Taxation of Islamic Finance (IF) and Its Exposure to Tax Costs under Ethiopian Tax Law

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Abstract

The uncertainty of the rule applicable for the taxation of Islamic finance (IF) causes vulnerability to cumbersome tax cost or tax avoidance risks. Stakeholders blame Ethiopian tax law for the differential tax treatment of IF and conventional bank (CB), exposing beneficiaries of IF to intermediary taxes (twice stamp duty - on purchase and resale) in trade intermediation services, triple in sharia compliant bond (sukuk), and denial of the deduction of financial costs. An article aims to examine the tax treatment of IF returns, intermediary activity, exemption and the deductibility of financing costs for IF. It has utilized a doctrinal research design which is limited to the analysis of law, secondary sources and some primary data. Specifically, it uses a comparative qualitative approach drawing lessons from Malaysian, the UK and SA because such jurisdictions have experience regarding tax treatment of IF transactions. The finding indicates that the Ethiopian tax law is silent on deductible IF costs, intermediary activities and whether or not IF returns are subject to corporate income, dividend and interest income taxes. The 2016 tax law allows deduction of interest cost for CB loans and denies deduction of equity finance costs (dividend) exposing IF for cumbersome costs. Thus, the silence of tax law, lack of a playing tax field for IF and CB and the law's denial of deduction denial to IF expose latter to higher costs and unsustainability. Thus, the Ethiopian tax law needs to be revisited in light of the equal tax treatment of IF and CB.

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Introduction

IF is non-interest funding, investment and trade centered mobilization and provision of financial resource with consideration that encompasses (a) trade intermediation like *murabaha* (cost plus profit or sale of goods at spot delivery with deferred payment), *ijara* (financial lease that combines financier's and client's joint purchase and ownership, financing, lease of right and hire purchase), forward sale (spot payment with deferred delivery), (b) partnership bank involving mudarabah (loss bearing and profit sharing equity) and *musharaka*h (profit and loss sharing partnership); (c) Islamic security (*sukuk*) market, and (d) *sharia* compliant insurance that involves mudarabah, agency investment and combination of investment, trade and financing with the prohibition of interest, uncertainties, exploitation and other prohibited behaviors that harm humans.[1]

Although IF is broader, it is interchangeably used with Islamic bank (IB) which refers to a *sharia* law compliant intermediation approach whereby an entity mobilizes depositors' fund as an intermediator similar to CBs. However, it has the distinction that IFB (a) shares profits, risks and loss with the depositors' along with removal of interest, uncertainties and other injustices and (b) sale varieties (*murabaha*, *ijara*) deliver asset to customers instead of cash and financier bears risk.[2] An Islamic IFB is the financial intermediation that conducts usuary-free and *shari'ah* compliant banking

[1]M. Kabir Hassan and Mervyn K. Lewis, Handbook of Islamic Banking, Edward Elgar Publishing Limited, (2007), p. 277.

[2]Munawar Iqbal and Philip Molyneux, Thirty Years of Islamic Banking: History, Performance and Prospects, First Edition, Palgrave Macmillan, (2005), p.36.

business services involving capital and labor partnership for profit and loss sharing and trade intermediation.[3] Paradoxically, CBs intermediates surplus deposits of lenders and shortages of borrowers through trading in debt that involves interest, transfers of cash and risk from lender to borrower in a loan contract relation with the borrower's commitment to repay principal and interest.[4]

In both CB and IF, the taxpayers' profit and state tax motives contradict. The inherent natures (real activities of merchandise, investment, joint acquisition of asset to lease usufruct and sale residue) of IF lead to two potential problems. First, IF's incomes likely escape tax (non-taxability of products for religious character of services or subject to lower taxation (non-intermediary activities like gain from sale and lease of asset escape tax) because of the way one characterizes return and costs to claim better tax reliefs.[5] Second problem is IF's exposure to excessive property transfer, capital gain tax costs, denial of loss and business costs deductions due to compliance with religious requirements of performing the real activities, series of financier participation in investment and merchandise of commodities.[6]While tax escaping creates revenue loss, extra taxation makes IF more expensive than CB loans due to

[3]Rafeeq Yunus Al-Masri, Islamic Jurisprudence of Financial Transactions, Islamic Economics Institute, King Abdul-Aziz University (2001), p.290.

[4]Larisa Dragomir, European Prudential Banking Regulation and Supervision: The legal dimension, First edition, Routledge (2010), p.30.

[5]IFB incomes that escape taxation include murabaha discounted interest loan fringe benefit - a house finance provided by commercial bank of Ethiopia to an employee when the markup rate (only 7%) under the finance is less than the market lending rate under Art. 8 and 12 of Income Tax Regulation 410/2017. Financier's charging of only 7% markup profit amounts to typical tax avoidance, difficulty of distinguishing recovery of *ijara*-capital goods lease cost and income.

[6]Interview with Teshome Ragasa, Legal Officer of Awash Bank SC (March 30, 2024) and Yahia Abdulrahman, The Art of Islamic Banking and Finance: Tools and Techniques for Community-Based Banking, John Wiley & Sons, Inc., New Jersey, (2010), p.57-58.

costs to its consumers, depositors and financiers.[7] Such cost causes a reduction in the IFB's investors profits and diversion of IFB users to CB where transaction costs are lower.[8]Such unfavorable and costly tax treatment may result in a reduction of IFB competitiveness losing customers for CB.[9]Further, non-diverting religiously sensitive IFB beneficiaries are exposed to high tax costs.[10]Tax costs perpetuate less financial inclusion, reviving the legacy of financial marginalization due to the lack of alternative IF in Ethiopia.[11]Thus, both under taxation and over taxation of IF breach the principles of equity, certainty, neutrality and convenience of taxation.

Nations diverge on the tax treatment of corporations', individuals',, transactions', investments and trading gains and respective costs. The Malaysia, the UK and SA have IF suitable tax rules for IF , ensuring parity treatment with CB, relief on the deductibility of costs, exemption of intermediary transactions and returns equivalent to interest.[12]

Ethiopia's IFB window services (since 2008) and four banks (zamzam, Hijra, Shebale and Rammis) have introduced stand alone IFB since 2018. But state's legal uncertainties, silence and non-responsiveness to IF expose the

[7]Syeda Fahmida Habib, Fundamentals of Islamic Finance and Banking, John Wiley & Sons Ltd, (2018), p. 88.

[8]Interview with Semir Teka, Director of Legal DepArtment of Zamam Bank SC (March 30, 2024).

[9]Ragasa, *supra* note 5.

[10]Mohammad Tembu, Legal Affairs Director at Hijra Bank SC (August 26, 2023).

[11]Semir Teka *supra* note 8 and Abdu director of Islamic finance at Maxbridge Education Development Share Company (2022).

[12]Ercanbrack, Jonathan G, The Law of Islamic Finance in the United Kingdom: Legal Pluralism and Financial Competition, School of Oriental and African studies, (2011), p.264.

sector to prohibitive tax costs, making IF less favorable than CB.[13] IFB stakeholders complain about 'tax, lack of specific rules and other legal barriers as the impediments inhibiting them from diversifying the IF transactions.'[14] The existing tax legal framework remains uncertain, unclear and silent so far as Ethiopian tax laws do not fully contemplate the underlying nature of IF.[15] Such uncertainty either opens room for tax avoidance or gives the discretion to tax authority which may interpret the law to impose taxes on IF due to (a) its vulnerability to property transfer tax, stamp duty and intermediate transactions like financer's purchase of commodity for resale and the Islamic bond (special vehicle purpose-SVP) buyer who purchases commodities or instruments to get profits from deals and (b) IF's stranger character hardly known to stakeholders who are exposed to risk of multiple costly tax.

Moreover, the means of separating of capital (financier's intermediary purchase from supplier and resale to client) and the repayment which customers pay to financier each year in IFB's asset finance is unclear in determination of taxable profit. As a result, banks and savers incomes may escape tax due to rule that suits nature; or capital, transactions and incomes could be subject to extra tax in Ethiopia. Furthermore, the Ethiopian tax laws' silence on the fate of taxability or otherwise of intermediary – special purpose vehicle's (SPV) transaction is also one of the uncertainties that question sustainability of IF. An uncertainty also exists in relation to deductibility of IFB loss in profit and loss sharing scheme, markup for customers and equity

[13] Interview with Nuri Husen, Vice President at Commercial Bank of Ethiopia-CBE Noor (August 5, 2023).

[14] Mohammad Tembu, *supra* note 10 and Eristu Kemal, Head of finance and investment division, Zamzam Bank SC (July 15, 2022).

[15] Zamzam Bank, Strengthening the Legal & Regulatory Frameworks of the IFB Business in Ethiopia (2022), p.13-14.

(mudarabah investment deposit cost of finance for financiers), demarcation of taxable and non-taxable payments for IF as compared to CF.

