Characterization of Taxable Units and Tax Bases under Schedule 'C' of the Federal Income Tax Proclamation of Ethiopia: A Commentary

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Abstract

Schedule 'C' is the third income tax schedule incorporated under the Federal Income Tax Proclamation of Ethiopia. The Schedule deals with business income taxation. Though the Schedule is entangled with several concerns, this work is restricted to issues related to the characterization of its taxable units and tax bases. As a commentary, it intends to serve as a guidance to understand the taxable units and tax bases of the Schedule. To accomplish this, the work used desktop research method and analyzed the relevant legislation, literature and cassation decisions. In examining how taxable units and tax bases are characterized under Schedule 'C', the work considers the areas of developments made by the current income tax regime such as the incorporation of provisions with clear income sources subject to the Schedule. Most importantly, the work tries to identify gaps (with potential administrative difficulties) that need consideration such as characterization tensions with other income tax schedule of the Proclamation and provisions that lack clarity. It also questioned the appropriateness of the inclusion of some entities (notably partnerships) as taxable units of the Schedule and it provides arguments to seek the attention of the concerned organs regarding the issues involved. Issuance of supplementary directives and advance rulings, the need to take relevant lessons from the experience of other jurisdictions and reconsidering some of the existing characterization are among the solutions the work recommends.

Key Terms: Characterization, Schedule 'C', Taxable unit, Tax base, Business, Business income

Introduction

In Ethiopia, the schedular income tax approach, which has been serving as the basic structure of income taxation to this day, was officially introduced in 1944.[1]

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Since then income from business is subjected to a separate schedule.[2] Under the current income tax regime, Schedule 'C', which is the third income tax schedule recognized under the Federal Income Tax Proclamation No. 979/2016 (the Proclamation),[3] is dedicated to taxation of business income. Regardless of the overall design of the income tax system, it is common to provide special rules for taxing business income. These rules are primarily related to the tax base, timing of the recognition of income and deductions, and collection of tax.[4] That is why, in Ethiopia too, the great majority of the provisions of the Proclamation and the Federal Income Tax Regulation No. 410/2017 (the Regulation) are devoted to the affairs of Schedule 'C' taxpayers.[5]

In the context of business income taxation, the characterization of a certain economic item as business income is important despite the nature of the income tax system (whether it is a schedular or global income tax system).[6] To determine whether an item of income is business income or not it is important first to determine whether the activity giving rise to the income is properly characterized as business.[7] The focus of this work is to examine these elements in the context of Schedule 'C' of the Proclamation. It tries to shed light on the taxable units and tax bases characterization under Schedule 'C'.[8] Since the work is a commentary, it is intended to help those who are interested (such as law students) as a guidance to understand the taxable units and tax bases of the Schedule. Moreover, law instructors may use it as an input for their class delivery, enriching it with further ideas. Having this in mind, in the following sections a critical analysis is made on the characterization of taxable units and

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[1] See Personal and Business Income Tax Proclamation No. 60/1944, *Negarit Gazeta*, (1944).

[2] Business income taxation was initially introduced as Schedule 'B' and it became Schedule 'C' in 1956, up on the introduction of rental income tax. See Income Tax Decree No. 19/1956, *Negarit Gazeta*, (1956). For detail historical facts, see Taddese Lencho, Towards Legislative History of Modern Taxes in Ethiopia, *Journal of Ethiopian Law*, Vol. 25, No. 2,(2012), pp. 116-120.

[3] Federal Income Tax Proclamation No. 979/2016, Federal *Negarit Gazzeta*,(2016), Art. 8. [Hereinafter, Proclamation No. 979/2016].

[4] Lee Burns and Richard Krever, Taxation of Income from Business and Investment, *in* Victor Thuronyi (ed.), *Tax Law Design and Drafting*, International Monetary Fund, Vol. 2, (1998), p. 1.

[5] See Proclamation No. 979/2016, *supra* note 3, Arts. 18-50 and the Federal Income Tax Regulation No. 410/2017, Federal *Negarit Gazeta*, (2017), Arts. 27-49. [Hereinafter, Regulation No. 410/2017].

[6] Burns and Krever, *supra* note 4, p. 2.

[7] *Id.*

[8] The characterization of taxable units and tax bases of Schedule 'A' and 'B' are discussed in the other issue of this Journal. See Belete Addis, Characterization of Taxable Units and Tax Bases under the Income Tax Schedules of Schedule 'A' and 'B' of the Federal Income Tax Proclamation of Ethiopia: A Commentary, *Bahir Dar University Journal of Law*, Vol. 8, No. 1, (2019), pp. 35-67. So, this work can be taken as part two of the commentary on the characterization of taxable units and tax bases of the income tax schedules. Schedule 'D' consists a dozen of income sources, hence, the discussion on its taxable units and tax bases cannot be made part of this work without exceeding the page limit of the Journal.

tax bases' of Schedule 'C' of the Proclamation, under section one and two respectively. The work winds up with concluding remarks and recommendations.

1. Taxable Units of Schedule 'C'

According to the Proclamation "… business income tax shall be imposed … *on a person* conducting business that has taxable income for the year" (emphasis added).[9] Since the provision uses the word 'person', both an individual and a body (a legal person) are taxable units of Schedule 'C'. The former category refers to a sole proprietor, while the latter constitutes a body conducting business. The term 'body' is not defined in the Proclamation, but under the Federal Tax Administration Proclamation No. 983/2016 (the Tax Administration Proclamation).[10] Art. 2 (5) of the latter defined 'body' as "a company, partnership, public enterprise or public financial agency, or other body of persons whether formed in Ethiopia or elsewhere." Thus, the listed entities are taxable units of Schedule 'C', as long as they conduct business. The list begins with company and it is defined as "a commercial business organization established in accordance with the Commercial Code of Ethiopia and having legal personality, and includes any equivalent entity incorporated or formed under a foreign law."[11] Accordingly, Share Companies (SCs) and Private Limited Companies (PLCs) are taxpayers of Schedule 'C'; as the Commercial Code recognizes only the two as 'company'.[12]

The other entity recognized as a 'body' is a partnership. Regarding the taxation of partnerships, there are two main approaches.[13] First, partnerships may be taxed as an entity ("*fiscal intransparency*"), emphasizing its similarity to corporations.[14] Second, the partnership is inexistent for tax purposes and serves

[9] See Proclamation No. 979/2016, *supra* note 3, Art. 18 (1).

[10] Federal Tax Administration Proclamation No. 983/2016, Federal *Negarit Gazeta*, (2016). [Hereinafter, Proclamation No. 983/2016]. The Income Tax Proclamation declares that the definition provided in the Tax Administration Proclamation is applicable to it, unless the term is defined otherwise in the Proclamation itself. See, the introductory paragraph of Art. 2 of Proclamation No. 979/2016.

[11] See *Id*, Art. 2 (7).

[12] See Commercial Code Proclamation, *Negarit Gazzeta*, (1960), Art. 212 (1) (e) and (f). [Hereinafter, the Commercial Code]. However, the Draft Commercial Code (which at the time of writing of this work is approved by the Council of Ministers and tabled to the House of Peoples Representatives (HPR) for its consideration and approval) stipulates that a PLC can be established by one person, which shall be named as "a single-member PLC". This seems that Ethiopia is on its way to embrace a one-man company. See the Draft Commercial Code, Arts. 505 (2), 508 and 210. If the Draft ratified as it is, a single-member PLC will also be made a tax payer of Schedule 'C', as a company.

[13] Martin H. Seevers, Taxation of Partnerships and Partners Engaged in International Transactions: Issues in Cross-Border Transactions in Germany and the US, *Houston Business and Tax Law Journal*, Vol. 2, (2002), pp. 147-151.

[14] *Id*.

merely as a "conduit" through which the individual partners derive their income ("*fiscal transparency*").[15] This approach emphasizes the partnership's characteristic as a mere aggregation of its partners.[16] Many jurisdictions adopted the latter approach while the entity approach is typically found in some Roman law countries, such as Spain, Portugal, and Latin American Countries.[17] The practice in many countries, however, shows that partnerships are recognized as a mere association of persons not as entity-proper and for taxation purpose, they are not taxed at the entity level (i.e., the only taxpaying persons are the individual partners).[18] For instance, in Nordic and many OECD countries partnerships are subject to a *transparent* tax assessment rules or considered as fiscally transparent entities.[19] This implies that taxation occurs at the participant level. Hence, business income is calculated and taxed at the partner level, not at a partnership.[20] The same goes to the U.S., Germany, and some transition/developing countries where, the partnership is treated as a conduit which passes income through to the partners.[21] In South Africa, a partnership is not a separate legal entity and therefore all partners are jointly and severally liable for the debts of the partnership.[22] Following this, the individual partners are taxed separately from the partnership, each on their share of partnership profits or losses.[23]

Once the *transparency* rule is adopted, the next important question is how to allocate partnership income to partners. Regarding this, there are basically two approaches.[24] The first is the entity theory which holds that the partnership is an entity separate from the partners; thus, the income of the partnership will be determined separately, and this income can then be allocated to the partners.[25] The second is the aggregate or fractional theory, which holds that the

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[15] *Id.*

[16] *Id.*

[17] *Id*. However, it can be said that whether a particular jurisdiction adopts an *intransparent* (i.e., entity) approach or a *transparent* (i.e., conduit) approach is a matter of tax policy rather than conceptual considerations.

[18] *Id.*

[19] Langhave Jeppesen *et al*, Taxation of Partnership in Nordic Countries, Legal National Reports for the Nordic Tax Research Council's Annual Meeting, *Nordic Tax Journal*, Vol. 2,(2015), pp. 63-108; and Commentary to OECD Articles of the Model Convention with Respect to Taxes on Income and on Capital [as updated in 2017], pp. 24-26.

[20] *Id.*

[21] See Seevers, *supra* note 13, pp. 147-151; and Alex Easson and Victor Thuronyi, Fiscal Transparency, *in* Victor Thuronyi (ed.), *Tax Law Design and Drafting*, International Monetary Fund, Vol. 2, (1998), p. 6.

[22] Nina Marie, The Treatment of Partnership Income and Expenditure in South African Income Tax Law, LL.M thesis, University of Cape Town, (2006), pp. 8-9.

[23] *Id,* p. 10.

[24] Easson and Thuronyi,*supra* note 21, p. 9.

[25] *Id*. This approach is very common in countries where the partnership has independent legal personality.

partnership does not exist independently of the partners; hence, there is no need to determine income at the entity level, rather each partner is simply allocated the partner's fractional share of partnership receipts and outgoings, and the tax consequences are determined in the hands of each individual partner.[26] There are also other issues that need to be addressed once, a *transparency* approach is adopted. For instance, the *transparency* principle makes it necessary to have rules regarding the ongoing taxation and tax laws have to incorporate several anti-abuse rules that aimed at preventing the use of personal companies (partnerships) as part of tax planning.[27]

Coming to the Ethiopia's income tax system, as it has been mentioned above, Art. 2 (5) of the Tax Administration Proclamation recognizes 'partnership' as a body and Art. 2 (23) of the same defines 'partnership' as "a partnership formed under the Commercial Code including an equivalent entity formed under foreign law." The Commercial Code recognizes four forms of partnerships: ordinary partnership, general partnership, limited partnership and joint venture.[28] Except joint venture all other forms of partnerships do have legal personality.[29] Thus, it is possible to conclude that in Ethiopia partnerships are recognized as incorporated entities, which makes them taxable units of Schedule 'C'. This is also how the income tax system understood partnerships.

