

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

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“To tax and to please, no more than to love
and to be wise, is not given to men.”

Edmund Burke

Abstract

The Ethiopian Value Added Tax of 2002 follows the standard approach of exempting financial services from VAT. Not all ‘financial services’ are, however, exempted from VAT. A number of services provided by the financial institutions are made taxable by the VAT laws of Ethiopia. No subject in this regard has probably attracted as much attention and controversy as that of sale by foreclosure of property held as security by banks. Both sides (i.e., members of the financial industry and the tax authorities) seemed locked in their conviction over the treatment of foreclosure sales in VAT. Members of the financial industry (in particular banks) are convinced that foreclosure sales enjoy the privilege of exemption in VAT while some within the Tax Authorities are equally convinced that foreclosure sales should be chargeable with VAT. These controversies have played out in the courtrooms, the press and a number of communications between the Tax Authorities and the members of the financial industry. This article examines these controversies and analyzes the scope of exemptions for financial institutions under Ethiopian VAT laws.

Key words:

VAT, exemptions, zero-rating, foreclosure sales, financial services, taxable transactions, taxable activity

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Introduction

Ethiopia joined what is now a large chorus of nations in the world by introducing the value added tax (VAT) in 2002 (effective January 2003).¹ The

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VAT laws of 2002 replaced the then general sales tax law (in force since 1993), which was a single-stage sales tax whose application was limited to manufacturers or producers and/or importers.² The VAT which replaced this tax is a multiple-stage sales tax with the ability to reach all levels of economic distribution (manufacture, wholesale and retail). Although VAT has the potential to reach all levels of economic distribution, the reach of VAT in Ethiopia was limited for administrative reasons to those businesses whose annual volume of trade exceeded half a million Ethiopian Birr (ETB). For those businesses whose annual volume of trade did not reach the half – a – million ETB, another tax was introduced along with the VAT, namely the turnover tax.³ The novelty as well as structural complexity of the VAT is such that small and medium-sized businesses could not be immediately brought within the fold of the VAT system.

Although VAT is generally recognized as a broad-based general sales tax, the VAT laws of Ethiopia issued in 2002 (the Proclamation and Regulations) came out with a fairly long list of exemptions for certain transactions in goods and services. The public policies (to the extent public policies could be inferred from the laws) that produced the exemptions vary from one exemption to another. We may, however, generalize the policies into two.

There are, on the one hand, lists of exemptions which seem to be motivated by the desire on the part of the government to encourage consumption of certain goods and services. Many of the exemptions fall in this category. The social policy of the government to encourage consumption drives the exemption for

¹ The value added tax has become one of the most remarkable fiscal phenomena of the modern times. All but one (i.e., the USA) of the industrial nations have adopted the VAT as one major source of government revenue, and more than 150 nations have now adopted VAT as their favorite indirect tax. In Africa, Ethiopia was the 36th African nation to catch the VAT-bug; see Alan Schenk and Oliver Oldman (2001), *Value Added Tax: A Comparative Approach, with Materials and Cases*, Transnational Publishers, Inc, New York, at 1; Richard Krever (ed., 2008), *VAT in Africa*, Pretoria University Law Publications (PULP), at 3; even in the United States, there are serious debates about the possible introduction of VAT to the United States; see Michael J. Graetz, “100 Million Unnecessary Returns”, *Yale Law Journal*, vol. 112, No. 2 (Nov. 2002); N. Gregory Mankew, “Much to Love, and Hate, in a VAT”, *the New York Times*, May 1, 2010; Lori Montgomery, “Once Considered Unthinkable, U.S. Sales Tax Gets Fresh Look”, *the Washington Post*, May 27, 2009.

² See Sales and Excise Tax Proclamation No. 62/1993, *Negarit Gazeta*, 52nd year, No. 61.

³ See Turnover Tax Proclamation No. 308/2002, *Federal Negarit Gazeta*, 9th year, No. 21.

merit goods like education, health and medical services, as well as those for books and transportation.

There are also exemptions in VAT which are not really motivated by the desire of the government to encourage consumption. Certain types of transactions in goods and services have proved difficult for conventional VATs to apply because of the technical challenges involved in levying VAT on these transactions. In this category of exemptions, we place the exemptions granted for the supply of residential houses, investment instruments like shares and bonds and the supplies of financial services.⁴

Whatever the motivations for exemptions may have been, exemptions for various types of goods and services are mainly to be found in the VAT Proclamation (hereinafter VATP) and VAT Regulations (hereinafter VATRs) – both issued in 2002.⁵ The Ministry of Finance is empowered by the VATP to grant exemptions to additional lists of goods and services not listed in the VATP and VATRs.⁶ The Ministry has since then added its own list of exemptions to the catalogue of exempted goods and services under the Ethiopian VAT regime. The exemptions for supplies of bread, *injera*, milk and agricultural inputs are some of the lists of goods added by the Ministry.⁷

The existence of exemptions in any tax law often leads to disputes over the nature and extent of the exemptions, and VAT is not an exception in this regard. Of the long list of exemptions, nothing has so far attracted as much attention from the Ethiopian tax authorities as the exemption of financial institutions.⁸ This is hardly surprising. Financial institutions, in particular banks, generate huge sums of revenue and it might at first be galling to think that these services

⁴ See Value Added Tax Proclamation No. 285/2002, *Federal Negarit Gazeta*, 8th year, No. 33, Article 8(2)(a) (b) (c); and Council of Ministers Value Added Tax Regulations No. 79/2002, *Federal Negarit Gazeta*, 9th year, No. 19, Articles 19, 20, and 21.

⁵ See VAT Proclamation 2002, *supra* note 4; VAT Regulations 2002, *supra* note 4.

⁶ See VAT Proclamation 2002, *supra* note 4, Article 8 (4).

⁷ See FDRE, Ministry of Finance and Economic Development, 1995 E.C., in Amharic, unpublished; see also T. Lencho, *The Ethiopian Tax System*, Michigan State Journal of International Law (upcoming).

⁸ See Getahun Worku, “Do Banks really need to Register for VAT for Collection of Loans?” *Reporter*, Vol. 16, No. 22/1126, *Yekatit* 6, 2003 E.C. in Amharic (translation mine); see also Kirubel Tadesse, “Unpredictable Tax Measures will Hurt Investments”, *Capital*, Vol. 13, No. 626, Sunday December 12, 2010; Mahlet Mesfin, “Financial Institutions, Tax Authority Disagree Over VAT”, *Addis Fortune*, Vol. 11, No. 552, November 28, 2010; Shimelis Abebe, “The Application of VAT on Sales Upon Foreclosure,” Addis Ababa University, Faculty of Law Library Archives, unpublished, May, 2009; ጥላሁን አክሲዮን “ባንኮች ወደ ታክስ መረብ ካልገቡ እርምጃ እንወስዳለን” - ጎግል ጋዜጣ ታህሳስ 29 ቀን 2003 ዓ.ም. ገፅ 10-11 ይመልከቱ።

are not affected by VAT when the tax has reached cafeterias and restaurants and small consumption items like tea and coffee.

The first sign of interest in taxation of financial institutions came in a case involving the sale through foreclosure of a debtor's property (collaterals) by Abyssinia Bank S.C. In *Abyssinia Bank S.C. vs FIRA*,⁹ a dispute arose over whether the sale of collaterals in a foreclosure by the Bank constituted a taxable transaction for VAT purposes. Abyssinia Bank S.C. (lender) took tires from Tana International Trading PLC (the borrower – hereinafter simply Tana International) as security for the payment of loans it extended to the latter. Tana International defaulted on its payment, and Abyssinia Bank sold the tires (collaterals) in a foreclosure sale for a total price of 4 million ETB. The Tax Authority assessed that VAT was due on the sales, to which the Bank objected. Abyssinia Bank argued that the sale was exempted from VAT as Abyssinia Bank is a financial institution. Federal Inland Revenue Authority (FIRA - the predecessor of ERCA) argued that the sale was not an exempt transaction although the Bank was a financial institution.

Abyssinia Bank appealed against the decision of the Tax Authority to the Tax Appeal Commission. The Commission decided by a majority opinion that the sales of tires by Abyssinia Bank S. C. constituted taxable transactions. The case went to the High Court on appeal, which reversed the decision of the Tax Appeal Commission. The High Court ruled that the sale did not constitute a taxable transaction as the sale by the Bank was not a continuous or regular activity of the Bank. Both the parties and the Tax Appeal Commission as well as the High Court dwelt on whether foreclosure constituted 'a continuous or regular activity' of the Bank because it seemed to them that the attachment of VAT on the sales turned on whether this requirement is met in the case or not.

Although the results went against the Tax Authority in the Abyssinia Bank case, the issue has since then lingered with some in the Tax Authority convinced that VAT should be payable upon foreclosure sales. As early as 2005, the Ministry of Revenues issued a Directive regarding the imposition of VAT upon some 'difficult-to-tax' transactions like the provision of lottery and gambling, travel agency services and purchase of used goods by used-goods-dealers.¹⁰ This rather generic 'directive' has a provision which states that 'the scope of exemptions for financial services does not cover the sale by foreclosure

⁹ See *Abyssinia Bank vs. Federal Inland Revenue Authority, Federal Tax Appeal Commission*, File No. 543, in Amharic, unpublished; *Abyssinia Bank S.C. vs. Federal Inland Revenue Authority*, Federal High Court, File No. 31952, in Amharic, unpublished.

¹⁰ See Federal Democratic Republic of Ethiopia, Ministry of Revenues, Directive No. 23/1997 (In Amharic, unpublished).

of goods held as security by financial institutions'. The 'directive' goes on to instruct banks to charge foreclosure sales with VAT.¹¹ However, it appears that the said 'directive' was not properly communicated to all the parties involved (it certainly was not implemented) as banks and the Tax Authorities are still arguing over the taxability (or otherwise) of foreclosure sales.¹²

Banks seemed convinced that their foreclosure sales were insulated from any form of tax claims.¹³ In a letter written in 1994 E.C (2002), the Ministry of Finance and Economic Development seemed to have given them assurance against the threat of taxes.¹⁴ The letter relieved banks from any duty to obtain tax clearance in respect of any property the banks took as security for loans – with the obvious view to facilitating foreclosure sales by banks. And more importantly, the letter conceded the priority of secured claims of banks over the collaterals against the competing tax claims of the government.¹⁵ Banks referred to this letter in support of their position that the sales of collaterals in foreclosure sales are exempted from the payment of VAT.

Well those were perhaps different times! Although the Tax Authority suffered a setback in the courts as shown in the Abyssinian Bank case, recent developments within the Authorities show that they are determined to collect VAT on foreclosure sales by banks. In 2010, Ethiopian Revenues and Customs Authority (ERCA – hereinafter simply the Tax Authority) – sent a circular letter to Banks reminding them of their duty to register for VAT for their services which are taxable under the VAT laws.¹⁶ The Authority bases its position on a provision in the VATR which mentions 'debt collection services' by financial

¹¹ See *id.*, Article 16(1) and (2).

¹² See Mahlet Mesfin, *supra* note 8.

