberal internationalism Encyclopædia Britannica available at <<https://www.britannica.com/topic/liberal-internationalism>> [Here in after, referred as Duncan Bell Liberal internationalism], [Last accessed 04/05/2017].

<sup>54</sup> Shawn Grimsle, Liberal Internationalism Definition and Principle, available, <<http://study.com/academy/lesson/liberal-internationalism-definition-principles.html>> [Here in after, referred as Shawn Grimsle, Liberal Internationalism Definition and Principle], [Last accessed 04/05/2017],

<sup>55</sup> Ibid.

<sup>56</sup> Duncan Bell Liberal internationalism.

<sup>57</sup> Shawn Grimsle, Liberal Internationalism Definition and Principle.

### 2.2.3. Transgovernmentalism

Transgovernmentalism is a theory of global governance that refers to the €intensive and continuous consultation process by which subunits national governments form international coalitions crossing national boundaries.<sup>58</sup> It views this interaction and coalition as an extension of the power of national government to exercise their power beyond their territory. ~~Views~~ Also the interaction as new channel for spreading democratic accountability, government integrity, and rule of law.<sup>59</sup>

Compared to the chaos paradigm of the new medievalists, transgovernmentalism insists that the states is not vanquishing rather disaggregating into is separate and functionally distinct parts.<sup>60</sup> It views the power of international bodies as an exercise of delegated power by national governments. Hence, globalization has led to the expansion of government authority and government spending instead of diminishing their authority.<sup>61</sup>

The aforementioned theoretical conception of sovereignty also encompasses in the context of fiscal sovereignty as it is one aspect of sovereignty of national governments. Therefore, the new medievalists hold that national governments have lost their national fiscal sovereignty like any other domestic powers by international non state actors.<sup>62</sup>

Transgovernmentalists understands the ~~exist~~ involvement and power of international bodies on the issue of taxation as an extension of the domestic fiscal power of nation states at the international level. Thus, it is an expansion of power of governments, because international non state actors that are working in the area of taxation are exercising the power that they have obtained from national governments through delegation.<sup>63</sup>

Similarly, liberal internationalists views the current collaboration, cooperation and increasing interdependence in between states in the area of taxation as a phenomena that enable states to

---

<sup>58</sup> Robert M. Cutter, The OSCE/S Parliamentary Diplomacy in Central Asia and the South Caucasus in Comparative Perspective, *Studia Diplomatica*, Vol. LIX, No. 2, 2006, pp. 20. [Here in after, referred as Robert M. Cutter, The OSCE/S Parliamentary Diplomacy]

<sup>59</sup> Id.

<sup>60</sup> Insop Pak, International Finance and State Sovereignty 186.

<sup>61</sup> Id.

<sup>62</sup> Ibid, p. 198.

<sup>63</sup> Ibid, p. 197.

expand their fiscal power of taxation beyond their territory and it calls for the establishment of supranational institutions and signing of binding tax treaties to enhance global governance.<sup>64</sup>

Despite this branch out understanding of globalization and national sovereignty, it is undeniable that globalization has affected many aspects of national performances including taxation. In this regard, it has caused; 1) increased activity multinational companies, 2) internationalization of the way business is organized, 3) considerable growth in the countries involved in the process, 4) greater complexity in foreign transaction and 5) substantial reduction in the significance of geographic borders.<sup>65</sup> It has also radically limited the power of taxation of national governments, in the field of highly mobile capital and flexible transitional corporations.<sup>66</sup>

Moreover, globalization has increased the mobility of economic activities, particularly capital investment. As a result, investors can change the location of their investment very easily. Thus, the difference that national governments levy tax on capital income becomes important.<sup>67</sup> This forces national governments to set lower business tax rates at the expense of their fiscal autonomy in order to attract and retain international investment and this dynamic is often described as tax competition.<sup>68</sup>

Vito Tanzi describes this tax competition as "tax degradation" where by some countries changes their tax system to raid the world tax base and exports their tax burden.<sup>69</sup> The competition to take the mobile economic activities does not only affect the tax design and policy of the states. It

---

<sup>64</sup> Id.

<sup>65</sup> Ing. Ivona Durinovo, Taxation under Conditions of Economic Globalization, National Economic Institute, Volume XIV, No.10, 2006, p. 18. Here in after, Ing. Ivona Durinovo, Taxation under Conditions of Economic Globalization].

<sup>66</sup> Ian Roxon, Limits to Globalization: Some Implications for Taxation, Tax Policy, and the Developing World, Law, Society and Economy Working Paper Series, 3/2012, Law Department, London School of Economics and Political Science, London, UK, 2012, p. Here in after, referred as Ian Roxon, Limits to Globalization].

<sup>67</sup> Erik Wibbels and Moisés Arce, Globalization, Taxation, and Burden Shifting in Latin America, International Organization, the IO Foundation, 2003, pp. 114-112. Here in after, referred as Erik Wibbels and Moisés Arce, Globalization, Taxation, and Burden Shifting in Latin America].

<sup>68</sup> Sagit Leviner, The Intricacies of Tax and Globalization, p. 214.

<sup>69</sup> Vito Tanzi, Globalization, Tax Competition and the Future of Tax Systems, IMF Working Paper series WP/96/141, Fiscal Affairs Department, December 1996, p. Here in after, referred as Vito Tanzi, Globalization, Tax Competition and the Future of Tax Systems].

also encourages mobility, ultimately which leads to economic distortion, as basic economic activities, capital and labor are relocated for tax purposes rather than productivity reasons.<sup>70</sup>

## 2.3. The Problem of Double Taxation

National governments levy and collect taxes from subjects within their national territory on the bases of one or all of the three relations; €citizenship,, €residence,, or €source,,. Particularly, the issue of international taxation revolves around the concept of residence and source which will be discussed in the section below.

### 2.3.1. Citizenship Principle

This principle works on the bases of the relationship that exists between tax subjects and taxing state. Thus, if an entity is a citizen of a certain state, it incurs tax liability by the mere fact that it is the citizen of that state. Hence, the source of the income and the residence of the tax payer are immaterial. However, citizenship based taxation is not that much popular because the overwhelming majority of citizens of a state are also residents of that state. As a result, residence jurisdiction and nationality jurisdictions overlap considerably. Thus, countries usually prefer residence.<sup>71</sup>

### 2.3.2. Residence Principle

The residence base taxation uses the place of residence of the tax payer as a base for assumption of tax liability. Residents of a country are taxed uniformly on their worldwide income, irrespective of the source of income. But, residents are not taxed by the home country on their income, even though the income is generated in that country unless the country has also adopted the source principle.<sup>72</sup>

Residence jurisdiction is more preferred than source jurisdiction by economists due to the following two reasons; first, they think that source of income is hard to pin down as there could

---

<sup>70</sup> James R. Hines Jr and Lawrence H. Summers, Globalization Affects Tax Design, chapter pages in book 23 - 157, by the National Bureau of Economic Research, University of Chicago Press, July 2009, p. 125.

<sup>71</sup> The United States of America is the only State where tax jurisdiction based on nationality is important, although a few other States, including Bulgaria, Mexico and the Philippines, have used citizenship as a basis for taxation in the past.

<sup>72</sup> Jacob Frenkel et al, Basic Concepts of International Taxation in an Integrated World, MIT Press Working Paper No. 3540, National Bureau of Economic Research, 1992, p 4. [Here in after, referred as Jacob Frenkel et al, Basic Concepts of International Taxation in an Integrated World].

be more than one source for a single income; second, ~~they that~~ residence jurisdiction promotes economic efficiency and effective allocation of resource as decision of the location of investment is not affected by tax rates.<sup>73</sup>

Nevertheless, pure residence based taxation is not realistic as; 1) it is unlikely ~~that~~ countries would give up their taxing right from ~~non~~ residents who are driving income with in their economy and territory, 2) it would be harmful for poor countries, who rely heavily on source taxation, 3) it is pretty much easy to evade or avoid by ~~claiming~~ international investments through tax heaven<sup>74</sup>. Therefore, states usually employ both residence and source based taxation.

### 2.3.3. Source Principle

Source based taxation emphasis the source of the income as the base for assessing tax liability. Hence, income originating in the host country is uniformly taxed, irrespective of the residency of the tax payer. The income of the residents generated outside of the home country is taxed by the home country.<sup>75</sup> It is justified on the ground that since a state has ~~as~~ contributed to the creation of the economic opportunities that allow the ~~tax~~ payer to generate that income, ~~that~~ state should claim its fair share of tax.<sup>76</sup>

The major problem with pure source based taxation is that, it enables investors particularly MNEs to play countries off against each other to obtain the lowest source based tax rates. Sometimes, its hardly possible to trace exactly the source of the income in which case it would be doubtful whether any investment income would be subject ~~to tax~~ ~~anywhere~~.<sup>77</sup>

Researchers suggest that the numbers of countries that are using source principle has diminished, because failure to tax residents on their worldwide income undermines the fairness of the tax

---

<sup>73</sup> Tax Justice Network Africa, Tax Justice Briefing Source and Residence, 15 September 2005, [here in after](#), Tax Justice Network Africa, p. 2.

<sup>74</sup> Id.

<sup>75</sup> Jacob Frenkel et al, Basic Concepts of International Taxation in an Integrated World.

<sup>76</sup> Committee of Experts on International Cooperation in Tax Matters, Introduction to International Double Taxation and Tax evasion and Advocacy, Seventh session, Geneva, 24-28 October 2011, Item 5 (h) of the provisional agenda Revision of the Manual for the Negotiation of Bilateral Tax Treaties, p. ~~9~~ ~~here in after~~, referred ~~as~~ introduction to International Double Taxation

<sup>77</sup> Tax Justice Network Africa, p. 2.

system and encourages residents to invest abroad which is against the national interest of the state in need of capital for domestic investment.<sup>78</sup>

These jurisdictional tax principles are coined originally for natural persons (individuals) in the context of the personal income tax. But, now their application is also extending for legal entities like corporations. Their residence and nationality is determined based on the place of incorporation or place of management.<sup>79</sup>

If all countries have adopted similar jurisdictional tax bases (citizenship, residence or source) there will be no problem in international taxation. However, that is not the case in reality since countries have different tax jurisdictional base. Given the free movement of goods and services across highly diversified tax jurisdictional bases, it is obvious that multiple taxing authorities may claim jurisdiction over the same activity or entity.<sup>80</sup>

Therefore, the entity will be subjected to double taxation due to the following reasons:<sup>81</sup>

- Residence-Residence Conflict: two states may tax a person (individual or company) on his worldwide income or capital because they have inconsistent definitions for determining residence;
- Source-Residence Conflict: one state may tax income derived by a person by application of the residence or nationality principle, whereas another state may tax that same income by application of the source principle;
- Source-Source Conflict: two states may invoke the source principle to tax the same item of income, due to conflicts in the way the source of income is determined under their domestic legislation;
- Triangular Cases: in some cases, a state may have a residence conflict with one state and a source conflict with another State.

On the other hand, double taxation is not favorable to the business operation. It seriously affects the free flow of cross border trade and investment activities. Thus, countries that are under conflict of tax jurisdiction must relinquish their jurisdiction and give it to one of the country

---

<sup>78</sup> Introduction to International Double Taxation, 12.

<sup>79</sup> Id.

<sup>80</sup> Id.

<sup>81</sup> Committee of Experts on International Cooperation in Tax Matters, pp. 114

in the conflict thereof. But, doing so is not an easy task as countries cannot give up their taxing rights easily because it seriously threatens their fiscal sovereignty. However, before doing that one fundamental question must be answered i.e. "which individual and entities does a particular country have the right to tax?".<sup>82</sup> Thus, countries have devised different methods of relief from double taxation to answer this question.

## 2.4. Methods of Relief from Double Taxation

If the problem of double taxation is not eliminated, crossborder economic relation would significantly be in trouble as two or more states subject the same income to taxation.<sup>83</sup> In order to eliminate the problem of double taxation, many states take unilateral measures or bilateral tax treaties.

### 2.4.1. Unilateral Measures

Unilateral measures to prevent international double taxation differ from country to country as it is only taken by the initiation of a single country. However, there are three distinct types of unilateral measures: the exemption of foreign source income, the tax credit for foreign taxes paid on foreign source income and the deduction from the taxable base of foreign taxes paid on foreign-source income.<sup>84</sup>

Unilateral actions could be applied either by setting out precise rules (e.g. Germany) or by giving much discretionary powers to the taxing authorities. But, in countries like Brazil, bilateral relief from international double taxation is sometimes granted subject to reciprocity.<sup>85</sup>

However, unilateral measures criticized as not effective as tax treaties. Because, as it will be discussed here in below tax treaties have multiple purposes and in addition to addressing double taxation problems they also gives solutions for other tax related problems.

---

<sup>82</sup> Stranton Makundi, Managing Tax Risks: Double tax Treaties and Implications to Undertakings of Multinationals THE CITIZIN Jan 21, 2016. Here in after, Stranton Makundi, Managing Tax Risks, available at, <<http://www.thecitizen.co.tz/oped/Double-tax-treaties-and-implications/1840568304277213npw03/index.html>> [Last Accessed 5/4/2017].

<sup>83</sup> Michael Lang Introduction to the Law of Double Taxation Conventions, Vienna, June 2010, p. 25.

<sup>84</sup> Ibid, 26.

<sup>85</sup> Id.

## 2.4.2. Double Taxation Treaties

Tax treaty is an agreement between two or more taxing state or countries.<sup>86</sup> Tax treaties mainly deal with the allocation of taxing rights over income or capital to one of the contracting states or both.<sup>87</sup> The overall purpose of double taxation treaties are; providing protection<sup>ax</sup> for taxpayers against double taxation, 2) assist in ensuring that double taxation does not discourage the free flow of international trade and investment as well as transfer of technology, 3) assist tax authorities to curb tax evasion through exchange of information, 4) assist in preventing discrimination in between tax payers.<sup>88</sup>

Apart from addressing the problem of double taxation and tax related treaties have the benefits of; facilitating inbound and outbound investment by reducing administrative complexity, recognizing corrections concerning transfer pricing, providing specific dispute resolution mechanisms and arbitration procedures and boosting the confidence of MNEs by providing applicable withholding tax rates.<sup>89</sup>

Most importantly tax treaties incorporate double taxation relief methods which are essential to a healthy flow of international investment and business activity. In this regard, there are two widely known relief methods. Firstly, a country may exempt its residents from tax income from investment and activities outside the country which is known as exemption method. Secondly the country may include foreign source income in the base on which it taxes residents but allow a credit for taxes paid to other countries which is known as tax crediting.<sup>90</sup> Both methods are discussed in detail as follows.

### 2.4.2.1. Exemption Method /Principle/

Under exemption method the resident state exempts certain incomes from foreign sources and the exemption is limited to income that is subjected to full taxation in the source state.<sup>91</sup>

---

<sup>86</sup> Stranton Makundi, Managing Tax Risks.

<sup>87</sup> Khadija Baggerman, Noudari and René Offermann, Foreign Direct Investment in Developing Countries: Some Tax Considerations and Other Related Legal Matters, Bulletin for International Taxation, June, 2016, p. 314. [Here in after, Khadija Baggerman, Noudari and René Offermann, Foreign Direct Investment in Developing].

<sup>88</sup> Stranton Makundi, Managing Tax Risks

<sup>89</sup> Khadija Baggerman, Noudari and René Offermann, Foreign Direct Investment in Developing, 314.

<sup>90</sup> Ibid, p. 315.

<sup>91</sup> Id.



typical effect of this method is that the source state will have the exclusive right to tax that item of income.<sup>92</sup>

According to the UN Model Law on Double Taxation, exemption method may be applied by two main ways which are "full exemption," and "exemption with progress,". Under the full exemption method, the income which may be taxed in other state/s is not taken into account at all by the state of residence for the purpose of its tax; state of residence is not entitled to take the income so exempted into consideration when determining the tax to be imposed on the resident.<sup>93</sup> Whereas, in the case of exemption with progress, the income which may be taxed in other state/s is not taxed by state of residence, but the state of residence retains the right to take that income into consideration when determining the tax to be imposed on the rest of the income.<sup>93</sup>

#### 2.4.2.2. Tax Crediting Method /Principle/

In the context of foreign tax crediting method, the resident state permits income tax paid to the source state to be set off against its own income taxes. Its target is "capital export neutrality," as capital export neutrality gives no room for tax factors to play a role in the investor's decision where to invest.

At this juncture an important question may be raised as to what could be the solution when the foreign tax rate is lower than the domestic? In this kind of scenario a foreign tax limitation is needed and there should not be any tax relief.<sup>95</sup>

Like the exemption method, tax crediting method may also be applied in two main methods which are known as "full credit," and "ordinary credit,". In the case of full credit, the state of residence allows the deduction of the total amount of tax paid in the other state on income which may be taxed in that state. On the other hand, under ordinary credit, the deduction given by the

<sup>92</sup> Introduction to International Double Taxation, 9.

<sup>93</sup> United Nations Model Double Taxation Convention between Developed and Developing Countries, Commentary on Elimination of Double Taxation, Department of Economic & Social Affairs, New York, 2011 p. 316. [Here in after, UN Model Double Taxation Convention]

<sup>94</sup> Joseph Edrey and Adrienne Jeffrey, Taxation of International Activity: Over Relief from Double Taxation under the U.S. Tax System, Berkeley Journal of International Law, Volume 9, Issue 1, 2991, p. 107. credit method typically applies to passive income, such as dividends, interest and royalties.

<sup>95</sup> For example, if there is a domestic tax rate of 40% and a foreign rate of 25%, the double taxation is 15%. The 15% excess of the domestic tax over the foreign tax reflects the simple fact that the domestic tax burden is higher than the foreign one.

resident state for the tax paid in the other State is restricted to that part of its own tax which is appropriate to the income which may be taxed in the other State.<sup>96</sup>

Therefore, the fundamental difference between exemption and foreign tax crediting method is that the exemption methods look at income, while the credit methods look at tax.

## 2.5. International Tax Competition

Tax competition is a highly debated issue as to its exact definition and desirability in international taxation. There is no any kind of uniformly accepted definition of tax competition particularly, on its content. With regard to the definition, the disagreement revolves around making analogy of the phrase tax competition, with market competition.

However, as it can be understood from the preceding discussion, increasing mobility of capital investment is one of the major effects of globalization. This increasing mobility of investment capital intensifies tax competition among states. Broadly speaking, tax competition depicts a strategic, non-cooperative interaction among states, where by each nation design its tax system in response to the arrangement of another country to attract and retain foreign investment.<sup>97</sup>

### 2.5.1. Arguments Surrounding International Tax Competition

There are two competing arguments surrounding the possible effects of tax competition on economies and tax systems of a given nation. The proponents of tax competition, essentially emphasizes the similarity in between tax competition and market competition and tries to extend those benefits of market competition in the context of tax competition.<sup>98</sup>

In the opposite, the proponents of limitation in favor of tax competition bases their arguments on the dissimilarity of tax competition and market competition. They argue that, in taxation there is nothing to be sold; there are no seller and buyer. Tax payers are just simply paying to benefit from general government services. Thus, tax competition should not be construed in the context

---

<sup>96</sup> UN Model Double Taxation Convention.

<sup>97</sup> Sagit Leviner, *The Intricacies of Tax and Globalization*, 213.

<sup>98</sup> Lilian V. Faulhaber, *The Trouble with Tax Competition: From Practice to Theory*, Working Draft of February 6, 2017, p. 8. [Herein after, referred as Lilian V. Faulhaber, *The Trouble with Tax Competition*]

of market competition and those stated benefits of market competition could not be extended to tax competition.<sup>99</sup>

### 2.5.1.1. Arguments against Limiting International Tax Competition

Advocates of international tax competition provides theoretical arguments and empirical researches that shows the positive benefits of competition on business organizations, tax authorities and economies. Further argued that, reacts positively towards tax rate decrease, tax competition tends to have positive impact to attract investment.