Although IF is pressing issue for banks and affects 34% of Ethiopia population, its taxation obstacle and related costs hardly got policy makers' priority since none of policy makers address IF prohibitive tax costs.[16]Thus, tax laws' non-responsiveness to IF's unique characters, its exposure to tax costs and intermediary transactions might hinder alternative IFB, financial inclusion and competitiveness of IF than CB.[17]

The article aims to examine the tax treatment of IF under Ethiopian Law. It studies the law's suitability for the taxation of trade intermediation business, capital gain and cost deduction for IF. It also examines the taxation treatment of lease payment, deductibility or otherwise of finance cost for IF and the existence of Ethiopian tax rules that suit the inherent nature of IF.

In doing so, the article has utilized a doctrinal approach which is limited to the analysis of law, secondary sources and interview data on the taxation of IF in Ethiopia. Specifically, it uses a comparative qualitative method taking lesson from Malaysian, the UK and South Africa (SA) due to their adoption of a dual bank system similar to Ethiopia and having better experience or substantial tax laws for the taxation of IF system. The study has confined to intermediary taxes on the transfer of asset (real estate, movable property, and stamp duty), IF income taxes payable by bodies and individuals for IFB sales, Islamic bond incomes and respective deductible costs compared to counter transactions in CB income. Article excludes VAT, TOT and transnational business tax because such taxes are eligibility for tax exemption and to avoid

[16]Interview with Ali Idris Ministry of Finance Officer (April 23, 2024) and Mohammad Kadir, Ministry of Revenue officer (April 15, 2024).

[17]Zamzam Bank, *supra* note 15.

the broadness of the work This Article argues for introducing neutral tax rules applicable for the taxation of IF incomes, reliefs of costs and intermediary activities to eliminate both costly tax impediment and non-taxation of IF incomes.

1. Nature of IF and Intermediation Taxation Foundations

1.1. Nature of IF

Islamic finance (IF) is the provision of non-interest bank, commodity backed intermediation, acquisition of fund for personal, joint project by two financiers, entrepreneurs and financiers for the production and distribution of goods or services to share profits and losses according to *sharia* principles.[18]It involves asset merchandise, leasing usufruct and investment intermediary partnership banking that subject to *sharia* commercial principles.[19]IF also entails *sharia* compliant capital market, microfinance service, insurance system, and IFB transactions whereby return free, commercial (financier engagement in asset merchandise disclosing cost of acquisition and profit), agency investment on behalf of owners or depositors for return and profit-and-loss sharing principles which are the base for financial asset mobilization and allocation among depositors, investors and entrepreneurs.[20] The profit and loss sharing models involve mudaraba (trust financing where only one partner provides the capital, and *musharaka* (partnership finance where both partners contribute the capital).[21]Thus, IF encompasses trade intermediation,

[18]M. Kabir Hassan and Mervyn K. Lewis *supra* note 1.

[19]Hassan and Lewis, *supra*note 1, Iqbal and Molyneux, *supra* note 2, and Abdulrahman *supra* note 5.

[20]Hatem Elliesie, Approaches to Islamic Financing and Banking: Between Islamic Legal Theory and Economic Practice, 20 Y.B. Islamic & Middle E. L. 204 (2018-2019). p.210.

[21]Id.

partnership of capital and work, investment agency, mixture of trade and investment, asset lease and finance characters unlike CB loans.[22]

IF has several inherent characteristics that establish *sharia* compliance. First, it centers on the inseparability of the bank's financial asset and real commodity or service acquisition by customers - all financial transactions are representative of real transactions.[23]Second, it centers on the prohibition of (interest, injustice, exploitation, risk transfer to borrower) and the permissibility of trade and investment as bank business which enables the bank to engage in (a) merchandise of assets and services for profit and (b) investment in real economy participating in equity ownership and profit and loss sharing.[24]Third, it relies on the inseparability IF business from sharing return, risk, effort and contribution.[25]Fourth it promotes the bank's inseparability from morality (utmost good faith of management, disclosure of acquisition cost and profits), benefits of the community (restriction of financing to permissible domains, useful projects) and compliance with the standards of *sharia*.[26]Thus, IF is mainly characterized by recognition of *sharia* compliant trade (asset purchase and resale at a disclosed price on credit sale) and investment for sharing contribution, effort, profit and risk as a bank. Such inherent natures of IF necessitate additional *sharia* requirements-intermediary activities which expose IF to extra tax costs.

1.2. Foundations of Intermediation Taxation

1.2.1. Feature of Good Tax System

[22]Munawar Iqbal and Philip Molyneux, *supra* note 2.
[23]M. Kabir Hassan and Mervyn K. Lewis, *supra* note 1 p, 279.
[24]Zamir Iqbal and Abbas Mirakhor, Introduction to Islamic Finance: Theory and Practice, (2nd Edition John Wiley & Sons Pte. Ltd 2011), p.158-161.
[25]Muhammad Ayub, Islamic Finance, (John Wiley & Sons Ltd 2007), p. 81.
[26] M. Kabir Hassan and Mervyn K. Lewis, *supra* note 1, p.84.

The good tax system is characterized by the following fundamental features which are significant for IF business too. First is sufficiency of revenue generation for financing public services.[27]Second is fair allocation of tax burden between persons, income and transactions consistent with norms of fairness (correlation of tax burden with benefits of a taxpayer and ability to pay).[28]Third is tax revenue's utilization only for lawful public purposes and welfare of taxpayers.[29] A Good tax system also entails simplicity (clarity and lower tax costs), convenient, certainty of rules applicable to payers, reasonable exemptions, non-taxation of capital, neutrality to economic activity and avoidance of double tax.[30]

A tax system is good for the financial system if it meets three main criteria. The first requirement is the minimization of tax distortions (tax law does not affect credit, deposit, business, investment in activity or operator via disintermediation).[31] The second requirement is tax system's equity for the rectification of distortions resulting from cost deduction or its denial, imperfect and asymmetric information and uniformity of allowance and exemptions for incomes.[32]Third, its neutrality to (a) capital inflow and outflow has the same standards for the treatment of onshore and offshore financial intermediaries – elimination of different marginal costs between different jurisdictions and (b) residents, non-residents, transactions, income

[27]OECD, Addressing the Tax Challenges of the Digital Economy, (2014).
[28]Taddese Lencho, The Ethiopian Income Tax System: Policy, Design and Practice, PhD Dissertation Tuscalosa, Alabama, (2014), p.131.
[29]Id.
[30]Hossein Askari Zamir, etal, Introduction to Islamic Economics Theory and Application, John Wiley & Sons Singapore Pte. Ltd, (2015), p.135.
[31]Matt Grudnoff, Principles of a Good Tax Evaluating our Taxation Choices, Australian Institute (2021), p.6-8 available at https://australiainstitute.org.au/wp-content/uploads/2021/07/Principles-of-a-good-tax.
[32]Freudenberg Brett and Nathie Mahmood, infra note 57, p.16.

and gains of depositors and businesses and expenses deduction ensuring neither item escapes the tax nor is subject to higher or lower tax.[33]

States have several approaches regarding the fiscal treatment of financial intermediation. The first is the tax law imposition of express taxes similar to real economy (finance subjection to income and withholding tax when receiving of paying interest or dividends, taxation of transfer of property) prioritizing revenue over other considerations.[34] Intermediary taxation involves deduction of expenses and loss plus exemption from sales taxes on account of: avoiding distortion of taxing intermediary characterization of financial activity, existence of technical difficulties in distinguishing costs and profits or pricing the service charges in intermediation and denial of costs deductions.[35]

The third is imposition of reserve requirements like a certain fraction of banks' deposits or capital in the form of liquid reserves in cash and designated government securities which are sold to banks or financial intermediaries who earn taxable interest via lending to state to enhance financial position of central bank – government.[36]Fourth, the government diverts fund of intermediaries' to public strategic sectors and borrowers who use it for manufacturing via interest rate regulations, incentives and subsidies functional to the intermediary deposit mobilized to allocate financial asset to the prioritized real economic sectors.[37]

[33]The International Bank for Reconstruction and Development (IBRD), Taxation of Financial Intermediation Theory and Practice for Emerging Economies, The World Bank 1818 H Street, NW (2003), p.6.
[34]Id, p.6-7.
[35]Id and Taddese Lencho, *supra* note 28.
[36]Id and Matt Grudnoff, *supra* note 31.
[37]Id, p.6, and Matt Grudnoff, *supra* note 31.

The financial sector's income taxability, exemption and deductibility of its cost rely on considerations including sector's vulnerability for tax arbitrage, exemption of difficult incomes and intermediary transactions.[38] However, it is not clear whether Ethiopian tax law is (a) friendly to IF which allows taxation of capital and deductibility of almsgiving cost, (b) neutral to IFB's character of trading and investment and CB's loan, and (c) suitable to eliminate double stamp duty and asset transfer tax imposition on intermediary activity.