Even though, partnerships are made taxpayers of Schedule 'C' under the Proclamation, this work intends to question its appropriateness. The mere fact that partnerships are given with legal personality may not necessarily mean that they are incorporated entities, hence, taxable at the entity level. In different jurisdictions, even if partnerships are given with legal personality under civil laws, this may not be necessarily the case under tax laws.[30] And again

[26] *Id*. This approach is very common in countries where the partnership has no independent legal personality, but viewed as a simple aggregation of the partners. From the two, the aggregate approach is considered as administratively complex since it depends on compliance by individual partners, which can lead to enforcement problems. For those with weak tax administration, the adoption of pure entity approach is widely recommended (determine the income at the entity level and flowed through to the partners as business income). There are also countries (such as the United States) which use a hybrid of the two approaches. See, *Id*, p. 24.

[27] For details, see *Id*, pp. 10-23. See also Jeppesen *et al*; *supra* note 19, pp. 63-108.

[28] Commercial Code, *supra* note 12, Art. 212 (1) (a) – (d). The new Draft Commercial Code deleted Ordinary Partnership, and introduces another form of partnership; limited liability partnership. See, Art. 212 of the Draft. This type of partnership is recognized as having an independent legal personality separate from the partners. The liability of the partners is also limited. The detail regulation can be seen from Arts. 257-270 of the Draft Commercial Code.

[29] *Id*, Art. 210 (2).

[30] While in some countries the tax status of an entity is determined by its status (as a legal person or otherwise) under civil law, in many systems the tax status of an entity is established by the tax law, and does not always coincide with its status under private law. See Easson and Thuronyi,*supra* note 21, p. 2.

partnerships may be treated as entities under tax laws but only for some important procedural matters; such as for filing financial information and accounting purpose, since the partnership accounting period and accounting method determines the tax liability of the partners.[31] Under the Commercial Code, except for few cases, partners in the partnership have unlimited liability.[32] If partnerships were truly considered as entities having separate existence with that of their partners (in the strict sense of the term 'legal personality'), they would have a limited liability which is the very doctrine developed following the 'legal personality' of companies/business organizations.[33] The main effect of having legal personality is for the organization to hold rights and bear liabilities by its own. Based on this it may be argued that like the experience in other jurisdictions, in Ethiopia too, partnerships are unincorporated (mere aggregation of partners). Understanding partnership in this way implies, when a partnership engages in business activities, business income tax will be logically imposed on the partners not on the partnership or at entity level.[34]

In addition to the above possible legal argument, imposing business income tax on partnerships at entity level may have other negative implications. The main reason for providing diverse forms of business organizations is to give wider opportunities/choices of doing business for the business community.[35] Tax implications are among the determining factors in the choice of a business form. Subjecting both a partnership and a company to the same taxation requirements/treatments, may narrow the choice of partnerships as a form of business doing. As long as partnerships are treated equally with companies, there will be tax at two levels: a business income tax at partnership level (with a harsh 30% flat rate) and at partners level dividend taxation on the profit distributed from the partnership. Under the repealed income tax proclamation No. 286/2002 (the repealed Income Tax Proclamation), the concept of dividend was restricted to distributions made by SCs and PLCs; hence, the taxable units

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[31] See Seevers, *supra* note 13, pp. 147-151; and Jeppesen *et al*, *supra* note 19, pp. 63-108.

[32] See Commercial Code, *supra* note 12, Arts. 255, 277, 280 and 296 for Ordinary Partnership, Joint Venture, General Partnership and Limited Partnership respectively. From the reading of these provisions, we can infer that except for limited partners in a limited partnership, there is personal or unlimited liability of partners for third parties. As mentioned above, the Draft Commercial Code introduces limited liability partnership. Save for few exceptions, the partners of limited liability partnership have limited liability (no personal liability). See, Arts. 264 and 265 of the Draft.

[33] See Endalew Lijalem Enyew, the Doctrine of Piercing the Corporate Veil: It's Legal and Judicial Recognition in Ethiopia, *Mizan Law Review*, Vol. 6, No.1, (2012), pp. 77-114.

[34] There is a view that the absence of legal personality of partnerships under civil/commercial laws in many countries may have facilitated for their *transparent* treatment under tax laws. See Easson and Thuronyi,*supra* note 21, p.5.

[35] Angela Schneeman, *the Law of Corporations and Other Business Organizations*, 5th ed., Delmar Cengage Learning, United States, (2010), pp. 21-23.

of dividend taxation was limited to shareholders of companies.[36] However, this is no more the case under the existing income tax Proclamation since the Proclamation defines "dividend" as "a distribution of profits by *a body to a member …*" (emphasis added).[37] As it has been seen partnerships are treated as 'body' under the tax laws, so, a partner who received a profit from the partnership will be a taxable unit of dividend tax. Besides, the definition of "dividend" cited above, explicitly mentions partnerships by name. Had partnerships been treated as "conduit", the profit distributed to partners would have been considered as a business income, not as a dividend.[38] In effect, under the Proclamation, there is no difference between the income tax treatments of partnerships and companies.

Moreover, even though it is decided to adopt the entity approach and made partnerships taxable units of Schedule 'C', differential treatments could have been considered. For instance, Micro Enterprises[39] are made taxable units of Schedule 'C'. However, in assessing their income tax liability, the applicable rate is the one applicable on individual taxpayers.[40] Hence, the 30% flat rate, applicable to 'body' taxpayers,[41] is not applicable to them. Moreover, regarding their duty to maintain books of account, micro enterprises are treated as individuals.[42] Thus, as long as their annual gross income is less than Birr 500, 000, they will be treated as category 'C' taxpayers,[43] which are not obliged to

[36] See, Income Tax Proclamation No. 286/2002, Federal *Negarit Gazeta*, (2002), Art. 34 (1). [Hereinafter, Proclamation No. 286/2002].

[37] See Proclamation No. 979/2016, *supra* note 3, Art. 2 (6).

[38] Many States consider the profits of a business carried on by a partnership are the partners' profits derived from their own exertions; they are business profits. The position is different for the shareholder of a company. The shareholder is not a trader and the company's profits are not his/her; so they cannot be attributed to them. The shareholder is personally taxable only on those profits which are distributed by the company. From the shareholders' standpoint, dividends are income from the capital which they have made available to the company as its shareholders. See, OECD Commentary, *supra* note 19, p. 135.

[39] Federal Urban Job Creation and Food Security Agency Establishment Regulation No. 374/2016, Federal *Negarit Gazetta*, (2016), Art. 2(3), defines Micro enterprises as "enterprises having a total capital, excluding building, not exceeding Birr 50,000 in the service sector or not exceeding Birr 100,000 in the industrial sector engaging 5 workers, including the owner, his family member and other employees." [Hereinafter, Regulation No. 374/2016].

[40] See Proclamation No. 979/2016, *supra* note 3, Art. 19 (3) and (4).

[41] See *Id*, Art. 19 (1).

[42] See Regulation No. 410/2017, *supra* note 5, Art. 48. It reads "[f]or the purpose of Art. 82 of the Proclamation, micro enterprises shall be treated as individual and the obligation to maintain books of account shall apply to such enterprises on the basis of their annual turnover." The cross referred provision of the Proclamation, deals about the record keeping duties of taxpayers.

[43] Proclamation No. 979/2016, *supra* note 3, under Art. 3 (1), categorizes the taxpayers of Schedule 'B' and 'C' in to Category 'A' - a body taxpayer and individual taxpayers with annual gross income of Birr 1, 000, 000 or more; category 'B' - individual taxpayers with annual gross income of Birr 500, 000 or more but less than 1, 000, 000; and category 'C' - individual taxpayers with an annual gross income of less than Birr 500, 000.

maintain books of account and whose income tax liability is determined based on a presumptive tax assessment.[44] Without such explicit exceptions made by the law, micro enterprises would have been considered as category ‘A’ taxpayers, which are imposed with a rigorous degree of tax assessment and record keeping.[45] This again will increase their compliance costs, which can be unbearable for enterprises with small capital, such as micro enterprises. Such a positive and differential treatment of micro enterprises is a new addition under the existing income tax system and this is one of the areas where the system makes an improvement. This helps these enterprises reduce their compliance cost by avoiding the strict book keeping requirement and also encourages their business growth by exempting them from the 30 % flat rate. In fact, its coverage of only micro enterprises can be a subject of critics. For instance, ‘small enterprises’ could have been made beneficiaries of such scheme.[46] Since no special arrangement is provided for them, they are equally treated as SCs and PLCs. This may put the income tax laws in paradox with the objective of recognizing these entities and government’s plea to design and implement appropriate economic policies, strategies, and legal and regulatory framework as prerequisites for creating an enabling environment to promote medium and small enterprises.[47]

Cooperative societies[48] are also exempted from paying income tax at entity level and the tax is imposed on members where they are required to pay income tax

[44] The book keeping standard varies according to the categories of taxpayers. While category ‘A’ and category ‘B’ taxpayers are required to maintain adequate books and records (the latter’s being imposed with a lesser standard than the formers), category ‘C’ are subject to a presumptive tax regime, which nonetheless requires them to declare their annual turnover to the tax authorities. See *Id*, Arts. 49, 82 and 83 and Regulation No. 410/2017, *supra* note 5, Art. 49.

[45] See *Id*, Arts. 82 and 83. The reading of these provisions is telling that more rigorous rules/duties of record keeping, tax assessment and declaration are imposed on category ‘A’ taxpayers, than the remaining two category taxpayers.

[46] Regulation No. 374/2016, *supra* note 39, Art. 2 (4) defines ‘small enterprises’ as “an enterprise having a total capital, excluding building, from Birr 50,001 to Birr 500,000 in the case of service sector or Birr 100,001 to Birr 1,500.000 in the case of urban agriculture, artisanal mining and construction sector engages from 6 to 30 workers including the owner, his family members and other employees.”

[47] See Gebrehiwot Ageba and Wolday Amha, Micro and Small Enterprises (MSE)Development in Ethiopia: Strategy, Regulatory Changes and Remaining Constraints, *Ethiopian Journal of Economics*, Vol. X, No 2, (2006), pp. 4-8. Given the state of current economic and social realities, it is advisable to follow the same policy with regard to the income tax treatment of small enterprises.

[48] "Cooperative Society" means a society established by individuals on voluntary basis to collectively solve their economic and social problems and to democratically manage same. This includes Agricultural, Housing, Industrial and Artisans Producers', Consumers, Savings and credit, Fishery and Mining Cooperative Societies. See Cooperative Societies Proclamation No. 147/1998, Federal *Negarit Gazeta*, (1998), Art. 2 (1) and (2). [Hereinafter, Proclamation No. 147/1998].

on their dividends.[49] This is despite the fact that cooperative societies have their own legal personality separated from their members and established as a limited liability entity.[50] Thus, though conventionally cooperative societies could be taxable units of Schedule 'C' for some other policy reasons they are exempted from paying income tax at entity level. Moreover, members of the cooperative societies are required to pay income tax on their dividends. This mean, the law treated the distributions from the societies to their members as a dividend not business income. If so, their exemption from business income tax is not only at entity level but also at individual level.