¹³ Even in their latest communications with the Tax Authority, Banks were quick to draw the attention of the Authority to the much favorable circular letter written by the Ministry of Finance and Economic Development; see Ethiopian Bankers Association, *Hidar* 8, 2003 E.C., in Amharic, unpublished.

¹⁴ See Ministry of Finance and Economic Development, Circular Letter, *Sene* 1994 E.C., in Amharic (unpublished).

¹⁵ The priority rights of banks and all other secured creditors was already asserted in the tax laws that came out in 2002 – see Income Tax Proclamation No. 286/2002, *Federal Negarit Gazeta*, 8th year, No. 34, Article 82; VAT Proclamation 2002, *supra* note 4, Article 32; the Turnover Tax Proclamation, *supra* note 3, Article 14; the Excise Tax Proclamation No. 307/2008, *Federal Negarit Gazeta*, 9th year, No.20, Article 11.

¹⁶ See Ethiopian Revenues and Customs Authority, *Tikimt* 3/2003 EC, in Amharic, unpublished.

institutions as taxable services¹⁷ and Directive No. 23/1997, which declares that foreclosure sales are chargeable with VAT.¹⁸

The Banks were predictably opposed to the idea of registration for VAT and expressed their objection to the move through their association – Ethiopian Bankers’ Association. They expressed their concerns by a letter written to the Tax Authority urging the latter to reconsider its position on this matter. The Tax Authority wrote a reply essentially insisting that they register for VAT for collection of the tax from foreclosure sales.¹⁹ In its reply, the Tax Authority drew the attention of banks to the taxation of debt collection services again, which is clearly indicated in the VATRs as a taxable service.²⁰

Recent developments have in general signaled the hardening of stance on the part of the government in its position on the payment of taxes on property held as security. The most recent income tax amendment law, for example, included a provision that requires banks to verify if borrowers have any outstanding tax claims against them before taking their property as security for loan – in effect reversing the policy of the government in place since 1994 E.C.²¹

The status of foreclosure sales under the VAT laws in particular and the scope of exemptions for financial services in general has divided opinions ever since. We have, on the one hand, people (mostly from the Tax Authority) who argue that foreclosure sales should be subject to VAT and there are, on the other hand, people who have argued that foreclosure sales are financial services and should not become subjects of VAT.

This article will explore the controversies surrounding the status of foreclosure sales in VAT and will use the controversies to examine the nature and scope of exemption for financial services under Ethiopian VAT laws. The article is not confined to finding answers to the question of whether VAT should attach to foreclosure sales, although it is inspired by it.

This article only addresses bank foreclosure sales. The debate over taxation of foreclosure sales need not, however, be confined to bank foreclosure sales, although the Tax Authorities have so far focused on this type of sale, presumably because of the sheer volume of the sales in this regard. Courts are also involved in foreclosure sales during execution of judgments (judicial foreclosure) and there is no reason why attention may not be drawn to these

¹⁷ See *id*, citing VAT Regulations 2002, *supra* note 4, Article 20 (8).

¹⁸ See *id*, citing Article 16(1) and (2) of Directive No. 23/1997.

¹⁹ See Ethiopian Bankers Association, Hidar 8, 2003 E.C., in Amharic, unpublished.

²⁰ See VAT Regulations 2002, s *supra* note 4, Article 20(8).

²¹ See Article 2(3) of Income Tax (Amendment) Proclamation No. 693/2010, *Federal Negarit Gazeta*, 17th year, No. 3.

sales as well. The situation may even come home to roost, as the tax authorities are also empowered by various tax laws to enforce taxes, if need be, by foreclosing upon the property of defaulting taxpayers. It is important to note at the outset that the insights developed in this article may be extended with equal force to all the other forms of foreclosure sales.

1. The Nature of Financial Institutions and Services: A Brief Overview

It is impossible to capture the essence of all financial services that financial institutions offer, so bewilderingly diverse and complex these services have become. The financial crisis of 2008 amply demonstrated how complex and protean financial services have become. The aim here is to grasp the general features of financial services that have made them something of a challenge for VAT systems in the world. For our purposes, we shall confine ourselves to the two well-known financial institutions: banks and insurance companies.

The banking industry offers various types of services. Many of us are familiar with commercial banks that perform the classic function of accepting deposits and making loans.²² Depending on the degree of financial freedom in a given country, banks may also perform other functions in the economy, like that of investment banking.²³ Financial institutions – those that provide intermediation services, among others – vary from country to country. The major ones may include commercial banks (of course), what Meir Kohn calls ‘near banks’ (saving institutions, credit unions and finance companies), insurance companies (life and non-life), investment intermediaries (pension funds, mutual funds), securities’ firms (e.g. brokerage firms), government intermediaries (national/central banks) and non-financial companies that supply financial services.²⁴ The Ethiopian Banking Business Proclamation lists as financial institutions ‘insurance companies, banks, micro-finance institutions, postal saving institutions, money transfer institutions and ‘other similar institutions to be determined by the National Bank’.²⁵

One of the core functions of a financial institution (in particular banks) is the provision of indirect lending.²⁶ This function is probably the best illustration (for

²² Stephen Valdez (5th edition, 2007), *An Introduction to Global Financial Market*, (Palgrave Macmillan), at 65.

²³ *Ibid.*

²⁴ Meir Kohn (2004), *Financial Institutions and Markets*, (Oxford University Press), at 124.

²⁵ See Banking Business Proclamation 592/2008, Federal Negarit Gazeta, 14th year, No. 57, Article 2(9).

²⁶ Meir Kohn, *supra* note 24, at 28.

our purposes) of what a financial intermediary like a bank does. The existence of a financial intermediary removes most of the barriers to lending in the market. The depositor's worry of 'default' by borrowers is greatly reduced by the bank's intercession as a party obligated to pay the depositor on demand.²⁷ Since the financial intermediary specializes in the lending, it has the capacity to cut down the risks of default by collecting a wealth of information about its customers – something which is not available to the depositor as such.²⁸ The financial intermediary also takes advantage of the benefits of pooling (to make large loans), specialization, continuing relationships, diversity and liquidity to supply financial services at a much lower cost than would be available otherwise.²⁹

Meir Kohn has captured the core functions of a financial institution in four words: delegation, credit substitution, pooling and netting.³⁰ Through the devices of 'delegation', a depositor delegates to an intermediary the works of making a loan (thereby reducing the transaction costs associated with lending).³¹ Through the devices of 'credit substitution', the financial intermediary substitutes its own credit for the credit of the borrower; depositors lend to the bank rather than to the ultimate borrower.³² An insurance company substitutes its own credit for that of members of an insurance pool.³³ The device of pooling makes the financial intermediary safer and more liquid.³⁴ And finally netting makes it possible for the financial intermediary to offset one transaction against another.³⁵ These operations of a financial intermediary all involve intermediation of borrowers and depositors (in the case of banks) or insurance policy holders and insurance claimants (in the case of insurance companies).

The Banking Business Proclamation places the intermediate services banks perform in the first order in its definition of 'banking business'.³⁶ Article 3(2) of the Banking Business Proclamation emphasizes the intermediate nature of 'banking business' when it states:

"banking business" means any business that consists of [among others]:

²⁷ *Ibid.*

²⁸ *Ibid.*

²⁹ See *id.*, at 28-30.

³⁰ *Id.*, at 37-40.

³¹ *Id.*, at 38.

³² *Id.*, at 38.

³³ *Id.*, at 38-39.

³⁴ *Id.*, at 39.

³⁵ *Id.*, at 39-40.

³⁶ See Banking Business Proclamation, *supra* note 25.

- a) receiving funds from the public through means that the National Bank has declared to be an authorized manner of receiving funds;
- b) using the funds referred to under paragraph (a) ... in whole or in part, for the account and at the risk of the person undertaking banking business, for loans or investments in a manner acceptable by the National Bank;

We have sufficient authority from the Banking Business Proclamation to place the accent of banking business on 'intermediation'. It is, however, well-known that while the primary functions of many financial institutions is financial intermediation, most financial institutions are not confined to just providing intermediation services. This is what complicates the application or otherwise of VAT upon financial institutions and other institutions that provide financial services. In addition to intermediation, financial institutions (in particular banks) are involved in the provision of a range of so-called 'direct services'. Some banking services are offered in exchange for the payment of direct fees (*for more on these direct services by Ethiopian banks, see below*). One of these is custody services. Customers who wish to deposit some high-value goods (e.g., precious metals) or burglar-prone goods like negotiable securities (e.g. shares and bonds) may do so with banks upon payment of some fees for safe keeping and related services of banks.³⁷ Like all consultancy firms, banks may also be involved in consultancy and/or advisory functions in exchange for the payment of fees.

Whatever these other services may be, the great challenge in VAT is one of distinguishing them from intermediation services, for on that depends whether to impose VAT on the services or not. We shall have occasion to deal with some of these services later under the section on the scope of exemptions for financial services.

2. Why Financial Services are Exempted from VAT

Most VAT systems in the world exempt financial services from VAT primarily because of the technical difficulties involved in identifying and isolating the service charges in financial services like the provision of loans, insurance services, sale of stocks, bonds and foreign currency exchanges.³⁸ The technical difficulty involved, as Yolanda Henderson noted, is that 'financial intermediaries provide a service by channeling funds of persons with certain preferences regarding risk and liquidity [i.e., depositors] to other persons with different preferences'.³⁹ For most of their intermediation services, financial

³⁷ Stephen Valdez, *supra* note 22, at 71.

³⁸ Yolanda Henderson, 'Financial Intermediaries Under Value-Added Taxation', (2001), in Schenk and Oldman, *supra* note 1, at 372ff.

³⁹ *Id.*, at 372.

institutions make profits by spreading the service charges between or among their various customers, thus concealing the value added from the reach of VAT. Banks spread the value added in loans between borrowers and depositors, by charging the former higher interest rates and paying a lower interest rate to the latter. The value added is spread between borrowers and depositors. Similarly, insurance companies spread the risk of insurance coverage among thousands, sometimes millions of policy holders and pay out insurance compensation when the risk materializes with some of their customers. The value added by insurance companies is more than the premiums they charge policy holders.⁴⁰

Harry Huizinga drew the differences between most other supplies and financial services when he wrote:

The value added created by a business is the value of its sales minus the value of its purchased capital and intermediate inputs. For most businesses, calculating total sale and purchases is straightforward. The problem with financial services... is that a major input is financial capital, and pricing such capital is difficult.

Banks, for example, do not 'buy' capital, so it is difficult for them to document how much they paid for this particular input. ...banks raise capital by taking in deposits or by accessing the capital markets. This difference implies many problems for value-added calculations. First, determining the price that banks pay for capital is difficult. The interest rate banks pay to depositors, for example, understates the cost since a whole array of services are tied to bank deposits and these are typically 'paid' for by offering depositors a lower interest rate. But even if it were possible to determine the price banks paid for the capital they use in providing financial services, this would not be enough. The loan interest rate charged to any particular business accounts for some default risk. And while banks surely evaluate such risks, their evaluations are not verifiable. Consequently, the amount of value added created by any given loan is very hard to calculate. *The crux of the problems is that it is virtually impossible for tax authorities to determine whether a high rate of interest on a loan represents big profits, which constitutes value added and thus should be taxed, or a big risk premium, which constitutes a cost and thus should not be taxed. Analogous difficulties arise for a wide range of financial services, including foreign exchange transactions and insurance.*⁴¹ (Italics mine)

Related to the difficulty of figuring out the value added in financial services is the difficulty in identifying the customers of intermediation services.⁴² Because borrowers pay interest in exchange for the extension of loans to them, we may

⁴⁰ Alan Schenk (Rep, 1989), Value Added Tax: A Model Statute and Commentary, American Bar Association Section of Taxation, at 170-171.