More importantly, advocates of tax competition insist that tax competition improves government efficiency and social welfare, and reduces government waste. This position is an extension of the benefit of competition in the context of free market, that is, competition enhances efficiency. Likewise, the proponents of tax competition argue that, tax competition in between jurisdiction makes governments more efficient and more responsive to the preferences of their citizens.<sup>100</sup>

The other argument in support of tax competition relates any efforts to curtail tax competition as a threat to sovereignty. The right to raising revenue through tax is one of the fundamental elements of sovereignty, which is exercised by the setting of tax rates and definition of tax bases. Hence, any challenge against tax competition is interference in the affairs of a sovereign state. However, this line of argument forgets that it is the states themselves who are airing their voice against tax competition.<sup>101</sup>

The other argument which is not build on the market competition analogy suggests that the optimal corporate tax rate in a small open economy is zero. Therefore, tax competition that involves reducing tax rates on corporate income is in fact beneficial, since it leads countries towards optimal level of corporate income tax rate. But, this finding heavily criticized as an over interpreted argument to mean that there should be no tax at all on corporate income which is not practically feasible.<sup>102</sup>

---

<sup>99</sup> Ibid, p. 10.

<sup>100</sup> Lilian V. Faulhaber, *The Trouble with Tax Competition*, p. 8.

<sup>101</sup> Ibid, p. 9.

<sup>102</sup> Id.

### 2.5.1.2. Arguments for Limiting International Taxation Competition

Quite to the opposite, adherents for limitation on tax competition presents a number of line of arguments based on theoretical and empirical researches that show the negative impact of tax competition on the economies and tax authorities.

The primary opponents of tax competition claim that tax competition undermines the fiscal autonomy of the state by effectively removing their autonomy prerogatives.<sup>103</sup> First, it contributes fiscal crises of welfare states as lower tax rates and incentives driven by tax competition results in revenue shortfall.<sup>104</sup> Ultimately this leads to an under provision of public goods.<sup>105</sup> Secondly, tax competition tends to lead to more regressive fiscal regimes, which may be at odds with the democratic preferences of citizens concerning the level of redistribution.<sup>106</sup> They conclude that, though states still possess the formal right to set tax policies (sovereignty), they cannot effectively pursue their desired policy goals (sovereignty) due to international tax competition.<sup>107</sup>

The second argument of proponents of limitation on tax competition related with more distortion and more regressive effect of tax competition. Tax competition forces jurisdictions to rely on revenue source other than corporate income tax. But these are more distortionary (since taxing labor income more leads to greater distortions to the labor market) and more regressive (since shifting the tax base more toward labor limits

The third argument in favor of limiting tax competition is that tax competition violates the "capital export neutrality" principle. This suggests that, investors should prefer the location of their firm where return on investment is maximized without taking in to account the tax rates.<sup>109</sup> However, tax competition forces investors to allocate their capital to the country where lower tax

---

<sup>103</sup> Peter Dietsch, *Catching Capital: The Ethics of Tax Competition*, Oxford University Press, 2012, 264 pp. \$34.95 (hbk), ISBN 9780190251512, [Here after, Peter Dietsch, *Catching Capital: The Ethics of Tax Competition* Available at <<http://ndpr.nd.edu/news/catching-capital-the-ethics-of-tax-competition/>> [Last accessed 04/05/2017]

<sup>104</sup> Peter Dietsch, *Catching Capital: The Ethics of Tax Competition*.

<sup>105</sup> Lilian V. Faulhaber, *The Trouble with Tax Competition*, p. 10.

<sup>106</sup> Peter Dietsch, *Catching Capital: The Ethics of Tax Competition*.

<sup>107</sup> Ibid.

<sup>108</sup> Lilian V. Faulhaber, *The Trouble with Tax Competition*, p. 11.

<sup>109</sup> Ibid, p. 12.

rates are there instead of on the bases of pure economic analysis such as market access, labor, and long term investment.<sup>110</sup>

Some scholars also view tax competition from the view point of distributive justice. They argue that tax competition widens the income gap in between capital owners and everyone else, as well as between rich and poor countries. Governments particularly in developing countries in order to compensate their losses under international taxation due to tax competition may tax labor heavily or impose other expenditures like taxes falling disproportionately on lower income groups.<sup>111</sup> Furthermore, this may result unfair distribution of tax burden in the business sector because MNEs benefits a lot while domestic small and medium sized enterprises are more heavily burdened.<sup>112</sup>

Despite the aforementioned diversified view concerning international tax competition, there are some consensuses among scholars concerning tax competition. For instance, there is an agreement that 1) tax policy has an influence on international investment and foreign investors are responsive to tax policy, 2) though the elasticity is debated, foreign investment increases as statutory corporate income tax rates decrease.<sup>113</sup>

## 2.6. Global Tax Governance

In the preceding topics we have seen that national governments have made an extensive tax policy reforms in order to coup up with the increasing mobility of capital investment due to globalization. They have devised different double taxation relief methods to eliminate double taxation problems as a result of conflict of jurisdictions; so as to retain and attract foreign capital investment. They have also engaged themselves in tax competition which has severely affected their fiscal selfdetermination. Consequently, this has effectively eroded the power of nation states to control and govern international taxation. It seems, global tax governance is out of the control of national governments.

---

<sup>110</sup> Id.

<sup>111</sup> Peter Dietsch, *Catching Capital: The Ethics of Tax Competition*.

<sup>112</sup> Thomas Rixen, *Global Tax Governance Normative and Institutional Issues*, May 2012, p. 3. Here in after, Thomas Rixen, *Global Tax Governance Normative and Institutional Issues*.

<sup>113</sup> Peter Dietsch, *Catching Capital: The Ethics of Tax Competition*.

Therefore, since international tax problems are happening at the global level the international tax system needs to have an institution that could properly regulate the governance of international taxation on behalf of national governments. Therefore, in this an ever interdependent and globalized world gradual emergence of global tax governance is inevitable.<sup>114</sup>

Unfortunately, at the global level there is no institution with a truly universal membership and/or an institutional apparatus that would be equally accountable to all members.<sup>115</sup> It seems that the internationalists thought is becoming to be the order of the day as we need a higher level of supranational institutions that tries to solve those problems in international taxation.<sup>116</sup> Nonetheless, it is not an easy task as Pascal Lamy described it, “[t]he world has three states, like mass; the national which is solid, the European which is liquid, the international which is gaseous.”<sup>117</sup>

There are ongoing attempts to establish multilateral incentives on tax cooperation at regional and group level, such as Addis Tax Initiative (ATI), African Tax Administration Forum (ATAF), Extractive Industries Transparency Initiative (EITI), Financial Transparency Coalition Inclusive Framework for BEPS Implementation (FTCI), and UN Committee of Experts on International Cooperation in Tax Matters.<sup>118</sup> However, these institutions lack universal membership and institutional apparatus and they are not in a position to claim international tax governance.<sup>119</sup>

---

<sup>114</sup> Prof. Dr. Jan Wouters and Katrien Meuwisse, Global Tax Governance: Work in Progress, Leuven Center for Global Governance Studies, Working Paper No. 59, February 2011, p. 59. Here in after, referred as Prof. Dr. Jan Wouters and Katrien Meuwisse, Global Tax Governance: Work in Progress?

<sup>115</sup> Wolfgang Obenland (Global Policy Forum), Options for Strengthening Global Tax Governance, Draft for Discussion, 8/Apr/2016, p. 5. Here in after, referred as Global Policy Forum, Options for Strengthening Global Tax Governance?

<sup>116</sup> Miriam Ronzoni, Global Tax Governance: The Bulletin Internationalists Must Bite And Those They Must Not MOPP 2014; 1(1): 37-59, p. 39.

<sup>117</sup> Prof. Dr. Jan Wouters and Katrien Meuwisse, Global Tax Governance: Work in Progress? 1.

<sup>118</sup> See Global Policy Forum, pp. 3, 4. There are a number of multilateral incentives on tax cooperation, some them are regional, some of them institutional and others established on individual country level as a group. Addis Tax Initiative (ATI) founded 2015, Mandate: Support for raising domestic public revenue, to improve fairness, transparency, efficiency, and effectiveness of tax systems by 2020 and stepping up domestic resource mobilization. Partners: Germany, United Kingdom, United States, Ethiopia, European Commission, OECD, and further countries and international organizations. African Tax Administration Forum (ATAF) 2008, Mandate: Improving the capacity of African tax administrations to achieve their revenue objectives, advancing the role of tax administration governance and state building; providing a voice for African tax administrations, and developing and supporting partnerships between African countries and development partners. Members: 37 African countries. Extractive Industries Transparency Initiative (EITI) 2002, Mandate: Development of transparency standards for payments to governments resulting from resource extraction. Members: 51 implementing countries.

At global level there have been also initiatives regarding fiscal policy that have implication for national policies and law. However, they cannot be referred as international tax laws, but, hesitant beginning of a form of global tax governance. On such governance activities the role of Group of Twenty (G20), the Organization for Economic Cooperation and Development (OECD), the United Nations (UN), the International Monetary Fund (IMF) and the World Trade Organization (WTO) are a notable examples.<sup>120</sup>

The G20 is an international forum which involves the world's leading industrialized and emerging economies.<sup>121</sup> The G20 summit when it was established the participants were limited to finance ministers and central bank governors, however, now this days heads of states are also participating.<sup>122</sup> The G20 frequently discusses issues of financial crises that our world is facing. It has also discussed on some tax policy issues specifically related with fiscal policy. For instance, it has deliberated discussions on tax havens and the elaboration of new taxation instruments and transparency and exchange of information for tax purposes.<sup>123</sup>

The G20 despite its indispensable role in global economic governance, it remains informal body: because it does not have a charter or voting mechanism, does not produce legally binding solutions, and even it does not have a secretariat to assist it.<sup>124</sup> Moreover, the G20, since it

---

Financial Transparency Coalition (FTC), Mandate: To curtail illicit financial flows through the promotion of a transparent, accountable, and sustainable financial system.

Members: Global network of civil society, governments, and experts with more than 150 allies, in 40 countries. Inclusive Framework for BEPS Implementation 2016, Mandate: Dialogue on equal footing to directly shape the standard setting and monitoring processes on BEPS issues. Membership: OECD and G20 members and all interested countries and jurisdictions, tbd.

UN Committee of Experts on International Cooperation in Tax Matters 1968/2004, Mandate: Review and update UN Model Double Taxation Convention between Developed and Developing Countries and the Manual for the Negotiation of Bilateral Tax Treaties between Developed and Developing Countries. Dialogue on enhancing and promoting international tax cooperation; Recommendations on capital mobility and the provision of technical assistance to developing countries and countries with economies in transition. Members: 25 tax experts appointed by the UN Secretary General

<sup>119</sup> Ibid.

<sup>120</sup> Prof. Dr. Jan Wouters and Katrien Meuwissen, Global Tax Governance: Work in Progress, 3.

<sup>121</sup> The Telegraph, Business, What is the G20 and How Does it Work? available at, <  
<http://www.telegraph.co.uk/business/0/what-the-g20-and-how-does-it-work/>> [Last accessed 5/8/2017]

<sup>122</sup> Ibid, The group accounts for 85 per cent of world GDP and thirds of its population.

<sup>123</sup> Prof. Dr. Jan Wouters and Katrien Meuwissen, Global Tax Governance: Work in Progress, 3.

<sup>124</sup> Ibid, p.6.

lacks institutional and implementation capacities to put policies in practice its legitimacy to make an intervention in the international tax governance regime would be questionable.<sup>125</sup>

The OECD is an international economic research and discussion organization and describes itself as an entity helping governments to tackle the economic, social and governance challenges of a globalized economy.<sup>126</sup> It aims to assist national governments in designing tax policies, by analyzing and organizing international tax policy experiences.<sup>127</sup> It has been successful in opening international Tax Dialogue (ITD), in order to facilitate discussions on tax matters, share good practices, and pursue common objectives in improving the functioning of national systems.<sup>128</sup> OECD is successful so far in developing different standards and model tax laws and in conducting researches in the area of tax laws and policies.

Nevertheless, OECD's Global forum has been criticized for restrictive membership and it is also characterized as rich man's club that lacks transparency. In particular, the inclusion of developing countries in the OECD has resulted the failure of some of its incentives.<sup>129</sup> Therefore, OECD cannot claim to be universal body in the global tax governance.

Unlike the G20 and the OECD, the UN is a universal organization with inclusive membership. The UN works in the area of taxation, which specifically aims to supporting developing countries' tax policy. It has developed Model Double Taxation Convention between Developed and Developing countries and this is one of the outstanding contributions of the UN in the global tax governance. The convention aim at preventing and eliminating double taxation and discrimination among tax payers at the international level so that it discourages activities that hinder the free flow of international trade, investment and transfer of technology. Apart from this, UN still needs so many improvements to be an international body that is in charge of global tax governance.<sup>130</sup>

---

<sup>125</sup> Ibid, p.9.

<sup>126</sup> BBC World News, OECD: What is it and what does it do? available at < <http://news.bbc.co.uk/2/hi/business/92719> > [last accessed 5/8/2017].

<sup>127</sup> Pro. Dr. Jan Wouters and Katrien Meuwissen, Global Tax Governance: Work in Progress, p. 9.

<sup>128</sup> Id.

<sup>129</sup> Insop Pak, International Finance and State Sovereignty, 203

<sup>130</sup> Pro. Dr. Jan Wouters and Katrien Meuwissen, Global Tax Governance: Work in Progress, p. 9.



Therefore, it can be understood from the forgoing discussion that globalization has effectively eroded the fiscal power of national governments in international taxation, has forced states to enter in to tax competition in order to attract and maintain investment capital. However, this is done without having an international institutions and laws that could address the problems associated with international taxation.

Therefore, national governments are deprived of their power to regulate international taxation international taxation, due to globalization and harmful tax competition. However, there is no a single responsible institution that regulates or govern international taxation. Thus, international taxation now left unregulated without having an organization responsible for global tax governance of international taxation this also becoming a source of many problems on power of taxation of developing countries, particularly, it has enabled MNEs to evaded taxes, which is the main point of discussion in the subsequent chapter.

## CHAPTER THREE

### CHALLENGES OF TAXING MNEs IN DEVELOPING COUNTRIES

#### 3.1. Introduction

In the forgoing chapter, we have seen globalization and international taxation. However, under this chapter the discussion will concentrate on the fact that globalization has caused the increasing mobility of capital and it has in turn heavily influenced the international tax system. Particularly, developing countries in order to retain and attract capital investment, they have entered in to state of tax competition. Somehow this, coupled with lack of global tax governance, has triggered the erosion of their fiscal sovereignty. Most importantly, globalization has enabled MNEs to cross the boundaries of many states and do business. At the same time has enabled them to reduce the amount of the tax they pay by taking the advantage of mismatch in between tax law of different countries, destroying the bases of income and shifting profits.

This chapter gets in to the heart of discussion of the common tax avoidance techniques of MNEs and the challenges that developing countries are facing. In so doing, the chapter begins by highlighting the illicit financial outflows from developing countries and the role of MNEs. Then it goes on the discussion of Base Erosion and Profit Shifting (BEPS), the predominant taxing challenge of developing countries over MNEs in the 21<sup>st</sup> century. This topic attempts to identify the legal and institutional framework challenges of taxing MNEs from general jurisprudence and the experience of developing countries. The chapter ends by making analysis of the effects of BEPS on developing countries.

#### 3.2. Illicit Financial Outflows from Developing Countries

The term illicit financial outflows (IFFs) emerged in 1990s and during this time, it was associated with capital flights. However, the term is nowadays becoming more popular and generally it refers to the movement of capital associated with money that is illegally earned,

transferred or used that tosses boarder<sup>131</sup>. Other than this much generalized description there is no consensus among scholars as to the contents and elements<sup>132</sup> of IFFs.

The World Bank categorizes the defining elements of IFFs into three main areas; 1) the acts themselves are illegal (e.g., corruption, tax evasion); or 2) the funds are the results of illegal acts (e.g., smuggling and trafficking in minerals, wildlife, drugs, and people); or 3) The funds are used for illegal purposes (e.g., financing of organized crime).<sup>133</sup> Global Financial Integrity (GFI)<sup>134</sup> also defines the term as, "transfer of money earned through illegal activities such as corruption, transactions involving contraband goods, criminal activities, and efforts to shelter wealth from a country's tax authorities",<sup>135</sup>

According to OECD illicit financial outflows generally involve practices like money laundering, bribery by international companies, tax evasion and trade mispricing. However, in practice it ranges from private individuals who transfer funds into private accounts to completed schemes involving criminal networks that set up multi-layered multi-jurisdictional structures to hide ownership.<sup>136</sup>

The aforementioned definition (GFI and OECD) tends to incorporate tax evasion and trade mispricing in the definition of IFFs. However, the issue regarding on whether commercial activities like tax avoidance should be part of IFFs is an ongoing discussion.<sup>137</sup> There are numerous and diversified data concerning the amount of the money outflows from developing countries through IFFs. It is basically happened due to insufficiency of data and different

---

<sup>131</sup> The World Bank, IBRD, IDA, Illicit Financial Flows (IFFs), April 14, 2016, available at <<http://www.worldbank.org/en/topic/financialmarketintegrity/brief/illlicit-financial-flows-iffs>> [Here in after, referred as World Bank Illicit Financial Flows (IFF)]. [Last accessed 10/05/2017]

<sup>132</sup> Ibid.

<sup>133</sup> Ibid.

<sup>134</sup> Global Financial Integrity (GFI) is a non-profit, Washington, DC based research and advisory organization, which produces high-caliber analyses of illicit financial flows, advises developing country governments on effective policy solutions, and promotes pragmatic transparency measures in the international financial system as a means to global development and security, available at <<http://www.gfintegrity.org/about/>> [Last accessed on 10/05/2017]

<sup>135</sup> The International Tax Compact (ITC), Addressing Tax Evasion and Tax Avoidance in Developing Countries, 22 December 2010, p. 10. Here in after referred as The International Tax Compact (ITC), Addressing Tax Evasion and Tax Avoidance in Developing Countries

<sup>136</sup> OECD, Illicit Financial Flows from Developing Countries: Measuring OECD Responses 2014, p. 16. Here in after referred as OECD, Illicit Financial Flows from Developing Countries

<sup>137</sup> World Bank, Illicit Financial Flows (IFF).

estimation techniques.<sup>138</sup> Yet, there are organizations that specifically conduct researches on the area and we will see some figures from their research findings to show the extent of the problem IFFs.

The FIG has recently released the findings of its study that shows the extent of IFFs over the period between 2005 and 2014 in developing countries. According to the study, IFFs are likely to account for between 14.1% to 24.0% of total developing country trade. On average, IFFs are estimated to be 4.6% to 7.2% of out flow total trade and 15% to 16.8% inflow total trade.<sup>139</sup>

IFFs growth was persistently high; it was likely to grow at an average rate of 8.5% and 10.1% a year over the ten years period. Outflows and inflows are also estimated to grow at annual average rate between 7.2% to 8.1% and 9.2% to 11.4% respectively. When these growth rates translated, it gives an estimated range for total IFFs \$2 trillion to \$3 trillion, outflows \$620 billion to \$970 billion, inflows \$1.4 trillion to \$2.5 trillion in 2014.<sup>140</sup> In terms of regions, the Sub-Saharan Africa ranked highest in IFFs, while a measure against the level of trade and it ranges 5.3% to 9.9% of the total trade in 2014.<sup>141</sup>

The United Nations Development Fund (UNDP) has also studied the extent of IFFs in least developed countries (LDC) over the period between 1990 to 2008 and the study's indicative results shows that IFFs from LDCs have increased from US\$9.7 billion in 1990 to US\$26.3 billion in 2008 implying an inflation-adjusted rate of increase of 6.2% per annum. The ratio of IFFs to GDP averages about 4.8%.<sup>142</sup>

MNEs are the main actors in this IFFs process and different organizations working on IFFs estimates the share of MNEs. Of IFFs from developing countries, MNEs share is estimated to

---

<sup>138</sup> The International Tax Compact (ITC), Addressing Tax Evasion and Tax Avoidance in Developing Countries 10.