This author believes that though it may not be strictly similar, such differential treatments can be considered for partnerships so that the business community can benefit from the availability of diverse forms of doing business. Of course, taxing partnerships as entities has the advantage of administrative simplicity, since it can be easier to collect tax from a single entity than from the individual participants.[51] However, the disadvantage is that once partnerships are decided to be taxed as entities, the income will be taxed at a flat rate rather than the marginal/progressive rates applicable to the individual taxpayers.[52] So, if the government preferred to tax partnerships as entities, for some reasonable justifications, it should at least provide some preferential treatments than treating them the same way with companies, in all respects.

On a related note, the repealed Income Tax Proclamation in defining "body" used the expression 'registered partnership' which had the effect of excluding joint ventures as they are not required to be registered.[53] Currently, the definitional provision of "body" simply uses the term 'partnership'. A body is considered as a resident of Ethiopia and subject to tax if it is incorporated or formed in Ethiopia.[54] Incorporation is made through registration but a joint venture is not subject to registration.[55] If so, how is it possible to apply tax on it as a 'body'? It may be hard for the Tax Authority to enforce it properly. Had the tax been imposed only at partner's level, this would have not been a big concern.

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[49] *Id*, Art. 31 (1) (a). Members shall receive dividends from profit according to their shares and contribution after deducting and setting aside an amount necessary for reserve and social services. See Arts. 5 (3) and 33 of the same.

[50] *Id*, Art. 10.

[51] Easson and Thuronyi, *supra* note 21, p.7. Taxing partnerships as entities may also helps to avoid discrimination between different forms of business organization and to eliminate "entity shopping" (many businesses may operate in the form of partnerships because such forms are taxed less heavily than corporations).

[52] *Id*.

[53] See Proclamation No. 286/2002, *supra* note 36, Art. 2 (2).

[54] Proclamation No. 979/2016, *supra* note 3, Art. 5 (5) (a).

[55] Commercial Code, *supra* note 12, Art. 272 (2).

In this regard, it may be helpful to cite one case entertained by the Federal Supreme Court Cassation Division.[56] In that case, the Court ruled that it is inappropriate to conclude that no partnership is formed based on the fact that the partnership agreement is not registered and does not specify the specific type of the partnership. According to the decision of the Court it is possible to consider that a joint venture is formed as it is not required to be registered. Regarding the business activity of the venture, the Court affirmed that the business activity of the joint venture is undertaken in the name of the partners not in the name of the venture.[57] Though the point of dispute in this case is not a tax dispute, it affirmed that in case of joint venture's business engagement the business activity is considered as done by the partners. Thus, the business income tax will be imposed on the partners not on the joint venture as a 'body'.

In the Tax Administration Proclamation public enterprises[58] are also listed as 'body'.[59] It is sound to make public enterprises taxable units of Schedule 'C' since they are commercial entities. The list also includes 'public financial agency', as a body. It is not clear, however, what it is meant by 'public financial agency'. The tax laws nowhere define this entity. If it is meant to refer to 'public financial enterprise' it refers to a public enterprise engaged in banking or insurance business; hence, already fall under the ambit of public enterprises.[60] If the term is seen from the perspective of its use of the word 'agency', it seems to refer to the 'Financial Public Enterprises Agency', which is established to regulate the public financial enterprises.[61] If so, this will not be a concern of business income tax since administrative agencies are not subject to tax. However, since the Amharic version of Art. 2 (5) of the Tax Administration Proclamation says *"...የመንግስት የፋይናንስ ድርጅት..."* it rather seems to refer to government owned enterprises engaging in banking or insurance business such as the Commercial Bank of Ethiopia and the Ethiopian Insurance Corporation.[62]

It should be underlined that the list of Art. 2 (5) of the Tax Administration Proclamation is not exhaustive. The phrase 'other body of persons' in the

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[56] See ወርቁ ወ/ጻዲቅ vs የወ/ስላሴ ወራሾች፤ ጠቅላይ ፍርድ ቤት ሰበር ሰሚ ችሎት፤ መ.ቁ 76394፤ 2005 ዓ.ም.

[57] *Id*. The court substantiated its verdict using Arts. 212 (1) and 272 of the Commercial Code.

[58] These are a wholly state owned enterprises established to carry on for gain manufacturing, distribution, service rendering or other economic and related activities. See the Public Enterprises Proclamation No. 25/1992, Art. 2 (1).

[59] See Proclamation No. 983/2016, *supra* note 10, Art. 2 (5).

[60] See the Financial Public Enterprises Agency Establishment Regulation No. 98/2004, Federal *Negarit Gazeta*, (2004), Art. 2.

[61] *Id*, Art. 3.

[62] *Id*, Art. 2 also uses the wording "የመንግስት የፋይናንስ ድርጅቶች" for the direct meaning of the English version "Financial Public Enterprises".

provision is indicative of the broad understanding of 'body'. If constructed extensively, it has the effect of including non-business entities such as not-for-profit-organizations (NPOs) and religious institutions, as taxable units of Schedule 'C' (provided that they conduct business). Even if there are diversified approaches among countries, concerning the income tax treatments of NPOs, the widely accepted practice is to exempt only public benefit organizations (PBOs).[63] The exemption of the latter is also weighted against many competing interests such as the impacts on the commercial sector and possible abuses of the PBOs for personal gains.[64] In Ethiopia, in order to raise funds for the fulfillment of their objectives, NPOs (both PBOs and non-PBOs) have the right to engage in any lawful business and investment activities, either directly or by establishing separate business entities, in accordance with the relevant trade and investment laws.[65] As a matter of principle, religious institutions should not carry out business activities since their sole objective is fulfilling the spiritual needs of their followers. Yet, it is considered as wise and prudent to permit religious institutions carry out very limited trade activities in order to enable them to generate some income to cover the costs of their humanitarian and social goals.[66] However, even if religious institutions engage in trade activities, they are not considered as traders for the purpose of the Commercial Code.[67] When it comes to the issue of income tax, the Proclamation exempts the income of a non-profit organization *other than business income that is not directly related to the core function* of the organization (emphasis added).[68] Thus, as a rule, income generated by non-profit organizations (including NPOs and religious institutions) is exempted from income tax. However, even if NPOs or religious institutions can engage in both related and unrelated business activities, the income they derived from a "business activity which is not directly related" with their main purpose of establishment is not exempted. So, the mere fact that they

[63] See Klaus J. Hopt *et al.*, *Feasibility Study on a European Foundation Statute*, Final Report to European Commission, (2015), p. 52. PBOs are established for the benefits of the general public, than for the few.

[64] Peter Pajas, Economic Activities of Not-for-Profit Organizations, Conference Report in Regulating Civil Society Conference, Budapest, (2015), p. 8. Specially, the tax privileges for business and passive investment activities of PBOs are recommended not to be extensive and should be attached with the necessary conditions.

[65] Organizations of Civil Societies Proclamation No. 1113/2019, Federal *Negarit Gazzeta*, (2019), Arts. 63 (1) (b) and 64 (1). [Hereinafter, Proclamation No. 1113/2019].

[66] See Tilahun Teshome and Taddese Lencho (eds.), Position of the Business Community on the Revision of the Commercial Code of Ethiopia, Addis Ababa Chamber of Commerce and Sectoral Associations, PSD Hub Publication No. 8, (2008), p. 8.

[67] Commercial Code, *supra* note 12, Art. 4 (1) reads "[u]nless otherwise expressly provided by law, bodies corporate under public law, such as administrative or *religious institutions* or any other public undertakings, shall not be deemed to be traders even where they carry on activities under Art. 5" (emphasis added). Art.5 (1) of the draft Commercial Code has also similar stipulation.

[68] See Proclamation No. 979/2016, *supra* note 3, Art. 65 (1) (m).

are non-profit entities will not grant them automatic exemption from business income tax. The institutions should make both activity and financial reports to the Tax Authority so that it can determine whether the income is related or not.[69] This indicates that non-profit entities can be taxable units of Schedule 'C'. Therefore, to be a tax payer of Schedule 'C'; the important factor is the activity (whether it is business or not) not the identity of the person (whether it is a commercial or non-commercial entity).

There are also certain entities which may be considered bodies for the purpose of Schedule 'C', yet, not taxable units of the Schedule. In this regard, we can mention cooperative societies, which are exempted from paying income tax at entity level.[70] On the other hand, as discussed above Micro-Enterprises which are conventionally characterized as 'body' are considered as 'individuals' at least in terms of the applicable tax rate and the use of presumptive taxation.[71] It means, still they are taxable units of Schedule 'C', but by large treated as individual taxpayers. It should also be remembered that 'body' taxpayers are not only those entities formed in Ethiopia, but also include those incorporated or formed under a foreign law.[72] Thus, as so long as they derive taxable business income, either as a resident by having effective management in Ethiopia or as a non-resident by deriving Ethiopian source business income, they are treated as taxable units of Schedule 'C'.[73]

To sum up this section, it is compelling to ask, what is/are the base(s) or factor(s) to characterize the taxable units of Schedule 'C'? The above discussion indicates that there seems no hard and fast rule to characterize business income tax payers. What is important is to follow the defining elements: whether someone or a certain entity engaged in activities construed as business with a view to generate profit (i.e., the activity test and profit motive, to be discussed

[69] For instance, NPOs (CSOs) are required to make annual financial, audit and activity report to the Civil Society Organizations Agency and other relevant bodies. See Proclamation No. 1113/2019, *supra* note 64, Arts. 71-76. The same goes to religious institutions where they are required to report their financial audit to the Ministry of Federal and Pastoral Development Affairs (now the Ministry of Peace). See በፌደራል አርብቶ አደር ልማት ጉዳዮች ሚኒስቴር የሃይማኖትና እምነት ድርጅቶች፣ማህበራትን ለመመዝገብ እና ተዛማጅ አገልግሎት ለመስጠት የወጣ፤ መመሪያ ቁጥር 1/2010 ዓ.ም. Art. 20 (5) (b) of this directive required religious institutions to report about the institutions they administered and the payment of relevant income taxes to the Ministry, in their annual financial audit report.

[70] See Proclamation No. 147/98, *supra* note 48, Art. 31 (1) (a).

[71] See Proclamation No. 979/2016, *supra* note 3, Art. 19 (3) and Regulation No. 410/2017, *supra* note 5, Art. 48.

[72] See Proclamation No. 983/2016, *supra* note 10, Art. 2 (5). There is an expression "… other body of persons *whether formed in Ethiopia or elsewhere*" (emphasis added).