⁴¹ Harry Huizinga, (Oct., 2002), Economic Policy, vol. 17, No. 35, 497-534, at 500.

⁴² Yolanda Henderson, *supra* note 38, at 374.

be inclined to believe that borrowers are the customers of banks.⁴³ But the interest paid by the borrowers does not reflect the price charged by financial institutions. Banks connect their relationships with borrowers with their relationships with depositors in ways that make it impossible to know how much value they have added in their services to individual borrowers and depositors.

While technical difficulties stand as the primary reason for exemption of financial intermediation services, it must be remembered that other reasons have also been cited to strengthen the exemption of financial services. These ‘ancillary’ justifications or ratiocinations are offered in resignation over the inevitable arising from the difficulty of taxing financial intermediation services. Some have argued that the nature of financial services justifies their exemption from VAT –or at least makes the exemption more acceptable than otherwise. Financial services (in particular loans) are often provided as inputs to investments, which are relieved from VAT anyway through the tax credit mechanism of the value added tax.⁴⁴

It is argued that even if financial services were to be subject to VAT, the recipient of the services would obtain full credit for the VAT paid on the financial services. The borrowers who obtain loans from banks will use the proceeds for investments and, in an ideal world, they should receive tax credits for their inputs, including taxes paid on financial services. The depositors who obtain interest on their loans may use the money to consume goods and services in the market, by which time they should pay VAT on their consumption. The borrowers of loans will use the proceeds either for investment or consumption. Their spending on consumption goods is subject to VAT when they purchase goods and services from the market (assuming the universal coverage of VAT). If they use the proceeds for investment, they will pay VAT for inputs of their business and these will also be chargeable with VAT, subject to the regular rules of input tax crediting. Hence, the argument runs, little is lost by exemption of financial services from VAT. But these arguments have been developed after it is realized that conventional VAT systems have insurmountable technical challenges in reaching intermediation services. If the technical problems did not exist in the first place, few governments would extend exemptions to provision of financial services.

3. Approaches to VAT treatment of Financial Institutions

Many different approaches have been proposed to the conundrum of financial services, some of which have been put in place in actual legislations.⁴⁵ The most

⁴³ *Ibid.*

⁴⁴ *Id.*, at 374-375.

⁴⁵ See Schenk and Oldman, *supra* note 1, at 361-372.

dominant approach has been that of the European Union, which is followed by many countries in the world.⁴⁶ The EU Directive on the Harmonization of VAT (also known as the VAT Directive) requires member states to exempt a wide range of financial services, such as those relating to the provision of loans, credit, credit guarantees, and transactions involving money, deposit, saving and current accounts.⁴⁷ The EU Directive is not of peremptory character as it authorizes member states to allow taxpayers to treat most of the ‘exempted’ financial services as taxable.⁴⁸ In general, the EU approach is one of exempting financial services and zero-rating⁴⁹ those financial services connected with zero-rated supplies (e.g., financial services rendered in connection with export of goods are zero-rated).⁵⁰

The consequence of exemption for financial services in the EU approach is that input tax credits are denied to exempt financial services. Under the EU Directive, input taxes attributable to exempt financial services are as a rule not entitled to credit.⁵¹ Where input taxes relate to both taxable and exempt financial services, the EU VAT Directive employs an allocation formula, the numerator of which is the VAT exclusive turnover for the year attributable to taxable (including zero-rated) transactions, and the denominator of which is the VAT exclusive turnover for the year attributable to taxable and exempt supplies.⁵²

⁴⁶ *Id.*, at 361.

⁴⁷ See Alan Schenk, ‘Financial Services’, in Richard Krever, *supra* note 1, at 37.

⁴⁸ *Id.*, Schenk quoting VAT Directive, Article 137(1)(a), footnote 12, at 37.

⁴⁹ VAT has a list of technical terms and jargons which baffle novice readers of VAT literature. One of these technical lingoos is the term ‘zero-rated’. Often used along with ‘exemptions’ – which is more familiar – zero-rated treatment is perhaps the most exalted and beneficial treatment in VAT. Zero-rated transactions enjoy a zero-rated treatment, which means that not only is no VAT chargeable on the output (sale), all the VAT paid on the inputs is fully creditable as well. Exemptions in VAT are often misleading. They convey the impression that VAT is not chargeable on exempted goods and services. That is not really the case. Exempted goods and services are exempted from the output VAT due on sales only. Exempted goods and services are not entitled to a tax credit for the VAT paid on inputs (a privilege reserved for zero-rated transactions) – which means that exempted goods and services carry a hidden VAT, i.e., VAT paid on inputs; see Michael Keen and Stephen Smith (2007), VAT Fraud and Evasion: What Do We Know and What Can be Done? IMF Working Paper WP/07/31, International Monetary Fund.

⁵⁰ Schenk, *supra* note..., foot note 13, at 37, quoting S Cnossen ‘VAT Treatment of Financial Services’ in Lindocrona et al (eds.) *International Studies in Taxation: Law and Economics* (1999) 91.

⁵¹ Schenk, *supra* note 47, at 37.

⁵² *Ibid.*; foot note 16, quoting EU Directive, Article 174.

Other approaches have also emerged, which, while resembling the EU approach in essential features, also depart in some respects. The Indonesian and Australian Goods and Services Taxes (GST)⁵³ – analogous to VAT – are, for example, distinguished for allowing some input taxes attributable to exempt financial services, in effect zero-rating some financial services even when these services are destined for the domestic market.⁵⁴ Somewhat similar to these approaches is that of New Zealand Goods and Services Tax (GST). New Zealand's GST has an elective scheme that zero-rates financial intermediation services rendered to certain qualified registered persons.⁵⁵ A recipient is deemed qualified if its taxable supplies amount to 75% or more of its total supplies.⁵⁶

South Africa has emerged as another model country for expanding the tax base for financial services beyond the conventional approach of the EU.⁵⁷ South Africa has adopted a VAT regime which imposes tax on financial services rendered for explicit fees.⁵⁸ South Africa has gone farther than many countries in expanding the reach of VAT on financial services,⁵⁹ and the South African approach is spilling over to the neighboring countries of Namibia and Botswana.⁶⁰ South Africa imposes VAT on currency exchange transactions, transactions involving cheques, letters of credit, debt, equity or participatory securities and some credit transactions.⁶¹ South Africa also imposes VAT upon fee-based services on checking and saving accounts, money transfers, off-site or electronic banking, credit and debit cards, foreign exchange transactions, mortgage loans, rental agreements, documentation and similar motor finance services, brokerage and underwriting transactions, registration of shares,

⁵³ GST – like VAT- is a multi-stage consumption tax on each point of supply in a production chain, with suppliers entitled to refunds of GST incurred on inputs; see P R Hill et al (2006,), *Australian GST Handbook: 2006-2007*, (Thomson), at 4; some countries have used other names to designate taxes analogous to VAT. VAT is known simply as a 'consumption tax' in Japan, and GST (Goods and Services Tax) in Canada, New Zealand and Australia; the acronyms for VAT obviously vary across languages: TVA in France, IVA in Spanish, NDS in Russian, and DRG in Georgian, see Victor Thuronyi (2003), *Comparative Tax Law*, Kluwer Law International, at 305.

⁵⁴ Schenk, *supra* note 47, at 38-39; see also P R Hill et al, *supra* note 53.

⁵⁵ Schenk, *supra* note 47, at 40.

⁵⁶ *Ibid.*

⁵⁷ *Id.*, at 41.

⁵⁸ Schenk & Oldman, *supra* note 1, at 361.

⁵⁹ Schenk, *supra* note 47, at 41.

⁶⁰ *Id.*, at 42.

⁶¹ *Id.*, at 41.

custody of securities, investment advice, and safety deposit boxes.⁶² The tax authorities in South Africa have developed a list of taxable, exempt and zero-rated financial services after consultation with representatives of the financial sector.⁶³

Upon closer examination, we notice that the South African approach is a variant of the EU approach, with the important difference that South Africa has developed a long list of fee-based financial services as taxable financial services. The South African VAT limits exemption to interest charges or discounts that serve as interest charges or interest penalties.⁶⁴

A country that has truly departed from the EU approach both in form and content is Israel. It taxes intermediation services through the addition method VAT,⁶⁵ and taxes their inputs through the regular VAT.⁶⁶ In effect, Israel imposes VAT on financial institutions in two ways. First, it charges VAT on inputs purchased by banks and these input VATs are not creditable (this is incidentally the case in all those countries which exempt financial services from VAT). In addition, Israel imposes VAT on the total of profits of financial institutions and wages paid by financial institutions to their employees.⁶⁷ The second VAT, for which Israel claims exception, is administered along with the income tax – in fact, the information collected for income tax purposes is used for application of VAT on banks.⁶⁸

The Ethiopian VAT law falls squarely within the EU approach, as aptly conceded by the drafter of Ethiopian VAT laws.⁶⁹ The VATP of 2002 curtly states that financial services are exempted from VAT, without going into details of what these services might be. The VATRs, issued along with the VATP, however, deal with this issue in some details. The VATRs list a number of financial services that are exempted from VAT (whether rendered for explicit

⁶² Schenk & Oldman, *supra* note 1, at 364.

⁶³ Schenk, *supra* note 47, at 41-42.

⁶⁴ Schenk & Oldman, *supra* note 1, at 364.

⁶⁵ The addition method VAT adds the components of value added, namely, interest on loans, rent paid, wages and salaries, and net profit to calculate the VAT due; see Schenk & Oldman, *supra* note 1, at 39-40.

⁶⁶ Schenk & Oldman, *supra* note 1, at 361.

⁶⁷ *Id.*, at 362.

⁶⁸ *Ibid.*; the Israeli VAT system is not without its critics; some argue that this form of tax imposes double taxation on financial services as no input tax credit is available to business borrowers; the tax is imposed after the fact; see *ibid.*

⁶⁹ See Schenk, *supra* note 47, at 34.

fees or not).⁷⁰ The VATRs also list the services that are taxable even when they are provided by financial institutions.⁷¹ We shall analyze the scope of VAT exemptions under Ethiopian law below.