1.2.2. The Principles of Taxing Financial Intermediary

There are different principles that guide the legislations on the taxation of financial intermediation. First, ability-to-pay principle correlates incomes and equitable distribution of the tax burden across individuals, firms and activities.[39]It permits deduction of costs and allowance of exemption for essential services.[40] Second, economic efficiency principle entails maximum tax benefits with lower tax costs and distortion in allocation of tax burden.[41]Third, principle of neutrality encompasses tax law impartiality and equal application to transactions and income.[42]

Fourth, taxation centers on the principle of legality (representation for making tax law, firm legal basis for tax law making and administration, non-delegation of tax law making and its restricted and doubtful interpretation in

[38]Id, p.7-50, Freudenberg Brett and Nathie Mahmood, infra note 57, p.16.
[39]Brian J. Arnold, International Tax Primer, Kluwer Law International BV, The Netherlands (2016) p.1-10.
[40]Federal Income Tax Proclamation (FITP) Number 979/2016, Federal *Negarit* Gazetta, (2016), Article 9; Income Tax Regulation 410/2017 (ITR), Federal *Negarit* Gazetta, Art.27 and FITP Deductible Expenses Directive No. 5/2018.
[41]FITP Art.7 and Patrick Honohan, Taxation of Financial Intermediation: Theory and Practice for Emerging Economies, The World Bank, (2003), p.57.
[42]Matt Grudnoff, *supra* note 31, p.6-7.

favor of the taxpayer.[43] Sixth is the prohibition of unfair advantage in tax administration and its law application by partial court.[44]Adam Smith's principles of taxation are summarized as (a) equality - tax payments should be proportional to income and applied equally to all concerned areas; (b) certainty- tax liabilities should be clear and certainly known; (c) convenience of payment - taxes should be collected at a time and in a manner convenient for taxpayer and (d) economy-taxes should not be expensive to collect and should not discourage business.[45]

The Article argues for neutral tax treatment of CB and IF i.e. both subjection to similar tax rate, rules, allowance of cost and loss deduction principles which intend to restrain state taxing power.

1.2.3. The Considerations for Parity and Differential Tax Treatment of IF and CB

The argument for equal or differential tax treatment has several conceptual considerations. Primarily, Economic Substance Doctrine (ESD) holds that tax law (a) requires the transactions under question must have economic essence (feature) separate and distinct from economic benefit achieved solely by tax reduction for getting differential tax treatment; (b) allows the legislature to ignore disguised formality divergence of transaction and rely merely on inherent nature of the transaction for attribution of tax to activity or

[43]Victor Thuronyi, Tax Law Design and Drafting, volume 1; International Monetary Fund: Chapter 2, Legal Framework for Taxation, (1996), p.1-56 and Kassim Kufa, Nexus of Sustainable Development and Tax Laws and Policies under Ethiopian Tax System, The International Journal of Business & Management (ISSN 2321–8916) Vol.5 Issue 10 (2017), p.4.

[44]Id.

[45]Emile Woolf International, Principles of Taxation, The Institute of ChArtered Accountants of Pakistan (2016), p.5.

income.[46]ESD is concept that permits the taxing authorities to disregard the tax consequences of an arrangement, transaction or series of IFB transactions (sales) that nominally meets the tax code requirements due to non-satisfaction of actual economic activity's character.[47]

In other words, the transaction sufficiently satisfies the ESD and acquires similar tax benefits (deduction of costs, recognition of loss as expenses and claim for tax exemptions) only if the taxpayer proves that (a) the transaction transforms the taxpayer's economic position significantly other than tax reduction, and/or (b) taxpayer's substantial non-tax economic purpose for entering into such transaction.[48]Contrary to this, the disguised and distortive transaction with mere tax avoidance and deceptive business motives lack elements of ESD and result in denial of tax benefits: lower tax rates, exemptions, expenses and loss deductions.

The essence of ESD is that existence or absence of substantially similar transactions; change in economic position of tax payer and non-tax avoidance goal of taxpayer determine the eligibility for application of the same or differential tax law reliefs: exemption, tax cost and loss deduction advantages for CB and IF. Thus, ESD has two implications: capability of recognizing similar or differential tax treatment for income or activity that satisfies ESD and denying tax benefits to disguised transactions, understatement of profits and overstatement of expenses of taxation.

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[46]Thabo Legwaila, The Substance Over Form Doctrine in Taxation: The Application of the Doctrine after the Judgment in Commissioner for the South African Revenue Service v NWK Ltd, SA Mercantile Law Journal Vol. 28, No.1, (2016), Tareq Moqbel, The UK Islamic Finance Taxation Framework and the Substance v Form Debate in Islamic Finance, 18 LEGAL Ethics 84 (2015).

[47]Bruce Fort. *Et al*, State Economic Substance Doctrine: The Role of the Economic Substance Doctrine in State Business Tax Compliance, Multistate Tax Commission, (2019).

[48]Id.

Secondly, the legal form of the transaction determines the tax treatment of income, activity and deductibility or otherwise of costs of business. It holds that the form of the transaction has to be taken into account to determine the tax treatment of transactions i.e. legal arrangement (artificial form of structure) is prioritized over economic substance to decide tax treatment of activity.[49] Hence, different tax law treatment should be provided for financial transactions with diverging form despite the similarity of economic substance and its harms for taxpayers. This has limitation of breaching the principle of equity and creates room for tax arbitrages.

The third consideration is the business purpose doctrine which entails a subjective parameter to know whether the taxpayer has a vital autonomous non-tax avoidance objective to get tax benefits of transactions.[50] Although this supplements ESD, it has drawbacks of distinguishing motives of the taxpayer.

From these considerations the EDS is preferred for its compatibility with the principle of equality, equity and neutrality that promote charging equals equally and unequals unequally with neutral tax law that applies the principle of substantive and procedural equity that suggests similar and differential tax treatment of IF and CB transactions and incomes based on the rule of reason. IF satisfies the ESD to be eligible to get similar tax law treatment or benefits provided to CB loans and certain differential treatments that suits its nature.[51]

But use of legal form of transactions (sale, lease, investment) impose more tax on IF and result in different outcomes leading to violation of the principle of

[49]Id.

[50]Thabo Legwaila, *supra* note 46 and Jonathan G, *supra* note 7.

[51]Jonathan G *supra* note 7 and Qatar Financial Center (QFC), Cross border taxation of IF in MENA region (2013).

equity due to application different tax laws for CB and IF forms.[52]This contradicts the equity principle that provides equal tax treatment of equals and unequal treatment of different persons and transactions.[53]Thus, non-EDS approach opens the room for more favorable treatment of CB and less treatment for IFB of finance despite similarity of activity.

1.2.4. Rationale for IF Vulnerability to Cumbersome Tax Costs

The inherent nature of IF including: the commodity sale, investment, right ownership and its trade intermediary required for *sharia* compliance of IF expose it to costly taxes.[54] The double transfer of assets creates double intermediary asset transfer taxes (on purchase and resale), increasing costs and reducing the competitiveness of IF.[55] This arises from the difficulty of: (a) separation of taxable incomes and supplementary activity (underlying intermediary transaction), (b) characterization of IFB trade related return and corporate income under schedular Ethiopian income tax system, (c) distinguishing tax free capital and taxable: capital gain, lease rent, mark up in lease finance, etc. which create IF's vulnerability to costly tax.[56]Besides, the involvement of IF's intermediation activities and associated costs incurred for ensuring *sharia* compliance of IF create concerns of taxing such activities by tax authorities which may refuse deductibility of such costs to IF.[57]

[52]Bruce Fort, *supra* note 47.
[53]Nicholas Jessop, Taxation of Islamic Finance in the UK: An Introduction, 8 J. TAX'n FIN. Products 17 (2009).
[54]Jonathan G *supra* note 7.
[55]Maria Bhatti, Taxation Treatment of Islamic Finance Products in Australia, 20 DEAKIN L. REV. 263 (2015).
[56]Id.
[57]Freudenberg Brett and Nathie Mahmood, The Constitution and Islam: Are Tax Reforms Possible to Facilitate Islamic Finance?, Revenue Law Journal: Vol. 20 : Iss. 1 , Article 5 (2011) http://epublications.bond.edu.au/rlj/vol20/iss1/5 (accessed February 25, 2024).

Furthermore, IF is exposed to legal risk of regarding the rule for the recognition of loss and its deductibility as cost by tax law due to its subjection to the principle of loss sharing.[58]These pose challenges to tax law to handle tax issues related to IF. Ethiopian IF sector is not immune from these inherent vulnerabilities of IF's transactions to cumbersome taxes and the challenges they pose to tax law. As a remedy the nations exercise taxing powers to adapt IF friendly tax rule for reducing transaction costs for IF via (a) extension of tax rules applicable to CF on taxation of (income, interest, etc); deduction of expenses and losses; (b) designing special rules for disregarding underlying – intermediary transactions of IF that produce costly tax; (c) the rule for separation of recovery of non-taxable capital and taxable gains in IF products to prevent less competitiveness of IF.[59]

Ethiopia also needs to reform its tax law for accommodation of IF for a several reasons. Primarily, Ethiopia needs to achieve national economic growth – benefits (foreign capital, jobs, innovation, prevention of tax revenue loss, product diversification and choice) which benefits not only Muslims but also all society from 200 billion business since IF would finance housing, education, business, health, unemployment, etc. of market, individuals and companies via alternative finance.[60]The failure to reform tax law amounts to the denial of access to good financial services and results in diversion of foreign IF asset and services to other IF friendly taxing jurisdictions.[61] Beside this, an inclusion of residents who neither invest asset in CB nor consume its services necessitates tax law change.