[73] See Proclamation No. 979/2016, *supra* note 3, Arts. 5 (5) (b) and (6) (3).

below). Thus, the taxpayers of Schedule 'C' are sole proprietors and bodies,[74] whether commercial or non-commercial, who/which engages in business activities, as long as they are not exempted. They can also be residents or non-residents.[75] If they are residents of Ethiopia, they are expected to pay income tax on their Ethiopian and foreign source business income, while non-residents will be taxable units of the Schedule if they received Ethiopian source business income.[76]

2. Tax Bases of Schedule 'C'

2.1. Business

As long as we are talking about income tax, it is clear that the tax is to be imposed on an item of income considered as business income. However, before determining whether an item of income is business income it is important to determine whether the activity giving rise to the income is characterized as a business. The Proclamation itself stipulates that "…business income tax shall be imposed … on a person *conducting business* that has taxable income for the year" (emphasis added).[77] Thus, the tax base of Schedule 'C' is income derived from business. In the absence of a definition in the income tax law, the term "business" will have its ordinary meaning, under commercial laws.[78] The Proclamation prefers to define "business" for its own purpose. It defines

[74] The absence of definition for the term 'body' in the Proclamation itself may make the exact identification of body taxpayers of Schedule 'C' a bit difficult. Unlike the current Proclamation, the repealed income tax proclamation had its own definition of 'body' (see Art. 2 (2)). However, scholars were critical of having repetitive definition of terms, including 'body' in many tax proclamations, while the terms signify exact similar meanings. Thus, they recommended defining such terms, under a single statute and declaring their cross-border applicability. See, Taddese Lencho, The Ethiopian Tax System: Excesses and Gaps, *Michigan State International Law Review*, Vol. 20, No. 2, (2012), pp. 355-356. The recent legislations have bought this idea and terms applicable for all tax laws (unless the context otherwise requires) are defined under the Tax Administration Proclamation (see Art. 2 where a definition for 44 terms is provided). As a matter of principle, this author too is in favor of having a single definition of terms which are applicable to several types of taxes across the board. However, at the same time it may also better to adopt a contextualized definition of 'body' under the Income Tax Proclamation for certain exceptional circumstances that enable flexibility [to tax or not to tax certain 'bodies'].

[75] See Proclamation No. 979/2016, *supra* note 3, Art. 7 - Both residence and source are used to assume income tax jurisdiction where residents of Ethiopia are subject to tax with respect to their worldwide income; while, non-residents are subject to tax in Ethiopia only with respect to their Ethiopian source income.

[76] *Id*, Art. 6 (2) and (3) stipulated the instances when to say business income is Ethiopian source. Income derived from conducting business in otherwise instances, will be considered as foreign business income and if a resident taxpayer has paid tax to the other jurisdictions on this income, it can claim a tax credit under Art. 45 of the Proclamation.

[77] See *Id*, Art. 18 (1).

[78] See Burns and Krever, *supra* note 4, p.2. In broad terms, a business is a commercial or industrial activity of an independent nature undertaken for profit.

business with three alternative categories.[79] Of course, the main definition of business is the one provided under Art. 2 (2) (a) of the Proclamation. It reads "[b]usiness means any industrial, commercial, professional, or vocational activity conducted for profit and whether conducted continuously or short-term, but does not include the rendering of services as an employee or the rental of buildings." From this definition, the following points can be inferred.

First, it recognizes a wide range of activities as business, owing to its expression 'any industrial, commercial, professional, or vocational activity'. The expression 'professional activity' by itself is too broad, arising from the existence of numerous professions.[80] So, based on this definition, service of a professional is a business activity. Second, the motive of the activity is the core element of business, i.e., it must be conducted 'for profit'. The phrase 'for profit' gives rise to a number of controversies particularly with religious organizations and charitable institutions. These entities, especially religious organizations, believed that they can engage in profit-making activities (side to side their main philanthropic or spiritual activities), however, without paying business income tax.[81] For them, the phrase 'for profit' concerns only business entities, though the Tax Authority back then had the opposite stand; hence, they are compelled to pay tax.[82] This author believes that the latter's stand is appropriate, at least, from the view point of the law. The phrase 'for profit' is to mean whether a person engages in the activity with a view to generate profit or not. It is immaterial, for what purpose a person will use the profit derived from the activity. The characterization of the activity as business is more important than the identity of a person who derives the income. Of course, it is without forgetting part of their income exempted from income tax. As discussed above, Art. 65 (1) (m) of the Proclamation exempt 'related business income' of a non-

[79] See Proclamation No. 979/2016, *supra* note 3, Art. 2 (2).

[80] Though, there is no agreeable definition, in general, profession is conceived as a paid occupation, especially one that involves prolonged training and a formal qualification and a skill involved predominantly mental/intellectual, than physical/manual. In fact, such classical definitions of profession are being questioned. See for instance, Alan Tapper and Stephan Millett, 'Revisiting the Concept of a Profession: Conscience, Leadership and the Problem of 'Dirty Hands'', Research in Ethical Issues in Organizations, Vol. 13, (2015), pp. 1-18. In Ethiopia, professional association is recognized as one type of civil society organizations under Proclamation No. 1113/2019, *supra* note 64, Art. 2 (1); and the draft Civil Societies Organization Regulation (expected to be ratified in the near future), under Art. 7 (1) defines 'profession' as "… educational certificate issued by officially recognized educational institution confirming knowledge, experience or skill relating to a profession or a profession certified by relevant Government or authorized body."

[81] Taddese Lencho, The Ethiopian Income Tax System: Policy, Design and Practice, PhD thesis, University of Alabama, (2014), pp. 297-311. See also Belete Addis, Income Tax Privileges of Charities and Charity Giving in Ethiopia: A Critical Legal Analysis, LL.M thesis, Bahir Dar University, (2018), pp. 48-70.

[82] *Id.*

profit organization. However, the fact that the income is exempted should not be construed to mean, the entities were not engaged in the activity 'for profit'. The exemption is made with a view to reward their social objectives, but not with a view that the activity they engaged in was not business or a for profit activity.

Third, the phrase 'whether conducted continuously or short-term' indicates that for a certain activity to be considered as a business, the frequency of the activity is immaterial. Hence, for business income tax purpose 'regularity' is not a determining factor so that it is inclusive of undertakings which may be done at once or infrequently, keeping in mind the tax administering organs are able to reach them. Here, the case of informal traders can be raised.[83] Informal trading is prevalent in Ethiopia (especially in major cities), mainly due to the increasing of unemployment; weak law enforcement; and the cost of operating formally such as high tax burdens, expensiveness of business premise rents, bureaucratic hurdles and corruption.[84] The operators in this sector are not paying business income tax not because they are not taxable units of Schedule 'C', but because the system (the tax authorities and its administration) is unable to reach them.[85] Though it is the duty of the taxpayers themselves to file their tax declaration and pay the income tax within the period specified by the law,[86] there is very little chance (if not absent) that informal traders will comply with this duty. Since they are not as such in the reach or regulation of the government they face little sanctions for not complying. The fact that informal traders have no fixed/known place of business operations and engage in activities without making commercial registration and without getting business license, makes it difficult for the Tax Authority to trace and tax them. In fact the Commercial Registration and Licensing Proclamation prohibit engaging in any business activity, without first, being registered in commercial register and securing business license.[87]

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[83] Informal traders or informal trade practices, commonly, refers to trade practices characterized by operation of commercial activities without adhering to the required regulatory laws such as business registration and securing business license. They are not intrinsically unlawful/illegal since they are not producing and selling illegal products and services, but failed to adhere the regulatory laws while expected to do so; such as not filing taxes. See Diana Farrell, The Hidden Dangers of the Informal Economy, *the McKinsey Quarterly*, Number 3, (2004), p. 28.

[84] See Asmamaw Enquobahrie, Some Controversies on Informal Sector Operation in Ethiopia: Problems and Prospects for a Development Strategy, (2006), p.9, available at http://homepages.wmich.edu/~asefa/Conference%20and%20Seminar/Papers/2003%20papers/Enquobahirie,%20Asmamaw%20(delete).pdf last accessed on 12 May 2020.

[85] For details about the potential adverse impacts of this sector on the formal business sector, including by not paying tax; see Yibekal Tadesse, Informal Trade Practices in Light of objectives of the Ethiopian Trade Competition and Consumer Protection Law: An Appraisal of the Law and the Practice, LL.M thesis, Bahir Dar University, (2017), pp. 52-90.

[86] See Proclamation No. 979/2016, *supra* note 3, Arts. 83 (4) – (6) and 84 (2) – (4).

[87] See the Commercial Registration and Licensing Proclamation No. 980/2016, Federal *Negarit Gazzeta*, (2016), Arts. 5 (1) and 22 (1). [Hereinafter, Proclamation No. 980/2016]. Here we can see that informal

However, it should be underlined that the fulfillment of these conditions is immaterial for the purpose of taxation (i.e., they are not a prerequisite for taxation).To impose business income tax, the important factor is whether the activity is construed as a 'business' or not under the income tax laws, not whether the operator is issued with a business license or not.[88]

Fourth, the definition has explicit exclusions. Accordingly, the rendering of services as an employee and the rental of buildings are not considered as business. In fact, these activities are already subjected to Schedule 'A' and 'B', respectively. It has been mentioned that services of a professional is a business activity. However, the exclusion here is telling that it is not the activity of all professionals that fall under the ambit of business. If the service of a professional is rendered as an 'employee', it is not considered as business owing to its explicit exclusion. There are instances where the concept of business may overlap with the notion of employment for tax purposes when 'employment' is defined broadly under tax laws in a way that includes some independent contractor relationships (i.e., relationships that are within the ordinary meaning of business).[89] In such cases, it is recommended that the definition must be coordinated with the definition of business so that the same economic activity is not characterized as both a business and an employment for income tax purposes.[90] This could be achieved by providing that a business does not include an employment and this is what the Proclamation preferred to do. Therefore, Ethiopian income tax system does not regard employment as business. In this case, professional activities that are subject to Schedule 'C' are those being rendered as an independent contractor or self-employed individuals.[91] That is

traders are committing concurrent offenses: not paying tax and undertaking business activities without getting registered and licensed.

[88] Related to this, Taddese has mentioned one case decided by the Federal Supreme Court Cassation Division, where the Court underlined the distinction between "business" and "business license" and treat the latter as a mere regulatory tool, thus, held that a business could exist independently of a business license. See, Taddese, *supra* note 80, p. 388.

[89] See Burns and Krever, *supra* note 4, p.2.

[90] *Id.*

[91] For instance, lawyers provide consultancy services by opening their own offices. In fact, there is an ongoing debate as to whether or not it is proper to consider legal advocacy services, as business. While the government is insisting that it is, hence, advocates need to pay business income tax, the latter's and legal academicians commonly oppose this view invoking that it would adversely affect the integrity or core value of the profession, i.e., the main aim of the service may tend to be commercial than serving justice. Currently, they are paying business income tax as a category 'C' taxpayer. One of the highly controversy on Art. 5 of the earlier draft of the Commercial Code was the unqualified inclusion of all consultancy services to the list of trade activities. Agreeing to the inclusion of consultancy services in the list of trading activities, scholars forwarded their recommendations for its qualifications like: "Without prejudice to the specific laws and regulations governing the licensing, code of conduct and discipline of the respective professions, consultancy services…" See Tilahun and Taddese, *supra* note 65, p. 9. But, the final Draft of the Code, is not mentioning consultancy services at all under Art. 7,

why it is important to carefully characterize employee and independent contractors, as it has income tax implications; while the former is taxed under Schedule ‘A’ the latter is charged under Schedule ‘C’. Coming to rental of buildings, the current Proclamation, clearly affirmed that rental of buildings are not subject to Schedule ‘C’, despite the activity is being undertaken for profit and for that matter even if it is done by companies which are considered as always commercial.[92]

The second alternative definition of business provided under the Proclamation reads “any other activity recognized as trade under the Commercial Code.”[93] For the purpose of the Commercial Code, traders are persons who professionally and for gain carry on the activities listed under Art. 5.[94] So, any activity which may not fall with the domain of the above definition of business, could also be considered as ‘business’ as long as it is recognized as trade under the Commercial Code. However, it has to be noted that the Proclamation’s conception of ‘business’ is broader than the Commercial Code’s conception of ‘trade’. The Code understood trade in its narrow sense where it provides a list of specific activities considered as trade, while this is not the case for the Proclamation.[95] In addition, Art. 5 of the Code does not include many professional activities as trade and excludes vocational activities, such as handicraftsmen, even if they are being done for profit-making.[96] But, these exclusions are no more relevant for the Proclamation, since it includes professional and vocational activities as business without exception. Besides,

where it lists out activities considered as trade. However, after naming 11 activities, the provision has indications that other main categories not mentioned by name may be considered as trade provided it is determined by the law. See Arts. 7 (1) (l) and 7 (2) of the Draft). Consultancy services can be still considered as trade using this open-ended expression.