<sup>139</sup> Global Financial Integrity, Illicit Financial Flows to and from Developing Countries

<sup>140</sup> Id.

See OECD, Illicit Financial Flows from Developing Countries p. 20. GFI estimates that between 2001 and 2010, illicit financial flows from developing countries totaled as much as USD 5.8 trillion; the People's Republic of China was responsible for almost half of the total, five times as much as the next highest source country, Mexico. The next three highest sources of illicit financial flows were Malaysia, the Russian Federation and Saudi Arabia.

<sup>141</sup> Ibid, p. 7.

<sup>142</sup> The United Nations Development Fund (UNDP), Discussion Paper Illicit Financial Flows from the Least Developed Countries 1990-2008, May 2011, p. 3.

be •660 and •870 billion each year.<sup>143</sup> Other reports also show that developing countries could lose as much as \$285 billion each year because of tax evasion and avoidance by MNEs through tax havens which is equal to 5% of their GDP.<sup>144</sup>

Tax Justice Net Work Africa also reported that African countries lose \$50 billion from MNEs<sup>145</sup> which is three times the amount they receive in the form of aid from the developed world. Meaning there is an out flow of \$3 for each \$1 inflow in the form of development assistance.<sup>146</sup> It has been also documented that the number of tax havens has risen from 25 in the 1970s to around 72 at present.<sup>147</sup>

OXFAM International has also reported that the year 2010, Africa has lost \$11 billion through the tricks used by MNEs to reduce tax bills, which is equivalent to six times the money needed to cover the fund in fighting ebola in of Sierra Leone, Liberia, Guinea and Guinea Bissau.<sup>148</sup>

IFFs have a multidimensional ~~negative~~ impact on political, economic and social affairs of developing countries. First and for most, it reduces domestic resources and tax revenues needed to fund poverty reducing programs, expansion of infrastructures and public utility expenditures.<sup>149</sup> This means fewer hospitals and schools, fewer police officers on the street, fewer roads and bridges and few jobs.<sup>150</sup>

Additionally, since many of the activities that generate IFFs are financial crimes such as money laundering, corruption and tax evasion they are damaging to all countries though the effects on developing countries are particularly destructive. Especially money laundering erodes the

---

<sup>143</sup> José Luis Escario Díaz-Berrio, The Fight Against Tax Havens and Tax Evasion Progresses the London G20 Summit and the Challenges Ahead Foundation Alternatives , 2011, p. 20. Here in after, referred as José Luis Escario Díaz-Berrio, the Fight against Tax Havens and Tax Evasion Progress

<sup>144</sup> Petr Janský and Alex Prats, Multinational Corporations and the Profit Shifting Lure of Tax Havens, Christian Aid Occasional Paper Number 9, March 2013, p.5. Here in after, referred as Petr Janský and Alex Prats, Multinational Corporations and the Profit Shifting Lure of Tax Havens

<sup>145</sup> Tax Justice Network Africa, Tax and International Financial Architecture, Here in after referred as Tax Justice Network - Africa], available at, <<http://www.taxjusticeafrica.net/en/programmes/internationalisation>> [Last Accessed 24/01/2017].

<sup>146</sup> World Investment Report 2015 Reforming International Investment Governance

<sup>147</sup> José Luis Escario Díaz-Berrio, the Fight against Tax Havens and Tax Evasion Progress, 17.

<sup>148</sup> OXFAM International, Multinational Companies Cheat Africa out of Billions of Dollars, published 2 June 2015, Available at, <<https://www.oxfam.org/en/pressroom/pressreleases/20152/multinational-companies-cheat-africa-out-billions-dollars>> [Herein after referred as, OXFAM International] Last Accessed, 24/01/2017

<sup>149</sup> World Bank, Illicit Financial Flows (IFF).

<sup>150</sup> OECD, Illicit Financial Flows from Developing Countries, p. 20

reputation and integrity of the financial sector which is the very foundation. Eventually, the long term economic growth and the welfare of the entire economy will be impaired.<sup>151</sup> It also shadows on the transparency and accountability of the government.<sup>152</sup>

### 3.3. Challenges of Taxing MNEs in Developing Countries

Multinational Enterprises (MNEs) also named as Multinational Corporations (MNCs) or Transnational Companies (TNCs) consist of independent legal entities that are located in different countries (parent and subsidiaries) but maneuver as a single economic entity.<sup>153</sup> They have played a significant role in globalization of trade and investment activities. They have also contributed for government budget in developing countries at about \$730 billion annually.<sup>154</sup> Globalization has also opened up opportunities for them to greatly reduce the tax they pay.<sup>155</sup>

Many countries including developing ones have reformed their international tax system in order to attract MNEs in to their jurisdictions to do business and also to promote overseas growth of their resident companies.<sup>156</sup> As a result, they have effectively reduced those problems associated with double taxation of MNEs. In developing countries, the limited range of taxable activities coupled with narrow tax bases have made the income from tax highly dependent on few tax payers, often multinational enterprises.<sup>157</sup>

Benjamin Franklin said that "nothing is certain except death and tax," to emphasize the inevitability of tax that nobody can hardly escape from paying it. Nevertheless, this popular quote does not seem to be true in today's economy, as some of MNEs do not pay their fair

---

<sup>151</sup> OECD, Illicit Financial Flows from Developing Countries, p. 15.

<sup>152</sup> World Bank, Illicit Financial Flows (IFF).

<sup>153</sup> Jodo Ferreir, How Mismatch Tax Rules Allow Multinational Enterprise to be One Step Ahead? In Particular, Appeal and Amazon King's Student Law Review, p. 60. Here in after referred as Jodo Ferreir How Mismatch Tax Rules Allow Multinational Enterprise to be One Step Ahead?

<sup>154</sup> UNCTAD, World Investment Report 2015: Reforming International Investment Governance, p. 164.

<sup>155</sup> OECD Policy Brief, Taxing Multinational Enterprises, Base Erosion and Profit Shifting (BEPS) Update No. 3, October 2015, p. 1. Here in after OECD Policy Brief Taxing Multinational Enterprises BEPS.

<sup>156</sup> Prafula Fernandez and Jeff Pope, International Taxation of Multinational Enterprises (MNEs) Revenue Law Journal, Vol. 12, No.1. January 200p. 106. Here in after, referred as Prafula Fernandez and Jeff Pope International Taxation of MNEs.

<sup>157</sup> Dirk Willem- te Velde, Typical Tax Findings and Challenges in Developing Countries Chapter in; Taxation and Developing Countries Training Notes September 2013, p. 9. Here in after referred as Dirk Willem- te Velde Typical Tax Findings and Challenges in Developing Countries.

share of tax by using loopholes in tax systems and managed to evade paying billions of dollars in various tax jurisdictions.<sup>158</sup>

The expansion of globalization has caused the rise of MNEs to do business crossing the boundary of many nations. International tax competition, double taxation relief methods, poor global tax governance and lack of capacity to tax on the part of developing countries have increased the opportunities for MNEs to minimize their taxable income by taking advantage of inconsistencies, gaps and complexities in tax laws of developing countries.<sup>159</sup> Moreover, since tax laws of developing countries are transplanted, they are usually complex to the tax authority not to the MNEs. Therefore, MNEs could easily manipulate the tax laws of developing countries.<sup>160</sup>

Additionally, the complexity of the transaction of MNEs coupled with poor regulatory system have made developing countries handicapped to exercise their taxing right over MNEs and protect their legitimate interests. For instance, the Panama Papers leak<sup>161</sup> is a notable example that shows both the complexity and the level of system of secrecy of jurisdictions that allows for the outflow of capital from developing countries.<sup>162</sup> It is also widely accepted that the current international financial system that determines the flow of capital between nations is flawed and not fit for the purpose of regulating tax evasion.<sup>163</sup>

---

<sup>158</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting, *Chapman Law Review*, Vol. 19 No. 1, 2016, p. 307. Here in after referred as Rachel J. Greenberg, Taking a Byte out of International Tax Evasion.

<sup>159</sup> Brian Mistler, Taking Actions against Base Erosion Profit Shifting, *Arizona Journal of International & Comparative Law*, Vol. 32, No. 3, 2015, pp. 903-904.

<sup>160</sup> *Ibid.*, p. 904.

<sup>161</sup> See theguardian.com, Newspaper, What are the Panama Papers? A guide to history's biggest data leak. The Panama Papers are an unprecedented leak of 11.5m files from the database of the world's fourth biggest offshore law firm, Mossack Fonseca. The firm is Panamanian but runs a worldwide operation. Its website boasts of a global network with 600 people working in 42 countries. It has acted for more than 300,000 companies. The leak shows the myriad ways in which the rich can exploit secretive offshore tax regimes. Twelve national leaders are among 143 politicians, their families and close associates from around the world known to have been using offshore trusts. Available at <<https://www.theguardian.com/news/2016/apr/03/what-need-to-know-about-the-panama-papers>> [Last Accessed 24/01/2017]

Other report also shows that tax evasion costs governments approximately \$200 billion per year as exposed in panama papers. Here is the price countries pay tax evasion exposed in panama papers available at, <<https://theintercept.com/2016/04/05/here-price-countries-pay-for-tax-evasion-exposed-in-panama-papers/>> [Last Accessed 24/01/2017]

<sup>162</sup> Tax Justice Network Africa.

<sup>163</sup> *Ibid.*

As a result, many international organizations, including UN are expressing their concerns regarding the problem of developing countries which are the host countries of MNEs. Their concerns revolve around the ability of MNEs to arrange their taxing structure and financing in ways which enable them to avoid tax or to divert income from high to low tax countries using the inability of developing countries to tax them<sup>164</sup>

### 3.3.1. Base Erosion and Profit Shifting (BEPS)

MNEs usually use BEPS in order to avoid or reduce the tax they pay. BEPS helps MNEs to extensively erode their base and shift their profit by artificially reducing the taxable profit and/or detaching their tax location from the location of their business activity<sup>165</sup>. The erosion of the base is basically conducted by shifting profits from high tax jurisdiction to low tax jurisdictions.<sup>166</sup> However, the profit is earned using the infrastructure, labor force and the business opportunities in the high tax jurisdiction country.<sup>167</sup>

The OECD defines BEPS in a comprehensive manner as “tax planning strategies that exploit gaps and mismatches in tax rules to make profits ... disappear for tax purposes or to shift profits to locations where there is little or no real activity but the taxes are low resulting in little or no overall corporate tax being paid.”<sup>168</sup>

Thus, BEPS has enabled MNEs either to avoid tax completely (double non taxation) or to pay a sum across two or more countries that is less than what they would pay in a single country.<sup>169</sup> The OECD estimates the revenue losses from BEPS \$100 billion annually which is equivalent to between 4% to 10% of the global revenue from corporate income tax.<sup>170</sup>

---

<sup>164</sup> Marianne Burge, Current Trends in the Taxation of Multinational Enterprises, The Tax Magazine, Price Waterhouse & Co.; New York City, December 1974, p. 746.

<sup>165</sup> International Monetary Fund, Issues in International Taxation and the Role of IMF, Jan 28, 2013, p. 4. Here in after, referred as International Monetary Fund, Issues in International Taxation and the Role of IMF

<sup>166</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 307.

<sup>167</sup> Id.

<sup>168</sup> OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, p. 7. Here in after, referred as OECD (2013) Addressing Base Erosion and Profit Shifting also available at <<http://dx.doi.org/10.1787/9789264192744>> [last accessed 20/12/2016].

<sup>169</sup> Patrick Love, OECD Insights Debate on the issue, what is BEPS and how can you Stop it, available at, <<http://oecdinsights.org/2013/07/19/what-bepshow-can-you-stop-it/>> [Here in after referred as Patrick Love OECD Insights, What is BEPS and how can you Stop it, [last accessed 20/12/2016]

<sup>170</sup> OECD policy Brief, Taxing Multinational Enterprises, BEPS p. 1.



More importantly, it has been calculated that around 60% of world trade actually takes place within MNEs.<sup>171</sup> This scenario has enabled MNEs to engage in tax planning in order to shift profits within affiliated groups from high tax to low tax countries.<sup>172</sup> Digital transactions, financial sector innovation, and intangibles are also believed to have contributed a lot in making the international tax system greener for BEPS.<sup>173</sup>

Additionally, international taxation rules of developing countries are not complete, they usually leave loopholes, while exempting companies from double taxation. This has enabled MNEs to avoid taxation completely and enjoy double-taxation.<sup>174</sup> This development is believed to have been facilitated by two factors 1) increasing importance of intangible assets like Intellectual Property,<sup>175</sup> which can be easily transferred to affiliates without having to move people or tangible assets, 2) increasing international tax competition which forces high tax jurisdiction countries to adopt low tax rates.<sup>176</sup>

The popular mechanisms for accomplishing BEPS are transfer pricing, hybrid mismatches, and special purpose entities (SPE).<sup>177</sup> The OECD adds treaty shopping and other tax avoidance mechanisms to this list.<sup>178</sup> All of them are discussed below.

### 3.3.1.1. Transfer Pricing / Transfer Mispricing /

This is the popular mechanism of tax avoidance by MNEs using pricing mechanism. It is usually employed by MNEs that are owned by a single parent company or MNEs that have parent subsidiary relationship (intra group transaction) residing in different tax jurisdictions.<sup>178</sup> Basically subsidiaries and parent companies are treated as separate entities and they are

---

<sup>171</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 313.

<sup>172</sup> International Tax Compact (ITC), Addressing Tax Evasion and Tax Avoidance in Developing Countries, 18.

<sup>173</sup> International Monetary Fund, Issues in International Taxation and the Role of MNEs, 28, 2013, pp. 3. [Here in after referred as International Monetary Fund].

<sup>174</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 310.

<sup>175</sup> See International Tax Compact (ITC), Addressing Tax Evasion and Tax Avoidance in Developing Countries page 9, for instance, Microsoft's worldwide effective tax rate dropped from 33% to 26% which partly resulted from earnings of foreign subsidiaries that were taxed at lower rates. Much of these tax savings have been realized in an Irish subsidiary, Round Island One Ltd., which holds much of Microsoft's intellectual property such as copyrighted licensing software codes that were developed in the US. Similar examples include Google Inc. or Oracle which have all set up Irish subsidiaries with the purpose to save taxes.

<sup>176</sup> Jodo Ferreir, How Mismatch Tax Rules Allow Multinational Enterprise to be One Step Ahead?

<sup>177</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 312.

<sup>178</sup> Patrick Love, OECD Insights, what is BEPS and how can you stop it

independently liable for their own taxes in their respective country of residence. This is vital for MNEs to avoid double taxation. Nonetheless, this may be used by MNEs to minimize or avoid overall tax burden.<sup>179</sup>

Therefore, since the transaction may be a controlled transaction, it may be artificially lowered or raised, resulting in over or under declaration of costs and in a jurisdiction. It may also result in under declaration of profits.<sup>180</sup> Finally, this puts the MNEs in a position to allocate profit among the different parts of the company in different countries. The MNEs themselves would be the ultimate decision makers regarding the question of how much and to which authority they should pay tax, which is strictly against the fiscal sovereignty of national governments.<sup>181</sup>

The arm's length principle is the internationally accepted and widely suggested underlying transfer pricing determination mechanism to combat transfer pricing.<sup>182</sup> The principle requires that, where related parties are engaged in a transaction with a related person, they allocate income as it would be allocated between unrelated entities in the same or similar circumstances.<sup>183</sup> In doing so, different methods have developed so far such as; comparable uncontrolled price method, resale price method, cost plus method, transactional net margin method, and transactional profit split method.<sup>184</sup> The major objective of adoption of all these

---

<sup>179</sup> International Tax Compact (ITC) Addressing Tax Evasion and Tax Avoidance in Developing Countries, 16.

<sup>180</sup> McNair, Transfer Pricing and Taxing Rights of Developing Countries, 16.

<sup>181</sup> Patrick Love OECD Insights, what is BEPS and how do you stop it?

<sup>182</sup> OECD (2013) Addressing Base Erosion and Profit Shifting

<sup>183</sup> Id.

<sup>184</sup> Art. 6 (a-e) of the Ethiopian transfer pricing directive No. 43/2015, define these methods as follows;

**Comparable Uncontrolled Price Method** which consists of comparing the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction(s).

**Resale Price Method** which consists of comparing the resale margin that a purchaser of property in a controlled transaction earns from reselling that property in an uncontrolled transaction on with the resale margin that is earned in comparable uncontrolled purchase and resale transactions.

**Cost Plus Method** which consists of comparing the mark up on those costs directly and indirectly incurred in the supply of property or services in a controlled transaction with the mark up on those costs directly and indirectly incurred in the supply of property or services in a comparable uncontrolled transaction.

**Transactional Net Margin Method** which consists of comparing the net profit margin relative to an appropriate base (e.g. costs, sales, assets) that one party to the transaction (the tested party) achieves in a controlled transaction with the net profit margin relative to the same base achieved in one or more comparable uncontrolled transactions.

**Transactional Profit Split Method**, which consists of allocating to each related person participating in a controlled transaction the portion of common profit (or loss) derived from such transaction that an unrelated person would expect to earn from engaging in a comparable uncontrolled transaction. When it is possible to determine an arm's length price for some of the functions performed by one or both of the related persons in connection with the transaction using one of the approved methods described in articles 2 (a) to (d), the

methods is to know the real price of the transaction and ensure that the transaction is not under or over estimated.

Having sound transfer pricing controlling mechanism is not sufficient to tackle the problem of transfer pricing in developing countries. Transfer pricing is conducted in a strong level of cooperation among subsidiaries based on a central decision making process being supported by professionals with high level of expertise in pricing. Therefore, it makes hardly easy to developing countries to combat this price manipulation using the arm's length pricing method.<sup>185</sup>

There are enormous challenges that developing countries are facing in order to be able tackle the problem of transfer pricing. Effective transfer pricing administration requires auditing skills and comparable goods in order to calculate the transferred price. But, developing countries are not fortunate enough to have highly trained accountants who can make deep analysis of transfer pricing and audit those complicated transactions of MNEs, to the opposite, MNEs have the most qualified accountants, economists and lawyers who could easily manipulate loopholes in developing countries tax system.<sup>186</sup>

Effective transfer pricing administration also requires sound and prudent transfer pricing laws and capacity to implement and monitor them since transfer pricing laws should be carefully crafted in the way that do not give rooms for MNEs to use the loopholes and manipulate it. Above all, we need to have well trained and qualified personals like lawyers, accountants and accountants who could understand, implement and follow up the strict adherence of those laws. Unfortunately, developing countries have failed to have these two important elements.<sup>187</sup>

Having sufficient resource needed to monitor trade in between related enterprises is at the heart of administration of transfer pricing. However, developing countries lack the resources needed to monitor controlled transactions. Quite to the opposite, MNEs have the resource to carry out

---

transactional profit split method shall be applied based on the common residual (or loss) that results once such functions are so remunerated.

<sup>185</sup> David McNair, Transfer Pricing and Taxing Rights of Developing Countries, pp.7-8.

<sup>186</sup> Ibid, P. 10.