[58]Maria Bhatti, *supra* note 55.
[59]Id and Freudenberg Brett and Nathie Mahmood, *supra* note 57, p.34.
[60]Id, Zamzam Bank *supra* note 5 and Nuri Husen *supra* note 13.
[61]Freudenberg Brett and Nathie Mahmood, *supra* note 57, p.35.

The right to choice and the legality of any form of finance (including IF) from whatever ideology requires reforming every institution, practice and policy including tax law that imposes cumbersome tax costs on IF for ensuring compatibility of new bank's approach allowing IF and pre-existing tax rules which should correct defects and uncertainties on taxing IF.[62] The tax law reform for removing impediment to IFB is consistent with 1995 FDRE constitution that promotes financial inclusion and citizens' equality to financial rights irrespective of their ideology.

The second reason is to create the equitable working environment for CB (debt finance) and IF (equity finance and trade intermediation) alternative services compatible with constitutional principle of facilitating equal economic opportunity and the systems for all including favorable tax facilitating fair share.[63] The achievement of neutrality, non-discriminatory and equitable economic outcomes for IF and CB transactions and participants in tax is other reason.

Thirdly, tax law neutrality to IF has regulatory (revenue administration procedural and substantive consistency) and political (legislative consent for imposition of tax or relieving IF from tax) considerations - incorporation of ideologies, religions and faiths of different groups and peoples in law including taxation cost because tax law should not differentiate different religious groups and their business financing.[64]

Fourthly, more diversification of IF services ranging from *murabaha* (cost plus markup), lease, forward sale, manufacturing, partnership and *sukuk*

[62]Halefom Awet, Interest-Free Banking and Taxation in Ethiopia: A Critical Analysis, Jimma University Journal of Law 11, 2019, pp. 32-54.
[63]Robert W. McGee, The Philosophy of Taxation and Public Finance, Kluwer Academic Publishers (2004), p.15-32.
[64]Id, p.263.

investment finances and respective incomes require tax reform that clarifies uncertainty remained on rule of their taxation. Below article examines approaches to avoid costly taxes against IF.

2. Selected Jurisdictions' Tax Treatment of IF

Two approaches exist to tax IF. These encompass non-modified use of tax legislation applicable for CB for IFB transactions such as trade related services (the same law applies for taxing all residents and transactions)[65] and accommodative revision of tax law for difficult IF services like Islamic bond transactions (introducing special tax rule that suit nature of IF).[66]

2.1. United Kingdom (UK)

a/ Level Playing Field for IF and CF

In the UK the same tax law applies for taxing (a) all residents and bank services (b) individuals and companies with the freedom of forming any *sharia* compliant or otherwise finance institutions without contradicting UK law.[67]UK tax law adopts (a) the principle of tax neutrality - equal treatment of CB and IF (b) detail abstract principles in legislation entailing religiously neutral expressions like 'alternative banking, financial instruments, investment bonds and financial arrangement clauses instead of *Arabic* terms in various Taxation Acts; (c) a universalistic approach to the law which focuses on the equal legal treatment of residents' capital or business for refraining from taking legislative positions on identity driven bank model; (d)

[65]Abdul Karim Aldohni, The Legal and Regulatory Aspects of Islamic Banking A comparative look at the United Kingdom and Malaysia, Routledge, (2011), p.108-111.
[66]Irish Tax and Customs, Tax Treatment of Islamic Financial Transactions, (2022), p 30-31.
[67]Id.

elimination of differential treatment of debt and equity finance model to create level playing field that prevents IFB's competitive position distortion by partial tax rules.[68]Thus, UK law provides equal tax treatment to IF and CB without express recognition of Islamic commercial principles and defining of IF words in tax laws because the definition of transaction is entirely free standing and same tax treatment is provided to any transactions (including IF).[69]

Two statutes incorporate the neutrality of tax rules by defining finance arrangement eligible for tax benefit without connecting to *Sharia* compliance. Primarily, UK Corporation Tax Act (CTA) 2009 Sec.503 defines trade related IF including *murabaha* using neutral terminology including (a) purchase and resale arrangements (b) first purchaser and second purchaser which either of them or both should be financial institutions, (c) first purchaser buys asset as financial institution for the purpose of intermediation and immediately sells it to second purchaser; (d) entire or part of payment of second sale deferred for period after sale, (e) the second purchase price exceeds the first purchase price, (f) excess or difference of two purchases equates, in substance to the return on an investment of money at interest in CB. UK's law disregards financier's purchase while the difference between the sale price and purchase is treated as interest for tax purpose.[70] This establishes any IF markup is taxable as interest.

With abstract non-Islamic terms, section 507 of UK's CTA of 2009 introduces investment bond arrangements (*sukuk*) that (a) provide for one person (bond holder or investor in *sukuk*) to pay some capital to another

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[68]Jonathan G., *supra* note 7, p.108-111 and Shah M. Nizami, 'Islamic Finance: 'The United Kingdom's Drive to Become the Global Islamic Finance Hub'.
[69]Id.
[70]Id and QFC *supra* note 51, p.54-56, s503 to 508 UK Corporate Tax Act (2009).

person (bond issuer or Special Purpose Vehicle (SPV)) which issues *sukuk*); (b) identify assets or a class of assets (bond's asset or rights) which bond issuer would acquire before or after arrangement from third party for the purpose of generating gains directly or indirectly; (c) specify the tenure - when bond term ceases to have effect; (d) impose obligation on bond issuer to undertake: disposal (sale) of bond's all assets in its possession at the end of bond term, repayment of capital (subject to reduction of bond's asset price falls) to bond holder during or after tenure at installment or lump sum, conducting of additional profits (which do not exceed reasonable commercial return on a loan of capital) to bond holder in one or several installment during or after tenure, arranging management or disposal of bond's asset or rights to gain sufficient income for redemption of capital (capable to be satisfied by recovery or issue or transfer of share or other securities) and additional payments, entire or partial financial liability for arrangement; (e) permit bond holder to transfer rights to new investor or to terminate it; (f) require arrangement existence as listed security in recognized stock exchange. The Law also imposes determination of the additional payment amount at the beginning of the term in reference to value or income generated by bond assets or other methods.[71]

Similar or equal tax treatment of IF and CF by tax law extends to 'the returns paid to the debt like Islamic bond's return taxation if that investment return were interest on a debt security, and the deductibility of such cost in the determination of corporate tax.[72]Moreover, the law allows *sukuk* holders to benefit from stamp duty relief on transfer as the Finance Act 2009 states that

[71]QFC, *supra* note 51, p.54-56.

[72]Edana Richardson, 'The Accommodation of Islamic Finance in Ireland's Financial Legislation: A Comparative Study of Wholesale Islamic Financial Products' (2011) 34 Dublin U LJ 127.

stamp duty shall not be chargeable on the issue, transfer or redemption of an investment certificate or *sukuk* certificates alike that of conventional bonds. The UK's CTA provides the transaction for sale of property from owner or supplier to the SPV and from the SPV back to the owner is disregarded for the purpose of property transfer tax, stamp duties land tax and capital allowances (depreciation).[73]

b. Taxation of Debt and Equity Finances and Exemption of Intermediary Transaction

Debt finance involves a loan relation between lender and borrower against interest and asset merchandise on credit sales (cost plus profit and lease) basis for return while equity finance covers *mudarabaha* and *musharakah* investors' expenditure of capital in purchasing ownership interest in business or provision of finance by owner for sharing profits and losses with the recipient of capital.

The tax law's (a) permission of deductible costs' of CB interest and (b) uncertainty, silence or denial of IF costs (mudarabah investment and trade related services (*murabaha* and lease) profits) deduction are primary barriers that increase IF vulnerabilities to cumbersome tax costs.[74]The UK's remedy for problems (a) and (b) is equal tax treatment of CB interest income and IF return that eliminate differentiation of CB debt finance and IF models of banking.[75]The tax impediment of dividend profit distribution taxation for mudarabah depositors and denial of its cost deduction under s209 (2) (iii) of 1988 ICTA is remedied by the exclusion of the *muḍarabah* from dividend

[73]Id.
[74]QFC, *supra* note 51, p.54-56 and Freudenberg Brett and Nathie Mahmood, *supra* note 57, p.16.
[75]QFC, *supra* note 51, p.54-56.

tax. UK's tax Act introduces for tax purpose the *muḍarabah* is treated as a loan relationship to treat return if it were interest gain contrary to its investment substantive character.[76]The mudarabah investment account and equity finance return acquires tax benefits (return subjection to interest income exemption or lower tax rate equivalent to CB interest) of credit sale IFB debt finance because *mudaraba*, agency investment and *murabaha* returns are recognized as interest payable on loan and subjects to the same tax treatment eliminating less favorable tax treatment of IFB resource mobilization, allocation and more favorable tax treatment of CB savers.[77]

Parity treatment of CB interest income and IF return taxation also extends to similar taxation of markup of *murabaha* commodity in Islamic interbank commodity market and interest security market on account of s47 UK's Finance Act 2005 which introduces markup or 'alternative finance return' substantive equivalence to CB interest [78]due to the economic substance similarity of CB and IF services'.