4. The Scope of Exemptions for Financial Services and Taxable Financial Services

Exemptions of whatever nature inevitably lead to disputes over the scope and nature of exemptions. The VATP of 2002 lists financial services as one of the services exempted from VAT but neither defines nor describes what these services are.⁷² It was left to the VATRs to list (if not define) the types of financial services that are exempted and those that are taxable.⁷³ The Regulations give a fairly extensive list of financial services that are exempted from VAT ‘whether provided for explicit or implicit fees’.⁷⁴ The Regulations give an equally extensive list of financial services that are taxable ‘whether or not they are rendered in connection with an exempt financial service’.⁷⁵

The list of ‘exempt financial services’, which incidentally does not seem to be exhaustive, includes in its ranks the familiar list of financial services provided by, among others, banks and insurance companies. Provision of loans or credits and foreign exchange transactions by banks is, for example, exempted from VAT.⁷⁶ Similarly, provision of insurance and reinsurance by insurance companies is exempted from VAT.⁷⁷ In addition, provision of provident funds, pension or retirement annuity funds by mutual fund companies, is also exempted from VAT.⁷⁸

Contrary to what some financial institutions (in particular banks) have come to believe, the exemptions are not granted because of what the institutions are but because of the nature of the services. VAT exemption for financial services is not to be interpreted as a privilege of the financial industry but of certain services provided by the industry. There are a number of provisions which emphasize this. First of all, the financial services that are granted exemption are

⁷⁰ See VAT Regulations 2002, *supra* note 4, Article 20(2); see also Schenk, *supra* note 47, at 35.

⁷¹ See VAT Regulations 2002, *supra* note 4, Article 20(6).

⁷² See *id.*, Article 8(2)(b).

⁷³ See *id.*, Article 20.

⁷⁴ See *id.*, Article 20(1).

⁷⁵ See *id.*, Article 20(6).

⁷⁶ See *id.*, Article 20(2) (a) and (b).

⁷⁷ See *id.*, Article 20(2)(d).

⁷⁸ See *id.*, Article 20 (2)(e).

exempted even when the services are rendered in connection with supplies of goods.⁷⁹ For example, banks enjoy exemptions for loans they extend in connection with the acquisition of goods in hire-purchase or finance lease cases, as long as the loans as well as the charges and interests for the loans are shown separately in the transactions and this is disclosed to the recipients of the goods.⁸⁰ The privilege of exemption also extends to suppliers that are not financial institutions if the suppliers provide loans with interest in connection with the acquisition of goods and services.⁸¹ Hence, suppliers of goods or services that provide loans to customers in connection with the acquisition of goods or services in hire-purchase agreements or finance lease agreements are also covered by the privilege of exemption. Even suppliers that sell goods on installment payment arrangements are covered by the privilege of exemption as long as they are able to insulate the loan transactions from the underlying sales transactions.⁸² The interest charged for installment (deferred) payments is exempted as a financial service while the underlying sales transactions are subject to VAT like all regular transactions.⁸³

The lists of exempted financial services are illustrative. We have no general provision that gives the common thread that connects all exempt financial services, which is a challenge when we are faced with new types of financial services that are not mentioned in the lists. We are therefore compelled to extrapolate from the illustrative list a common thread that characterizes all exempt financial services. That common thread is ‘intermediation’, which, as alluded to before, makes it difficult for VAT systems throughout the world to apply conventional VAT upon these services.⁸⁴ The last item in the list of exempt financial services in the VATRs makes a reference to ‘provision of intermediation services by a buy-aid society or medical aid fund’, which seems to indicate the nature of financial services which compelled exemption in the first place.⁸⁵ It is intermediation that put financial services beyond the reach of conventional VAT and it is intermediation which should extend exemption to those services that are not mentioned in the list.

The VATRs also list taxable financial services.⁸⁶ The list includes ‘legal, accounting, record keeping services’, ‘safe custody services’, ‘data processing

⁷⁹ See *id.*, Article 20(2) (c).

⁸⁰ See *ibid.*

⁸¹ See *id.*, Article 20(5).

⁸² See *id.*, Article 7(4)(b) and Article 20(5).

⁸³ See *id.*, Article 20(5).

⁸⁴ See above.

⁸⁵ See VAT Regulations 2002, *supra* note 4, Article 20(2)(g).

⁸⁶ See *id.*, Article 20(6).

and payroll services’, ‘debt collection and factoring services’, ‘management services’ and ‘trustee, financial, advisory and estate planning services’.⁸⁷ Even a cursory reading of the list and prior knowledge of the range of services provided by financial institutions in Ethiopia will indicate that the list is forward-looking. There are many services in the list which are either entirely unknown in the lexicon of Ethiopian financial industry or not yet put in place. As in the case of exempt financial services, the list is additional evidence that the exemptions are not granted to the financial industry as such but due to the nature of certain services which happen to be commonly offered by financial institutions. While intermediation services are the core functions of financial institutions, financial institutions are not confined to providing just intermediation services.

Even in the limited range of functions provided by financial institutions in Ethiopia, some of the taxable services are well known practices. Some banks are known to provide payroll services for other businesses and the government.⁸⁸ The Tax Authorities themselves are increasingly relying upon banks for processing tax payments.⁸⁹ Many taxpayers particularly in the capital – Addis Ababa – remit taxes through banks. Banks also offer safe custody services to customers. One of the well-publicized services of banks in recent times is the sale of shares on behalf of companies that are about to be established, and banks offer these services in exchange for the payment of commissions.⁹⁰ While these services are well-known in the financial industry, other services in the list are not so well known. Banks and insurance companies in Ethiopia are seldom involved in the provision of the so-called ‘legal, accounting, management, estate planning and financial advisory services’. Debt collection and factoring services are probably unknown in the Ethiopian financial industry – a factor which partly accounts for the confusion that surrounds these concepts in the VAT. The list of ‘taxable’ financial services, like that of exempt services, is taken from the laws of mature financial and tax systems and is not illustrative of the practice in Ethiopia.

The challenge here is distinguishing and characterizing certain transactions as ‘exempt’ and others as ‘taxable’. While this problem is not of financial institutions and services *per se*, it is more pronounced here. There are of course clear cases on both sides. Supplies of loans and acceptance of deposits (the classic banking transactions) should remain exempted even when banks appear to charge explicit or implicit fees for these services. Similarly, the provision of

⁸⁷ See *id.*, Article 20(6) (a-g).

⁸⁸ Interview with Ato Eshetu Erana, Oromia International Bank, formerly a legal advisor to the National Bank of Ethiopia, May 9, 2011.

⁸⁹ *Ibid.*

⁹⁰ *Ibid.*

insurance coverage by insurance companies (including re-insurance) should remain exempted regardless of how these services are structured between insurance companies and policy holders.

There are also clear cases on the side of ‘taxable’ financial services. The provision of payroll services, the collection of taxes on behalf of tax authorities, rental of safe boxes for valuable items are clearly taxable even if these services are provided by financial institutions. These services are typically provided in exchange for the payment of direct fees or commissions. There is therefore little or no difficulty in reaching these types of transactions through conventional VAT systems.

The less common practices in the list have led to mis-constructions in practice. Some within the Tax Authority have, for example, considered foreclosure sales to be ‘debt-collection’ services, which, as we saw above, are included in the list of taxable services. In *Abyssinia Bank* case (*supra* note 9), the counsel for the Tax Authority argued that foreclosure sales constitute ‘debt collection’ services in the VATRs literally understanding debt collection to mean any action of the bank to collect its own debt. This is clearly a misunderstanding. There is the need go no farther than the VATRs to understand what ‘debt collection’ and ‘factoring services’ might mean for VAT purposes. Debt collection and factoring services are described in sort of suggestive way in Article 20(8) of the VATRs as ‘services related to debt recovery, litigation and the management of the recovery of the amount due from the debtors.’ If the Regulations are not sufficiently suggestive, recourse may be made to the mature practices of the range of financial and other services in other countries.

We need to define and fix the meaning of ‘debt collection and factoring services’, which the VATRs mention among those services taxable if and when they are provided by financial or non-financial institutions. It is doubtful if any financial institution in Ethiopia provides ‘debt collection’ services. The VATRs refer to debt collection of a different order. Debt collection services are typically provided by financial and non-financial institutions in other countries to persons who do not want to spend time and money collecting debts from their debtors. Many companies in the developed world outsource debt collection to specialized agencies or companies in order to cut down on the administrative costs of debt collection. Debt collection agencies or companies typically charge their customers fees or commissions for their services. They pursue defaulting debtors and collect debts on behalf of their clients.

Factoring is also probably entirely unknown in Ethiopian financial practice. Factoring companies or enterprises purchase trade debts (accounts receivables)

from clients at a discount before the debts are due.⁹¹ Factoring involves the sale of accounts receivable at a discount to factoring companies in order to improve cash flows.⁹² It is one of the great devices created to increase liquidity of otherwise illiquid assets, namely accounts receivables. ‘Factor’ companies may be independently established to provide factoring services; or financial institutions like banks may create units or subsidiaries to provide factoring services to customers who need these services.⁹³ In any event, it may be seen that the ‘debt collection’ and ‘factoring’ services mentioned in the VATRs have nothing to do with foreclosure sales. Foreclosure sales may be understood colloquially as debt collection *actions*, but they are not ‘debt collection’ *services* in the technical language of these services.

Apart from the real problem of delimitation, there is also a problem of unbundling taxable services from exempt services when the two are provided by financial institutions in undifferentiated manner. Financial institutions may make the task of unbundling difficult by providing both services in undifferentiated fashion. Financial institutions may choose to provide taxable services along with exempt financial services without charging explicit fees, concealing the value added in the range of services they provide as a whole to a customer. If a bank provides investment advisory services to a borrower as a package of services it provides to the latter, how are we going to separate the fees for the investment advisory from the interest chargeable on the loans when the bank has not done so in its transactions?

After carefully weighing how VAT operates, financial institutions should realize that it is in their best interest to un-bundle exempt financial services from taxable services. Financial institutions obtain the right to claim input tax credit in respect of the taxable services, and they are able to claim input tax credits only if they un-bundle the taxable services from the exempt services.

5. Why Foreclosure Sales is Missing from the List

Both sides have tried to make a point out of the absence of foreclosure sales in the list of either exempted financial services or taxable financial services. Those who wished to press for the taxation of foreclosure sales pointed to the absence of foreclosure sales among the list of exempted financial services as evidence of

⁹¹ See Ross Cranston (2nd ed., 2002), *Principles of Banking Law*, (Oxford University Press), at 260.

⁹² See *id.*, at 354-355.

⁹³ Factoring services may be ‘recourse’ or ‘non-recourse’ services. In a non-recourse factoring services, the provider (called the factor) bears the risk of losses on bad debts, while in a recourse factoring, the factor reserves the right of recourse in case the factor is unable to collect the debts; *id.*, at 355.

the intention of the lawmakers to exempt foreclosure sales from the payment of VAT. Those who wished to see foreclosure sales exempted pointed to the absence of foreclosure sales in the list of taxable supplies as evidence that these sales are exempted from the payment of VAT. Which begs the question: why is foreclosure sales not mentioned in the list of either exempted or taxable financial services?

The speculation that foreclosure sales did not appear in the list because these forms of sales were unknown or even uncommon banking practices must be dismissed immediately. Foreclosure sales are fairly common practices of banks even in Ethiopia where the financial sector is not as developed and certainly not as diverse and complicated as in some other countries. The Proclamation which authorizes banks to foreclose debtors' property precedes the VAT legislations by at least four years.⁹⁴ The list of exempt and taxable financial services in the VAT laws of Ethiopia includes some uncommon and even non-existent financial services in Ethiopia, no doubt in anticipation of the development and diversification of financial services in that direction in the future. How is this rather expansive and forward-looking list said to be missing foreclosure sales by banks?