[92] See Proclamation No. 979/2016, *supra* note 3, Art. 2 (2) (c). To have a glimpse of why is this; readers are strongly advised to consult the first commentary- Belete, *supra* note 8, pp. 64-67.

[93] *Id*, Art. 2 (2) (b).

[94] Commercial Code, *supra* note 12, Art. 5. The reasons for cross refereeing to the Commercial Code is associated with the impossibility of exhausting all activities in the Proclamation and the fact that the Code is considered as the source for answers to the ultimate question of which activities should qualify as ‘trade’. See Taddese, *supra* note 80, p. 381.

[95] *Id*, Art. 5 listed 21 activities as trade. Whether this list is exhaustive or not was the subject of debate for a long time, though subsequent legislations and acts of the Ministry of Trade conclusively proved the list is illustrative. In this regard, Art. 7 of the draft Commercial Code explicitly adopted the ‘indicative approach’ since it allowed the inclusion of other activities (beyond those named specifically) as trade, provided it is determined by the law. Such laws can be the Commercial Registration laws or directives issued by Ministry of Trade like the Ethiopian Business Licensing Categories Directive No. 17/2019 – also known as the Ethiopian Standard Industrial Classification (ESIC). Once an activity is considered as trade or business, it will open up the way for income taxation of the activity.

[96] For the exclusions, see *Id*, Arts. 6 - 9. These exceptions are maintained under the current Draft Commercial Code with few modifications and one addition; special profession (ልዩ ሙያ). See, Arts. 9-13 of the Draft.

while 'regularity' of the activity is material under the Code this is not the case under the Proclamation.

The third alternative definition of business is "any activity, other than the rental of buildings, of a share company or private limited company whatever the objects of the company."[97] So, if the activity of the company is rental of buildings, it is not subject to Schedule 'C' (but Schedule 'B'), while the rest activity of companies are considered as 'business' irrespective of their objectives, i.e., it is immaterial whether the objective of the company is profit making or not. Thus, if someone wants to engage in non-profitable activities without paying business income tax, company is not a sound choice.[98] Under the Commercial Code too, SCs and PLCs are always regarded as commercial in nature whatever their objects are.[99] Though companies are always considered as commercial/business persons, if their activity is rental of buildings, they are excluded from business income tax and subjected to Schedule 'B'. This inversely is telling that business persons are not fully subject to Schedule 'C'. Even if the Proclamation does not consider rental of buildings as business, it does not mean that the undertakings are not business for other purposes: such as for the purpose of commercial registration and licensing or other regulatory purposes.[100] So, the definition of "business" under the Proclamation should be taken only for the purpose of income tax, not for all other purposes too.

From the reading of Art. 2 (2) of the Proclamation and other laws mentioned above (the Commercial Code and the Commercial Registration and Licensing Proclamation), it is clear that there are two cumulative requirements for a certain activity to be considered as 'business'. These are the activity test (type of activity) and the profit test (motive of the activity).[101] The activity test requires for the concerned activity to fall under the category of activities provided under the Proclamation. This simply means the activity must be capable of being

[97] See Proclamation No. 979/2016, *supra* note 3, Art. 2 (2) (c).

[98] Some jurisdictions recognize companies formed for non-commercial purposes (like charities), such as, 'company limited by guarantee', where the members guarantee the payment of certain amounts, usually nominal, if the company goes into insolvent liquidation, but otherwise they will have no economic rights in relation to the company. See Getahun Seifu, Revisiting Company Law with the Advent of Ethiopian Commodity Exchange (ECX): An Overview, *Mizan Law Review*, Vol. 4, No.1, (2010), p. 106.

[99] Commercial Code, *supra* note 12, Art. 10 (2) reads "[s]hare companies and private limited companies shall always be deemed to be of a commercial nature whatever their objects." The same is true under the Draft Commercial Code-Art. 14 (2).

[100] If we refer to the ESIC cited above, we can find rental of buildings in the listed business categories.

[101] See Taddese, *supra* note 80, p. 382. Taddese has made these notes based on the definition of 'businesses' under the repealed Income Tax Proclamation, but holds true for the current Proclamation too.

categorized under the expression of 'any industrial, commercial, professional or vocational activity; or any other activity recognized as trade under the Commercial Code; or any activities by companies apart from rental of buildings'. It is said that this expression is capable of including any human activity as a business.[102] But, the second requirement (the profit test), helps us narrow down the activities so that it can make sense. The phrases, 'conducted for profit' in the Proclamation and 'for gain' in the Commercial Code implied this test. Accordingly, any activity will be subject to Schedule 'C' only if it is undertaken with the intent to generate profit. This, of course, should only be taken as a rule since there can be exceptional circumstances. For instance, as stated above, companies are subject to business income tax even if their activity is not made for profit (unless the activity is the rental of buildings which is subject to Schedule 'B').

2.2. Business Income

A person conducting business will derive 'income', on which the tax under Schedule 'C' is to be imposed.[103] This refers to 'business income', the tax base of the Schedule 'C'. Thus, the characterization of an income as business income is important, especially in schedular income tax systems where it is common for separate taxes to be imposed on employment, business, and investment income.[104] Defining business income or providing the particular items of income that are considered as business income can be used as a way of characterization.[105] When it comes to the Proclamation, the definitional provision, Art. 2 (4), without defining 'business income' it simply cross refers to Art. 21. The cross-referred provision, most importantly, Art. 21 (1), provides the list of income categories which are considered as business income. First, "the gross amounts derived from the conduct of a business, including the gross proceeds from the disposal of trading stock and the gross fees for the provision of services."[106] The first part of this sentence uses a general and broad expression, where all income derived from the conduct of a business is considered as business income. Then, the second part of the sentence mentions two illustrations. One is the disposal of trading stock, which is about trade in goods. According to the Proclamation, trading stock includes: anything

[102] *Id*, p. 389. Proclamation No. 286/2002, *supra* note 36, Art. 2 (6), had similar expression.
[103] See Proclamation No. 979/2016, *supra* note 3, Art. 18 (1) that reads "…*business income tax* shall be imposed … on a person conducting business that has *taxable income* for the year" (emphasis added).
[104] Burns and Krever, *supra* note 4, p.2. Consequently, the characterization of an item of income determines which tax regime applies to it.
[105] *Id*, p. 3.
[106] See Proclamation No. 979/2016, *supra* note 3, Art. 21 (1) (a).

produced, manufactured, purchased, or otherwise acquired for manufacture, sale, or exchange; any raw materials or consumables used in a production or manufacturing process; or livestock, but not including animals used as beasts of burden or working beasts.[107] In general, trading stocks are goods which are the subject of sale by a business person (goods for sale), inputs of production (raw materials) or work and other current/consumable goods. Thus, the proceeds from the disposal of such goods are considered as business income. The other illustration is the provision of services which is about the trade in services. So, the fees derived from the supply of services are considered as business income.

The second category of business income is "a gain on disposal of a business asset."[108] In its ordinary meaning, disposal covers all situations in which the ownership of the asset changes.[109] In this regard, Art. 67 (1) of the Proclamation states that "[a] person disposes of an asset when the person has *sold, exchanged, or otherwise transferred legal title to the asset*, and *includes* when the asset is cancelled, redeemed, relinquished, destroyed, lost, expired, or surrendered" (emphasis added). The important factor to determine whether the transaction is disposal or not is the transfer of ownership of the asset from one person to another (the Amharic version of Art. 67 (1) says *"...በሀብቱ ላይ ያለውን የባሌበትነት ስም ሲያስተላልፍ ..."*). It is common and advisable to include any gains arising on the disposal of business assets as business income and the inclusion should be to all assets of a business and not just those used in the normal operations of the business.[110] This way, the concept of business asset should include not only assets physically used in, or held by the business, but also investment assets related to a business activity. This is the case under the Proclamation where 'business asset' is defined as "an asset held or used in the conduct of a business, wholly or partly, to derive business income."[111] Business assets are different from trading stocks because they are capital goods not current goods. These are, for instance, properties or machines that a business owns and uses but which it does not buy and sell as part of its regular trade. The gain from the disposal of such assets is considered as business income. To say there is gain from the disposal of a business asset, the amount by which the consideration for the disposal of the asset must exceed the net book value of the asset at the time of disposal.[112] However, where the business asset in question is also regarded by

[107] See *Id*, Art. 2 (24).
[108] *Id*, Art. 21 (1) (b).
[109] Burns and Krever, *supra* note 4, p.49.
[110] *Id*, p.7.
[111] See ProclamationNo. 979/2016, *supra* note 3, Art. 2 (3).
[112] *Id*, Art. 21 (3). At this juncture, we can notice one of the developments the current Proclamation has made. It dedicates separate provisions to explain the important accounting concepts, which are

the law as a taxable asset,[113] the gain which shall be considered as business income is the amount (if any) by which the cost of the asset exceeds the net book value of the asset at the time of disposal and any gain above the cost is taxable under Art. 59.[114] Thus, if business persons are transferring their business asset above the net book value of the asset[115] (but below the cost) it will be taxed under Schedule 'C'. But, if business persons dispose the asset above the cost, it will be capital gain and hence will be taxed under Schedule D. Here the gain is not necessarily to mean the profit rather the sales proceeds obtained from the business asset. The possible reason is that since the law deducts the costs of the business asset in the form of depreciation allowance;[116] if business persons are to sale the property, the proceeds will be part of business income.

The taxation of gains from a disposal of business assets indicates that the Proclamation recognizes not only the sale of inventory (trading stocks) or the provision of services that results in the realization of business income, but also sale of business assets. However, this recognition rule has exception in which the sale of business assets does not result in the recognition of income. Under the Proclamation, non-recognition results when assets are transferred in the context of corporate reorganization.[117] Thus, a gain derived from disposal of business asset done as part of corporate re-organization will not be considered as 'gain' taxable under Schedule 'C'. This allows businesses to engage in business reorganizations, such as mergers, without fear of income taxation. It has to be clear that the objective here is not to grant a tax exemption to the companies or shareholders involved, but to neutralize the tax consequences of the business

necessary to determine income tax liability, especially for a tax to be imposed on income derived from disposal of assets. The Proclamation, under Arts. 67 – 70, deals with acquisition of an asset, disposal of an asset, cost of an asset, net book value of a business asset and consideration for the disposal of an asset. Stipulating what kinds of transactions constitute disposal, what kind of expenses are considered as cost, and which payments are treated as consideration (the price received for the asset) has important significances, including to understand the tax to be imposed on a gain derived from the disposal of business assets. So, to meaningfully comprehend the taxation of disposal of business assets, readers are advised to go through these provisions.