The UK adopts a rule of reason based-on a case by case basis approach for *ijara* (hire-purchase) return taxation due to the difficulty of characterization of a lease as an operating lease and financial lease (loans).[79]Consequently, some lease finance incomes are not taxed if they were CB interest but Islamic lease finance is taxed as conventional asset lease income because (a) the re-characterization of IF lease return as CB interest will not apply to leasing arrangements used to finance the purchase of certain assets such as a house

[76]Jonathan G *supra* note 7, p.267, and Abdul Karim Aldohni, *supra* note 65, p.108-111.

[77]Shah M. Nizami, *supra*note 68, Angelo M Venardos, Current Issues in Islami Banking and Finance Resilience and Stability in the Present System, World Scientific Publishing Co. Pte. Ltd, Singapore, (2010), p.33.

[78]Maria Bhatti, *supra* note 55.

[79]Abdul Karim Aldohni, *supra* note 65, p.108-111.

and commercial assets i.e. capital goods lease tax treatment is retained for IF related to house lease finance and (b) it is not appropriate to adjust the taxation of leasing to align with loan taxing regimes as there are many commercial and legal differences between general leasing arrangements and finance lease transactions.[80]The remedy is the application of general lease tax rule for IF lease since general leases provide flexibility and tax advantages (financier exemption from income tax and deductibility of finance costs for the customer who retains withholding tax).[81]

In the other *ijara* (hire-purchase) scenario where the lessee acquires the asset at end of lease, there is a separation of lease finance income and residue sale contracts resulting in the dichotomization of payments into non-taxable recovery of capital and taxable markup which is taxed as if it were CB loan interest income using ESD for taxing income arising from markup in lease.[82]Moreover, diminishing *musharaka*h (lease to own) income is taxable as if it were CB loan interest income while it is exempted from capital gain and withholding stamp taxes.[83]However, in full or perpetual partnership financing- participatory intermediation model, profit would be taxed as dividend or corporate tax without the need to treat dividend as interest.[84]

UK develops the principle of economic substance (factual reality) similarity of transactions (equivalent nature, purpose, function and effect) rather than the legal form (structural CB attribution to cash loan with interest and IF attribution to commerce, investment and asset acquisition according to the rule) difference for establishment of equal tax treatment IFB *murabaha*,

[80]Abdul Karim Aldohni, *supra* note 65, p.108-111.
[81]Id.
[82]Id, p.109.
[83]Id, p.108-111.
[84]Jonathan G note 7, p. 267, Richardson *supra* note 72.

mudarahah investment and alternative capital market profits and CB interest.[85] While the use of similar economic substance facilitates level playing environment for IF and CB via same tax liability for both, wrong IF transactions subjection to different costly taxation due to its legal and multi-tiered contractual forms expose it to less favourable tax treatment.[86]

Alternative finance tax relief is subject to limitations like only one relief can be claimed in an effort to prevent tax avoidance and relief abuse.[87]The other limitation is not all IF incomes are taxed as if it were interest and only trade intermediation and Islamic bond or security investment should be taxed if they were CB loans interest incomes satisfying economic substance doctrine that establishes economic equivalence of CB loan interest and IF markup for taxpayers while the perpetual partnership banking model (*murabaha*h and *musharaka*h financing) should be taxed as corporate income taxes.

Secondly, the possibility of the imposition of double or multiple intermediary taxes (twice stamp duty on trade related IFB and alternative security services) arising from the inherent nature of IF makes its costs cumbersome than CB.[88]The UK's solution is level playing field treatment for every finance that involves (a) presuming IF sales as CB finance for taxation; (b) removal of the double asset or land transfer stamp duty on Islamic mortgage, *murabaha*, diminishing *musharaka*h, child trust funds, companies, trusts, charities and partnerships; (c) extension of conventional finance interest exemption to Islamic bond return and (d) IF exemption from tax on capital gains for redundant purchase and sale in intermediary activity via ignoring of

[85]Jonathan G *supra* note 7, p.265.

[86]Abdul Karim Aldohni, *supra* note 65, p.108-111 and Jonathan G *supra* note 7, p.263-264.

[87]Jonathan G, *supra* note 7, p.268.

[88]Id.

underlying transaction for ensuring similar tax treatment for IF and CB.[89] In order to avoid hire-purchase and diminishing *musharaka*h vulnerability to cumbersome stamp duty, UK entirely removed credit arrangements including *ijara*-lease for all assets that have the same characteristics as a hire purchase arrangement from stamp duty.[90]This covers recognition of profits distribution to investment account holders as finance cost deductions– similarly to deductible interest charges.

Although the UK's approach has limitations of complexity and suitability for non-Muslim majority countries where main consideration of IF is economic utility than financial inclusion of minority, Ethiopia may adapt the UK's principle of equal and neutral tax treatment to IF and CF with necessary adjustment irrespective of service compliance with *Sharia* principles adhered.

2.2. Malaysia

Malaysia adopts tax law that provides equal tax treatment for IF and CB recognizing any IF products is taxable as if it were CB loans disregarding underlying intermediary activity and SPV transactions for avoiding IF's exposure to cumbersome tax costs.[91]Its Income Tax Act of 1967 parag 2(7) provides any reference to interest in tax law shall apply, mutatis mutandis, to gains or profits received and expenses incurred, in lieu of interest, in transactions conducted in accordance with the principles of *sharia*. It entails taxability of any returns of IF as if it were CB interest and eligibility of any IF expenses to the deduction.

[89]Abdul Karim Aldohni, *supra* note 65, p.108-111.
[90]Id, p.109.
[91]QFC, *supra* note 51, p.20-54; Bhupalan Renuka, An Introduction to Islamic Finance and the Malaysian Experience (2009); and Malaysia Income Tax Act of 1967 (here after MITA) parag 2(8).

Moreover, Malaysia exempts an instrument executed pursuant to a scheme of financing for *sharia* compliance from stamp duty.[92]The act also provides any SPV and investment in Islamic security exemption from the responsibility of stamp and income taxes. Similar to equity oriented *sukuk*; other Islamic finance structures are accorded the tax neutrality treatment equating them to CF loan transactions and allow deductions, exemptions, etc of CB.[93] Similarly, all CB tax rules relating to 'interest' like withholding tax and exemptions on 'interest' will equally apply on the 'gains' or 'profit' of IF.[94]This exemption covers ten years relief for IB conducted in international currencies, income of *sukuk* and gain for local Islamic funds.[95]

Alike UK, it provides parity of tax treatment between IF services (*sukuk*, *murabaha*, mudarabah, etc) and CB services' return.[96]The law leaves out the underlying transaction so that tax neutrality can be achieved in IF transaction avoiding double stamp tax (at purchase and resale) while the mark-up element (profit) is a taxable income as if it were interest.[97]Moreover, the Art.2(8) of 1967 Malaysia ITA recognizes deductibility of financing cost for issuer of *sukuk* similar to interest deduction for loan in CF bond and non-imposition of stamp duty on the issue, transfer or redemption of a *sukuk* certificate. Subsection 2(8) ITA provides the underlying asset transaction between originator and SPV will be ignored for tax purposes.

In mudarabah and *musharaka*h, profit attracts business income tax if participants are financial institutions who can claim deduction as cost of

[92]Schedule II of The Malaysian Stamp Act (1949).
[93]QFC, *supra* note 51, p.20-54.
[94]Id.
[95]MITA and Bhupalan Renuka, *supra* note 91.
[96]Abdul Karim Aldohni, *supra* note, pp.108-111.
[97]MITA, subsection 2(8).

finance for the distribution of return to financier while partner's income does not attract firm tax.[98]The Malaysia's hire purchase and diminishing *mushakah* of financier's income and any eventual capital gain on disposal of residual asset to client may attract tax. The tax reform avoids cumbersome costs of *ijara*-lease finance via (a) disregarding underlying transactions from capital gain and stamp duty except client's capital gain; (b) taxing lease markup as if it were CB interest; (c) allowing lease markup deduction as costs of finance in determination of client's tax, and (d) making caution to ensure non-taxation of recovery of capital.[99]

2.3. South Africa (SA)

SA has tax law that provides same treatment for CB and IF disregarding intermediary transactions.[100] The SA Tax act of 2010 introduces a level playing field for CB and IF services (*murabaha*, lease and forward sales).[101]Tax reform covers (a) *shari'ah*-compliant banking products like *mudaraba, murabaha* and diminishing *musharaka* definition in income tax law (b) inclusion of *sharia* compliant arrangements accompanied by tax law parity treatment for CB and IF and (c) South Africa Reserve Bank (SARB) recognizing of any profits from IFB as its counter interest of CB and extension of CB threshold based interest exemption principle to mudarabah agreement to satisfy tax exemption presuming both mudarabah and CB saving accounts are comparable returns to investors.[102]

[98]Bhupalan Renuka, *supra* note, 91.
[99]Bhupalan Renuka, *supra* note, 91.
[100]Omar Salah and Christa Rautenbach, 'Islamic finance: A Corollary to Legal Pluralism or Legal Diversity in South Africa and the Netherlands? The Comparative and International Law Journal of Southern Africa, Vol. 48, No. 3.
[101]Id, 506.
[102]Freudenberg Brett and Nathie Mahmood, *supra* note 57, p.34.