<sup>187</sup> Id.

complicated transactions. Thus, tax administration authorities in developing countries may find it very difficult to trace those transactions.<sup>188</sup>

Fighting with transfer pricing is all about finding the real price of the goods and service in a transaction. Care must be taken in the valuation process not to over or under value transactions. In so doing, the appropriate mechanism is having comparable data for calculating costs or resale price of goods and services. Still getting comparable data for calculating costs or resale price of goods and services is a big challenge in developing countries.<sup>189</sup>

OECD and other international organizations working on transfer pricing suggest that international cooperation and information exchange in between tax authorities in jurisdictions where MNEs are working is imperative in controlling transfer pricing.<sup>190</sup> But, here again tax authorities in developing countries lack international cooperation on tax matters which makes difficult for an individual tax authority in developing country to control transfer pricing and other tax avoidance practices.<sup>191</sup>

All these challenges on the part of developing countries have helped MNEs easily shift their profit to - no or low- tax jurisdictions. These are the most important challenges that a certain tax authorities, laws and policy makers in developing countries needs to be aware of any effort to retain and attract FDI and MNEs.

### 3.3.1.2. Hybrid Mismatch Arrangements

Hybrid mismatch arrangements are other elements of BEPS that are often employed by MNEs. The OECD defined hybrid mismatch arrangements as; “an arrangement that exploit differences in the tax treatment of an entity or instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral.”<sup>192</sup>

---

<sup>188</sup> Ibid, pp. 912.

<sup>189</sup> Ibid, 11.

<sup>190</sup> Id.

<sup>191</sup> European Union, p. 15

<sup>192</sup> Base Erosion and Profit Shifting (BEPS) Explanatory Notes and its implication to Nigeria Newsletter, November 2015, p. 1.

This kind of mismatch arrangement normally destroys the taxable income in effect.<sup>193</sup> This method enables hybrid MNEs to have the same money or transaction treated differently (as debt or equity) by different countries, so that they claim deduction twice for the same thing in order to avoid or minimize tax.<sup>194</sup> They may also claim deductions without matching income or uses differences in between countries` rules related to foreign tax credits or exemptions.<sup>195</sup> Hybrid mismatch arrangement may arise due to; €hybrid entity mismatch,, €financial instrument mismatch,, €hybrid transfer,, €hybrid permanent establishment mismatch,, import mismatch or dual resident mismatch.<sup>196</sup>

#### a) Hybrid Entity Mismatch

Hybrid entity mismatch refers to the hybrid nature of entities meaning entities that are treated as taxable persons under one territory's tax law, but as transparent entities under another countries tax law.<sup>197</sup> In other words, the situation attributable to differences in the legal characterization of an entity, where the same entity is seen as transparent for tax purposes in one jurisdiction and as transparent by another jurisdiction.<sup>198</sup> Now, let us see how entity mismatch allows MNEs to avoid taxes the following example

An Ethiopian resident company (ETcomp) makes royalty payments to another group company (ETcomp2) resident in Kenya. These are fully taxable in Kenya but, as part of a wider arrangement ETcomp2 in turn makes royalty payments to ETcomp1, which reduce its profits. ETcomp1 is organized under Kenya`s laws but seen as transparent there. Sudan, on the other hand, considers ETcomp1 as a separate taxable entity (it is thus a hybrid entity). Accordingly, neither Sudan nor Country Kenya imposes tax on the royalty income of ETcomp1.

<sup>193</sup> OECD (2013) Addressing Base Erosion and Profit Shifting, p.7.

<sup>194</sup> Id.

<sup>195</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 310.

<sup>196</sup> Global Tax Alert, European Commission releases draft directive addressing hybrid mismatches with non countries, European Commission proposes to extend Tax Avoidance Directive to also deal with hybrid mismatches with third countries 26 October 2016, <http://www.taxadvisermagazine.com/article/hybrid-mismatch> [Here in after referred as Global Tax Alert].

<sup>197</sup> Tax Adviser, Hybrid Mismatch, Ed Wright provides analysis on the UK implementation of Action 2 of the OECD BEPS project available at <<http://www.taxadvisermagazine.com/article/hybrid-mismatch>> [Here in after, referred as Tax Adviser Hybrid Mismatch] [Last Accessed 23/01/2017]

<sup>198</sup> Global Tax Alert, p.2.

#### b) Hybrid Transfer Mismatch

Refers to the situation when the laws of two jurisdictions differ on whether the transferor or the transferee of a financial instrument has got the ownership of the payments on the underlying assets.<sup>199</sup> Thus it is possible for the MNEs to make a certain property to be treated as transfer of ownership of an asset in one country but as a loan collateral in another, through playing off one country's tax system against another.<sup>200</sup>

#### c) Hybrid Permanent Establishment (PE) Mismatch

This kind of mismatch occurs when a business activity in a jurisdiction is treated as being carried out through a permanent establishment by one jurisdiction while those activities are not in another jurisdiction.<sup>201</sup> As a result, the following kind of situations may be created; the profits from these business activities are not taxed while they are carried on whereas the jurisdiction where the taxpayer is a resident provides for an exemption of those profits.<sup>202</sup>

#### d) Financial Instrument Mismatch

This kind of mismatch is attributable to the features of a single financial instrument which is treated as debt in one territory and equity in another. This may result in double non taxation of the payment. Let's see how it works;

Assume that a company in Ethiopia buys financial instruments issued by a company in Kenya. Under Ethiopian tax laws, the instrument is treated as equity, whereas for Kenya's tax purposes the instrument is regarded as a debt instrument. Payments under the instrument are considered to be deductible interest expenses for the company under Kenyan tax law while the corresponding receipts are treated as dividends for Ethiopian tax purposes and therefore exempt therein. Thus, the company would not pay tax for the instrument to Ethiopia nor Kenya this is what we call it double non, taxation.

---

<sup>199</sup> Guest author, Combating BEPS and Making Sure we have Fair Tax Systems: An OECD/G20 Venture, 29 September 2014, available at <http://oecdinsights.org/20109/29/combating-beps-and-making-sure-we-have-fair-tax-systems-an-oecd-g20-venture/> [Here in after, referred as Guest author, Combating BEPS and Making Sure we have Fair Tax Systems], [Last Accessed, 29/01/2017].

<sup>200</sup> Ibid.

<sup>201</sup> Global Tax Alert, p. 3.

<sup>202</sup> Tax Adviser, Hybrid Mismatch

<sup>203</sup> Id.

Vitally, all these hybrid mismatches leads to double deduction, deduction with inclusion, non taxation without inclusion; and double tax credits.<sup>204</sup> A deduction/noninclusion mismatch arises when a person obtains a tax deduction for a payment without there being a corresponding amount of fully taxable income arising to another person. A double deduction mismatch occurs when tax deductions for the same payment are available to ~~taxpayers~~, or to the same taxpayer for two different taxes.<sup>205</sup>

Countries, particularly, the developed ones, have issued an anti-hybrid mismatch rule that allow them to impose additional taxable income when corporate taxpayer receives a payment that would otherwise give rise to a mismatch; or to deny tax deductions, or limit their use, when corporate taxpayer makes such a payment.<sup>206</sup>

Fighting hybrid mismatches begins with having carefully crafted and sound hybrid mismatch rules that empowers the tax authority to impose additional taxable income, deny deduction or limit their use while hybrid mismatch activities are conducted. Next in order to properly implement those anti-hybrid mismatch rules it entails well trained personals, cooperation and information exchange with other tax authorities, and resources. However, as we have seen in the context of transfer pricing developing countries lags behind from the required standard and the same holds true when it comes to combating hybrid mismatch arrangements. These are the most critical challenges of developing countries in their endeavor to exercise their taxing rights over MNEs.<sup>207</sup>

### 3.3.1.3. Special Purpose Entities (SPEs)

SPEs are legal entities established to fulfill narrow, specific or temporary objectives. They are created in an economy other than those in which the parent companies are resident.<sup>208</sup> However,

---

<sup>204</sup> Global Tax Alert, p. 3.

<sup>205</sup> Tax Adviser, Hybrid Mismatch

<sup>206</sup> Ibid.

<sup>207</sup> Patrick Love OECD Insights, what is BEPS and how can you stop it?

<sup>208</sup> See, US Legal, Special Purpose Entity (SPE) Law and Legal Definition, available at <<https://definitions.uslegal.com/s/specialpurposeentity-spe/>> [Last Accessed 20/01/2017]

SPEs are defined either by their structure (e.g., financing subsidiary, holding company, base company, regional headquarters), or their purpose (e.g., sale and regional administration, management of foreign exchange risk, facilitation of financing of investment), available at <<https://definitions.uslegal.com/s/specialpurposeentity-spe/>> [Last Accessed 20/01/2017]

<sup>209</sup> Glossary of Foreign Direct Investment Terms OECD, 2001, not published, available at, <<https://stats.oecd.org/glossary/detail.asp?ID=2515>> [Last accessed 29/01/2017]

SPEs have no or limited links or physical presence or employees to/in the economy which they are hosted, they are not also engaged in production of manufacturing services.<sup>210</sup>

If they have this kind of relationship with the host economy, it may be asked what is the purpose of their establishment in the host economy and why the host economy allow them to operate in its jurisdiction

MNEs usually establish SPEs for cost minimization and tax planning of their own group company and to take advantages of legal and fiscal regimes in different jurisdictions. They also establish to exploit royalties and firm rights. But, sometimes they may engage in cash management and securitization activities.<sup>211</sup> Their core business also involves holding activities or group financing, and their assets and liabilities are investments in or from other countries.<sup>212</sup>

Therefore, the purpose of the establishment of SPEs in the host economy provide nothing to the host economy other than serving as an instrument of tax avoidance in order to take the advantage of tax systems. Hence, developing countries should either ban their establishment or allow them to operate under strict control and scrutiny.

#### 3.3.1.4. Treaty Shopping

As we have seen in the previous chapter, countries usually voluntarily relinquish their taxing rights by concluding double taxation treaties. The main purpose of these treaties are; 1) alleviating double taxation and allocating taxing rights in between the signatory countries, 2) harmonizing definitions in countries' tax codes and this enables the countries to have an agreed procedures that can be invoked if there is issue of double taxation and establishes a framework for mutual assistance in enforcement.<sup>213</sup> They also provide different method of double taxation relief.<sup>214</sup>

However, nowadays these noble objectives of tax treaties are being defeated and shopped by MNEs. Treaty shopping is an arrangement through which a person who resides in none of

---

<sup>210</sup> IMF Committee on Balance of Payments Statistics, Direct Investment Technical Expert Group, Background Paper (Diteg) # 9, Definition of Special Purpose Entities, Prepared by Balance of Payments and Financial Accounts Department, De Nederlandsche Bank, November 2004, p. 5.

<sup>211</sup> Ibid, pp. 5- 6.

<sup>212</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 310.

<sup>213</sup> Gust Author, Combating BEPS and Making Sure we have Fair Tax Systems

<sup>214</sup> Ibid.



the contracting states attempts to obtain benefits that the treaty grants to the resident of the states by setting up a shell company in one of the contracting states and routing investments through it.<sup>215</sup>

Therefore, if the country cannot exercise its taxing rights granted by the tax treaty, the MNEs will be free from any taxation both from the host economy and the resident country i.e. double, non, taxation. Moreover, MNEs that are not the resident of neither of the contracting states will benefit from the terms of the treaty.<sup>216</sup>

### 3.3.1.5. Thin Capitalization

Debt and equity are principal methods of corporate financing. It is a well established result, both theoretically and practically; these modes of corporate financing play an important role in determining the capital structure of companies.<sup>217</sup> Consequently, MNEs would choose its capital structure according to differences in international taxation.<sup>218</sup> MNEs consist of a group of legally independent companies in different states. Despite the legal independence, the groups of companies have a common interest.<sup>219</sup> Hence, they may arrange borrowing from affiliated companies and are therefore able to optimize their capital structure over all affiliates in order to minimize the tax burden of the whole company group.<sup>220</sup>

In many of tax jurisdiction interest paid are deductible expenses, thus, MNEs make the debt in order to increase the deductible interest. Thus, this deductibility of interests paid motivates companies in low tax jurisdiction to grant intercompany loans to affiliates located in high tax countries, so that substantially lowering their tax obligation.<sup>221</sup> Therefore, MNEs as many times as possible will try to pass funds raised by loans through conduit companies and this may enable interest deductions to be taken several times (without offsetting tax on receipts).<sup>222</sup>

---

<sup>215</sup> Ibid.

<sup>216</sup> OECD (2013) Addressing Base Erosion and Profit Shifting

<sup>217</sup> Michael Overesch and Georg Wamser, Corporate Tax Planning and Thin Capitalization Rules Evidence from a Quasi-Experiment Applied Economics September 2007, p.2.

<sup>218</sup> Tatjana Đukic, Thin Capitalization Rules in EU Member States Review article, University of Ljubljana, Faculty of Administration, pp. 833. [Here in after, Tatjana Đukic, Thin Capitalization Rules in EU Member States]

<sup>219</sup> Khatereh Razazi, Thin Capitalization- Compatible with EC law Faculty of Law, University of Lund, 2008, p. 4.

<sup>220</sup> Tatjana Đukic, Thin Capitalization Rules in EU Member States p. 284.

<sup>221</sup> International Monetary Fund, p. 5

<sup>222</sup> Id.

Therefore, many countries, typically, high tax countries attempt to restrict the use of intercompany loans by imposing so-called thin capitalization rules. This thin capitalization rule usually determines the taxpayers subject to the rule, scope of application, the approach, maximum allowable debt, treatment of disallowed interest, other measures and planning.<sup>223</sup>

### 3.4. Effects of Base Erosion Profit - Shifting and other kind of Tax Arrangements on Developing Countries

BEPS affects everyone; governments, individual tax payers, business communities and even MNEs themselves.<sup>224</sup> Particularly, for governments in developing countries the impact is severe and multidimensional. It reduces their incomes and raises the cost of ensuring compliance.<sup>225</sup> More importantly, it undermines their legitimacy as this would be considered as the manifestation of their inability to protect their fellow citizens.<sup>226</sup>

BEPS has also the effect of undermining the tax system's integrity and eroding the trust of citizens.<sup>227</sup> Ultimately, it will undermine voluntary compliance by all taxpayers upon which modern tax administration depends. This is what has been observed in some countries while people making demonstrating showing the slogan "Why we are Taxed more than a Multinational!,"<sup>228</sup>

BEPS has also a negative repercussion on individual tax payers because MNEs pay low or no tax, individual taxpayers must shoulder a greater share of the tax burden. Since, collecting tax from wage income is pretty much easier than capital incomes; the greater tax burden will rest on individual tax payers.<sup>229</sup>

---

<sup>223</sup> Ernst & Young LLP, Thin Capitalization Regimes in Selected Countries, Report Prepared for the Advisory Panel on Canada's System of International Taxation, Advisor Panel on Canada's System of International Taxation, 2008, pp. 111.

<sup>224</sup> OECD Policy Brief, Taxing Multinational Enterprises, BEPS p. 1.

<sup>225</sup> Id.

<sup>226</sup> David McNair, David McNair, Transfer Pricing and Taxing Rights of Developing Countries.

<sup>227</sup> OECD Policy Brief, Taxing Multinational Enterprises, BEPS p. 1.

<sup>228</sup> Ibid.

<sup>229</sup> Patrick Love, BEPS: why you're taxed more than a multinational available at, <  
<http://oecdinsights.org/2013/02/13/why-youre-taxed-more-than-a-multinational/>> [Last Accessed 23/2017].

<sup>229</sup> José Luis Escario Díez, p. 19.

BEPS also do ~~not~~ affect MNEs themselves; apparently this assertion appears to be odd as MNEs may get short term benefits via BEPS. Nevertheless, in long term MNEs face significant reputational risk from the public focus on their tax affairs and they will be the first ~~to~~ <sup>230</sup> witness public riots and massive resistance movements, this is what we are witnessing in some developing countries in Africa.

BEPS has also unparalleled negative impact on domestic companies in the host economy; because, they ~~do~~ not have the same capacity ~~to~~ banking profits offshore. This leaves them in uneven playing field when competing with MNEs, this would lead to unfair competition and they would be kicked out from the market. Finally, this results in social inequalities and weakens social cohesion ~~within~~ <sup>231</sup> a country.

---

<sup>230</sup> OECD Policy Brief, Taxing Multinational Enterprises BEPS p. 1.

<sup>231</sup> José Luis Escario Díaz Berrio, p. 19.

## CHAPTER FOUR

### TAXING THE INCOME OF MULTINATIONAL ENTERPRISES IN ETHIOPIA: LEGAL AND INSTITUTIONAL FRAMEWORK CHALLENGES

#### 4.1. Introduction

In this chapter, the legal and institutional framework challenges of taxing MNEs, ways of combating BEPS in Ethiopia are discussed. Chapter is organized on the basis of the challenges identified.

The discussion of legal framework challenge covers the challenges related to effective transfer pricing legislation, absence of anti-hybrid mismatch rules, absence of avoidance of treaty shopping clauses, absence of detailed rules of thin capitalization, and absence of general anti base erosion rules.

The discussion on institutional framework challenge of taxing MNEs covers the challenges related to awareness of BEPS, lack of capacity to tax, lack of cooperation and exchange of information, lack of capacity to follow, implement and monitor, and lack of resource and ICT infrastructure.

#### 4.1. Status of FDI and MNEs in Ethiopia

After the downfall of the socialist regime in 1991, the country has taken tremendous structural economic reforms such as decentralizing the economy, opening up many investment areas to the private sector, lifting the restriction on the private sector and other trade liberalization measures.<sup>232</sup> Motivated by these structural reforms and investment incentive in subsequent investment laws, many local and international companies that request for investment permit have flourished.<sup>233</sup> Over the past ten years, 5,231 foreign based companies have applied for investment permit at the Ethiopian Investment Commission (EIC).<sup>234</sup> Of all these foreign based

---

<sup>232</sup> Yosef A. Gebreegziabhe, *Ethiopian Law on Transfer Pricing: A Critical Examination*, pp. 218-219. [Here in after, referred as Yosef A. Gebreegziabhe, *Ethiopian Law on Transfer Pricing*]

<sup>233</sup> Id.

<sup>234</sup> Information from EIC Data and Information Center, Summary of Foreign Direct Investment (FDI) Projects By Year and Investment Status Since August 22, 1992 to 09, 2017.

companies there are around two hundred fifty that fulfill the criteria of MNE and work under parent and subsidiary company relationship, basically <sup>235</sup> which is the main focus of this research.

Year	Total No of Projects	Pre-Implementation	Implementation	Operation
		No of Projects	No of Projects	No of Projects
2007	372	22	69	281
2008	432	21	111	300
2009	379	23	108	248
2010	390	28	168	194
2011	296	69	71	156
2012	545	275	67	203
2013	618	348	101	169
2014	348	140	81	127
2015	390	173	89	128
2016	334	198	55	81
2017	88	84	2	2
Grand Total	5,231	1,452	1,092	2,687

Table 1. Source: Ethiopian Investment Commission, Summary of FDI Projects by Year and Investment Status, since 2007May 09, 2017

The Ethiopian government sees Foreign Direct Investment (FDI) as one of the most important strategic tools for the economic development of the country. The sector has shown a considerable amount of growth. For example, of the total investment projects licensed between 1992 and 2012, FDI's share was 5.80%.<sup>236</sup> This has made the country to be one of the top 10

<sup>235</sup> Interview with Anonymous Senior Tax Audit Expert 1 and 2 at Transfer Pricing Unit, Large Taxpayers Office (LTO), ERCA, on the Sufficiency of the Current Transfer Pricing Rule to Tax MNEs, May 23, 2017 [Here in after, referred as Interview with Anonymous Senior Tax Audit Experts 1 and 2, at Transfer Pricing Unit, LTO, ERCA]

<sup>236</sup> Ethiopian Investment Commission, Ethiopia: A Preferred Location for Foreign Direct Investment in African Investment Guide to Ethiopia, 2015, p. 6.

investment destinations in Africa by registering 100% change in FDI inflow with a continuous increase of more than 12% per annum.<sup>237</sup>

It has also been reported that FDI inflow increased from \$6 billion in 2007 to \$100 billion by 2016 and a total of \$102 billion FDI inflow was registered during the decade. As highlighted in GTP II, the government is also expecting FDI inflow to play a pivotal role in increasing the country's foreign exchange earnings.<sup>238</sup> Both permanent and temporary employment opportunities have also shown a remarkable growth from 95,396 to 277,224 and from 124,808 to 303,304 in the past ten years, respectively.<sup>239</sup> The FDI sector has also created approximately a total of half a million job opportunities over the past ten years.<sup>240</sup>

Year	Total No of Projects	Operation			
		No of Projects	Capital in '000' Birr	Permanent Employment	Temporary Employment
2007	372	281	6,948,351	95,396	124,808
2008	432	300	7,077,363	34,479	46,451
2009	379	248	11,520,997	18,294	21,425
2010	390	194	8,608,835	11,753	12,905
2011	296	156	13,905,863	8,774	10,442
2012	545	203	6,860,922	6,977	4,384
2013	618	169	9,316,979	11,704	8,435
2014	348	127	6,563,262	11,398	1,757
2015	390	128	4,448,133	6,541	2,702
2016	334	81	1,581,984	6,628	662
2017	88	2	14,093	69	0

<sup>237</sup> Ethiopian Investment Commission Economic Indicators available at, <<http://www.investethiopia.gov.et/why-ethiopia/economic-indicators>> [Last Accessed, 26/01/2017]

<sup>238</sup> Federal Democratic Republic of Ethiopia Growth and Transformation Plan II (GTP II) (2015/16-2019/20), Volume I: Main Text, National Planning Commission, May, 2016, Addis Ababa.