There is one plausible explanation which may at first sound counter-intuitive but true in retrospect. Foreclosure sales by banks are not services in the strict sense of the term 'services' under the VAT laws. They are self-help actions by banks. Banks resort to foreclosure sales to enforce the payment of loans in the event of the loans remaining unpaid by debtors upon the expiry of due dates. When loans are paid on time by borrowers, the security agreement is terminated and the collaterals are redeemed to the borrowers. The payment of the loan by borrowers occasions no VAT whatsoever as there are no taxable transactions between the borrowers and the bank. As the extension of the loan was exempted from VAT, so is the payment of the loan by the borrowers.

The absence of foreclosure sales by banks from the list of either 'exempt' or 'taxable' financial services is, therefore, not a result of oversight by the drafter but a recognition that foreclosure sales are not even distinct financial services. Foreclosure sales typically occur in order to enforce the terms of a contract of loan. The bank which seeks enforcement through foreclosure is not providing any service to any person, but helping itself to repayment of the loan. While foreclosure sales appear as transactions between banks and bidders, they are in reality actions taken by banks to enforce the terms of a loan contract – in other words, self-help services. As we shall explore below, the mere fact that

⁹⁴ See Property Mortgaged or Pledged with Banks Proclamation No. 97/1998, *Federal Negarit Gazeta*, 4th year, No. 16; a Proclamation to Provide for Business Mortgage Proclamation No. 98/1998, *Federal Negarit Gazeta*, 4th year, No. 17.

foreclosure sales are self-help actions does not exempt them from VAT. While from the vantage point of the banks, foreclosure sales are self-help actions, they also conceal another layered transaction, which may make them eligible for VAT.

6. The Nature of Bank Sale Foreclosures

Foreclosure sales are not different from other conventional sales. Foreclosure sales exhibit all the attributes of a typical sales transaction. There are typically two parties involved, the seller and the buyer. There is an express price and an object of sale. The only thing peculiar about foreclosure sales is the circumstances under which the sales occur. Foreclosure sales invariably occur to enforce a payment of debt, which is expressed in a separate contract or a judgment of a court.⁹⁵ Another peculiarity (if we can call it that) of foreclosure sales is that these sales typically occur in auction sales. But that does not change the nature of foreclosures as sales.

The Civil Code of Ethiopia treats ‘sale by auction’ as one type of sale.⁹⁶ The Civil Code describes the peculiar circumstances in which auctions occur. One of these is the fact that the sale is made to the highest bidder.⁹⁷ Whoever participates in a public auction is bound by his offer on the terms or conditions of the sale unless a higher bid is made or his offer is not accepted immediately after the usual calls.⁹⁸ Once auction sales are consummated, they assume the conventional attributes of a typical sale, with obligations on the part of the seller to deliver the goods and of the buyer to pay the price.⁹⁹

Since the sales transactions accompanying foreclosure procedures are nothing out of the ordinary, they are not really difficult to tax. Foreclosure sales are thoroughly accessible to VAT on technical grounds. Foreclosure sales meet the profile of ‘supply of goods or services’ (*for the meaning of supply of goods or services, see below*).¹⁰⁰ They also meet the requirement of consideration, the price at which the goods are foreclosed and sold constituting consideration for the supply of goods in foreclosure sales.¹⁰¹ We do not even have to resort to one

⁹⁵ See Property Mortgage Proclamation, *supra* note 94, Article 3; Business Mortgage Proclamation, *supra* note 94, Article 13; Civil Procedure Code of Ethiopia (1965), *Negarit Gazeta* – Extraordinary Issue No. 3 of 1965, Articles 394ff.

⁹⁶ See the Civil Code of Ethiopia (1960), *Negarit Gazeta*, Gezette Extraordinary, 19th year, No. 2, Articles 2403-2407.

⁹⁷ See *id.*, Article 2404.

⁹⁸ See *id.*, Article 2404(2).

⁹⁹ See *id.*, Article 2403.

¹⁰⁰ See VAT Proclamation 2002, *supra* note 4, Article 4(1)(a).

¹⁰¹ See *id.*, Articles 6 and 12.

of the presumptive rules of VAT in order to figure out the value of the supplies. Those who vociferously argue for taxation of foreclosure sales can therefore be forgiven for mingling foreclosure sales with ordinary sales transactions that attract VAT. The only thing different about foreclosure sales is the circumstances in which the sales occur. Foreclosure sales occur typically to enforce a debt, whether that debt is expressed in a separate contract or in a judgment of courts.

Both the Property Mortgage and Business Mortgage Proclamations furnish all the necessary elements we need to characterize foreclosure sales for VAT purposes. Since both Proclamations are virtually identical in every respect except the underlying property subject to sale, we use the two pieces of legislation interchangeably for the purposes of this article. Both laws emphasize the agency character of foreclosure sales. Although banks are in charge of foreclosure sales, both laws emphasize that foreclosure sales are ‘executed on behalf of the debtor’.¹⁰² Banks are not regarded as owners of the property they foreclose. In fact, banks are ‘liable for any damage they cause to the debtor in the process of selling the property through foreclosure procedures.’¹⁰³

Only in exceptional cases are banks authorized by law to have the debtor agree in a contract of loan for banks ‘to take over the property in consideration of its estimated value as specified in the contract of loan’.¹⁰⁴ But the transfer of the property even then occurs from the debtor to the bank, which effectively prevents foreclosure sales from happening. In all circumstances, the transfer of property occurs from the debtor to third parties, and in exceptional circumstances, the transfer occurs from the debtor to a creditor bank. We have therefore established conclusively that banks are involved in foreclosure sales as agents of debtors, not as owners of the property foreclosed. The proper characterization of the foreclosure sales sets the stage for the next question: should VAT apply to foreclosure sales. The next section addresses this question.

7. VAT and Bank Foreclosure Sales: Setting Different Scenarios

In order to properly understand the nature of foreclosure sales and their VAT implications, there is no better place to start from than the opinions of the drafter of the Ethiopian VAT laws: Professor Alan Schenk. Professor Schenk was also a Reporter for the Committee on Value Added Tax of the American Bar

¹⁰² See Property Mortgage Proclamation, *supra* note 94, Article 5; Business Mortgage Proclamation, *supra* note 94, Article 15.

¹⁰³ See Property Mortgage Proclamation, *supra* note 94, Article 7; Business Mortgage Proclamation, *supra* note 94, Article 1.

¹⁰⁴ See Corrigendum to Property Mortgaged or Pledged with Banks Proclamation No. 97/1998 No. 1/1998, *Federal Negarit Gazeta*, 4th year, No. 17.

Association Section of Taxation.¹⁰⁵ As a member of the said Committee, Professor Schenk helped draft a Model Value Added Tax Statute suitable for adoption by the United States (incidentally the US is the only industrialized nation which does not have a national Value Added Tax). The Model Statute has a special section devoted to the transfer in satisfaction of debts, to which reference is here made for its instructive points on VAT and foreclosure sales.¹⁰⁶ Section 4039 of the Model Statute provides that ‘the transfer of property or services by a debtor to a creditor in payment or reduction of debt is a sale of such property or services.’ In his explanatory text to this section, Professor Schenk charts different scenarios of transfer of property or services from a debtor to a creditor.

The first scenario is where the debtor transfers ownership (title) of the property to a creditor in payment of the debt.¹⁰⁷ In this instance, writes Professor Schenk, a transfer occurs from the debtor to a creditor. The second scenario is where the property (collateral) is sold by or on behalf of the debtor to a third party in a foreclosure or similar sale and the proceeds are used to pay the debt.¹⁰⁸ In this second instance, too, the debtor is regarded as the seller of the collateral.¹⁰⁹ In both instances, the transfers or sales may be taxable, depending on whether the debtor is a registered VAT payer. If the debtor is not registered for VAT (for example, if the debtor is selling his/her residential property in a foreclosure), the transfer or sale is not chargeable with VAT, because the debtor (as a supplier) is not a registered person. In all instances involving dealings between debtors and creditors, the only situation where the creditor (e.g., the bank) may be required to account for the VAT is where the ‘creditor has control over the remittance of the proceeds to the debtor’.¹¹⁰

If we transpose the scenarios established by professor Schenk in the abstract to the concrete situation of the *Abyssinian Bank* case, three scenarios will emerge. The *first* and most likely turn of events in these kinds of situations is that Tana International (debtor) would pay back the loan it owed to the Bank along with the interest due thereon. In so doing, Tana International redeems the collateral. The repayment of the loan as well as the interest due thereon is an exempt financial transaction. Under Ethiopian VAT laws, neither the transfer of

¹⁰⁵ See Alan Schenk, *supra* note 40.

¹⁰⁶ See Section 4039, in Alan Schenk, *supra* note 40, at 181.

¹⁰⁷ *Ibid.*

¹⁰⁸ *Ibid.*

¹⁰⁹ *Ibid.*

¹¹⁰ *Ibid.*

the collaterals as security nor the redemption of the collaterals attracts VAT.¹¹¹ The redemption of property leads to taxation only where the original transfer of the property constitutes a supply of goods under the VAT law. This occurs in finance lease or hire-purchase (hiring sale) agreements.¹¹² The granting of security interest by a debtor to a creditor is a non-taxable transaction and the redemption of the collateral upon payment of the debt (the loan) does not lead to taxation either.

The *second* scenario is that Tana International (the debtor) agrees to surrender the collaterals to the Bank in payment of the loan. This is regarded as a supply of goods by Tana International to Abyssinia Bank. The fact that the supply occurs in the context or against the background of payment of the loan does not change the nature of the supply for VAT purposes. It is taxable. Tana International is required to issue VAT invoices and collect the VAT due upon the transfer of the collaterals just as it would be required to if the collaterals were sold in the market.

The *third* scenario, as actually happened in the Abyssinia Bank case, is the case of the Bank foreclosing the collaterals as it is authorized by Property Mortgage and Business Mortgage Proclamations. Here the characterization of the transaction is important. The law casts the transaction as one occurring between the debtor and a winning bidder, the Bank acting merely as an agent. In essence, therefore, the transaction is not different from the second scenario above, except that the transfer now occurs from the debtor to a third party bidder, instead of from the debtor to the bank. This transfer carries VAT as in the second scenario. It fulfills all the requirements of VAT. Since those who object to taxation of foreclosure sales doubted whether these sales are taxable transactions within the meaning of the VAT laws, it may be in order to review the notion of ‘taxable transactions’ and cognate VAT concepts to assess whether foreclosure sales meet this basic requirement in VAT.

8. The Notion of “Taxable Transactions”

The key to the application of VAT to domestic supplies of goods and services is the notion of ‘taxable transactions.’¹¹³ Every supply of goods or services must

¹¹¹ Article 3 (10) of VAT Regulations states that ‘the provision of goods on consignment and the transfer of goods to a person in a representative capacity is not a supply’; VAT Regulations 2002, supra note 4.

¹¹² See *id.*, Article 7(4).