Alike UK and Malaysia, the SA adopts the principle of substance over form as the foundation for taxing IF and CB arrangements similarly. Moreover, tax law responds to *murabaha's* - 'purchase for resale with profit' agreement whereby for tax purpose (a) the law presumes the financier - non-involvement in purchase or sale of the asset (b) law presumes client acquires asset directly from supplier for disregarding underlying transaction from sales and stamp duty; (c) regarding asset transfer duty and VAT the preceding two presumptions apply for shifting property transfer duty and VAT to customer instead of financier or bank and (d) law and SARB characterize mark up as interest to qualify for interest income tax exemption under income tax law.[103]

Furthermore, the Securities Transfer Tax Act permits *murabaha* agreement to be used by a Collective Investment Scheme in Securities (CIS) as a lender for the acquisition of securities favoring bank but the CIS is deemed not to have acquired beneficial ownership of the security under the *murabaha* agreement to eliminate tax associated with financing security in connection with *murabaha* via disregarding of the underlying transaction for security investment, thereby relieving transactions from costly intermediate tax.[104]Alike *murabaha*, the South Africa provides similar tax treatment for Islamic bonds (known as *sukuk*) and CF bond.[105]Furthermore, *Sharia'h*-compliant lease and sale contracts (comparable to conventional installment credit agreements) receive similar tax treatment to CB loan.[106]

[103]Omar Salah and Christa Rautenbach *supra* note 100, p.508-506.
[104]Freudenberg Brett and Nathie Mahmood, *supra* note 57, p.34.
[105]Omar Salah and Christa Rautenbach, *supra* note 100a, p.510-511.
[106]Id.

3. Taxation of IF Incomes under Ethiopian Tax Law

The main issues are whether or not: (a) newly introduced Ethiopian IF services are vulnerable to cumbersome tax costs – impediments covering imposition of stamp duty and capital gains on intermediary activity in trade intermediation and *Islamic* security investment); (b) legislation provides similar taxation to CB and IF transactions and allow deductibility of costs to both; (c) parity treatment of CB and IF by existing tax law breaches the *sharia* compliance that leads to IF's reputation risks; (d) applying current tax law provision without necessary changes removes cumbersome costs and (e) IF incomes rates of taxation are clear for earning, fees, markups, lease rents and return payments arising from purchase and resale agreements, rent agreements and intermediation agreements and IF corporate tax.

3.1. Accommodation of IF Products under Ethiopian Tax Law

Contrary to the principle of clarity, certainty and legality, until April 2024 Ethiopian tax law does not make any reform to remove tax obstacle to IF and the law remains uncertain whether or not IF providers intermediary activity and its customers would pay sales tax or eligible for CB loan exemptions from sale taxes.[107]Such uncertainty leads to revenue compromise or IF sector victimisation by cumbersome taxes.[108]IFBs complain legal barrier including tax obstacle regarding taxability of IF transactions *(murabaha, lease, mudarabah, musharakah),* intermediate activity and non-deductibility of IF finance costs.[109]The customers also complain the uncertainty of markup cost deduction and subjection to costly intermediary stamp duty and property

[107]Mohammad, *supra* note 16.
[108]Ali Idris, *supra* note 16.
[109]Zamzam Bank, *supra* note 15, p.15-16.

transfer taxes.[110]Thus, taxability and non-taxable alternative transaction, sales, returns and way to reduce IF's costly tax expense remain vague. [111]

The 2016 Ethiopian Income Tax Proclamation (ITP) and its subordinate laws (regulations, directives, circulars and tax rulings) do not adopt principle which eliminates cumbersome tax costs against IF.[112]Ethiopia neither introduces the UK's legislative neutrality to religious expression nor Malaysia's expressive recognition of IF. That is, none of tax legislations (ITP No.979/2016, tax administration code Pro.No.983/2016 and their respective subordinate legislations) entail rule for taxing income (a) alternative finance like profit sharing agency to CB, (b) trade based finance products like *murabaha*, *ijara*, *istisna, salam*; (c) equity related bank products like mudarabah and *musharaka*h and (d) taxable IF incomes including markup, profits, returns, management fees, etc arising from trade intermediation and investment finance.[113] The meaning of dividend in Art.2 (6) and interest in Art.2 (16) of ITP No.979/2016 remain silent regarding the applicability of CB loans cost deduction rule for investment partnership returns and markup of IF products. Such silence poses tax obstruction to IF or opens the room for its tax avoidance. Despite peculiarity of Ethiopian tax law that prescribes special tax rule for taxing business disregarding commercial code, it does not cover deductibility of IF costs, exemption of intermediary transactions and taxation of returns peculiar to IF in definition of words like income, dividend, interest, capital gain, etc. Thus, the Ethiopian tax law does not recognize whether or

[110]Kemal Shallo, Customer of Awash Bank and CBE (Jan. 17, 2023) complains that series of IFB transactions make more costly than CB.

[111]Taddese Lencho, To Tax or Not To Tax: Is That Really The Question? VAT, Bank Foreclosure Sales, and the Scope of Exemptions for Financial Services in Ethiopia, Mizan Law Review Vol. 5 No.2, (2011), p.279.

[112]Arts.3, 6, 7(1)(c), 8(1)(d), 12, Art.28 & 45-48 ITR and Art. 23, 26, 59(7)(c), ITP Art.18, and 19 of ITP *supra* note 40.

[113] The ITP, Art.18-21.

not any of IF services should be categorized under CB loan, commercial relation or any other scheme for tax purpose.

Ethiopian tax law reform has to consider either of the following approaches. First option is UK's tax law neutral or non-discriminatory treament for IF and CB and use of alternative finance arrangement without the need to mention specific *sharia* compliant IF products. The second option is Malaysia and SA tax law approach which expressly recognise *sharia* compliant finance services like *murabaha*, mudarabah, *musharaka*h, *ijara*, etc. Ethiopian tax reform should adopt Malaysia's expressive approach of recognizing alternative IF services and define *murabaha*, *musharaka*h, mudarabah, etc with ways of taxing incomes arising from IF because Malaysia approach is simple, clear and promotes *sharia* compliance of alternative finance. This requires amendment of Article 2, Arts.18-27, 34-35, 51-64, 66-72, etc of Ethiopian ITP No.979/2016. Thus, ITP No.979/2016 with its regulation, Tax administration Proclamation No.983/2016 with its regulation and other subordinate legislation amendment should include the list of IF products and their respective meaning that simplify taxation of incomes attributable to IF.

Although ITP No.979/2016 fails to make express reference to IF services, there are general rules which can positively be interpreted to establish Ethiopian jurisdiction to tax IF incomes. Accordingly, Art.6 (4) establishes Ethiopian source jurisdiction which can be interpreted to tax IF profits paid to any person by resident, markup received from clients, and gain arising from sale of share or bonds issued by resident company. But the application of such tax law for taxing IF incomes by interpretation is inconsistent with the principle of legality that prohibits taxation without firm legal basis and tax law reform should expressly recognize IF and indicate tax rules applicable to charge IF incomes and facilitate tax relief for costs and intermediary activity.

Moreover, the Ethiopian tax law does not clearly stipulate incomes of IF which subjects to schedule D incomes (5% or 10% CB interest incomes) or 30% corporate income tax. Nor does ITP in schedule C expressly includes principles which enable the taxation of IF incomes and deductibility of its costs.[114] Similarly, schedule D remains silent regarding taxability of *mudarabah* depositors income and any IF income that attract withholding tax.[115] Besides, there is no clear rule regarding ways of separation of taxable return and how capital recovery is exempted except Art.24 which addresses the recognition of gain and loss and deductible expenses for lease business. Thus, no legislative amendments have yet been made for the accommodation of IF taxable return and non-taxable capital.

3.2. Intermediary Transactions Taxability

Intermediary transactions involve the activities of SPV, such as buying, selling and similar behaviors involved in IF contracts for *sharia* compliance of IF services. Taxing such activity exposes IF to cumbersome tax costs. But the Ethiopian law does not provide clear tax rule that prescribes taxability or otherwise of intermediary transactions. This opens the room for different interpretations: chiefly regarding the taxability of intermediary activity by tax law. This means that the application of existing Ethiopian tax law to IF services imposes two taxes on IF: stamp duty and capital gains.