The source of the foreign direct investments is diverse. But Turkey, Peoples Republic of China, India in that order were the top three investors in terms of the amount of capital invested in the economy. In terms of number of projects, Peoples Republic of China, India, and Turkey in that order constituted the top three investors in the country during the plan period.

<sup>239</sup> Information from EIC Data and Information Center, Summary of Foreign Direct Investment (FDI) Projects By Year and Investment Status Since August 22, 1992 to 09, 2017.

<sup>240</sup> Ibid.

Grand Total	5,231	2,687	101,878,447	277,224	303,304
-------------	-------	-------	-------------	---------	---------

Table 2. Source: Ethiopian Investment Commission Summary of FDI Projects by Year, Capital inflow and Employment opportunity, since 2007- May 09, 2017

Ethiopia has repeatedly amended its investment law in order to attract and retain FDI. The majority of the incentives are related to taxation. For instance: 1) up to 100% custom duty exemption on import of capital goods for eligible area of investment, 2) activity specific and location of investment based income tax exemption period for 01 years, 3) investors that have suffered from losses during the income tax exemption period are entitled to loss carry forward for half of the tax exemption period, 4) export tax exemption except a few products, 5) Drawback Scheme, Voucher Scheme and Bonded Factory and Manufacturing Warehouse Schemes. It seems that the country is under state of tax competition and is affected by the wave of globalization.<sup>241</sup>

However, despite this growth of FDI, many foreign companies are said to have committed various forms of tax abuses in the country. For instance, Addis Fortune, a local News Paper has reported about the involvement of Indian, Israeli, Chinese and UAE's companies in tax abuses.<sup>242</sup> This is a good alarm for the Ethiopian government to check and regulate its tax system that could regulate MNEs in the country. Otherwise, if the harm outweighs the benefit, it will have a negative impact on the integrity of the entire tax system. The experience of many developing countries shows that in order to effectively combat tax abuses by MNEs, strong legal and institutional frameworks play irreplaceable roles.

As indicated in the previous chapter, developing countries have enormous challenges in taxing MNEs. Hence, Ethiopia, like any other developing countries, faces tremendous challenges. Both the legal and institutional framework challenges of the country are discussed herein below.

<sup>241</sup> Ethiopian Investment Commission, Incentives, Taxation, and Other Procedures, available at <<http://www.investethiopia.gov.et/investmentprocess/incentives-taxation-and-other-procedures>> [Last Accessed on 26/01/2017].

<sup>242</sup> Addis Fortune, News Paper, Tax Fraud by Foreign Companies in Ethiopia, Vol. 16 , No. 801, Sep 07, 2015, available at, <<http://addisfortune.net/articles/tax-fraud-by-foreign-companies-in-ethiopia/>> [Last accessed 26/01/2017].

## 4.2. Legal and Institutional Framework Challenges of Taxing MNEs

Taxing MNEs requires effective legal and institutional frameworks in a developing country. Ethiopia is not an exception; the country faces those challenges of taxing MNEs that other developing countries are facing today. Therefore, like any other developing country, BEPS techniques are also problems in Ethiopia. It is also inevitable that it faces those challenges of taxing MNEs in relation to BEPS like other developing countries do. As discussed in the previous chapter, these challenges can be categorized as legal and institutional framework challenges as the fight against BEPS requires carefully crafted legislation and effective institutional enforcement mechanisms. Thus, the challenges are discussed below with their respective categories.

### 4.2.1. The Legal Framework Challenges to Fight against BEPS by MNEs

The first step in fighting BEPS by MNEs and other tax avoidance and evasion mechanisms is having well-articulated, carefully crafted and detailed legislation. Ethiopia has incorporated anti tax avoidance rules like income splitting, transfer pricing, and tax avoidance schemes in the new Federal Income Tax proclamation for the first time.<sup>243</sup> The proclamation has also incorporated thin capitalization and tax treaty rules.<sup>244</sup> The country has also enacted a directive that provides rules on Transfer Pricing (Directive No 43/2015).<sup>245</sup> Having these rules by itself is a one step forward in the fight against BEPS.

However, compared to other developing countries, Ethiopia lags behind in having rules that specifically aimed at fighting against BEPS by MNEs. In the subsequent topic, an attempt is made to see what the Ethiopian legal framework looks like and to assess the challenges in the fight against BEPS.

#### 4.2.1.1. Challenges in Relation to Effective Transfer Pricing Legislation

Transfer pricing is one of the popular and widely used methods of tax evasion by MNEs using the instrumentality of pricing mechanisms in controlled transactions.<sup>245</sup> The transfer price is the

---

<sup>243</sup> Federal Income Tax Proclamation No. 976/2016, Federal Negarit Gazeta Ordinary Issue, 2<sup>nd</sup> Year No. 104, 18 August 2016, Articles 78-80.

<sup>244</sup> Ibid, Art. 47 & 48.

<sup>245</sup> Patrick Love OECD Insights.



agreed price of a transaction between controlled entities, and the process for setting that price is commonly referred to as transfer pricing.<sup>246</sup> Using this process, MNEs shift their profits from high tax jurisdiction to low tax jurisdiction as a result of which they avoid or minimize the amount of the tax they pay.<sup>247</sup> OECD recommends the application of the arm's length principle in the valuation of controlled transactions.<sup>248</sup> The arm's length principle dictates that controlled transactions should be priced according to the price at which the transaction would take place if the actors in the transaction were not related.<sup>248</sup>

However, the most important legal framework challenge that many developing countries are facing with in order to tackle transfer pricing problem is ensuring appropriate transfer pricing rules in place.<sup>250</sup> Having sound principle in primary legislation is not sufficient to effectively control controlled transactions, it rather requires detailed transfer pricing regulations, including guidance notes, specific documentation, and annual transfer pricing disclosure requirement.<sup>251</sup>

The concept of transfer pricing was introduced for the first time in Ethiopia in the Income Tax Proclamation No. 286/2002 (ITP). It requires transactions between related persons to be conducted at arm's length.<sup>252</sup> Nevertheless, the ITP was without having any kind of guidance on how this arm's length standard could be implemented.<sup>253</sup> For the effective implementation of this provision, lack of directive, absence of comparable data, lack of trained experts, lack of

---

<sup>246</sup> Alexander Readhead, Preventing Tax Base Erosion in Africa: a Regional Study of Transfer Pricing Challenges in the Mining Sector, Natural Resource Governance Institute, July 2016, p. Here [in after, referred as Alexander Readhead, Preventing Tax Base Erosion in Africa].

<sup>247</sup> Patrick Love OECD Insights.

<sup>248</sup> Alexander Readhead, Preventing Tax Base Erosion in Africa: 11

<sup>249</sup> Id.

<sup>250</sup> Id.

<sup>251</sup> Id.

<sup>252</sup> Income Tax Proclamation No. 286/2002, Federal Negarit Gazeta Ordinary Issue, Year No. 34, 4 July 2002. [Here in after, referred as Income Tax Proclamation No. 286/2002]. Art. 29 what follows concerning Transfer Pricing

1) 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 directives to be issued by the Minister.

2) 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, provided conditions between related persons do not differ from those, which would be made between independent persons.

<sup>253</sup> Joel Cooper and Monia Volpatò Ethiopia Introduces New Transfer Pricing Directive, Tax Insight, 4 October 2016, Here in after, Joel Cooper and Monia Volpatò Ethiopia introduces new transfer pricing directive, available at <<https://www.dlapiper.com/en/slovakrepublic/insights/publications/2016/10/ethiopia-introduces-new-transfer-pricing-directive/>> [Last accessed 27/05/2017]

well-organized system for documentation, and lack of identification of companies to be considered as related parties were the most important challenges.<sup>254</sup>

However, the transfer pricing directive No. 43/2015 issued by the MFEC formerly named as MOFD has made it clear how companies, particularly, MNEs should arrange their business operation to comply with the arm's length principle and it has put significant milestones in that regard.

The directive sets out its scope of application (Art. 3), defines the arm's length principle and comparability (Art. 4 and 5), specifies approved methods of transfer pricing with their respective selection method (Art. 6 and 7), introduces the arm's length range (Art. 10), provides guidance on possible source of comparable information (Art. 11), specifies the responsible person with respect to transfer pricing documentation (Art. 15), gives specific guidance on the application of the arm's length principle to service transactions and intangibles transactions, specifies articles on corresponding adjustment (Art. 16 and 17). It also makes cross reference to the possible application of the OECD guidelines in case where interpretation is not possible under the directive. As a result, the directive has received appreciations by tax scholars for it has remained consistent with international standards addressing some of the crucial concerns.<sup>255</sup>

Nonetheless, the guidance of the directive is as to the application of Art. 29 of the ITP No. 286/2002, was repealed by ITP No. 979/2016. Somehow it seems illogical to have a directive that is meant to be issued to implement a repealed legislation. However, the new ITP has devised a mechanism that keeps the directive still enforceable, because a directive issued under repealed law shall continue to apply so far as they are in congruence with this proclamation and until such time as they are replaced by new directive.<sup>256</sup>

The new ITP under Art. 79 has introduced new provisions which have not been incorporated in the repealed ITP. In the repealed ITP, if there is transfer pricing in a certain transaction, the tax authority would only be empowered to direct the income of one or more of those related persons

---

<sup>254</sup> Yosef A. Gebreegziabher, *Ethiopian Law on Transfer Pricing* pp. 218-219.

<sup>255</sup> Joel Cooper and Monia Volpatò, *Ethiopia Introduces New Transfer Pricing Directive*.

<sup>256</sup> Federal Income Tax Proclamation No. 976/2016 [Federal Negarit Gazeta Ordinary Issue 2<sup>nd</sup> Year No. 104, 18 August 2016, Art. 101 (6) [Here in after, Federal Income Tax Proclamation No. 976/2016]

and include profits which they might have made, but for those conditions.<sup>257</sup> Thus, the power of the authority was only limited to the allocation of the income.

Conversely, the new ITP does not restrict the power of the authority in allocation of income. Rather the authority is empowered to make distribution, apportion or allocation of income, gains, deductions, losses or tax crediting between the parties where the transaction is not in arm's length.<sup>258</sup> Thus, deductions, losses and tax crediting are included, and this widens those transactions that fall under the transfer pricing, accordingly the power of the authority also expands.

Furthermore, the repealed ITP was profoundly criticized for not incorporating a provision that requires taxpayers to keep and submit documents when they make transactions with related persons.<sup>259</sup> Whereas, the new ITP has addressed this issue and requires taxpayers to include details of their transaction with related persons during tax year with the tax payer's tax declaration for the year.<sup>260</sup>

The new ITP has defined an "arm's length transaction," as "a transaction between independent persons who are dealing with at arm's length with each other," which the predecessor failed to do. The new ITP has also specifically empowered the MFEC to issue directives concerning transactions that takes place outside of Ethiopia in relation to transfer pricing.<sup>261</sup>

Therefore, it can be understood that there is a significant difference between the new and repealed ITP concerning the content and the issues surrounding transfer pricing. However, the existing transfer pricing directive is meant to implement Art. 29 of the repealed ITP. Thus, to be logical, the directive should be revised in the light of Art. 79 of the new ITP. Tax audit experts at ERCA, LTO, transfer pricing unit and an expert called Abebe Gebremedhin together agree with this idea.<sup>262</sup>

---

<sup>257</sup> Income Tax Proclamation No. 286/2002, Art. 29 (1).

<sup>258</sup> Federal Income Tax Proclamation No. 976/2016, Art. 79 (1).

<sup>259</sup> Yosef A. Gebreegziabher, Ethiopian Law on Transfer Pricing, p. 219.

<sup>260</sup> Federal Income Tax Proclamation No. 976/2016, Art. 79 (5).

<sup>261</sup> Ibid, Art. 79 (6).

<sup>262</sup> Ibid, Art. 79(2) (3).

<sup>263</sup> Interview with Anonymous Senior Tax Audit Expert1 and 2 at Transfer Pricing Unit, Large Taxpayers Office (LTO), ERCA, on the Sufficiency of the Current Transfer Pricing Rule to Tax MNEs, May 23, 2017 [Here in after, referred as Interview with Anonymous Senior Tax Audit Experts1 and 2, at Transfer Pricing Unit, LTO, ERCA]

Apart from structurally adjusting the directive in the light of the new ITP, the Ethiopian transfer pricing legal regime is in a good order. It includes and defines the arm's length principle; it has implementation directive; it sets out specific documentation and transfer pricing disclosure requirement. All these features make the transfer pricing regime to be consistent with international standards.

#### 4.2.1.2. Challenges in Relation to Absence of Anti-hybrid Mismatch Rule

Hybrid mismatch arrangements are the second important elements of BEPS techniques used by MNEs. This arrangement enables MNEs to achieve double taxation, including long term deferral, and it reduces the collective tax bases of countries.<sup>264</sup> The arrangement basically exploits differences in tax treatment of an entity or instrument under the laws of different tax jurisdictions.<sup>265</sup> It is the researcher's conviction that MNEs conduct international business in an increasingly integrated way, combining technology, production, marketing, and diversity of related tangible services across states. Such state integration puts MNEs in a better position to use hybrid mismatches which results in reduction of their overall tax liability.<sup>266</sup>

As discussed in the review of literature in the preceding chapter, hybrid mismatch arrangements arise as a result of hybrid entity mismatch, financial instrument mismatch, hybrid transfer, hybrid permanent establishment mismatch, import mismatch or dual residence mismatch.<sup>267</sup> Taking into account the overall negative impact of hybrid mismatch arrangements on competition, efficiency, transparency and fairness, the OECD Action 2 of the BEPS Action Plan recommends countries to adopt anti-hybrid mismatch rules as part of their domestic legislation.<sup>268</sup> However, it may increase the compliance obligation as taxpayers will be required to obtain sufficient information

---

Interview with Mr. Abebe Gebremedhin, Legal advisor at Domestic Tax Program Development and Support Division, at ERCA, on the Sufficiency of the Current Transfer Pricing Rule to Tax MNEs May 23, 2017. Here in after, referred as Interview with Abebe Gebremedhin Legal advisor at Domestic Tax Program Development and Support Division, at ERCA].

<sup>264</sup> Australian Government the Board of Taxation Implementation of anti-hybrid rules available at, <<http://taxboard.gov.au/consultation/implementation-of-anti-hybrid-rules/>> [Last accessed 29/5/2017].

<sup>265</sup> Base Erosion and Profit Shifting (BEPS) Explanatory Notes and its implication to Nigeria p.1.

<sup>266</sup> Bartek Kuñiacki and al, Preventing Tax arbitrage via Hybrid Mismatches: BEPS Action 2 and Developing Countries, University of Vienna, International Taxation Research Paper Series, No. 2007, p. 1.

<sup>267</sup> Global Tax Alert p. 2.

<sup>268</sup> The Australian Government Board of Taxation Implementation of OECD Hybrid Mismatch Rules Report to the Treasurer, March 2016, p. 17.

to identify and assess the expected tax treatment of instruments or entities in the counterparty jurisdiction.<sup>269</sup>

Anti-hybrid mismatch rules basically empower the tax authority to impose additional taxable income, deny deduction or limit the use of deduction in cases where a certain company is found engaged in one of hybrid mismatch arrangements.<sup>270</sup> Therefore, having anti-hybrid mismatch legislation is a vital instrument in the fight against BEPS.

However, Ethiopia does not have any hybrid mismatch rule. An expert interviewed by the researcher at MFEC does not have a clue about it, but, the ministry is empowered to enact a directive on BEPS including hybrid mismatch arrangements.<sup>271</sup> Though the researcher was not able to find practical cases concerning hybrid mismatch in Ethiopia, it can be presumed to be an issue in the country given the increasing inflow of FDI and MNEs. Thus, it is wise to have such kind of legislation.

Anti-hybrid mismatch legislations links the Ethiopian tax treatment with the tax treatment in a particular foreign country, and possible mismatches between the two countries will be easily eliminated. However, in the absence of this rule, if a certain company is found engaged committing one of the hybrids mismatch arrangements, the country will not have the mechanisms to penalize the company. Thus, the company will go unpunished. Therefore, the country needs to have a rule that obliges those perpetrators of hybrid mismatch to pay the money that they have evaded.

#### 4.2.1.3. Challenges in Relation to Absence of Avoidance of Treaty Shopping Clauses

Although the main purpose of double taxation treaties is in order to allocate taxing rights of the contracting states, sometimes treaties are being shopped and used as a means of tax evasion by MNEs. This is why treaty shopping is considered as one of the elements of BEPS.<sup>272</sup> Treaty shopping refers to the activities of companies or individual traders who are the resident of none

---

<sup>269</sup> Ibid, p. 2.

<sup>270</sup> Tax Adviser Hybrid Mismatch

<sup>271</sup> Interview with Ms. Serkalem Enyew Legal Expert, Legal Department, Ministry of Finance and Economic Cooperation (MFEC) on the Awareness of BEPS, May 20, 2017. Here in after referred as Interview with Ms. Serkalem Enyew Legal Expert, Legal Department, at MFEC

<sup>272</sup> Gust Author OECD

of the contracting states. It is an attempt to obtain the benefits that the treaty grants to the resident states by establishing a shell company in one of the contracting state and routing investments through it.<sup>273</sup>

In order to avoid treaty shopping, the possession of a separate legislation concerning the MNEs may not be feasible. OECD and countries usually try to give solutions in the treaties themselves using any of the following three approaches.

The first approach is that they can incorporate a clause in the preamble that the treaty partners should not intend to create opportunity for themselves by tax avoidance including treaty shopping. However, this approach triggers another issue, concerning the legal status preamble in a treaty. What would be its effect? Is it just a motherhood statement or will it influence interpretation of the tax treaty? These issues still remain unresolved.<sup>274</sup>

The second approach is inclusion of a Limitation of Benefits (LOB) clause in the treaty. The clause may limit the benefit of the treaty to only qualified persons like persons who have genuine residence, are active in conducting businesses, and are eligible to derivative benefit exceptions and by discretionary reliefs by the authority.<sup>275</sup>

The third approach is inclusion of a general-abuse rule based on the principal purposes of a transaction, €principal purposes test,. On the basis of this approach treaty benefit denied if it is reasonable to conclude that obtaining the treaty benefit was one of the principal purposes of the arrangement or transaction that resulted in the benefit.<sup>276</sup>

To make an assessment of how Ethiopia has handled treaty shopping, researcher has tried to interview an expert from MFEC. The researcher also reviewed some of the treaties that the country has signed to assess the inclusion of those treaty shopping avoidance mechanisms. Most of the treaties signed by MFEC do not have €limitation on benefit,, and €principal purpose

---

<sup>273</sup> Gust Author OECD

<sup>274</sup> Lee Burns, BEPS and Developing Countries, Graduate School of Government University of Sydney, p. 20.