[113] This refers to non-business capital assets (specifically immovable asset, shares and bonds) taxable under *Id*, Art. 59 (which founds under Schedule 'D'). The term 'taxable asset' is introduced by the current Proclamation. This may arise from the Proclamation's distinction of capital assets as business and non-business assets. A gain from the disposal of business capital assets is subject to Schedule 'C' (Art. 21 (1) (b)), hence, Art 59 concerns with non-business capital assets. Thus, if Art. 59 employed the term 'capital assets' it may found confusing since it does not tax all capital assets, but a specified non-business capital assets.

[114] *Id*, Art. 21 (4).

[115] Mathematically speaking; net book value of the asset is cost of an asset minus depreciation allowances. Cost of an asset does not include the allowed deductions, hence the value of the business asset is still not net, and then when the allowed deductions reduced, the value of the asset will become net.

[116] See ProclamationNo. 979/2016, *supra* note 3, Art. 25. See also, RegulationNo. 410/2017, *supra* note 5, Art. 36.

[117] *Id*, Art. 35.

reorganization, so that the reorganization involves neither a tax advantage nor a tax disadvantage.[118] During reorganizations, it will be considered as if the transferee has acquired the asset with a cost equal to the cost of the asset.[119] However, to have this effect the transfer has to meet the pre-conditions provided under Art. 35 of the Proclamation. To mention the basic ones: the transfer should be from a resident company to a resident company; the transfer should be made as part of reorganization and the Tax Authority shall be satisfied that the reorganization does not have a principal purpose of tax avoidance.[120]

Does the above category of "business income" (i.e., disposal of business assets) include a gain from the sale of business? The Commercial Code recognizes business as an intangible movable property.[121] It is also clearly stipulated that business is more than its constituent elements, such as the business assets.[122] Hence, business itself, as a type of asset, can be owned, leased, mortgaged, contributed to another business or disposed.[123] If business can be subjected to sale, separate of its elements, which income tax schedule charges the gain derived from this? A related question that should be asked (perhaps before the where to tax question) is; when to say business is sold? In this regard, it is important to notice that some elements of business are considered more essential than the others. The Commercial Code, clearly states that good will is the main part of business[124] and declares that sale of good will entails sale of business.[125] Even, Art 127 (2) of the Code, while listing the remaining constituent elements

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[118] See, Frans Vanistendael, Taxation of Corporate Reorganizations, *in* Victor Thuronyi (ed.), *Tax Law Design and Drafting*, Vol. 2, International Monetary Fund, 1998, p. 13. The principle of tax neutrality in business reorganization has two aspects: one, no tax is levied at the time of the reorganization and two after the reorganization, the taxable profits of the transferee company and its shareholders are calculated on the basis of tax elements that were present in the transferor company and its shares immediately before the reorganization.

[119] See Proclamation No. 979/2016, *supra* note 3, Art. 35 (1). This is done by deeming the taxpayer to have disposed of relevant property for consideration equal to its cost and to have reacquired the property (if there has been no actual disposal of assets) or to have acquired replacement property for consideration equal to the original cost. See Burns and Krever, *supra* note 4, p. 53.

[120] For tax avoidance schemes and the methods adopted to fight it, see *Id*, Arts. 78-80. The detailed rules setting conditions for tax-free reorganizations vary considerably from one country to another, but can be summarized in two basic conditions: continuity of business enterprise and continuity of shareholder interest. See Vanistendael, *supra* note 117, p. 14. In addition to these conditions Art. 35 of the Proclamation also requires the existence of 'a bona fide commercial or business purpose or the absence of tax avoidance'.

[121] Commercial Code, *supra* note 12, Art. 124. But, it is not as ordinary movable. We can infer this from the registration requirement imposed on transactions concerning business such as sale or hire. Besides, it is only mortgage attached to business, not pledge which is security with movable property. See Arts. 150 -209 of the same.

[122] *Id*, Arts. 127 (2) and 128.

[123] *Id*, Arts. 150-209.

[124] *Id*, Art. 127 (1).

[125] *Id*, Art. 159.

of business, use the word "may". This may be constructed to mean that business can be established only with good will. Therefore, a sale of business can be understood as referring to the sale of business in its totality or sale of the good will. Coming to the tax issue, it is good to note that sale of business is an exit from business.[126] Since Schedule 'C' is about income derived from "conducting business", it seems that it is not inclusive of a gain derived from sale of business. Hence, the above category of business income (Art. 21 (1) (b) of the Proclamation), concerns with a gain from the sale of elements of a business (business assets), not a gain from sale of business in its totality. If Schedule 'C' is not the place to tax a gain from sale of business, then under which Schedule will it be taxed? Considering business as investment/capital asset, it may be resorted to Art. 59 of the Proclamation, which deals with a gain from disposal of investment assets. However, this provision exhaustively listed assets subject to its taxation (i.e., immovable asset, a bond and a share). Thus, it is not inclusive of a gain from disposal the business itself.

The third category of business income is "any other amount included in business income of the taxpayer for the tax year under the Proclamation."[127] This indicates that the list under Art. 21 (1) of the Proclamation is not exhaustive. Thus, it is possible to include other amounts as business income provided that it is considered as such by the Proclamation. For instance, we can mention Art. 50 of the Proclamation, which, imposed business income tax (at the rate of 3% of the gross amount) on a non-resident conducting an international air transportation business and derived income for the carriage of passengers, livestock, mail, merchandise, or goods embarked or loaded in Ethiopia and destined for a place outside Ethiopia.[128] The contrary reading of Art. 27 of the Proclamation can also be considered for this purpose. This provision list downs automatic non-deductable expenditures and expenditures not deductible if they exceed a certain amount. If the expenditures are not going to be deducted or the amount exceed the deductable amount, they are going to be considered as business income. Besides the Proclamation, the Regulation has also additional tax bases of Schedule 'C'. Income from lease of business assets is one of them. Art. 22 of the Regulation reads "[i]ncome derived from the lease of a business, including goods, equipment, and buildings that are part of the normal operation

[126] Of course, it can be an entry to business for the buyer or may be for the seller if she is doing the sale to expand/change her business.

[127] See Proclamation No. 979/2016, *supra* note 3, Art. 21 (1) (c).

[128] This tax is not applicable to an amount that is exempt income; an amount derived in respect of a passenger who is in Ethiopia as a result of being in transit between two places outside Ethiopia and the transshipment of livestock, mail, merchandise, or goods. See *Id*, Art. 50 (2).

of a business, shall be taxable under Schedule 'C' of the Proclamation". This refers to buildings and other assets which are part of the business and handed over to the lessee (business owner) since they cannot be separated from the business. A gain from a foreign currency exchange is another income source recognized as business income under the Regulation.[129] A taxpayer may have foreign currency holdings as a consequence of engaging in international transactions such as receiving foreign currency as payment for services rendered or goods supplied or may acquire foreign currency to meet business expenditure or may keep foreign currency as a hedge against inflation or as an investment.[130] In each case, the foreign currency is an asset of the taxpayer so that a gain or a loss will accrue as the value of the foreign currency fluctuates relative to the local currency during the period in which the foreign currency is held. It is such transactions that are dealt under Art. 44 of the Regulation where it states a foreign currency exchange gain derived by a taxpayer shall be included in business income.[131]

Based on the above discussion, it is possible to conclude that business income tax is imposed on income, cash or in kind,[132] derived from business activities. It has to be underlined that business income is not limited to those discussed above. As stated above, while elaborating 'business income' Art. 21 (1) (a) of the Proclamation uses the expression "the gross amounts derived from the *conduct of a business, including* …" (emphasis added). It is after this inclusive statement, the Proclamation goes to the specific inclusion rule or explicitly mentions sources considered as business income. So, the specific types of income discussed above are illustrative examples of business income. Other income sources can also be considered as the same, so long as they are derived from the "conduct of business", though they are not explicitly mentioned under the Proclamation or the Regulation.[133] So, the baseline is whether the income in

[129] See Regulation No. 410/2017, *supra* note 5, Art. 44.

[130] See Burns and Krever, *supra* note 4, pp.28-31.

[131] Regulation No. 410/2017, *supra* note 5, Art. 44 (1). 'Foreign currency exchange gain' is defined as "a gain attributable to currency exchange rate fluctuations derived in respect of foreign currency transactions." See Art. 44 (6) (b) of the same.

[132] The word 'amount' (የገንዘብ መጠን) includes an amount in kind. See Proclamation No. 979/2016, *supra* note 3, Art. 2 (1).

[133] For instance, amounts received as consideration for accepting a restriction on the capacity to carry on business; amounts received as an inducement payment to enter into a contract or business arrangement; gifts received by a person in the context of a business relationship; recovery of amounts previously deducted as business expenses, including bad debt claims; and amounts received in respect of lost business profits under a policy of insurance or a contract for indemnity or as a result of a legal action are among the items considered as business income in various jurisdictions. See Burns and Krever, *supra* note 4, p.8. These sources may be taken as potential business income sources for Schedule 'C', so long as they are considered as income derived from "conducting business". This of course is without

question is derived from activities constituted as business or not; and whether the income in question is exempted or not since exempted income does not make the tax base of Schedule 'C' from the very beginning.[134] It should also be remembered that the income sources discussed above are the tax bases of Schedule 'C', not taxable business income. The Proclamation stipulates that taxable business income of a taxpayer can be known after the total business income of the taxpayer is reduced by the total deductions allowed.[135] Thus, there is a need to identify all the allowed deductions and made the deductions thereof from the gross business income of the taxpayer.[136] In addition, according to Art. 21 (2) of the Proclamation, exempt income is not considered as business income. In effect, unlike deductions, from the outset exempt income does not make part of the tax base of Schedule C'.[137]

2.3. Schedule 'C' *vis-a-vis* Other Income Tax Schedules

The fact that the current Proclamation dedicates a separate provision to define 'business income' or to provide income sources which are considered as 'business income' can be taken as an improvement. The repealed Income Tax Proclamation had imposed business income tax on "income realized from entrepreneurial activity", however, without clarity as to which income source constitute part of the income realized from entrepreneurial activity and which does not.[138] However, it does not mean that the existing Proclamation's characterization of business and business income has left no issue to talk about. In its nature, Schedule 'C' shares borders with other Schedules, which may increase the cases of overlap. As it has been seen, the Proclamation, in defining "business" includes professional and vocational activity, but excludes services of an employee. This means the rendering of services as an employee is not

forgetting the possible adverse impacts of not explicitly providing the tax bases under the law; it will hinder predictability or goes against the canon of certainty.

[134] See Proclamation No. 979/2016, *supra* note 3, Art. 21 (2).

[135] *Id*, Art. 20 (1).

[136] Schedule 'C' is known for its extensive deductions. The issues of deductions including deductible expenses, non-deductible expenses and depreciation allowances applicable for Schedule 'C' taxpayers are mainly dealt under *Id*, Arts. 22-33 and more extensively under Regulation No. 410/2017, *supra* note 5, Arts. 27-47.