¹¹³ See VAT Proclamation 2002, supra note 4, Article 7(1)(a)); see also, Article 3 of the VAT Proclamation which prescribes the scope of application of VAT; taxable transactions, imports of goods and import of services; for imports, it is not at all necessary for the imports to be taxable transactions.

be a taxable transaction before VAT attaches to it. Article 7(3) of the VATP defines a taxable transaction as:

... a supply of goods or a transaction of services in Ethiopia in the course or furtherance of a taxable activity other than an exempt supply...

The notion of taxable transaction is relevant to all transactions that attract VAT. We shall examine this notion for purposes of understanding ‘foreclosure sales’ in VAT. We can deduce from a cursory reading of the definition above that the notion of taxable transactions consists of at least three elements. A taxable transaction is:

- a) a supply of goods or services;
- b) that occurs in Ethiopia;
- c) in the course or furtherance of a taxable activity.

Since there is little doubt that foreclosure sales that have become a matter of some debate all occur in Ethiopia, we shall easily dispense with the second element (b) and focus upon elements (a) and (c) instead.

8.1- Supply of Goods or Services

Both the VATP and the VATRs contain definitions that will help us unlock the meaning of the first element for application of VAT: supply of goods or services. Goods are defined in the VATP expansively as ‘all kinds of corporeal movable or immovable property’, including ‘thermal, electrical energy, heat, gas, refrigeration, air conditioning and water’ but excluding ‘money’.¹¹⁴ And services are defined as ‘work done for others, which does not result in the transfer of goods’.¹¹⁵ Between them, the notions of goods and services share all types of goods and services imaginable, except money, which is excluded from VAT because of its unique role in the market as a medium of exchange.¹¹⁶ The meanings ascribed by the VATP and the VATRs to ‘supply of goods’ and ‘supply of services’ is a mere expansion of the meaning of goods and services. Supplies of goods or services are therefore understood as ‘sale’, ‘grant’ ‘transfer’ or ‘rendition’ of goods or services.¹¹⁷

With respect to foreclosure sales, few would doubt that foreclosure sales represent supplies of goods within the meaning given to these terms in the VAT laws. The only question over which the opposing camps have parted company is whether foreclosure sales constitute exempt supplies, which we shall examine

¹¹⁴ See *id*, Article 2(7).

¹¹⁵ *Id*, Article 2(16).

¹¹⁶ See *id*, Article 2(8).

¹¹⁷ Compare the terms used in the definitions with VAT Proclamation, Article 4(1)(a)&(b).

later in this article. Foreclosure sales represent conventional sales of goods and easily qualify as supplies of goods for purposes of VAT.

8.2- In the course or furtherance of a taxable activity

This requirement, a subject of much debate in the *Abyssinian Bank* case, actually consists of two elements: ‘taxable activity’ and ‘in the course or furtherance of...’. It will be seen that a separate analysis of the two elements is necessary for proper understanding of the application of VAT upon domestic supplies of goods and services.

a) ‘Taxable Activity’

This requirement in particular has been a subject of intense debate among the opposing camps as well as in the Tax Appeal Commission and the Courts. Like the notion of ‘taxable transactions’, of which it is a part, the notion of taxable activity is defined in the VATP and elaborated in the VATRs. Article 6 of the VATP defines ‘taxable activity’ as ‘an activity which is carried on continuously or regularly by any person’ ‘in Ethiopia or partly in Ethiopia’ involving or intending to involve... the supply of goods or services to another person for consideration’.¹¹⁸ The notion of ‘taxable activity’ consists of at least three elements, as can be readily inferred from the definition. The activity must:

- i) be continuous or regular;
- ii) involve or be intended to involve a supply for consideration; and
- iii) be carried on in Ethiopia or partly in Ethiopia.

In connection with foreclosure sales, elements (ii) and (iii) were never contested. For whatever it is worth, it is element (i) that has become a subject of some debates. In the *Abyssinia Bank* case, the counsel for the Bank argued that foreclosure sales are not ‘continuous or regular’ activities of banks, their regular activity being the business of banking. For our purposes, we shall concentrate upon the issue of ‘continuity’ or ‘regularity’ in VAT and explore why it is placed as one of the requirements for application of VAT in domestic transactions.

In the *Abyssinia Bank* case, it is aptly shown that the parties as well as the tribunals have tended to confuse ‘taxable activities’ with ‘taxable transactions’. The two expressions, while related, are not the same. The requirement of ‘continuity’ or ‘regularity’ is an attribute of a taxable activity, and not of a ‘taxable transaction’. It may be helpful to remember that other countries use phrases like ‘economic activity’, ‘enterprise’ or ‘business’ to refer to what the

¹¹⁸ For more on the notion of taxable activity, see Schenk and Oldman, *supra* note 1, at 96-98; P.R. Hill et al, *supra* note 53, at 61-64.

Ethiopian VAT law calls ‘taxable activity’.¹¹⁹ A taxable activity must be a continuous or regular activity to be subject to the regime of VAT. Contrary to the conventional misconception, VAT is not a transactional tax like stamp duties or even customs duties. VAT requires some regularity in the activity of the taxpayer and imposes certain ‘recurrent’ obligations upon taxpayers. Taxpayers in VAT must be registered for VAT.¹²⁰ Taxpayers must maintain books and records for purposes of complying with the regime of VAT.¹²¹ Taxpayers must file returns on a regular basis, every month in Ethiopian case.¹²² There are regular communications between taxpayers and the government, involving transactions such as input tax credits, refunds and payment of VAT on outputs.¹²³ For those taxpayers who have installed ‘sales register machines’, these ‘communications’ now occur in real time.

All these attributes of VAT indicate that the regime of VAT applies to those taxpayers who exhibit certain attributes, regularity or continuity of activity being one of them. Certain transactions may nominally meet the registration threshold (e.g., one time transactions involving millions of Birr) but they do not attract VAT because they do not meet the profile of a taxable activity as a ‘continuous’ or ‘regular’ activity. A one-time supplier of goods or services cannot become a taxpayer for VAT purposes, although that person may become a taxpayer for purposes of transactional taxes like stamp duties.

In practice, there is a tendency to confuse a taxable activity with taxable transactions, as amply shown in the *Abyssinia Bank* case. The counsel for the Bank argued that the sale of collaterals in foreclosure sales does not constitute a ‘continuous’ or ‘regular’ activity of the bank. This argument arises from the confusion of taxable transactions with taxable activities. For application of VAT, the transaction does not have to be continuous or regular to attract VAT as long as the transaction is carried in the context of a taxable activity. Setting aside for the moment the argument of whether a bank is exempted from VAT or not, transaction of foreclosure sales by the bank does not have to be continuous or regular for it to attract VAT as long as it is supplied by a continuous or regular activity, i.e., the bank. The phrase ‘taxable activity’ refers to the bank, and the phrase ‘taxable transactions’ refers to, among others, foreclosure sales

¹¹⁹ The Australian GST law, for example, uses the word ‘enterprise’ to refer to the same thing; see P.R. Hill, *supra* note 53, at 61; Professors Schenk and Oldman use the expression ‘taxable business activity’ to refer to what is known in Ethiopian VAT legislation simply as ‘taxable activity’; see Schenk and Oldman, *supra* note 1, at 105.

¹²⁰ See Schenk and Oldman, *supra* note 1, at 90.

¹²¹ See VAT Proclamation 2002, *supra* note 4, Article 16.

¹²² See *id.*, Articles 37-39.

¹²³ See *id.*, Articles 20, 21, 26, 27 and 28.

of collaterals. The transaction itself may be rare or unique in the life cycle of a taxable activity, but that is of no consequence for VAT. As long as the transaction occurs in the context of a regular or continuous activity, it is chargeable with VAT no matter how rare.

This distinction was not heeded in the arguments of the parties in the *Abyssinia Bank* case, although there is sufficient authority in the VAT laws showing how the two phrases are different. The VATRs make this distinction abundantly clear. Article 4 of VATRs seems to anticipate the possible confusions that might arise between taxable activities and taxable transactions. It states that ‘anything done in connection with the commencement or termination of a taxable activity’ is also a taxable activity. Sales during liquidations may be rare or even unique for that business, but they constitute taxable transactions since they are carried on in connection with a taxable activity, in this case in connection with its termination. The rarity of the transactions themselves is of no consequence for VAT.

Unfortunately, the confusion is not limited to the *Abyssinia Bank* case. Apparently stung by the setback in the *Abyssinia Bank* case, the Tax Authorities pushed through an amendment of the provisions in this regard in a bid to do away with the requirement of ‘continuity’ or ‘regularity’ for application of VAT.¹²⁴ This, we submit, is totally unnecessary. The requirement of ‘regularity’ or ‘continuity’ is an essential, nay, indispensable attribute of a taxable activity in all VAT systems, Ethiopia unexcepted. Doing away with the requirement of ‘regularity’ or ‘continuity’ might mean in the future (if the amendments are to be taken seriously) that VAT in Ethiopia would apply to one-time transactions by consumers – turning VAT into transactional taxes like stamp duties. This is contrary to the nature of VAT. What the Tax Authorities did not realize in pushing through this amendment is the difficulties involved in bringing consumers into the network of a regular activity of VAT – registration, input tax credits, etc.

b) ‘In the course or furtherance of...’

Another requirement in VAT which might engender disputes particularly in the context of foreclosure sales is the phrase ‘*in the course or furtherance of...*’. The parties in the *Abyssinian Bank* case alluded to this phrase in defending their respective positions. The counsel for *Abyssinia Bank* suggested that foreclosure sales are not ‘in the course or furtherance of’ a banking activity.

The VAT laws do not furnish a general definition for the phrase ‘in the course or furtherance of...’. Instead, we have several provisions in the VAT

¹²⁴ See Value Added Tax (Amendment) Proclamation No. 609/2008, Federal Negarit Gazeta, 15th year, No. 6, Article 2(3).

laws that enumerate specific instances in which supplies of goods or services might or might not constitute ‘in the course or furtherance of a taxable activity’. The phrase ‘in the course or furtherance of...’ might at first be puzzling until we realize that the phrase is intended to capture all the multifarious forms of supplies ‘in connection’ with a taxable activity. In fact, some laws use a more genial phrase ‘in connection with...’ to refer to the same requirement.¹²⁵ Registered taxpayers may supply goods or services in various circumstances, some of which are regarded as ‘in the course or furtherance of...’ and others are not regarded as such. Obviously, supplies of goods or services to customers for value in arm’s length transactions constitute ‘in the course or furtherance of a taxable activity’. VAT laws are not limited, however, to the conventional supplies of goods or services to presume that supplies constitute ‘in the course or furtherance of...’.

The provisions pertaining to the requirement of ‘in the course or furtherance of...’ depart from our preconceived notions of what might constitute as supplies of goods or services ‘in the course or furtherance of a taxable activity’. Withdrawals of business goods for personal consumption of the taxpayers or family members are considered to be in the course or furtherance of a taxable activity although we are wont to regard these conventionally as ‘not in the course or furtherance of a taxable activity’.¹²⁶ Similarly, the VAT laws presume that supplies of goods to employees at a discount or for free are supplies ‘in the course or furtherance of a taxable activity’.¹²⁷ The only supplies that are not considered to be ‘in the course or furtherance of a taxable activity’ are those supplies that are not related to or connected with the business activity, such as sales of personal property by a taxpayer. For example, if a hotel owner sells his personal vehicle, the supply does not attract VAT even though the deal may have been struck with a customer of the hotel. Whether a supply is in the course or furtherance of a taxable activity, of course, depends on the facts and circumstances of each case.