<sup>275</sup> Id.

<sup>276</sup> Ibid, 22.

test,, clause. However, recently on the basis of the recommendation from OECD and UN there is an attempt to incorporate those treaty avoidance clauses through amendment<sup>277</sup>

Ethiopia has concluded a number of avoidance of double taxation and prevention of fiscal evasion treaties with a view to avoiding Double Taxation.<sup>278</sup> However, researchers unable to find such kind of treaty shopping avoidance clauses in most of treaties reviewed. Therefore, unless the country has designed a proper follow up and evaluation mechanisms, treaties may not bring the intended outcomes. They may be shopped by MNEs and the country may benefit nothing other than serving as an instrument of treaty abuse for MNEs.

#### 4.2.1.4. Challenges in Relation to Absence of Detailed rules of Thin Capitalization

Corporate financing schemes i.e. debt and equity financing have their own implication on tax consideration of a company and sometimes tax effects of funding with debt or equity can even be decisive.<sup>279</sup> As the remuneration for debt (interest payments) are generally considered as ordinary business expense, eligible for deducted in determining taxable income.<sup>280</sup> Conversely, remunerations for equity are typically not deductible in determining corporate taxable income.<sup>281</sup>

Mindful of this tax effect of debt and equity financing, MNEs use intra group financing as a tax planning instrument so as to reduce the group's effective tax rate, by making the interest

---

<sup>277</sup> Interview with Ms. Serkalem Enyew, Legal Expert at Legal Department MFEC, on Treaty Shopping. For instance, Protocol amending the Convention between the Kingdom of Netherlands and FDRE for avoidance of double taxation and prevention of fiscal evasion with respect to taxation on income, under Art. 21 provide limitation on benefit clause. It limits the benefits of Art. Paragraph 2 of Art. 10, Art. Paragraph 2 of Art. 11, Art. Paragraph 2 of Art. 12 only for qualified persons.

<sup>278</sup> For example, Ethiopia has concluded bilateral avoidance of double taxation and prevention of fiscal evasion treaties with the following countries, Singapore (August 24, 2016), Ireland (August 12, 2016), Cyprus (January 18, 2016) Cyprus (December 30, 2015), Switzerland (October 27, 2015), Poland (July 13, 2015), United Arab Emirates (April 12, 2015), Kenya (March 11, 2014), ~~can~~, Ethiopia (July 16, 2013), Portugal, (May 25, 2013), Qatar (April 11, 2013), India (April 1, 2013), Saudi Arabia (28, 2013), Netherlands (August 10, 2012), Seychelles (July 14, 2012), Uganda (27/7/2011) Ethiopia's House of People's Representatives ratifies four DTAs with China, Egypt, India and Sudan on June 21, 2012.

TREATYPRO, The online tax treaty resource, Latest Treaty Updates: Ethiopia available at: [http://www.treatypro.com/treaties\\_by\\_country/ethiopia.asp](http://www.treatypro.com/treaties_by_country/ethiopia.asp) [last Accessed on 26/01/2017].

<sup>279</sup> René Offermanns and Boyke Baldewski, Anti-Base Erosion Measures for Intra-Group Debt Financing Chapter 4, p 103. Here in after, referred as René Offermanns and Boyke Baldewski, Anti-Base Erosion Measures for Intra-Group Debt Financing.

<sup>280</sup> Alexander Trepelkov and al, United Nation Hand Book on Selected Issues in protecting Tax Bases Developing Countries, United Nations, New York, 2015, p. 156.

<sup>281</sup> Id.

deductible excessive.<sup>282</sup> This is the major reason why this kind of financing structure has attracted the attention of many countries and international organizations and has become a subject of OECD's BEPS Action Plan.<sup>283</sup>

In order to describe this scenario, scholars in taxation use the informal term "thin capitalization," to indicate that the entity is thinly capitalized with equity while it is funded with substantial amount of debt.<sup>284</sup> So as to ensure that debt to equity ratio is not used for base erosion purposes countries usually stipulate restrictions on the deductibility of interest.<sup>285</sup> In this regard, there are a number of systems of restrictions, namely the "standalone approach," the "worldwide ratio approach," the "debt-to-equity safe harbour approach," the "interest-to-profit approach," and the "hybrid approach."<sup>286</sup>

Thin capitalization is also recognized in the Ethiopian legal system. The new ITP prohibits deduction of interest calculated by the given formula, for a foreign controlled resident company other than financial institution if the average debt to average equity ratio exceeds of 2:1 for a tax year. The formula is  $A \times B/C$ , where: A is the company's total amount of deductible interest for the year, B is the company's excess debt for the year and C is the company's average debt for the year.<sup>287</sup> However, this deduction shall not be disallowed if the amount of the average debt of the company for the year does not exceed the arm's length debt amount.<sup>288</sup>

The proclamation also provides the ground for the application of the thin capitalization rule to a non-resident company with a permanent establishment in Ethiopia.<sup>289</sup> It also defines important word and phrases such as; "arm's length debt amount," "average debt," "average equity," "debt," "debt obligation," "equity," "excess debt," and "foreign controlled resident company."<sup>290</sup>

---

<sup>282</sup> René Offermanns and Boyke Baldewings, Anti-Base Erosion Measures for Intra-Group Debt Financing, p.103.

<sup>283</sup> Id.

<sup>284</sup> Ibid, 105.

<sup>285</sup> Ibid, 106.

<sup>286</sup> Id.

<sup>287</sup> Federal Income Tax Proclamation No. 976/2016, Art. 47(1).

<sup>288</sup> Ibid, Art. 47 (2).

<sup>289</sup> Ibid, Art. 47 (3).

<sup>290</sup> Ibid, Art. 47 (4).



Since this provision is general and the concept of thin capitalization is technical, it needs to have further detailed legislation that gives guidance and better clarity. However, there is no any kind of regulation or directive concerning thin capitalization in Ethiopia.

#### 4.2.1.5. Challenges in Relation to absence of General Anti-Base Erosion Rules

There are numerous kinds of base erosion, but, what they all have in common is that the taxable base in the source country is minimized by deductible payments, while those payments are not taxed or taxed at a low tax rate in the country where the payee is resident.<sup>291</sup> Therefore, alternatively it is also possible to fight all base erosion techniques by having general anti-base erosion rule in lieu of addressing each and every techniques of base erosion. Unfortunately, Ethiopia does not have such kind of general-anti-base erosion rules applicable over all kinds of base erosion techniques.

Hence, absence of general anti base erosion rule or doctrine is also a challenge to the Ethiopian tax system to combat tax evasion, particularly, through the establishment of special purpose entities. For instance, general anti-base erosion rule limits or denies the availability of undue tax benefits, like, in situations where transactions lack economic substance or tax business purpose.<sup>292</sup> Therefore, SPEs that are established in the host economy only for tax purpose will not be benefited from deductions if they lack economic substance. Sometimes anti-base erosion rules also imposes higher withholding taxes on, or deny the deductibility of certain payments like payments made to entities located in other jurisdiction.

Nonetheless, Ethiopia is not fortunate enough to have general anti-base erosion rule. Hence, it would be challenging to the tax authority to impose higher withhold taxes or deny the deductibility of certain payments made by entities that are only established for tax purposes without having any kind of economic substance.

#### 4.3.2. The Institutional Framework Challenges to Combat BEPS

Having sound laws may not be sufficient enough to combat BEPS by MNEs. It requires a strong tax administration institution which has the capacity to implement legislation and monitor BEPS

<sup>291</sup> René Offermanns and Boyke Baldewijn, Anti-Base Erosion Measures for Intra-Group Debt Financing, p.103.

<sup>292</sup> Gust Author OECD

issues. The institution needs to have the necessary resource ~~and~~ relevant information concerning the MNEs operating in the country. It also needs to have the capacity to create international cooperation with taxing authorities of other countries in which other related enterprise of the MNE are operating or selling ~~their~~ products.

#### 4.3.2.1. Challenges in Relation to Awareness of BEPS

Combating BEPS to the least necessitates understanding of the following questions: what does BEPS mean? What are the constituting elements? How does it operate? What are the main actors? These coupled by knowledge of the magnitude of the problem' are crucial issues.

As discussed in the foregoing chapter, BEPS refers to tax planning strategies that exploit gaps and mismatches in tax rules to make profits to disappear or shift to locations where there is little or no tax.<sup>293</sup> In the majority of cases, this is conducted by MNEs that have ~~parent~~ subsidiary company relationship or ~~inter~~ company group.<sup>294</sup> Transfer Pricing, Hybrid Mismatch Arrangements, Special Purpose Entities (SPEs), Treaty Shopping and Thin Capitalization are the common BEPS techniques.<sup>295</sup>

In order to make an assessment of the awareness ~~of BEPS~~, the researcher has approached the office mandated to register and give information regarding FDI in the Ethiopian Investment Commission (EIC) and asked for the list and the number of the MNEs that are operating under ~~parent~~ subsidiary company relationship. The officer who is in charge of the task replied that they do not make separate registration for MNEs that are operating in that kind of relationship and all foreign companies are registered as FDI investor in general.<sup>296</sup>

The researcher also posed ~~some~~ questions to a legal expert at the MFEC, relating to the content and elements of BEPS. ~~But,~~ the expert has no idea ~~about~~ hybrid mismatch arrangements. She

---

<sup>293</sup> IMF, Issues in International Taxation and the Role of IMF.

<sup>294</sup> Ibid, pp. 4-5.

<sup>295</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 312.

<sup>296</sup> Interview with Ms. Amelework Ayalew, Information and Documentation Expert at Ethiopian Investment Commission (EIC), on Awareness of BEPS, May 24, 2007. [Here in after, , referred as Interview with Ms. Amelework Ayalew, Information and Documentation Expert, at EIC]

further added that the most widely known BEPS technique is transfer pricing; the other methods are not given much attention.<sup>297</sup>

People interviewed from the ERCA responded that they know transfer pricing very well but not that much familiar with the other elements of BEPS. They said that, BEPS are usually employed in between controlled companies. Even recently they have identified those foreign companies that are operating under intra company group and their number is more than two hundred. But, still they are not that much clear with how BEPS operate except transfer pricing.<sup>298</sup>

They further said that, higher government officials do not know the technicality of BEPS and do not give that much attention. Even, sometimes they are not ready to extend the necessary support to audit MNEs.<sup>299</sup>

#### 4.3.2.2. Challenges in Relation to Lack of Capacity to Tax MNEs

As previously discussed in the previous chapter, 60% of world trade is in between MNE that have parent, subsidiary company relationship.<sup>300</sup> BEPS activities are conducted in highly centralized decision making process with highly level of secrecy, backed by a well paid and educated lawyers and accountants who could easily manipulated loopholes in the tax laws of developing countries.<sup>301</sup> Breaking up this strong bond in between intra companies and subjecting them to proper tax jurisdiction involves well trained accountants, economists and lawyers who can understand and make analysis of highly sophisticated BEPS agreements and audits those complicated transactions of MNEs.<sup>302</sup> Particularly, a transfer pricing unit should be staffed with project and team manager, lawyers, economists, accountants, auditors, database experts, business process experts and communication/public relations experts.<sup>303</sup>

---

<sup>297</sup> Interview with Ms. Serkalem Enyew, Legal Expert, Legal Department, at MFE, On Challenges in Relation to Awareness of BEPS. She is also one of the drafter of the Transfer Pricing Directive.

<sup>298</sup> Interview with Anonymous Senior Tax Audit Experts 1 and 2, at Transfer Pricing Unit, LTO, ERCA.

<sup>299</sup> Ibid.

<sup>300</sup> Rachel J. Greenberg, Taking a Byte out of International Tax Evasion, 313.

<sup>301</sup> David McNair, Transfer Pricing and Taxing Rights of Developing Countries, 7-8.

<sup>302</sup> Ibid, P. 10.

<sup>303</sup> Alexander Readhead, Preventing Tax Base Erosion in Africa, 24.

However, so many international organizations air out their concerns regarding the limited capacity of developing countries' tax administration to deal with BEPS issues.<sup>304</sup> Even, developing countries themselves recognizes, they lack experience to deal with BEPS matters.<sup>305</sup>

Cognizant of these facts, so many countries and international organizations signed the Addis Tax Initiative in the 2015 UN Financing for Development Conference in Addis Ababa. They have declared their commitment to support developing countries to raise domestic public revenue and to improve the fairness, transparency, efficiency and effectiveness of their systems.<sup>306</sup> More importantly, they have vowed to cooperate with developing countries to combat BEPS and to double their support for technical cooperation in the area of taxation.<sup>307</sup>

Therefore, in order to properly combat BEPS, Ethiopia also needs to have necessary capacity to exercise its taxing rights over MNEs. Thus, to make an assessment of the reality on the ground the researcher has approached tax audit expert ERCA, LTO.

Mr. Nebyu Gedelie Tax Audit Coordinator at ERCA, LTO is highly cynical about the capacity of ERCA auditors to understand and make analysis of those highly technical and sophisticated BEPS agreements and complicated transaction of MNEs for the following four reasons;

Firstly, BEPS techniques by their nature entail high level of knowledge and experience in pricing, and he do not think that the tax authority have such level of knowledge, skill and experience. Secondly, more experienced and senior accountants are leaving the authority and majority of accountants are junior accountants. Thirdly, there are piece meal trainings by the government and international organizations, but, taking in to account the extent of the problem and capacity of MNEs there are a lot of things to get improved. Fourthly, still these trainings are only limited to transfer pricing and it does not include other elements of BEPS.<sup>308</sup>

---

<sup>304</sup> Middle East BEPS Bulletin Developing Countries Show strong Interest in the OECD's BEPS Recommendations, Middle East BEPS Bulletin from Tax and Legal Services Middle East, p. 3. Here in after, referred as Middle East BEPS Bulletin].

<sup>305</sup> Id.

<sup>306</sup> Id.

<sup>307</sup> Id.

<sup>308</sup> Interview with Mr. Nebyu Gedelie Alemie, Tax Audit Coordinator at ERCA, LTO, on Capacity to Tax MNEs May 22, 2017. [Here in after, , referred as Interview with Mr. Nebyu Gedelie Alemie, Tax Audit Coordinator at ERCA, LTO]

He further added that the problem is on the contracts and treaties that the government signs. When the treaties and contracts are signed they are designed in the ways that helps MNEs to engage in BEPS. Hence, as an auditor, you can do nothing other than upholding the terms of treaty and the contract.<sup>309</sup>

Further he is worried about the long arms of MNEs and even sometimes they influence government officials and he describes the situation as follows;

Apart from the lack of capacity sometimes there is no willingness, commitment and determination on the part of higher government official to get MNEs audited a properly taxed. Sometimes we start investigating MNEs relating to BEPS, the MNEs just directly go to the higher officials and higher official orders us to interrupt the investigation. I am sorry to say so, the government only wants that MNEs entered in the country and get started operation is not really concerned about the tax benefits. Even, there is no proper orientation for MNEs when entered in to the country regarding their tax obligation.<sup>310</sup>

Two anonymous senior tax auditors from LTO Transfer Pricing Unit sustains Mr. Neda's regarding the capacity of tax auditors to tax MNEs in relation to BEPS. They said we have enormous knowledge, skill and experience challenges or gaps to technically understand BEPS.<sup>311</sup> However, in order to fill these gaps there is training by the UK government in three months interval concerning transfer pricing.<sup>312</sup>

With regards to other professional like lawyers, they have similar idea like the accountants and economists interviewed, regarding their capacity to tax MNEs. Mr. Abebe Gebremedhin said that it is clear that we lack capacity to let alone those complicated BEPS agreements of MNEs we cannot even properly understand and implement the transfer pricing directive issued in our country a year before.<sup>313</sup>

Mr. Getasew Tessema, former public prosecutor at ERCA and now public prosecutor for Economic Crimes at General Attorney Office, is seriously worried about BEPS techniques by

---

<sup>309</sup> Ibid.

<sup>310</sup> Ibid.

<sup>311</sup> Ibid.

<sup>312</sup> Ibid.

<sup>313</sup> Interview with Mr. Abebe Gebremedhin Legal advisor at Domestic Tax Program Development and Support Division, at ERCA, on Capacity to Tax MNEs

MNEs and he said that<sup>314</sup> have cases in relation to BEPS by MNEs which are under investigation, but, it is hardly possible to trace their transactions and collect evidence, then, make MNEs liable for their miss deed, with the auditing and legal capacity that we have today.

#### 4.3.2.3. Challenges in relation to Lack of Tax Cooperation and Exchange of Information

Tax Cooperation and exchange of information are important factors in the fight against BEPS as reliable information is a base for effective and efficient tax administration.<sup>315</sup> MNEs use Non Cooperative tax jurisdictions to take the advantage of lack of adequate international information exchange system and creates a fertile ground for BEPS.<sup>316</sup> International organization including OECD advises developing countries to establish strong cooperation and exchange of information agreements with other tax authorities where MNEs are operating.<sup>317</sup>

Some scholars are skeptical about the ability of developing countries to make the best use of such agreements, as they may not have an equal opportunity to obtain the most relevant information nor analytical capacity.<sup>318</sup> But, for whatever reasons, having such kind of agreement is better than nothing. It is not doubtful that having such kind of cooperation and exchange of information agreement could be beneficial to Ethiopian.

The U.N. manual and OECD guidelines recommend that countries establish a transfer pricing unit (€unit,) within their revenue authority.<sup>319</sup> Having such specialized unit is vital; because 1) since the unit is filled with a specialized team of auditors charged with the responsibility of implementing transfer pricing rules they will have more specialized expertise on the area, 2) knowledge can be built up quickly through direct experience in auditing border transactions; and 3) clear lines of authority and communication are established in this regard.<sup>320</sup>

---

<sup>314</sup> Interview with Mr. Getasew Tessema Public Prosecutor at Federal General Attorney Office, Economic Crimes Division, on Capacity to Tax MNEs, May 19, 2017. [Here in after, referred as Interview with Mr. Getasew Tessema, Public Prosecutor at Federal General Attorney Office, Economic Crimes Division].

<sup>315</sup> \_\_\_\_\_ International Tax Cooperation for Development Taxation as a key driver of financing for sustainable development, Briefing Note, p. 4 [Here in after referred as International Tax Cooperation for Development]

<sup>316</sup> OECD Global Forum on Development Domestic Resource Mobilisation for Development: the Taxation Challenge Issues Paper, p. 1.

<sup>317</sup> International Tax Cooperation for Development, pp. 45.

<sup>318</sup> Id.

<sup>319</sup> Alexander Readhead, Preventing Tax Base Erosion in Africa, 19.

<sup>320</sup> Id.

the ERCA has made a progress in establishing transfer pricing unit at Large Taxpayers Office (LTO) recently.