[137] To this end, it is important to go through the lists of Schedule 'E' and find out the possible exemptions applicable to Schedule 'C' taxpayers. There is also floor exemption (the first 7, 200 birr) for individual taxpayers under Art. 19 (2) of Proclamation. There are also exemptions under other laws. For instance, income tax exemptions are provided for investors under the Investment Regulation No. 270/2012, Federal *Negarit Gazzeta*, (2012), Arts. 5-7. The draft Investment Regulation tabled for the Council of Ministers consideration (at the time of writing this work) has also similar treatments.

[138] See Proclamation No. 286/2002, *supra* note 36, Art. 17. Art. 24 was the only provision that addressed the issue of what income source to include in Schedule 'C', which was about a gain from transfer of business assets.

considered business, hence, subject to Schedule 'A'; while the rendering of services through other forms of relationships such as, as an 'independent contractor', is considered as business and subject to Schedule 'C'. Art. 2 (7) of the Proclamation, defines employee as "…an individual engaged … to perform services under the *direction and control* of another person, other than as an independent contractor …" (emphasis added); while Art. 2 (15) of the same defines independent contractor as "an individual engaged to perform services under an agreement by which the individual retains *substantial authority* to direct and control the manner in which the services are to be performed" (emphasis added). Though the two phrases in these provisions, "direction and control" and "substantial authority", are important to determine whether the relationship is an employment or independent contract, the income tax laws failed to set clear criteria for the phrases. Thus, the lack of clarity (to the required extent) as to the boundary between employment relationship and independent contract may open a door for overlap between the two Schedules.[139]

The Proclamation also excludes "rental of buildings" from the ambit of business, hence, the income derived from this activity shall not be considered as business income. However, this conclusion is incompatible with Art. 22 of the Regulation, according to which a lease of a building as part of the normal operation of a business is not subject to Schedule 'B', but Schedule 'C'. It should be noted that this provision is not inclusive of all buildings destined for conducting business, such as buildings rented out as a business premise. It only concerns with buildings which are part of the business and handed over to the lessee (the business owner) since they cannot be separated from the business. This can be the case, for instance, for undertakings where the rental of buildings is fully integrated into the other businesses, which are taxable under Schedule 'C' (e.g. hotel businesses). But, lease of buildings in other forms or other than rental of buildings which have become part of the business inseparably is subject to Schedule 'B'. Thus, aware of this distinction is important to appropriately characterize the income or to avoid possible overlap between the two Schedules.[140]

On a related note, it is important to distinguish between lease of a business and lease of business assets. It is not only assets which are considered as business asset,[141] but also business itself as a property can be a subject of lease.[142] The

[139] For the details in this regard, see Belete, *supra* note 8, pp. 46-48 and 53.
[140] For the details see, *Id*, 59 and 62.
[141] For instance, buildings can be leased as a business premise. See the Commercial Code, *supra* note 12, Arts. 142 - 147. Other movable assets such as machines or equipments can also be subjected to lease.

question here is whether the nature and scope of the lease under Art. 22 of the Regulation include both these separate leases? Seeing the title of the provision, "lease of business assets", it may be said that business lease is not a subject matter of Schedule 'C'. However, in the body part, the provision has the expression "…the lease of a business…", hence, business lease seems also to be included. In addition, if lease of business assets fall under Schedule 'C', for a stronger reason lease of a business will also fall under the same.[143] Even if the Commercial Code is clear in that business is more than its constituent elements including the lease right over the business premise,[144] there is a common misunderstanding about business and business premise. Whenever transactions, such as lease or sale, are made concerning the business premise, there is a tendency to consider as if the same has happened to the business. This seems the reason that the Federal Supreme Court Cassation Division in several occasions has entertained cases related to the confusion between business lease and lease of business premise.[145]

While undertaking their business activities, Schedule 'C' taxpayers may also derive income sources falling under Schedule 'D'. In such cases, they are not required to add these incomes in their Schedule 'C' income since these are subject to final taxes under Schedule 'D'.[146] But, this prescription alone may not avoid the characterization overlaps or difficulties. Schedule 'C' activities are responsible for generating many forms of income taxable under Schedule 'D'.

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[142] *Id*, Arts. 194 – 205. These provisions indicate that business as a property can be leased.

[143] This seems the position of the Regulation too, when it use the phrase 'lease of a business' under Art. 22. If so, the provision not only taxes business assets which are rented out together with the business/good will; but also the lease of good will or lease of the business assets together with the business. In the latter case, the lease will be treated as business lease, not lease of assets. Business lease is mainly about lease of good will, which can be made together with the business assets or not.

[144] See the Commercial Code, *supra* note 12, Arts. 127 (2) (c) and 151 (2).

[145] For instance, in one case, after declaring the divorce of the spouses, the lower court allowed the division of the business, owned by the divorcing spouses. However, the lesser (also owner) of the business premise (Gondar City *Arada Kebele* Administration) intervened and opposed the decision invoking that the divorcing spouses should not be allowed to take a property which they do not own. The Administration argued that the spouses have no ownership entitlement over the business. When this matter reached to the cassation bench (after the Amhara Regional Supreme Court decided that the divorcing spouses have no entitlement over the property in question); the Court decided that the concept of business is greater than the trading stocks and the building where the business is being operated. Citing Art. 127 (2) of the Commercial Code, the bench affirmed that business is separate from the lease right over the business premise. Rather business includes the rental rights a person has over the premise. The court then proclaimed that the ownership right of the *Kebele* Administration is over the business premise, not over the business. See ሀጂ ታጁ ለገሰና መሬም መሀመድ vs የጎንደር ከተማ ማዕከላዊ አራዳ ቀበሌ፤ ጠቅላይ ፍርድ ቤት ሰበር ሰሚ ችሎት፤ መ.ቁ 3760፤ 2000 ዓ.ም. See also ፀጋየ አማን ለጃ vs የካ ክ/ከተማ ወረዳ 08 አስተዳደር፤ ጠቅላይ ፍርድ ቤት ሰበር ሰሚ ችሎት፤ መ.ቁ 79561፤2006 ዓ.ም. In this case too, the cassation bench affirmed the separate existence of business lease and lease of a business premise.

[146] See Proclamation No. 979/2016, *supra* note 3, Art. 64 (2). It provides that tax paid under Schedule 'D' is final income tax regarding that income.

Among the income sources taxable under Schedule 'D'; dividends, windfall profit, undistributed profit and repatriated profit are solely results from Schedule 'C' business activities.[147] Business activities may also be regarded as the source for other income sources of Schedule 'D'.[148] This opens a room for possible overlaps between the two Schedules.

This may happen, for instance, between payments made for independent contractors (subjected to Schedule 'C') in one hand and management and technical fee on the other hand (which are subject to Art. 51 of Schedule 'D').[149] If someone independently performs managerial or technical services and received payments as a result: is it considered as business income or management/technical fee? We cannot use 'regularity' of the service as a factor to categorize the income as business income or management/technical fee, since it is immaterial for the Proclamation's conception of "business".[150] Management and technical fees are made taxable under Schedule 'D' only when derived by non-residents. Nowhere in the Proclamation are management and technical fee made taxable when received by residents of Ethiopia. This may opens a room for an argument in that when the fees are received by the latter, it will be considered as business income since these can fall under "professional activities", which are considered by the Proclamation as business unless given in the form of employment services; and when received by non-residents it shall be taxed under Schedule 'D'.

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[147] These income sources are defined in related with business. The relevant provisions of the Proclamation, governing these income sources, use either the term 'profit' which refers to income derived from business activities or 'business' or both. See *Id*, Arts. 2 (6) (which defined 'dividend' as "distribution of *profits*"); 60 (1) (states that "Windfall *profit* obtained from *businesses* …"); 61 (titled 'undistributed *profit*"); and 62 (1) (opened with the expression "A non-resident conducting *business* …") - (emphasis added).

[148] For instance, commercial banks derive 'interest' income from their banking business; granting loans to persons with an obligation to pay interest is one of the banking businesses. See the Banking Business Proclamation No. 592/2008, Federal *Negarit Gazeta*, (2008), Art. 2 (2) (b); and the Banking (Amendment) Proclamation No. 1159/2019, Federal *Negarit Gazeta*, (2019), Art. 2 (13). Publishing service of books, musical books and others is considered as one of the business categories per the Ethiopian Standard Industrial Classification (ESIC). These publishing businesses may derive 'royalty' income from copy right works they owned; when they allowed others to use it for consideration. They can be owner of copyright works in different occasions such as by financing the work or when only the publisher's name appears on the work (in in the absence of proof to the contrary). See the Copyright and Neighboring Rights Protection Proclamation No. 410/2004, Federal *Negarit Gazeta*, (2004), Arts. 21 (4) and 22 (3).

[149] ProclamationNo. 979/2016, *supra* note 3, Art. 2 (17) defines management fee as; "an amount as consideration for the rendering of any managerial or administrative service, but does not include employment income." Art. 2 (23) of the same also defines technical fee as; "a fee for technical, professional, or consultancy services, including a fee for the provision of services of technical or other personnel."

[150] See *Id*, Art. 2 (2) (a); in defining "business" it uses the expression "… whether conducted continuously or short-term …"

However, resident persons who obtained income from a rendering of technical service may be the subject of Schedule 'D' pursuant to Art. 63 (as "other income"). Art. 63 of the Proclamation is the comparable provision to Art 21 of the OECD and UN Model Conventions which attribute an exclusive taxing right to the state on items of income not covered by other distributive rules of the income tax law.[151] When there is difficulty in characterizing an income, this provision will be relevant.[152] Hence, unlike the repealed income tax laws, under the current Proclamation, not only the technical service fee of non-residents, but also the income of residents from technical service may be taxed under Schedule 'D'. Accordingly, a resident person who received an income from technical service can be taxed under Art. 63, if the income is not considered to be income from carrying on business, independent (professional) personal services or as an employment income[153] under the Proclamation. Moreover, it is good to notice that a non-resident who provides a technical service will be the subject of Schedule 'C' if a non-resident person provides the service with permanent establishment.[154] So, if a non-resident received any income sources from its permanent establishment in Ethiopia, it is not subject to the non-resident taxation of Art. 51. A non-resident doing business in Ethiopia through permanent establishment is subject to the other provisions of Schedule 'D' or 'C', as long as the income is attributable to this establishment. Thus it is important to distinguish between a non-resident and a non-resident having permanent establishment in Ethiopia.[155]

Difficulties may also arise with capital gain tax. As discussed above, a gain from disposal of a business asset is subject to Schedule 'C'. However, in case the business asset in question is also happened to be a taxable asset, the gain which

[151] See OECD Articles of the Model Convention with Respect to Taxes on Income and on Capital [as updated in 2017], Art. 21; and Articles of the United Nations Model Double Taxation Convention between Developed and Developing Countries, (2011), Art. 21.

[152] Proclamation No. 979/2016, *supra* note 3, Art. 63 reads "A person who derives any income that is not taxable under Schedule A, B, C, or the other Articles of this Schedule shall be liable for income tax at the rate of 15% on the gross amount of the income". There are, several income sources not explicitly provided with a Schedule or a provision to be taxed under, such as the proceeds from sale of business, raised above. So, this provision can be used as a last resort to tax such income sources. In the absence of Art. 63, the effect would have been exempting those income sources.

[153] Regarding employment income vs. management/technical fee, see Belete, *supra* note 8, pp. 55-56.