Given the expansive meaning proffered to the phrase ‘in the course or furtherance of a taxable activity’, it is difficult to argue that foreclosure sales by banks are not in the course or furtherance of a taxable activity. Foreclosure sales easily meet the requirement of ‘in the course or furtherance of a taxable activity’ both from the vantage point of borrowers (who as we shall see later on are the

¹²⁵ See Section 4003 of the Model Act, in Alan Schenk, Reporter, *supra* note 40

¹²⁶ See VAT Proclamation 2002, *supra* note 4, Article 4(2).

¹²⁷ See *id.*, Article 4(4); VAT Regulations 2002, *supra* note 4, Article 3(2); but payment by employers for goods purchased from third parties does not constitute a supply by the employer in the course or furtherance of a taxable activity; see VAT Regulations 2002, *supra* note 4, Article 3(3).

real suppliers of goods in foreclosure sales) and banks. VAT laws are indifferent to the purposes for which or the circumstances under which supplies are made. As we saw above, even personal consumption of business goods (called withdrawal of goods for personal consumption) constitutes a supply in the course or furtherance of a taxable activity. It is of no consequence to VAT that the supplies are made to pay debts, as foreclosure sales are. Even if we assume that foreclosure sales are supplies of goods by banks, we can argue that foreclosure sales are ‘in the course or furtherance of taxable activity’ of banks. But that argument is not necessary at all, for it is the result of the mis-location of the supply in foreclosure sales.

9. The Route of the Supplies in Foreclosure Sales

Apart from the common misunderstanding surrounding the notions of taxable activities and taxable transactions, we submit that the confusion surrounding foreclosure sales also arises from the mis-location of the route of the supplies. Both Abyssinia Bank and the Tax Authorities viewed the transaction as something occurring between banks and third party bidders. Surprisingly, both the Tax Appeal Commission and the High Court seemed to be in agreement with the parties in spite of the opposite conclusions they reached. They all seemed to view foreclosure sales as sales by banks to third parties. That is clearly a misunderstanding of foreclosure sales.

Although banks carry out foreclosure sales, the transactions occur between debtors and third party bidders, not between banks and third party bidders. Both the Property and Business Mortgage Proclamations cast the transactions as occurring between debtors and third party bidders, banks acting merely as agents.¹²⁸ The focus of attention for purposes of meeting the requirement of a taxable activity should therefore be not banks but the business of the debtor. If the activity of the debtor is a taxable activity, the sale of property in foreclosure sales is a taxable transaction regardless of whether banks are registered or not, exempted or not. Conversely, if the activity of the debtor is not a taxable activity, the sale of property in a foreclosure sale does not transform the sale into a taxable transaction. Both Abyssinia Bank and the Tax Authorities were led astray in their arguments because they mischaracterized and mis-located the route of the transaction as something occurring between banks and third parties. The Tax Appeal Commission and the High Court joined the chorus of confusion in characterizing the transactions as occurring between banks and third parties.

This of course does not mean that sales transactions never occur between banks and third party bidders. In some cases, banks may become direct suppliers

¹²⁸ See Property Mortgage Proclamation, *supra* note 94, Articles 3 and 5; Business Mortgage Proclamation, *supra* note 94, Articles 13 and 15.

(and not mere agents) of goods. Banks may take over the collaterals as payments of loans and later on sell the collaterals in public auctions. Both the Property and Business Mortgage proclamations authorize banks to take ownership of collaterals if the public auctions fail to fetch the price indicated in bids the second time around.¹²⁹ These transactions are not foreclosure sales. Banks sometimes sell their used inventory and stocks (e.g., vehicles) as well as property claimed from debtors as collaterals. These are taxable transactions too, although they are not as such related to foreclosure sales.

We recall that Professor Schenk made one exception for cases in which banks (as creditors) may be said to be suppliers in foreclosure sales (*see Section 7 above*). That exception is where banks as creditors have ‘control over the remittance of the proceeds to the debtor.’¹³⁰ Ethiopian laws that authorize banks to foreclose debtors’ collaterals do not provide for instances where banks may control remittances of the proceeds to debtors, but they do provide for cases in which banks may take over the collaterals in payment of the loan (debt). Even then, the route of the transaction is not altered. The supply occurs from debtors to banks. The taxation of this supply, as alluded to before, depends on whether the debtor is a taxpayer under VAT. If the bank sells the collateral in a public auction, the supply will now become a supply by the bank to a third party. This sale in a public auction or for that matter any type of sale is a taxable supply. The argument that the banks are exempted for their financial services does not have much traction in such cases.

10. Banks as Agents in Foreclosure Sales and Application of VAT to Agents

We have concluded so far that in the supply of goods in foreclosure sales, banks act as agents of borrowers while they sell goods to third parties. This does not let banks completely off the hook of VAT obligations. We need to examine a few more provisions of the VAT laws of Ethiopia to check whether banks are obligated as agents to collect VAT on foreclosure sales.

Both the VATP and VATRs deal with cases of supplies of goods by agents. An agent is defined in the VATP as ‘any person who acts on behalf of and on instruction from another person’.¹³¹ Unless we argue that the agency function of banks in foreclosure sales does not square with the strict definition of agents in

¹²⁹ See Corrigendum, *supra* note 104 and Business Mortgage Proclamation, *supra* note 94, Article 13.

¹³⁰ See Alan Schenk, *supra* note 40, at 181.

¹³¹ VAT Proclamation 2002, *supra* note 4, Article 2(2).

VAT law, we must be prepared to apply the rules of VAT pertaining to agents to banks as agents.¹³²

The VATP presumes that supplies by agents are supplies made by principals except in two cases.¹³³ The first case involves ‘services rendered by an agent to the principal’.¹³⁴ Here the VAT law presumes that the supply is made by an agent. It is not hard to imagine why that is the case. In truth, the supply is made by the agent, not qua agent but as principal. Hence, if an agent charges the principal for her service as agent, the supply is made by the agent to the principal, not qua agent but as principal.

The second exception involves an agent who supplies goods or services on behalf of a principal who is not a resident of Ethiopia.¹³⁵ Here, too, the VATP presumes that the supply is made by the agent in Ethiopia. Again, it is not difficult to imagine why there is this exception. The presumption that a supply by an agent is a supply by the principal is unworkable in such cases. Since the principal is not a resident of Ethiopia, it is pointless to stipulate that the principal is a supplier when it is known that Ethiopian tax jurisdiction cannot reach the principal. It is the agent who is accessible to Ethiopian tax jurisdiction and it is therefore the agent who should remain answerable for all obligations arising from VAT in such cases.

In any event, we have established the general rule that supplies by agents are considered to be supplies by principals. That being the case, we need to figure out what that means for both the principal and the agent, and what their respective obligations are in transactions chargeable with VAT. Whatever obligations agents may assume in VAT, we must remember that the obligations of agents are contingent upon the obligations of principals.

In general, it may be stated that where principals have no obligations, nor should agents. Where principals have obligations in VAT, however, agents qua agents have a number of obligations in VAT. One of these obligations is the obligation to issue VAT invoices for the supplies. Article 13 of VATRs authorizes (in effect obligates) agents to issue a VAT invoice to purchaser of goods where the purchaser is a registered person.¹³⁶ Since both the principal and the agent are required to issue invoices, this may lead to the issuance of double

¹³² While banks may be said to act on behalf of borrowers in foreclosure sales, they do not do so on the instructions of borrowers. Foreclosure sales typically occur against the interests or in the face of objections of borrowers.

¹³³ See VAT Proclamation 2002, *supra* note 4, Article 24(1).

¹³⁴ See *id*, Article 24(2).

¹³⁵ See *id*, Article 24(3).

¹³⁶ See VAT Regulations 2002, *supra* note 4, Article 13(1); the phrase ‘where the purchaser is a registered person’ appears to be superfluous.

VAT invoices. The VATRs anticipate this problem and prohibit the principal from issuing VAT invoices where the agent has issued one, and vice versa.¹³⁷ Where no invoice is issued for the supply either by the principal or the agent, the agent and the principal will be held liable (probably jointly and severally).

In practice, the proximity of the agent to the purchaser of the goods means that it is the agent who should issue VAT invoice for the supply. In any event, it is clear that the agent has an obligation of issuing VAT invoices for the supply that s/he makes for the principal. Foreclosure sales by banks are transactions by banks as agents on behalf of principals – borrowers. Thus, banks have all the obligations incumbent upon agents in VAT. Whether banks should register for VAT in order to account for VAT in foreclosure sales is quite another matter, and we shall explore below whether that is necessary.

11. Should Banks Register for VAT to Account for Foreclosure Sales?

Registration performs certain administrative functions in VAT. It is primarily designed to provide government with the necessary information needed to assess and collect VAT from taxpayers.¹³⁸ Registration is what brings businesses within the network of VAT administration. Those businesses that are registered for VAT are required to perform certain duties from time to time, like issuing invoices on transactions, collecting the VAT due and transmitting the proceeds to the government.¹³⁹ Those who are registered are also entitled to certain privileges not available to unregistered persons. The most important privilege is the right to obtain tax credits for VAT paid on purchases or inputs.¹⁴⁰

Even if we agreed that VAT is due on foreclosure sales, it is by no means settled that banks should therefore register for VAT – despite the clamor to get the banks registered for VAT on account of the sales they conduct in foreclosures.¹⁴¹ Thankfully, the answer to this question of registration is made considerably easier by the characterization of foreclosure sales as supplies of goods by debtors through the agency of banks to third party bidders (this is a typical route of foreclosure sales). As already emphasized, VAT is due if debtors are registered taxpayers or required to be registered for VAT. Conversely, VAT is not due upon foreclosure sales, if the debtor involved is not

¹³⁷ See *ibid.*

¹³⁸ See Schenk and Oldman, *supra* note 1, at 90-91.

¹³⁹ See VAT Proclamation 2002, *supra* note 4, Articles 20 and 22.

¹⁴⁰ See *id.*, Article 21.

¹⁴¹ See Mahlet Mesfin, Kirubel Tadesse, Getahun Worku and Tilahun Aklilu, *supra* note 8.

registered or required to be registered in the first place. This contains within it the solutions we are to seek on the question of registration.

If debtors are registered for VAT, there is no reason why banks are to register for VAT to account for VAT in foreclosure sales. Banks should use the registration identity and certificate of debtors to account for VAT during foreclosure sales. They should use the VAT invoices of debtors to collect VAT and account for the proceeds to the government. We have already asserted that banks are agents in foreclosure sales. To be sure, agents may be required to have their own registration in VAT,¹⁴² but we submit that registration is not required of banks in order for them to account for VAT during foreclosure sales. The circumstances under which banks operate in foreclosure sales make registration pointless. In foreclosure sales banks represent disparate numbers of debtors (some registered and others not), and it does not make any administrative sense to require them to register for VAT when they act as agents for multiple debtors in different foreclosure sales.