In order to assess the practice on the ground the researcher has interviewed an expert from ERCA, Domestic Tax Program Development and Support Division. The expert accepts the importance of tax cooperation and exchange of information in between tax authorities of different countries in the fight against BEPS. However, he said ERCA do not have any kind of formal tax cooperation and exchange of information agreement with any country's tax authority concerning MNEs and BEPS.<sup>321</sup> Other experts from Large Tax Payers Office (LTO), Transfer Pricing Unit also affirm this assertion.<sup>322</sup>

In order to fill this gap there is an attempt to incorporate tax cooperation and exchange of information clauses in tax treaties that the Ministry of Finance and Economic Cooperation (MFEC) signs.<sup>323</sup> Nonetheless, since these treaties are general and specifically aimed at avoiding double taxation, they do not precisely deal with MNEs and BEPS. More importantly, usually these clauses are optional clauses, thus, countries are at liberty to make reservations.<sup>324</sup>

#### 4.3.2.4. Challenges in Relation to Lack of Capacity to Follow up, Implement and Monitor MNEs

Fighting BEPS necessitates strong capacity to following up, implement and monitoring mechanisms both in the host country and elsewhere that the MNEs are operating.<sup>325</sup> Therefore, the first step is clearly mandating the institution that runs those activities

The researcher was interviewed a consultant at EIC and IFC, and posed this issue, the respondent said that,

I think the missing link is here, there are four institutions concerning MNEs, the National Bank of Ethiopia (NBE) concerning their loan abroad and reparation of their capital, MFEC mandated to enact directives concerning BEPS, EIC mandated to register and provide tax incentive, and ERCA mandated to tax them. These institutions are mandated to follow up and monitor the MNEs

---

<sup>321</sup> Interview with Mr. Abebe Gebremedhin, Legal advisor at Domestic Tax Program Development and Support Division, at ERCA, on Cooperation and Exchange of Information.

<sup>322</sup> Interview with Anonymous Senior Tax Audit Experts 1 and 2, at Transfer Pricing Unit, LTO, ERCA, Cooperation and Exchange of Information.

<sup>323</sup> Interview with Ms. Serkalem Enyew, Legal Expert, Legal Department, at MFEC, on Challenges in Relation to Cooperation and Exchange of Information

<sup>324</sup> Ibid.

<sup>325</sup> European Union, p. 15

with their respective activities. But these respective activities have their own implication on taxing MNEs. Hence, the absence of a single institution that can follow up and monitor MNEs has contributed a lot in the proliferation of BEPS in Ethiopia.<sup>326</sup>

Next to identification of the institution which is empowered to follow up and monitor the activities of MNEs, having the capacity to do so is very decisive. Particularly the taxing authority needs to have this capacity. Experts ERCA agreed that the capacity to follow up and monitor is not also different from the capacity that mentioned earlier. Thus in this regard there is also serious capacity gap.<sup>327</sup>

#### 4.3.2.5. Challenges in relation to Lack of Resource and ICT Infrastructure

Resource is vital in order to exercise one's taxing right over MNEs and to fight against BEPS by MNEs. It is one of the very serious challenges of developing countries. Resource basically refers to the budget for expenses like; employment well trained personals, travel and related expenses for auditing and collection of evidence abroad for investigation where MNEs operates. On the other hand MNEs have sufficient resource need to conduct BEPS and make that information out of the reach of the concerned tax authority.<sup>328</sup>

When we see the Ethiopian context, the researcher has checked audit coordinator at LTO, as to whether the authority has sufficient resource needed to tax MNEs. The coordinator replied that;

Let alone resource for taxing activities of MNEs abroad the authority does not have sufficient resources for allowance and per diem for domestic auditing member instance when we have been instructed to finalize auditing of an MNE within two weeks while actual time need to investigate that MNE was two months and this happen due to lack of resources.<sup>329</sup>

More importantly, nowadays we are living in a digital age whereby transactions are conducted in a mouthclick. A lot of transactions worth of millions and billions of Dollars comes in and goes

---

<sup>326</sup> Interview with Ms Fantu Consultant at EIC and International Financial Corporation (IFC) Capacity to Follow, Implement and Monitor MNEs May 23, 2017. [Here in after, referred as Interview with Ms Fantu Consultant at EIC and International Financial Corporation (IFC)].

<sup>327</sup> Interview with Mr. Nebyu Gedelie Alemie, Tax Audit Coordinator at ERCA, LTO, on Capacity Followup, Implementation and Monitor and Interview with Anonymous Senior Tax Audit Experts 1 and 2, at Transfer Pricing Unit, LTO, ERCA, on Capacity Followup, Implementation and Monitor.

<sup>328</sup> David McNair, Transfer Pricing and Taxing Rights of Developing Countries, pp. 9-12.

<sup>329</sup> Interview with Mr. Nebyu Gedelie Alemie, Tax Audit Coordinator at ERCA, LTO, on Resource and ICT Infrastructure.



out from Ethiopia without crossing the physical boundary of the country and out of the preview of the tax authority. Taxing these kinds of transactions requires development of infrastructures and usage of state-of-the-art technologies in sector. This is one of the gigantic challenges of the Ethiopian tax authority.<sup>330</sup>

Furthermore, lack of comparable data is one of the serious problems in developing countries to combat BEPS, particularly in case of transfer pricing in order to calculate the arm's length price of a product. Comparable data by their nature requires huge data base documentation.<sup>331</sup> Accountants at the transfer pricing unit agreed that lack of comparable data is a problem here in Ethiopia. Cognizant of this problem, the transfer pricing directive obliges the person under investigation to provide comparable data.<sup>332</sup> Therefore, they said, it is doubtful that the authority does not have sufficient comparable data documentation.<sup>333</sup>

Mr. Abebe Gebremedhin, also agrees with the opinion of these two tax auditors, but, he said there is an improvement. The authority is now building huge data base for documentation and he hopes that the problem will be resolved very soon.<sup>334</sup>

---

<sup>330</sup> David McNair, Transfer Pricing and Taxing Rights of Developing Countries, 1.

<sup>331</sup> Id.

<sup>332</sup> Interview with Anonymous Senior Tax Audit Experts 1 and 2, at Transfer Pricing Unit, LTO, ERCA, Challenges in Relation to Resource and ICT Infrastructure.

<sup>333</sup> Ibid.

<sup>334</sup> Interview with Mr. Abebe Gebremedhin, Legal advisor at Domestic Tax Program Development and Support Division, at ERCA, on the Challenges in Relation to Resource and ICT Infrastructure.

## CHAPTER FIVE

### CONCLUSION AND RECOMMENDATION

#### 5.1. Conclusion

The development of science and communication technology has accelerated the process of globalization that turns our world to a smaller village. As a result, the cost of communication has greatly reduced. This has enabled MNEs to manage and do business across the boundary of so many sovereign nations. It has also enabled MNEs to contribute a lot in the increasing integration of world trade and economy. Globalization has intensified the increasing mobility of capital, which has made MNEs to be responsive to favorable tax jurisdictions. In turn, developing countries have taken enormous tax reforms and trade liberalization measures in order to retain and attract capital investment in their jurisdiction. This has seriously eroded their fiscal sovereignty.

On the other hand, MNEs have made their BEPS techniques more technical and much diversified. Thus, taking the advantage of lack of effective BEPS legislation and limited capacity of tax authorities of developing countries, they have evaded billions of dollars every year and they also take the lion's share in the illicit financial outflows from developing countries. Therefore, BEPS has attracted the attention of national governments and international organizations. Particularly, many developing countries are taking normative and institutional reform measures in order to effectively exercise their taxing rights over MNEs.

Ethiopia has a favorable policy towards FDI. As a result, the number of MNEs and the capital inflow are increasing from time to time. Like other developing countries, the country is also facing similar kind of challenges in taxing MNEs. Therefore, this research has investigated the legal and institutional framework challenges of the country to exercise its taxing rights over MNEs in relation to BEPS. Hence, for a certain country, in order to effectively combat BEPS and overcome the challenges associated thereof, it needs to have laws that specifically address each and every element of BEPS such as transfer pricing, hybrid mismatch arrangements, SPE, treaty shopping and thin capitalization. However, the findings of this research show that it is hardly possible for the country to properly tax MNEs by the existing legal and institutional frameworks.

In this regard, the Ethiopian transfer pricing regime recognizes and defines the arm's length principle, it has implementation directive, it sets specific documentation and transfer pricing disclosure requirements. All these features make the transfer pricing regime to be consistent with those international standards. Nonetheless, since, the directive was issued for the implementation of Art. 29 of the ITP No. 286/2002, which is repealed and replaced by Art. 79 of the new ITP No. 979/2016, thus seems it is illogical.

With regards to hybrid mismatch arrangements, the country does not have any kind of anti hybrid mismatch rule that enable the tax authority to deny or limit the deduction of an income, which is earned as a result of mismatch in tax treatment of an entity or instrument under the of the country and other tax jurisdiction/s. Similarly, the country does not have general anti erosion rule, which requires economic substance in the purposes of establishment of companies other than tax purpose. Hence, for the tax authority would be difficult to deny or limit deductions or claim unpaid taxes through the establishment of such kind of entities.

Concerning treaty shopping, the prevailing mechanism of fighting treaty shopping is inclusion of limitation of benefit and principal purposes test clauses in the treaties themselves. However, most of avoidance of double taxation and prevention of fiscal evasion treaties reviewed have no such kind of clauses. Interviewees from MFEC also agree with this assessment and, state that only in recently signed treaties that they can find avoidance of treaty shopping clauses.

Regarding, thin capitalization; there is a single provision in the new ITP that deals with this matter. Content wise it sets out the maximum debt to equity ratio and formula for the calculation of the maximum amount of interest eligible for deduction. It also stipulates the manner how foreign resident or Ethiopian permanent establishment companies should be treated. Nevertheless, there is no detailed legislation that gives guidance for the implementation of this provision

Therefore, the legal framework of the Ethiopian tax system has a lot of limitations except the transfer pricing regime. In this legal framework, it is hardly possible to effectively combat BEPS and subject MNEs into the country's tax jurisdiction.

In addition to fully fledged and comprehensive legal framework, fighting BEPS and taxing MNEs entails having vibrant institutional framework. It refers to awareness of BEPS, capacity to tax MNEs, capacity to follow up, implement and monitor, tax cooperation and exchange of information, and resource and ICT infrastructure.

Interviewees from ERCA, MFEC, and EIC agreed that both higher officials and experts have the problem of awareness of BEPS and the elements thereof. Particularly, the problem is serious when it comes to top ranking government officials and sometimes it is difficult to get help from them when their assistance is needed. They further added that understanding BEPS requires highly specialized knowledge and expertise on the area, but, since their knowledge is very intuitive, their awareness is minimal. However, relatively of all elements of BEPS, transfer pricing is well known. Even the interviewees themselves do not have a clue about hybrid mismatch arrangements and SPEs. There is also awareness problem regarding the extent of the problem.

Apart from awareness about BEPS, capacity to tax is another essential element in order to tackle BEPS. The establishment of a transfer pricing unit in ERCA, LTO, is a good move. However, according to the interviewees, the unit as well as the tax authority is not staffed with well trained and experienced project and team managers, lawyers, economists, accountants, auditors, database experts, business process experts and communication/public relations experts. Hence, there is lack of capacity to understand BEPS agreements and audit those complicated transactions of MNEs.

Conversely, MNEs have well trained personas who have the necessary knowledge, skill and expertise to manipulate tax laws of Ethiopia. Firstly, since the majority of tax laws are imported from the developed world, MNEs have the upper hand of the knowledge. Secondly, since MNEs have sufficient resources they could attract and employ best minds around the world. The interviewees from ERCA and MFEC also agreed that there is no planned and well organized training on the area of BEPS and those piecemeal training schemes are only limited to transfer pricing.

It is also disclosed that ERCA and other stakeholders institutions like MFEC, EIC and NBE do not have the capacity to follow up, implement and monitor MNEs. First, there is a role confusion

between these institutions regarding the mandate of follow up and monitor the activities of MNEs. Secondly, as interviewees confirmed that ERCA does not have the capacity to follow up, monitor, and trace the transaction of MNEs abroad.

With respect to tax cooperation and exchange of information agreements, interviewees from ERCA and MFEC approved that the Ethiopian government does not have any kind of tax cooperation and exchange of information agreement with any tax authority around the world concerning BEPS. However, interviewee from MFEC said that an attempt is made to fill out the gap in tax treaties by inclusion of exchange of information clause. However, since tax treaties are concluded for the purpose of avoidance of double taxation, they cannot specifically address the problem of BEPS.

The last but not the least prerequisite in the fight against BEPS is sufficient resource and ICT infrastructure. Interviewees agreed that like the aforementioned institutional framework challenges of taxing MNEs, the tax authority does not have also sufficient resource needed to tax MNEs. More importantly, transfer pricing requires proper documentation and ICT infrastructure in order to get comparable data. According to the interviewees from the Transfer pricing unit, due to lack of comparable data it is the company under investigation who is obliged to produce comparable data. On the other hand, the interviewee from ERCA head office said that, there is an ongoing effort by the tax authority to install huge documentation data bases.

Therefore, the institutional framework of the Ethiopian tax system is suffering lack of awareness of BEPS, capacity to tax MNEs, tax cooperation and exchange of information, capacity to follow up, implement and monitor activities of MNEs and sufficient resource needed, comparable data and ICT infrastructure.

## 5.2. Recommendation

Based on the findings of this research, the following recommendations are forwarded. The first recommendation concerns the legal framework needed to fight BEPS and subject MNEs in to the country`s tax jurisdiction. The second recommendation relates to establish institutional framework to properly exercises ones taxing right over MNEs and tackle those challenges associated with BEPS.

Legal framework reform recommendation includes the following;

- 1) Concerning transfer pricing, MFEC has to revise the transfer pricing directive and make it in the light of Art 49 of the new ITP.
- 2) With respect to hybrid mismatch arrangements, since the country does not have anti hybrid mismatch arrangements directive that determines scope of application, the tax payers subject to the rule, and that empowers the tax authority to deny or limit deductions as a result of this kind of arrangements has to be issued by MFEC
- 3) Regarding SPEs, as the country does not have a rule that prohibits the establishment of companies that do not have economic substance rather for the purpose of taxation general anti base erosion rule that requires establishment of companies with economic substance or that prohibit establishment of companies without economic substance be enacted by the MFEC
- 4) Coming to treaty shopping, as previously concluded most of avoidance of double taxation and prevention fiscal evasion treaties does not have limitation on benefit and principal purpose test clauses, thus, it is hardy possible to fight treaty shopping. Therefore, MFEC have to renegotiated and incorporate these treaty shopping avoidance clauses and future treaties must also include these clauses.
- 5) Concerning, thin capitalization, given the technicality of the matter single provision in the new ITP is not sufficient to properly implement the rule. There must be a directive that gives a positive guidance in the implementation and determines, tax payers subject to the rule, scope of application, the approach, maximum allowable debt, treatment of disallowed interest, and other measures and plan MFEC has to issue thin capitalization rules directive

The other recommendation of this research in relation to institutional reform measures that must be taken in order to make the tax authority and other stakeholder institutions working in the area of BEPS and MNE more vibrant and keen to the problem of BEPS. Therefore, institutional framework reform recommendation includes the following;

- 1) Awareness creation about the nature BEPS, constituent elements of BEPS, how does they operate, and the main actors and the extent of the problem responsible experts and higher officials in the tax authority, MFEC and EIC must be given
- 2) Equip the revenue authority and MFEC with well defined BEPS expertise, who could understand and deeply analyzes BEPS agreements and complicated transaction of MNEs.

Therefore the following actions ought to be taken;

- Ø BEPS training should be delivered in conjunction with embedded technical assistance from outside exp so that BEPS specialists could deepen their knowledge and confidence by working on practical cases alongside experienced tax auditors.
  - Ø Basic BEPS training should be provided to all tax auditors in LTO, so that they could identify BEPS issues during general audits and alert the specialists.
  - Ø Prioritize the following BEPS experts the training; economists, lawyers, and accountants.
  - Ø The short term training program should not also be limited to transfer pricing and it must be extended to other elements of BEPS.
- 3) The tax authority must sign tax cooperation and exchange of information agreements with other countries tax authorities, where MNEs doing business in Ethiopia are incorporated or sale their products. The agreement should specifically aim at combating BEPS by MNEs.
  - 4) Establish an intergovernmental mechanism among ERCA, MFEC, EIC and NBE to automatically share information related to companies operating in Ethiopia. The capacity of ERCA to follow up and monitor the overseas activities of MNEs operating in Ethiopia must be enhanced and sufficient resources must be allocated.
  - 5) The tax authority should also be equipped with ICT infrastructure for documentation data base and thereby the challenge in relation to comparable data will be mitigated if not resolved.

## Bibliography

### I. Books and Articles

1. Alexander Readhead, Preventing Tax Base Erosion in Africa: a Regional Study of Transfer Pricing Challenges in the Mining Sector, Natural Resource Governance Institute, July 2016.
2. Alexander Trepelkov and et al, United Nation Hand Book on Selected Issues in protecting Tax Bases of Developing Countries, United Nations, New York, 2015.
3. Base Erosion and Profit Shifting (BEPS) Explanatory Notes and its implication to Nigeria.
4. Błażej Kuźniacki and et al, Preventing Tax arbitrage via Hybrid Mismatches: BEPS Action 2 and Developing Countries, University of Vienna, International Taxation Research Paper Series, No. 2017.
5. Committee of Experts on International Cooperation in Tax Matters, Introduction to International Double Taxation and Tax evasion and Avoidance, Seventh session, Geneva, 24-28 October 2011, Item 5 (h) of the provisional agenda, Revision of the Manual for the Negotiation of Bilateral Tax Treaties.
6. David McNair and et al, Transfer Pricing and Taxing Rights of Developing Countries, Christian Aid, April 2010.
7. Dirk Willem- te Velde, Typical Tax Findings and Challenges in Developing Countries, Chapter in; Taxation and Developing Countries Training Notes, September 2013.
8. Dirk Willem- te Velde, Typical Tax Findings and Challenges in Developing Countries, Chapter in; Taxation and Developing Countries Training Notes, September 2013.
9. Erik Wibbels and Moisés Arce, Globalization, Taxation, and Burden Shifting in Latin America, International Organization, 57, the IO Foundation, 2003.
10. Ernst & Young LLP, Thin Capitalization Regimes in Selected Countries, Report Prepared for the Advisory Panel on Canada's System of International Taxation, Advisor Panel on Canada's System of International Taxation, May 2008.
11. Ethiopian Investment Commission, Ethiopia: A Preferred Location for Foreign Direct Investment in Africa, an Investment Guide to Ethiopia, 2015.
12. Ethiopian Investment Commission, Ethiopia: A Preferred Location for Foreign Direct Investment in Africa, an Investment Guide to Ethiopia, 2015.



13. European Union, Policy Department DG External Policies, Revenue Mobilization in Developing Countries: Issues and Challenges, April 2014.
14. Federal Democratic Republic of Ethiopia, Growth and Transformation Plan II (GTP II), (2015/16-2019/20), Volume I: Main Text, National Planning Commission, May, 2016.
15. Global Financial Integrity, Illicit Financial Flows to and from Developing Countries: 2005-2014, April I 2017.
16. Global Tax Alert, European Commission releases draft directive addressing hybrid mismatches with non-EU countries, European Commission proposes to extend Anti-Tax Avoidance Directive to also deal with hybrid mismatches with third countries 26 October 2016.
17. Ian Roxan, Limits to Globalization: Some Implications for Taxation, Tax Policy, and the Developing world, LSE Law, Society and Economy Working Paper Series, 3/2012, Law Department, London School of Economics and Political Science, London, UK, 2012.
18. IMF Committee on Balance of Payments Statistics, Direct Investment Technical Expert Group, Background Paper (Diteg) # Definition of Special Purpose Entities, Prepared by Balance of Payments and Financial Accounts Department, De Nederlandsche Bank, November 2004.
19. Information from EIC Data and Information Center, Summary of Foreign Direct Investment (FDI) Projects By Year and Investment Status Since 1992, August 22, 1992 May 09, 2017.
20. Ing. Ivona Durinovo, Taxation under Conditions of Economic Globalization, National Economic Issues, BIATEC, Volume XIV, No.10, 2006.
21. Insop Pak International Finance and State Sovereignty: Global Governance in the International Tax Regime, Annual Survey of International & Comparative Law, Vol. 10 Issue (No.) 1, 2004, p. 203.
22. International Monetary Fund, Issues in International Taxation and the Role of IME, January 28, 2013.
23. Jacob Frenkel et al, Basic Concepts of International Taxation in an Integrated World, MIT Press, Working Paper No. 3540, National Bureau of Economic Research, 1992.