[154] See Proclamation No. 979/2016, *supra* note 3, Art 51(3). Permanent establishment is one of the grounds of assuming income tax jurisdiction in Ethiopia. For the details about permanent establishment, see Art. 4 of the same.

[155] Yet, the mere fact a person has a permanent establishment in Ethiopia is not a ground to exclude it from non-resident taxation. It is only if the income concerned is attributable to the permanent establishment, where in such cases, the other provisions of Schedule 'C' or 'D' that are applicable to a resident of Ethiopia will be equally applicable to a non-resident. Therefore, care must be taken in characterizing the income.

will be considered as business income is the amount by which the cost of the asset exceeds the net book value of the asset at the time of disposal and any gain above cost is taxable under Schedule 'D' (Art. 59).[156] Thus, the mere fact that it is a business asset does not necessarily mean the gain from its disposal is wholly subject to Schedule 'C'. Business assets are assets being held or used in conducting a business activity subject to Schedule 'C'. However, the assets taxable under Art. 59 are not assets held or used to conduct business at the time of their disposal. The person buying them may latter use them to conduct business or buy the assets to make them part of its business operation. But at the time of disposal they were not part of a business operation. Therefore, it needs a cautious tax administration, which can differentiate between taxable asset and business asset and also a careful calculation of the amount belongs to each Schedule.

The specific inclusion of 'income from lease of business assets', on the one hand, and the exclusion of 'income from casual rental of assets', on the other hand may also further complicate the scope of Schedule 'C'. Income from casual rental of assets is subject to Schedule 'D', as per Art. 58 of the Proclamation. Art. 50 of the Regulation tries to clarify this provision, by stating that income derived from 'casual rental of asset' means "gross income derived by a person who is not engaged in the regular business of rental of movable or immovable asset." It is not clear whether the phrase 'casual rental of asset' includes income from casual rental of business asset. In other words, the Regulation is not clear whether the fact that the regularity or causality of the lease would make any difference for business lease and lease of business assets (which are subject to Schedule 'C'). However, since Art. 50 of the Regulation is intended to clarify Art. 58 of the Proclamation (which is under Schedule 'D'), it is unlikely that it includes casual rental of business assets. Therefore, it can be concluded that any rental of business asset is subject to Schedule 'C', irrespective of the frequency of the lease. This way, we can mitigate the possible characterization conflict. Of course, other way outs may be considered such as the nature of Schedule 'D'. Under the Ethiopian income tax system, passive income sources and most irregular income sources are taxed under Schedule 'D'. So, even if the income from a casual rental of business assets is not taxed under Art. 58 as a casual rental of assets, it may be still taxed under Schedule 'D' as 'other income' per Art. 63.

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[156] See Proclamation No. 979/2016, *supra* note 3, Art. 21 (4). Meaning, if the sale is above the net book value but below the historical cost, it will be subject to Schedule 'C' and if the sale is above the net book value and again above the historical cost, it will be subject to Schedule 'D' as a capital gain.

The potential for overlaps or characterization difficulties between Schedules 'C' and 'D' may not be limited to the above cases. In this regard, it may be helpful to highlight some of the problems reflected in the previous income tax system and see if the current system is any better. For instance, characterization difficulties were claimed between business income and royalties, where, a publishing company was required to include income from the sale of books in its business income under Schedule 'C' and income from royalties from the sale of same books by others under Schedule 'D'.[157] This author believes that this practice is compatible with the spirit of the current Proclamation. Selling of books is a business for a publishing company, thus, the income from this activity is a business income taxable under Schedule 'C'. For others, who derive income from the books, for instance, if the author derives income from the sale of its own book, Schedule 'D' is appropriate - taxable under Art. 54, as royalty. It would be royalty for a publishing company if the payment is made to it because it allows others to use the book which a company has copy rights over.[158] Similar concern was also raised between business income and interest income. For instance, if a company derived 'interest income' from loans granted to other companies/businesses, the company was required to add this income with its Schedule 'C' income; while if the interest income was derived from deposits in a bank, this income was subjected to Schedule 'D' (and not required to be added as business income under Schedule 'C').[159] So, there was a need to identify the very source of the income to characterize it as business or interest income. The current Proclamation addressed this concern by subjecting all kinds of interest income to Schedule 'D', irrespective of the source it is derived from.[160]

[157] See Taddese, *supra* note 80, p. 372.

[158] Besides, the fact that the current Proclamation provides a list of payments that are considered as 'royalty' also mitigates this concern. See Proclamation No. 979/2016, *supra* note 3, Art. 2 (20). This provision tries to define 'royalty' as a periodic or lump sum payment made to use or to have a right to use the number of assets and rights listed under it [the provision]. Art. 2 (2) of the Copyright and Neighboring Rights Protection (Amendment) Proclamation No. 872/2014, Federal *Negarit Gazeta*,(2014), also defines royalty' as "fees payable to an owner of a work protected under this Proclamation by the user of such work for commercial purpose."

[159] See Proclamation No. 286/2002, *supra* note 36, Art. 36; and Art. 10 of the [repealed] Income Tax Regulation No. 78/2002, Federal *Negarit Gazeta*, (2002).

[160] See Proclamation No. 979/2016, *supra* note 3, Art. 56. At this point it is good to note that the method of explicitly including a certain item as business income may be used to give priority to the characterization of a particular item of income as business income where the income may also be characterized as investment income. For example, investment income usually includes interest income. However, where interest income is derived by a person in carrying on a business of banking or money lending, it is appropriate to treat the income as business income and not investment income. The same goes to interest income derived incidental to business operations. See Burns and Krever, *supra* note 4, p. 8.This was true under the previous income tax system where interest received by a Schedule 'C' taxpayer from loans to others as part of its business and interest derived by a non-resident financial institution from loans granted to Ethiopian resident business were taxable under Schedule 'C' as

Before closing this commentary, this author wants to remind readers that Schedule 'C' includes income from mining and petroleum operations. Though, these operations were subjected to separate income tax regimes for a long period of time,[161] the current income tax system merges them with the other business income sources, under Schedule 'C'. Since, both mining and petroleum operations are business activities; it is sound to subject them to a similar regime of business income tax. However, it is important to note that though they share the provisions of Schedule 'C' with other business activities subject to Schedule 'C', there are also a variety of treatments applicable only to the mining and petroleum operations (i.e., treatments not applicable to the other income sources of Schedule 'C'). Chapter four of the Proclamation (Arts. 36 - 44), is dedicated to provide special provisions applicable to the two operations. Accordingly, there are long lists of special definitions[162] and special rules concerning tax rates,[163] deductions,[164] and expenditures,[165] among other things. It is acceptable and also expected to have some special rules, owing to the special nature of the two operations.

Concluding Remarks

This work tried to examine issues relating to the characterization of taxable units and tax bases of Schedule 'C', which taxes business income. As revealed in the discussion, the current income tax system has made improvements that are helpful in identifying the taxpayers and the type of income sources subject to the Schedule. The relevant provisions are providing that the taxable units of business income tax are persons, both individuals and legal/bodies, conducting business. Body taxpayers constitute a wide range of entities, including non-commercial ones, as long as they are engaged in activities defined as business. The characterization of the activity as business is found more important than the

business income; while interest accruing from deposit accounts were taxable under Schedule 'D' as passive/investment income. However, currently the Proclamation taxes all kinds of interest income under Schedule 'D'. Though, this can ease the characterization process from an administrative point of view, its appropriateness of considering certain interest incomes which typically are business income, such as interest income derived by commercial banks from their lending activities, as passive/investment income may be questioned.

[161] See the Mining Income Tax Proclamation No. 53/1993, *Negarit Gazeta*, (1993); the Mining Income Tax (Amendment) Proclamation No. 23/1996, Federal *Negarit Gazeta*, (1996); and the Petroleum Operations Income Tax Proclamation No. 296/1986, *Negarit Gazeta*, (1986).

[162] Proclamation No. 979/2016, *supra* note 3, Art. 36, is dedicated to provide definitions (for 20 terms) only applicable to the mining and petroleum operations.

[163] *Id*, Art. 37. The rate is reduced to 25% than being 30% which is applicable to other body taxpayers.

[164] For instance, deduction is allowed for reinvestment, to the extent of 5% gross income (which is not allowed to the other business taxpayers of Schedule 'C'). See *Id*, Art. 42.

[165] There are the so-called exploration expenditure, development expenditure and rehabilitation expenditure which are unknown to the other taxpayers of Schedule 'C'. See *Id*, Arts. 39-41.

identity of a person who derives the income. Since there is no hard and fast rule to characterize business income tax payers, the important thing is to identify; one, whether someone or a certain entity is engaged in activities considered as business with a view to generate profit and two, whether the said entity is exempted or not. In terms of tax base, business income tax is imposed on income derived from conducting business activities. Besides, this catches all expression, the Proclamation goes on to list down the main income items considered as business income. Yet, the baseline is whether the income in question is derived from activities that are treated as business or not; and whether the income in question is exempted or not.

The work also raised questions regarding the appropriateness of the inclusion of certain taxpayers (and income sources) under Schedule 'C'. Partnerships are a notable example. For this, the work has tried to indicate the concerns involved and tried to shed a light on the jurisprudence and prevalent international experiences so that the relevant government organ can be aware of the issues and consider appropriate measures. This work has argued for a differential income tax treatment of partnerships, than the existing one. The same goes to small enterprises. This requires the reconsideration of the existing characterization. However, this author is not in a position to recommend the implementation of this proposal without careful analysis and consideration. By large, the work has made the discussions more with the aim of raising questions than to make statements, and in a spirit of seeking further understanding regarding the taxable units and tax bases of Schedule 'C'.

The tensions between Schedule 'C' and the other income tax Schedules is also highlighted.[166] For instance with Schedule 'A', the case of employee/employment income and independent contractor/business income is raised, which is the result of exclusion of employees from business income tax, however, without having clear parameters to distinct employee from independent contractor. The same exclusion is made regarding rental of buildings, which primarily are subjected to Schedule 'B'. Yet, this definitional exclusion is incompatible with the Regulation's prescription which subjects the lease of buildings as part of the normal operation of business to Schedule 'C' (than, Schedule 'B'). Hence, it needs a careful characterization. Schedule 'D' is

[166] Overlapping between income tax schedules is one of the disadvantages of a schedular income tax structure. See Lee Burns and Richard Krever, 'Individual Income Tax', *in* Victor Thuronyi (ed.), *Tax Law Design and Drafting*, International Monetary Fund, Vol. 1, (1996), p. 3. Thus, the work is not saying that the problem is peculiar to Ethiopia, but intends to give insights as to the possible tensions so that the concerned organs can be aware of them and if found practically problematic, to explore potential way outs.

dedicated to charge mainly irregular and passive income sources, most of which are derived by Schedule 'C' taxpayers while undertaking their business activities. Though, this cannot be a reason by itself, there are instances where potential characterization difficulties could be posed between the two Schedules. As a way out from these and other related problems, the work recommends for the enactment of supplementary directives/guidelines either by the Ministry of Revenue or Ministry of Finance. The latter may also issue public advance rulings which setting out its interpretation of the law, regarding the raised issues.[167]

[167] The Ministry of Finance is empowered to issue such rulings. See Proclamation No. 983/2016, *supra* note 10, Arts. 68-75. For details about advance rulings, see Taddese, *supra* note 73, pp. 365-369.