Unlike UK, Malaysia and SA which presume non-involvement of financer in purchase and resale to disregard intermediary activities for tax purpose, Ethiopia does not provide tax legislative response that exempts intermediary activities from taxes. This allows the imposition of an obligation on the

[114] The ITP, Arts.19-50, *supra* note 40.
[115] The ITP, Arts.51-64, *supra* note 40.

supplier and bank to withhold stamp duty on activity. Article 3 of the stamp duty law provides that the following instruments shall be chargeable with stamp duty: bond, security deeds; power of attorney; and documents of title to property. This stamp duty during approval of customer's power of agency to purchase asset on behave of financier and property transfer from supplier to the financier and then to customer shall apply to frequent intermediary activities of IFB services of trade intermediation and Islamic bond purchase contracts for resale to customers.[116]Such intermediary taxation of multiple transfers is barrier for asset backed trade intermediation activity which is vulnerable to more tax that increases the cost of acquisition and supply of asset. As Mohamed rightly found stamp duty poses a difficulty to the IFB transactions when title deed transfers twice in single financing transactions in *murabaha* and *ijara* in which transaction attracts double asset transfer tax.[117]This results in costly tax expenditure to IF that receives less favorable tax treatment and becomes less competitive than CB [118]breaching the principles of equity and neutrality making IF less competitive and unviable than CF.

Secondly, Ethiopian tax law provides a gain on the disposal of certain investment property subjects to tax at 15% for immovable property and 30% for a share or bond provided the amount of consideration in sale exceeds the cost of asset acquisition.[119]Besides, tax law includes taxable activities like the acquisition of assets, title disposal, exchange, cancellation, redemption, relinquishment, destruction, loss, expiration, surrendering or passing of legal

[116] The Ethiopian Stamp Duty Proclamation No.110/1998, Art 3.

[117]Mohammed Ibrahim Ahmed, Islamic Banking in Ethiopia and Its Legislative Challenges, 16 J Int'l L Islamic L (2020), p.62.

[118]Mzee Mustafa Mzee, 'The Legislative Challenges of Islamic Banking in Tanzania' 45 JL Pol'y & Globalization (2016), p.131.

[119]The ITP Art 58, and The ITR Art 6, *supra* note 40.

title for consideration to another.[120] Application of these provisions likely impose capital gain tax on all IF intermediary transactions with rate ranging from 15 to 30 percent while its counter CB incomes might be subject to lower income tax rates (5% for resident and 10% for dividend and non-resident interest income earners). This imposes extra tax on cost plus markup transactions or trade intermediation of IFB services as Ethiopian income tax law does not provide any clue for an exemption and disregarding of underlying transactions of IF.

Moreover, Ethiopian tax law does not recognize loss and profit sharing characters of IF which requires the recognition of loss as expense that should be deducted as cost of finance. Instead Ethiopian law has general remedy for carrying loss forward and provides permissibility of off setting loss against future gain and carrying loss forward infinitely for offsetting in the future until loss fully offsets gains income when substantiated by reason that satisfies revenue authority.[121] Article of 71 of ITP No.979/2016 seems to address the rule for deferral of recognition of gain and loss on the disposal of asset but deny the recognition of gain or loss for exchange between related person, spouses or transfer of asset to executor on death and replacement of asset on its loss, destruction or compulsory acquisition of asset. However, rule does not make express reference to IF nor it includes rule that exempts capital gain during purchase for resale to customers. Thus, there is no clear deferral of recognition of gain or loss for IF nor indication of applicability of an existing tax law for carrying loss forward for IF.

Furthermore, Ethiopian Income tax law not only impose cumbersome costs on IF but it also marginalizes some employees who do not consume fringe

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[120] The ITP Arts 66-70, *supra* note 40.
[121] The ITP Art.59 (4) and Art.26, *supra* note 40.

benefits that entail interest charge as Art.8 (1) (d) and 12 of Council of Minister's Income Tax Reg.No.410/2017 (CMITR) provides a discounted interest loan provision to employees as fringe benefits without alternative *sharia* compliant benefits like provision of asset with discounted markup. The tax law does not recognize the deductibility of employee's discounted financing fringe benefits in determining the firm's tax. These employee fringe benefits should be reformed by introducing asset finance supply to employees with discounted markup that should be deductible for both CF and IF.

One of the most significant obstacles to IF is article 72 of ITP No.979/2016 which prohibits regulator from accepting, registering and approving of transfer or disposal asset unless it is satisfied that tax required under this law is paid. ITP empowers revenue and document authentication authorities to impose extra tax costs on IF which is exposed to capital gain tax as per Art.71 (recognition of gain or loss) and Art.21 (capital gain on disposal of asset).

Finally, the market lending rate applicable for CB loans and NBE discounted facilities to commercial banks included in Article 7 of CMITR No.410/2017 does not indicate the IF rate of markup and profit of investment account holders. This implies absence a level playing field for CB and IF services income tax in Ethiopia.

Ethiopia can take lesson from UK, Malaysia, and SA that: (a) disregard taxation of underlying or intermediate activity like purchase and resale transaction of *murabaha*, lease, progressive release of fund against future delivery, forward sale and SPV (trade in security); and (b) presume financier's non-involvement in intermediary activity and direct client's asset acquisition from supplier to provide similar tax treatment for CB and IF for

stamp duty purpose.[122]The exemption of intermediary transactions from capital gain and asset transfer stamp duties should be introduced to ensure equal tax treatment of any form of finance.[123]

3.3. Taxation of IF Markups and Profits

Ethiopia tax rules remain silent on the rules applicable for the taxation of markup of trade related IFB and profits on investment intermediation, Islamic capital market and other IF services. None of tax laws provide differential or similar tax treatment of IF and CB. Unlike comparative experiences, Ethiopian income tax law does not address the tax treatment of IF services nor does the law consider IF services as loan relationships for the coherent tax purposes. Nor does the law clarify *sharia* compliance implication of tax treatment of markup or profit as if it were interest by tax law although experience of other nations reveal the use of word interest for tax purpose does not affect the *Sharia* compliance of *murabaha* and other IF services. Nor does the tax law avoid the uncertainty relates to the issue of distinguishing taxable income and non-taxable capital characterization with respective deductible costs of finance for IF.

The existing tax law application to CF and IF exposes the latter to additional costs. For instance, Ethiopian tax law provides CB interest income is subject to a rate of 5% for resident and 10% for non-resident according schedule D. However, the prohibition of interest in IFB creates uncertainty of the rule for taxing income arising from IF. This uncertainty would either cause some IF incomes to escape the tax (religious activity exemption argument and the difficulty of distinguishing between recovery of capital and taxable lease

[122]Bhupalan Renuka, *supra* note, 91, and Omar Salah and Christa Rautenbach note 100, p.509-511.
[123]Id.

finance income) or more excessive tax costs to IF. This exposes IFB to extra tax costs that makes it less competitive, systemic failure or bankruptcy and consequent marginalization of some investors and customers from the financial market.

The inherent nature of the Ethiopian schedular tax model may worsen the uncertainty of extending CB rules for taxing IF services (*murabaha*, lease, mudarabah, forward sale) incomes since (a) CB or financial company incomes might be simultaneously subject to schedule C's 30% flat rate when it loans fund to other businesses and 5% interest withholding income under Schedule D interest from deposits in a bank, (b) the law is silent on IF subjection to capital gain, the person responsible for capital gain or exemption.[124]Thus, the taxability of IF income is subject to open interpretations (some gain subjection to schedule C while other subjects to schedule C) although the principle of certainty and legality respectively require a clear and strong legal base for taxation.

Moreover, the position of Ethiopian tax law is not clear whether the rule of taxing CB depositors' interest income is applicable for IFB mudarabah saving account depositors' profits and *murabaha* markup. The main limitations include the silence of tax law on ways of taxing mudarabah investment account holders return/profit sharing, withholding duties of financiers, lack of government tax law response for taxing IF incomes, lack of clarity in the law on permissibility of deduction of *murabaha* markup as cost of business and uncertainty as to whether the return on certain Islamic finance products will be characterized as a capital or revenue gain or loss.

[124] Taddese L. Gemechu, The Ethiopian Income Tax System: Policy, Design and Practice PhD A Dissertation submitted to Graduate School of the University of Alabama, (2014), p.373.

IF incomes (*ijara* return and mudarabah investment incomes) may escape tax due to the unsuitability of existing tax legislation. The comprehensive provision which can positively be applied to IFB is Article 63 of ITP No.979/2016 that provides a person who derives any income that is not taxable under Schedule A, B, C, or the other Articles of Schedule D shall be liable for income tax at the rate of 15% on the gross amount of the income. Revenue authority can apply Art 63 to tax any IF incomes including trade intermediation markup, equity finance incomes, and fund management fees. But it may either impose more or less tax treatment on IF breaching the principle of equality and neutrality which provides similar treatment of incomes and person in similar situation.

The other uncertainty of Ethiopian tax law relates to taxing *ijara* incomes contrary to other nations varying experience in which some states exempt the capital part of *ijara* payment and impose tax only on profit (considering profit as interest loan income) that goes to financier while some entirely exempts lease finance and *sukuk* transactions from tax except profit (recognized as interest) earned by the investor (issuer) of IF.