24. James R. Hines Jr and Lawrence H. Summers, *How Globalization Affects Tax Design* Chapter pages in book (123 - 157), by the National Bureau of Economic Research University of Chicago Press, July 2009.
25. Jodo Ferreir, *How Mismatch Tax Rules Allow Multinational Enterprise to be One Step Ahead? In Particular, Appeal and Amazon's* Student Law Review.
26. José Luis Escario Díaz Berrio, *The Fight against Tax Havens and Tax Evasion Progress since the London G20 summit and the challenges ahead* Fundación Alternativas , 2011.
27. José Luis Escario Díaz Berrio, *The Fight Against Tax Havens and Tax Evasion Progress Since the London G20 Summit and the Challenges Ahead* Foundation Alternativas , 2011.
28. Khadija Baggerman Noudari and René Offermanns, *Foreign Direct Investment in Developing Countries: Some Tax Considerations and Other Related Legal Matters* Bulletin for International Taxation, June, 2016.
29. Khatereh Razazi, *Thin Capitalization- Compatible with EC law* Faculty of Law, University of Lund, 2008.
30. Ligin idil OZTIG, *Globalization and New Medievalism: A Reconsideration of the Concept of Sovereignty* Heinonline, 6 Rev. Int'l L. & Pol. 125 2010, abstract page.
31. Lilian V. Faulhaber, *The Trouble with Tax Competition: From Practice to Theory* Working Draft of February 6, 2017.
32. Marianne Burge, *Current Trends in the Taxation of Multinational Enterprises*, The Tax Magazine, Price Waterhouse & Co.; New York, December 1974.
33. Michael Lang *Introduction to the Law of Double Taxation Conventions*, Vienna, June 2010.
34. Michael Overesch and Georg Wamser, *Corporate Tax Planning and Thin Capitalization Rules: Evidence from a Quasi-Experiment* Applied Economics September 2007.
35. Middle East BEPS Bulletin, *Developing Countries Show strong Interest in the OECD's BEPS Recommendations* Middle East BEPS Bulletin from Tax and Legal Services Middle East.
36. Miriam Ronzoni, *Global Tax Governance: The Bulletin Internationalists Must Bite And Those They Must Not* MOPP 2014; 1(1): 379.

37. OECD Policy Brief, Taxing Multinational Enterprises, Base Erosion and Profit Shifting (BEPS), BEPS Update No. 3, October 2015.
38. OECD Policy Brief, Taxing Multinational Enterprises, Base Erosion and Profit Shifting (BEPS), BEPS Update No. 3, October 2015.
39. OECD, Illicit Financial Flows from Developing Countries: Measuring OECD Response 2014.
40. Petr Janský and Alex Pratta, Multinational Corporations and the Profit Shifting Lure of Tax Heavens, Christian Aid Occasional Paper Number 11, March 2013.
41. Petr Janský and Alex Pratta, Multinational Corporations and the Profit Shifting Lure of Tax Heavens, Christian Aid Occasional Paper Number 11, March 2013.
42. Prafula Fernandez and Jeff Poppe, International Taxation of Multinational Enterprises (MNEs), Revenue Law Journal, Vol. 12, No.1. January 2002
43. Prafula Fernandez and Jeff Poppe, International Taxation of Multinational Enterprises (MNEs), Revenue Law Journal, Vol. 12, No.1. January 2002.
44. Pro. Dr. Jan Wouters and Katrien Meuwissen, Global Tax Governance: Work in Progress?, Leuven Center for Global Governance Studies, Working Paper No. 59 February 2011.
45. Prof. Pascal Salin, Arguments in Favor of Globalization, University Paris Dauphine
46. Rachel J. Greenberg, Taking a Byte out of International Tax Evasion: Combating Base Erosion and Profit Shifting, Chapman Law Review, Vol. 19 No. 1, 2016.
47. René Offermanns and Boyke Baldewijs, Anti-Base Erosion Measures for Intra-Group Debt Financing.
48. Robert M. Cutter, The OSCE's Parliamentary Diplomacy in Central Asia and the South Caucasus in Comparative Perspective, Studia Diplomatica, Vol. LIX, No. 2, 2006.
49. Sagit Leviner, the Intricacies of Tax and Globalization, Colombia Journal of Tax Law, Vo. 5 No. 207, 2011.
50. Tatjana Đukic, Thin Capitalization Rules in EU Member States, Review article, University of Ljubljana, Faculty of Administration.
51. Tax justice Network Africa, Tax Justice Briefing Source and Residence, 15 September 2005.

52. The Australian Government Board of Taxation, Implementation of OECD Hybrid Mismatch Rules, A Report to the Treasurer, March 2016
53. The International Tax Compact (ITC), Addressing Tax Evasion and Tax Avoidance in Developing Countries, 22 December 2010.
54. The United Nations Development Fund (UNDP), Discussion Paper Illicit Financial Flows from the Least Developed Countries, 1990-2008, May 2011.
55. Thomas Rixen, Global Tax Governance, Normative and Institutional Issues, May 2012.
56. UNCTAD et al., 2002, Glossary, p. 170.
57. United Nations Conference on Trade and Development (UNCTAD), World Investment Report 2015: Reforming International Investment Governance, 2015.
58. United Nations Model Double Taxation Convention between Developed and Developing Countries, Commentary on Elimination of Double Taxation, Department of Economic & Social Affairs, New York, 2011.
59. Vito Tanzi, Globalization, Tax Competition and the Future of Tax Systems, IMF Working Paper series WP/96/141, Fiscal Affairs Department, December 1996.
60. Wolfgang Obenland (Global Policy Forum), Options for Strengthening Global Tax Governance, Draft for Discussion, 8/Apr/2016.
61. Yoseph Edrey and Adrienne Jeffrey, Taxation of International Activity: Over Relief from Double Taxation under the U.S. Tax System, Berkeley Journal of International Law, Volume 9, Issue 1, 2991.
62. \_\_\_\_\_ International Tax Cooperation for Development, Taxation as a key driver of financing for sustainable development, Briefing Note.

## II. Legal Sources

1. Federal Income Tax Proclamation No. 976/2016, Federal Negarit Gazeta Ordinary Issue 22<sup>nd</sup> Year No. 104, 18<sup>th</sup> August 2016.
2. Income Tax Proclamation No. 286/2002, Federal Negarit Gazeta Ordinary Issue 6<sup>th</sup> Year No. 34, 4<sup>th</sup> July 2002.
3. Directive Issued to Provide Rules on Transfer Pricing, Directive No 43/2015.

### III. Other Sources

#### i. Internet

1. Addis Fortune, News Paper Tax Fraud by Foreign Companies in Ethiopia Vol. 16 , No. 801, Sep 07, 2015, available at <http://addisfortune.net/articles/tax-fraud-by-foreign-companies-in-ethiopia/> [Last accessed 26/01/2017].
2. Australian Government the Board of Taxation Implementation of anti-hybrid rules available at, <http://taxboard.gov.au/consultation/implementation-of-anti-hybrid-rules/> [Last accessed 29/5/2017].
3. BBC World News, OECD: What is it and what does it do? available at, <<http://news.bbc.co.uk/2/hi/business/927195.stm>> [Last accessed 5/8/2017].
4. Brian J Taylor The Impact of Globalization on Taxation available at <<http://ezinearticles.com/?The-Impact-of-Globalization-on-Taxation&id=6140542>> [Last accessed 5/4/2017]
5. Duncan Bell Liberal internationalism Encyclopædia Britannica available at <<https://www.britannica.com/topic/liberal-internationalism>> [Last accessed 04/05/2017].
6. Ethiopian Investment Commission, Incentives, Taxation, and Other Procedures, available at <<http://www.investethiopia.gov.et/investment-process/incentives-taxation-and-other-procedures>> [Last Accessed on 26/01/2017]
7. Ethiopian Investment Commission, Economic Indicators, available at, <<http://www.investethiopia.gov.et/why-ethiopia/economic-indicators>> [Last Accessed, 26/01/2017].
8. Ethiopian Investment Commission, Economic Indicators, available at, <<http://www.investethiopia.gov.et/why-ethiopia/economic-indicators>> [Last Accessed, 26/01/2017]
9. Global Financial Integrity (GFI), available at <http://www.gfintegrity.org/about/> [Last accessed on 10/05/2017].
10. Glossary of Foreign Direct Investment Terms, OECD, 2006 not published, available at, <<https://stats.oecd.org/glossary/detail.asp?ID=2545>> [Last accessed 29/01/2017]
11. Guest author, Combating BEPS and making sure we have fair tax systems: An OECD/G20 Venture 29 September 2014, available at

- <<http://oecdinsights.org/2014/09/29/combatting-and-making-sure-we-have-fair-tax-systems-an-oecd-g20-venture>> [Last Accessed, 20/12/2017].
12. Joel Cooper and Monia Volpatò Ethiopia Introduces New Transfer Pricing Directive Tax Insight, 4 October 2016, available at, <<https://www.dlapiper.com/en/slovakrepublic/insights/publications/2016/ethiopia-introduces-new-transfer-pricing-directive>> [Last accessed 27/05/2017].
13. Jorg Friedrichs, The Meaning of New Medievalism, European Journal of International Relations, available at <<http://journals.sagepub.com/doi/abs/10.1177/1354066101007004014>> [Last accessed 04/05/2017].
14. OECD (2013), Addressing Base Erosion and Profit Shifting, OECD Publishing, available at, <<http://dx.doi.org/10.1787/9789264192744>> [Last accessed, 20/12/2016].
15. OXFAM International, Multinational Companies Cheat Africa out of Billions of Dollars published, 2 June 2015, Available at, <<https://www.oxfam.org/en/pressroom/pressreleases/2015/26-02/multinational-companies-cheat-africa-out-billions-dollars>> [Last Accessed, 24/01/2017].
16. Patrick Love OECD Insights Debate on the issue What is BEPS and How can you Stop it?, available at, <<http://oecdinsights.org/2013/07/19/what-beps-show-can-you-stop-it/>> [last accessed 20/12/2016]
17. Patrick Love, BEPS: why you're taxed more than a multinational, available at, <<http://oecdinsights.org/2013/02/13/beps-by-youre-taxed-more-than-a-multinational/>> [Last Accessed 23/1/2017].
18. Patrick Love, BEPS: why you're taxed more than a multinational, available at, <<http://oecdinsights.org/2013/02/13/beps-by-youre-taxed-more-than-a-multinational/>> [Last Accessed 23/1/2017]
19. Peter Dierckx, Catching Capital: The Ethics of Tax Competition, Oxford University Press, 2015, 264pp., \$34.95 (hbk), ISBN 9780190251512, available at <<http://ndpr.nd.edu/news/catching-capital-the-ethics-of-tax-competition/>> [Last accessed 04/05/2017].

20. Shawn Grimsle, Liberal Internationalism Definition and Principle available, <<http://study.com/academy/lesson/liberal-internationalism-definition-principles.html>> [Last accessed 04/05/2017].
21. Stranton Makundi, Managing Tax Risks Double tax Treaties and Implications to Undertakings of Multinationals THE CITIZIN Jan 21, 2016, available at, <<http://www.thecitizen.co.tz/open/Double-tax-treaties-and-implications/1840568304277213npw03/index.html>> [Last Accessed 5/4/2017].
22. Tax Adviser, Hybrid Mismatch, Ed Wright provides analysis on the UK implementation of Action 2 of the OECD BEPS project <<http://www.taxadvisermagazine.com/article/hybrid-mismatch>> [Last Accessed 23/01/2017].
23. Tax Justice Network Africa, Tax and International Financial Architecture available at, <<http://www.taxjusticeafrica.net/en/programmes/international-taxation/>> [Last Accessed 24/01/2017].
24. Tax Justice Network Africa, Tax and International Financial Architecture available at, <<http://www.taxjusticeafrica.net/en/programmes/international-taxation/>> [Last Accessed 24/01/2017].
25. The Telegraph, Business, What is the G20 and How Does it Work available at, <<http://www.telegraph.co.uk/business/0/what-is-the-g20-and-how-does-it-work/>> [Last accessed 5/8/2017].
26. The World Bank, IBRD. IDA, Illicit Financial Flows (IFFs), April 14, 2016, available at <<http://www.worldbank.org/en/topic/financialmarketintegrity/brief/illlicit-financial-flows-iffs>> [Last accessed 10/05/2017].
27. theguardian, Newspaper, What are the Panama Papers? A guide to history's biggest data leak, available at <<https://www.theguardian.com/news/2016/apr/03/what-need-to-know-about-the-panama-papers>> [Last Accessed 24/01/2017]
28. TREATYPRO, The online tax treaty resource, Latest Treaty Updates: Ethiopia available at, <[http://www.treatypro.com/treaties\\_by\\_country/ethiopia](http://www.treatypro.com/treaties_by_country/ethiopia)> [Last Accessed on 26/01/2017].

29. US Legal, Special Purpose Entity (SPE) Law and Legal Definition available at, <<https://definitions.uslegal.com/s/special-purpose-entity-spe/>>, [Last Accessed 20/01/2017].
30. \_\_\_\_\_, Globalization Positive or Negative P. 1 [Hereinafter Globalization , Positive or Negative, available at <[http://www.edu.gov.mb.ca/k12/cur/socstud/frame\\_found\\_sr2/bl6.s/d/](http://www.edu.gov.mb.ca/k12/cur/socstud/frame_found_sr2/bl6.s/d/)>] [Last accessed 10/05/2017].
31. <<https://theintercept.com/2016/05/here-is-the-price-countries-pay-for-tax-evasion-exposed-in-panama-papers/>> [Last Accessed 24/01/2017]

## ii. Interviews

1. Interview with Anonymous Senior Tax Audit Expert1 at Transfer Pricing Unit, Large Taxpayers Office (LTO) ERCA, on the Sufficiency of the Current Transfer Pricing Rule to Tax MNEs, Cooperation and Exchange of Information May 23, 2017.
2. Interview with Anonymous Senior Tax Audit Expert2 at Transfer Pricing Unit, Large Taxpayers Office (LTO) ERCA, on the Sufficiency of the Current Transfer Pricing Rule to Tax MNEs May 23, 2017.
3. Interview with Mr. Abebe Gebremedhin Legal advisor at, Domestic Tax Program Development and Support Division, ERCA, on Capacity to Tax MNEs, on Awareness of BEPS, the Sufficiency of the Current Transfer Pricing Rule to Tax MNEs, Cooperation and Exchange of Information, on Resource and ICT Infrastructure May, 23, 2017.
4. Interview with Ms Fantu, Consultant at EIC and International Financial Corporation (IFC), on Capacity to Follow, Implement and Monitor MNEs May 23, 2017.
5. Interview with Mr. Nebyu Gedelie Alemie, Tax Audit Coordinator ERCA, LTO, on Capacity Followup, Implementation and Monitor Capacity Followup, Implementation and Monitor, May 22, 2017.
6. Interview with Mr. Getasew Tessema, Public Prosecutor at Federal General Attorney Office, Economic Crimes Division, on Capacity to Tax MNEs May 19, 2017.
7. Interview with Ms. Amelework Ayalew, Information and Documentation Expert at Ethiopian Investment Commission (EIC), Awareness of BEPS May 24, 2007.



8. Interview with Ms. Serkalem Enyew Legal Expert, Legal Department, Ministry of Finance and Economic Cooperation (MFECC), the Awareness of BEPS, on Challenges in Relation to Cooperation and Exchange of Information May 20, 2017.

## Annex

### A. Semi-structured Interview Questions for the Ethiopian Revenue and Customs Authority (ERCA), Addis Ababa.

- i. On the legal framework
  1. Do you think that the existing legal and institutional frameworks are sufficient enough to avoid/minimize BEPS? Such as Transfer Pricing, Hybrid Mismatches, Special Purpose entities (SPEs), Treaty Shopping, Thin Capitalization?
  2. What are the governing laws for the problems of Hybrid Mismatches, Special Purpose entities (SPEs) and Treaty Shopping?
- ii. On the institutional framework
  - a) On Awareness of BEPS
    1. What does BEPS mean? What are the constituent elements? Do you know Transfer Pricing, Hybrid Mismatches, Special Purpose entities (SPEs), Treaty Shopping, Thin Capitalization?
    2. How does BEPS operate and what are the main actors?
    3. Do you know the number of MNEs that are operating under parent subsidiary relationship in Ethiopia?
    4. Do you think that such kind of relationship gives an opportunity for MNEs to conduct BEPS?
    5. Do you think that BEPS is an issue in Ethiopia?
  - b) On Capacity of ERCA to tax MNEs
    1. Do you think personals at ERCA such as economists, auditors, lawyers etc. has the capacity to tax MNEs?
    2. Do you think ERCA has the capacity to effectively follow, implement, and monitor, MNEs activities in relation to BEPS?
    3. Do you think that ERCA has the resource needed to monitor and trace the sale of products manufacture abroad, but, produced here in Ethiopia by MNEs?
    4. Do you think that ERCA has sufficient comparable data to evaluate the arm`s length price of products, in the context of transfer pricing?

c) On Tax Cooperation and Exchange of Information regarding BEPS

1. Do you think that Tax cooperation and exchange of information is important to fight BEPS?
2. Do IRCA have any tax cooperation and information exchange agreement with other taxing authorities where MNEs sell their products or reside?

iii. On BEPS in general

1. Have you ever faced problems in relation to BEPS?
2. Can you tell me any other challenges of taxing MNEs?

B. Semi-structured Interview Questions for the Ministry of Finance and Economic Cooperation, Addis Ababa

i. On the legal framework to fight BEPS by MNEs

1. Do you think that the existing legal and institutional framework is sufficient enough to avoid/minimize BEPS? Such as Transfer Pricing, Hybrid Mismatches, Special Purpose entities (SPEs), Treaty Shopping, Thin Capitalization?
2. What are the governing laws of the problem for Hybrid Mismatches, Special Purpose entities (SPEs) and Treaty Shopping?

ii. On the institutional framework to fight BEPS

a. On Awareness of BEPS

1. What does BEPS mean? What are the constituent elements? Do you know Transfer Pricing, Hybrid Mismatches, Special Purpose entities (SPEs), Treaty Shopping, and Thin Capitalization?
2. How does BEPS operate and what are the main actors?
3. Do you know the number of MNEs that are operating under parent/subsidiary relationship in Ethiopia?
4. Do you think that such kind of relationship gives an opportunity for MNEs to conduct BEPS?
5. Do you think that BEPS is an issue in Ethiopia?

b. On Tax Cooperation and Exchange of Information regarding BEPS

1. Do you think that Tax cooperation and exchange of information is important to fight BEPS?

2. Do IRCA have any tax cooperation and information exchange agreement with other taxing authorities where MNEs sell their products or reside?
- iii. Semi-structured Interview Questions for Ethiopian Investment Commission, Addis Ababa
- iv. On the legal framework to fight BEPS by MNEs
  1. Do you think that the existing legal and institutional framework is sufficient enough to avoid/minimize BEPS? Such as Transfer Pricing, Hybrid Mismatches, Special Purpose entities (SPEs), Treaty Shopping, Thin Capitalization
  2. What are the governing laws for the problem for Hybrid Mismatches, Special Purpose entities (SPEs) and Treaty Shopping?
    - i. On the institutional framework to fight BEPS
      - a. On Awareness of BEPS
        1. What does BEPS mean? What are the constituent elements? Do you know Transfer Pricing, Hybrid Mismatches, Special Purpose entities (SPEs), Treaty Shopping, and Thin Capitalization?
        2. How does BEPS operate and what are the main actors?
        3. Do you know the number of MNEs that are operating under parent-subsidary relationship in Ethiopia?
        4. Do you think that such kind of relationship gives an opportunity for MNEs to conduct BEPS?
        5. Do you think that BEPS is an issue in Ethiopia?