Consequently, the Ethiopian government has not made any tax policy response to the birth of IF as of April 2024. The interview with officials reveals that Ethiopia has not introduced any changes to tax law for accommodation of IF.[125]Tax authority faces difficulty in treatment of IF or it imposes less favorable tax treatment to IF due to its inherent unique characters.[126] The practice of newly established full-fledged IB institutions reveals *murabaha* markup incomes subjection to 30% corporate income and

[125]Interview with Wondissen Fikadu, Tax Officer of FDRE Ministry of Revenue (October 18, 2023).

[126]Mohammad, *Supra* note 16.

there is no practice of presuming or equivalence of markup incomes of IF if it were CB interest incomes which are subject to 5%.[127]This practice implies lack of clarity of tax law that imposes expensive tax costs on IF which would be less competitive than CB which pays less tax on interest incomes. IF subjection to 30% corporate tax contrary to CB which subjects 5% interest rate tax discriminates similar incomes although they have the same economic substance and consequences to tax payers.

The other issue is whether or not Ethiopian tax law provides finance incomes exemption for policy considerations. Contrary to the experience of other nations, which extends interest income withholding exemptions to underlying transactions in IF, Ethiopia does not provide financial intermediary exemptions available for certain asset backed arrangements such as a commodity *murabaha*h and an asset based securitization arrangement provided the arrangement meets the public offer test and is economically equivalent to either a debenture or a debt interest that is currently eligible for the interest withholding tax exemptions.

Furthermore, the distribution of partnership finance (mudarabah investment depositor, investment agency account holders and *musharaka*h contributors) return that relies on profit sharing is taxable in other nations as per rate provided by corporate and individual tax payers. But whether such new incomes can be subject to dividend or corporate interest rate income is uncertain in Ethiopia. Thus, the Ethiopian corporate and individual business tax laws do not have the rule for IFB or alternative finance arrangement incomes' taxation.

[127]Siraj A and Abdulahi Abdulkadir, Workers at Hijra Bank, (October 17, 2023).

Ethiopian tax reform can learn the following lessons from the UK, Malaysia and SA to settle uncertainty on the applicability of existing income tax laws for IF services.

First, the lack of clarity in Ethiopian tax law regarding *sharia* compliant security income should be resolved via disregarding the taxation of incomes from special purpose vehicle - intermediary transactions to avoid alternative security finance vulnerability to cumbersome tax costs.

Second, the law should introduce trade intermediation related deferred payment markup and similar IF returns taxation as if it were interest received by the CB lender implementing the presumption of equivalence of IFB returns and CB interest. The reform should also include the UK's IF similar treatment with CB-CF products - the taxation of IF products should present 'no obstacles nor special treatment': in other words, a 'level playing field i.e. neutral tax treatment for CB and IF in income tax, withholding tax; and property transfer tax.

Third, taking lesson of treating -taxation of IF returns as if it were interest on CB loans (presumption of IF return as interest) for tax purpose never contradicts *sharia* compliance of IF provided parameters of constructive or actual possession, joint ownership, risk and profit sharing are satisfied. Presuming IF return as interest for tax purpose may erode IF's sector reputation temporary. However, such reputation loss can be mitigated via awareness creation strategies: training, media advertisement and *sharia* scholars' education.

Fourth, Ethiopia tax law may consider lessons of the UK, Malaysia and SA laws which presume trade intermediation relation between financer and buyer as loan relation between lender and borrower in order to tax markup of IF as if

it were CB interest income. The amendment to Ethiopian tax law should encompass any reference to interest in tax law shall apply, making necessary change, to gains or profits received and expenses incurred, in IF transactions conducted in accordance with the principles of *sharia.* The law should also include the principle of economic substance that dictate equal economic outcome of interest and markup or return on mudarabah depositor's investment account, agency investment account of IF should be prioritized over form of finance transactions (as loan, trade, investment, financial instrument investment) since most IF products mirror the economic effects of CF products.

Consequently, the Ethiopian income tax law should draw lessons from UK, Malaysia, and South Africa which tax incomes arising from IF as if it were interest. That is markup from asset merchandise, lease, progressive finance combination with deferred asset delivery, forward sale and return from *mudarabaha* investment account holders should be taxed as if they were interest incomes of CB. This is because the tax law should provide similar treatment to comparable CB interest incomes and IF profits. Thus, CB 5% for resident and 10% for non-resident interest rate should apply to markups and profits of IF in order to eliminate less favorable tax treatment to IF since the tax law should adhere to the principle of equality, neutrality and fair treatment of finance.

3.4. Deductibility of IF Costs

The Ethiopian tax law differentiates deductibility of debt and equity cost of finance which increases IF costs. The Ethiopian tax also law permits interest expense deductibility as finance cost if ratio of debt to equity finance is not

more than 2:1 but expressly denies the deduction of dividends.[128]This is disadvantageous to equity centered IF because *shariah* does not recognize interest in IFB.

The remedy is Ethiopian tax law reform should introduce rules of allowing deduction of IF business cost comparable with interest cost deduction. The law should allow deductibility of cost related to financing IF like mudarabah investment depositors' profits and investment agency fees paid to financers who provide fund to IB. The economic substance doctrine suggests similar cost of finance deduction allowance for IF and CB.

Furthermore, whether or not conventional bond interest cost deduction is applicable to Islamic bonds (*sukuk*) holders, who claim ownership in underlying asset for *sharia* compliance, remains unresolved under Ethiopian tax law. Whereas IF's equity nature denies deductibility of finance costs according to Art 23 and 47 of Ethiopian ITP No.979/2016, *sukuk* exchange in capital market might attract additional stamp duty costs. Denial of cost deduction and imposition of stamp duty for IFB result in less favorable or competiveness of IFB compared to CB which receives interest cost deduction and exemption from stamp duty. Ethiopia should adopt UK and Malaysia lessons of allowing deductibility Islamic bond costs of finance, risk sharing loss and expenses alike conventional bond expenses.

However, the deductibility of interest costs is subject to the following legal limitations. Primarily, Art.23 of ITPNo.979/2016 states that interest debt is deductible only if the debt is used to drive business income. Art.23 also allows the deductibility of debt financing costs for term loan and debt instruments (debentures) that involve deductible interest expenses. Such a tax

[128]Arts 23 and 47 of ITP, *supra* note 40.

advantage is not available for equity financing - raising capital through the sale of shares in a company as Article 27 (1)(d) of ITP No.979/2016 does not allow the deductibility of loss recoverable by insurance, dividend distribution and pay-out profits to shareholders as cost of financing except depreciation of assets. This implies equity model of financing bank investment is more expensive than debt model of financing financial investment. The favorable treatment of debt finance than equity finance creates less favorable treatment to IF which (a) prohibits interest and (b) uses merchandise and equity finance modes including risk-loss bearing and profit-sharing ways of finance whose tax law does not allow deduction of dividend distribution as cost of finance.

Article 23 (2) (a) of ITP No.979/2016 provides that an interest cost paid or payable to bodies or financial institutions recognized by national bank of Ethiopia (NBE) and foreign bank permitted to lend to persons in Ethiopia shall be deductible even when interest rate for paid or payable interest exceeds 2% points used between NBE and commercial banks. However, Article 23 (2) (b) of same prohibits deductibility of interest cost paid or payable to related person who is resident of Ethiopia except interest included in schedule D related person who may claim deduction. The law seems to prohibit the deductions of interest finance costs for individuals when interest rate exceed 2% points of rate used between NBE and commercial banks under Article 23 (2) since individuals are not recognized by NBE. However, tax law hardily covers deductible and non-deductible finance costs of IF.

Further, the deduction of charitable donation is recognized in Art. 24 of ITP No.979/2016 when donation is made for: Ethiopian charities and societies as defined in sub article 3 of this provision and development, an emergency call by the government to defend sovereignty and integrity of country, to prevent or provide relief in relation to man-made or natural disaster or epidemic or for

any other similar cause. This deductibility of charitable donations is a positive move friendly to IF requires to payment *zakah* (alms giving) responsibility.

The Ethiopian tax law lacks rules for (a) the deduction of IFB costs in the acquisition of assets for deferred payment arrangement; (b) recognition of financial cost and its deductibility for borrower, (c) extending schedule C business deduction to IF services; and (d) identification of taxable capital gains and tax-exempt intermediary activity. The remedy is the tax law should be amended to ensure that the finance gain or cost of finance in respect of Islamic deferred payment arrangements is treated in the same way as interest cost for CB.

Conclusion

The article concludes the following points. Primarily, it finds a lack of clear tax law applicable for taxing IF incomes (markup and profits) as an obstacle to the progress of IFB products in Ethiopia, contrary to the law's promise to ease the business environment.

Secondly, the status quo application of existing Ethiopian tax legislation to IF would result in a more onerous tax treatment of IF than CF-CB in Ethiopia. Thirdly, in contrast to other nations like Malaysia, the UK and South Africa who have IF friendly tax law, no tax legislative measures have been made to facilitate IFB transactions in Ethiopia so far. Thus, Ethiopia needs to modify its tax laws in order to facilitate conducive environment for IF adapting Malaysia and SA model of tax laws reform that provide similar tax treatment to IF and CB to have IF friendly tax law that allow deduction of costs, loss in IF and disregarding of intermediary activity to remove anti-competitive tax costs.