Requiring banks to register for VAT complicates the administration of VAT in foreclosure cases. As we shall examine below, the imposition of VAT upon foreclosure sales is not a simple affair of slapping the sales with the VAT rates (15% in Ethiopian case). There are additional tasks involved, such as the computation of input tax credits. Since the supplies in foreclosure sales occur from borrowers to purchasers, it makes little sense to require registration of banks, when all we need (and should care about) is the registration of borrowers by whom the supplies are made.

The tax authorities may be worried about possibilities of tax evasion or tax avoidance by banks and borrowers. But the conventional registration is not a solution to these problems. The tax authorities may use other administrative devices to hold both banks and borrowers accountable for charging VAT on foreclosure sales. We have already seen that banks and borrowers are jointly and severally liable for issuing VAT invoices on foreclosure sales. There are severe penalties in the VAT laws against those who fail to issue VAT invoices when they are required to do so.¹⁴³ If these are not deterrent enough, the Tax Authorities may use well-known administrative devices to ensure that VAT is effectively chargeable on bank foreclosure sales. One commonly used device is to require banks to furnish detailed information to tax authorities on foreclosure sales and the names of borrowers whose securities have been sold in foreclosure

¹⁴² See VAT Proclamation 2002, *supra* note 4, Article 2(11), where a person is defined as any natural person, sole proprietor, body, joint venture, or association of persons (*including a business representative residing and doing business in Ethiopia on behalf of the principal*) (italics mine).

¹⁴³ See VAT (Amendment) Proclamation, *supra* note 124, Article 50(b).

sales. These additional precautionary measures are in reality not necessary because banks should be motivated to charge foreclosure sales with VAT for fear of the penalties that attach in the event of their default.

In sum, the tax authorities may hold banks to account using other administrative devices, but the conventional registration should not be one of them. The clamor for registration of banks for accounting for VAT in foreclosure sales is yet again another misunderstanding of the nature of VAT, the scope of VAT exemptions for financial services and the nature of foreclosure sales.

While registration of banks is clearly neither a solution nor necessary for purposes of taxation of foreclosure sales, this should not be seen as a blanket exemption of banks and other financial institutions from the obligation of registration for VAT. As pointed out above, banks and other financial institutions may supply a number of taxable services which require registration for VAT. Banks may provide payroll, accounting, auditing, management, advisory and trust services for fees. Banks may also provide safe keeping services, again for fees. These services are taxable under the VAT laws. It is therefore paramount that banks and other financial institutions are registered for VAT in order for them to account for VAT on these services. Banks and other financial institutions may contest or resist moves for registration on the ground that the value of these services do not exceed the registration threshold (currently 500, 000 ETB). Many in the past have resisted registration on this ground before (in fact, most of the disputes between tax authorities and taxpayers have arisen from those taxpayers who believed that their annual turnovers do not reach the registration threshold).¹⁴⁴

But in the case of financial institutions, this argument should have no traction whatsoever. The basic rationale for VAT registration threshold is administrative. It is generally assumed that those businesses whose annual turnovers exceed a certain threshold possess the administrative capacity to comply with the recording and accounting requirement of VAT, such as the capacity to issue VAT invoices. The threshold is set at a fairly high turnover solely on this ground. In the case of financial institutions, few would dispute that these

¹⁴⁴ The Tax Authorities have resorted to presumptive registration schemes in the past in part in order to forestall the arguments of some taxpayers that their annual turnovers would not cross the registration threshold. Many businesses were ordered to register for VAT based on a presumption that the volume of transactions in these types of businesses exceeds the half a million ETB threshold. These business include: jewelry stores, computer stores, flour factories, etc; see Ministry of Revenues, FDRE, Ref. No. 01/A29/306/45, Sene 17, 1995 E.C, in Amharic, unpublished; see also Mahlet Mesfin, *Ambiguous VAT Registration Leaves Bitter Taste*, Addis Fortune, vol. 12, No. 575, May 8, 2011.

institutions have the capacity to comply with VAT, regardless of the total volume of taxable supplies in a year. Given the high capital requirements for financial institutions in this country, it should be presumed that all financial institutions possess the capacity for complying with VAT obligations regardless of whether their core financial services are exempted from VAT.

Reluctance to registration is often the result of misapprehension of the real nature of VAT. Financial institutions should not resist calls for registration at all; in fact, they should call for it. Although they should collect VAT on their taxable supplies, they should also realize that they are entitled to tax credits on inputs attributable to their taxable supplies.¹⁴⁵ Financial institutions will be entitled to tax credits only if they are registered for VAT. The entitlement to tax credits should provide them with incentive enough for registration.

12. VAT Invoicing in Foreclosure Sales: VAT Exclusive or Inclusive Invoices?

As they contemplate collecting VAT on foreclosure sales, banks are confronted by twin sets of problems or challenges. The first is how to apply VAT on foreclosure sales that have already occurred without or prior to the knowledge that these sales carry VAT. The second is how to apply VAT on foreclosure sales after the knowledge that these sales carry VAT. The circular letter cited above clearly indicates the intention of the Authorities to collect VAT from foreclosure sales that have already happened (over the past eight years if we start from the beginning). It is necessary to keep the two situations apart for purposes of analyzing how VAT may be imposed on foreclosure sales. Before we examine how VAT applies to the two sets of situations, we need to review how VAT is computed in general.

VAT can be computed exclusive or inclusive of the tax itself.¹⁴⁶ We are accustomed to the VAT exclusive of the price, with tax invoices showing the price of the good separately from the VAT. So with a 15% VAT rate, a 100 ETB good will be sold for a total of 115 ETB, 15 ETB being exclusive of the price of the good. This method of computing VAT is (or should be) followed in all transactions where VAT is clearly known to apply and where it is easy to apply VAT this way. VAT may also be computed inclusive of the tax, which is expressed in a formula:

$$(\text{Price (inclusive)} \times \text{VAT rate}) \div (100 + \text{VAT Rate}) = \text{Amount of VAT}$$

Hence a price inclusive of VAT in the above example would yield the following result:

$$(115 \times 15) \div (100 + 15) = 15$$

¹⁴⁵ See VAT Proclamation 2002, *supra* note 4, Article 21(2).

¹⁴⁶ See Schenk & Oldman, *supra* note 1, at 32.

This method ensures that the taxpayer who uses VAT exclusive method and the taxpayer who is subject to the VAT inclusive method are both subject to the same tax rate (15% in the above example) and collect the same amount of tax (15 ETB in the example).

The VAT inclusive method is not recommended on transparency grounds. However, it may become unavoidable in some cases. There are instances where a taxpayer may not have issued VAT exclusive invoices to buyers. In the above example, a taxpayer may have sold the good for 115 ETB inclusive of VAT. In that situation, it will be unfair to the taxpayer (and an over taxation) to impose 15% VAT upon the 115 ETB as if 115 ETB were exclusive of VAT.¹⁴⁷ Imposing a VAT 15% upon an already sold good yields in this example 17.25% ETB, requiring the supplier to remit to the government 2.25 more than he could have collected from the purchaser. The VAT inclusive method of calculation ensures that the VAT remains the same whether the goods are sold exclusive or inclusive of VAT.

There are two compelling reasons why VAT inclusive method becomes the preferred method of computation in the context of foreclosure sales. The first is for foreclosure sales that have already occurred. For these sales, it is too late to apply VAT exclusive method for the simple reason that the sales have already happened. We cannot expect banks to recall the winners of the bids in foreclosure sales and account for the VAT due on the sales. To require banks to pay the VAT as if they collected the VAT from the sales would be to assume that VAT is a direct tax obligation of the banks (which it is not). On a 100 ETB good, a 15% VAT is not 15 ETB (as the VAT exclusive method would indicate) but about 13 ETB, which comes as a result of the application of the VAT inclusive method of computation.

In the practices of the Ethiopian Tax Authorities, there is a tendency to apply the VAT exclusive method regardless of the circumstances of the case. This is clearly a misunderstanding of how VAT operates and what the tax means. In foreclosure sales that have already occurred we cannot apply (without grievous injustice) the VAT exclusive method. The VAT inclusive method is the only fair method that should apply in such instances.

Even in foreclosure sales that have occurred after banks realize that these sales carry VAT, we may need to employ the VAT inclusive method if the bidders are not informed in advance that the bid prices are exclusive of the VAT. Otherwise, slapping the sales with VAT will constitute an unwelcome surprise, something that the bidders have not bargained for. Since foreclosures typically occur in public auctions, the application of VAT upon the bid price may depress the bid market and discourage bidders from bidding up to the full

¹⁴⁷ If penalties are to be imposed, they should be calculated separately.

price of the goods sold. In anticipation of the VAT, bidders may be forced to underbid in public auctions. Of course, all attempts must be made to inform bidders in advance that the bid prices are exclusive of the VAT, in which case the VAT exclusive price would be appropriate.

The VAT inclusive method encourages bidders to bid without restraint in expectation that whatever price they bid for, that price includes the VAT in it. It frees the bidding process from the fear of VAT being applied after the auction has been closed. Tax invoices may still be issued in the VAT inclusive method, by putting the price separately from the VAT, with the price now lower than the whole bid price. There is nothing extraordinary about this practice. Even in the VAT exclusive world, we are accustomed to being informed the VAT inclusive price when we shop for goods and services in the market. When we eat at restaurants, the menus at the restaurants usually show the VAT inclusive price of the food even though when the invoice arrives, we are able to see the VAT exclusive price.

In sum, the VAT inclusive method of VAT computation is the only way out if banks are to be asked to pay VAT on foreclosure sales they conducted before they realized VAT was due. We cannot apply the VAT exclusive method of computation on sales that have already occurred. We cannot also, without distorting the very notion of VAT, apply the VAT exclusive method of computation in a foreclosure sale where the bidders are not in advance informed that the bid price is exclusive of VAT. The imposition of VAT after the foreclosure sales have been closed will obviously take bidders by surprise and might even derail the process of foreclosure sales in the future.

13. Input Tax Credits in Foreclosure Sales

An argument for taxation of foreclosure sales is only the beginning of the process. Even if we were to agree that foreclosure sales attract VAT (in cases where the debtor is a registered person), we must permit credits for input taxes paid on the acquisition of the goods now being sold through foreclosures. The VAT laws require full credits for input taxes paid on taxable supplies, and foreclosures sales should be no different. Even if banks are collecting VAT on the outputs (foreclosure sales), they are not under obligation to transmit the whole to the government. They are entitled (or the debtor is) to claim input tax credits for VAT paid on the acquisition of the property now being sold through foreclosures. Now that banks realize VAT may be due on foreclosure sales, they should adjust their business transactions with borrowers and insist on getting the input VAT paid on goods they hold as collaterals, for their capacity to obtain input tax credits depends on this. Let's take an example to illustrate this point. Suppose ABC Bank foreclosed a taxable supply of goods for a bid price of 4 million ETB exclusive of VAT. The Bank, as an agent, is required to issue invoice on behalf of the debtor on the sale price. The output tax on the

foreclosure sale is 15% x 4 million ETB, which is 600,000 ETB. Suppose the debtor acquired the goods for 3 million ETB, exclusive of VAT. The input tax paid on the goods is therefore 15% of 3 million ETB, which is 450,000 ETB. The Bank is required to pay the difference to the government, which is 150, 000 ETB.¹⁴⁸

In order to expedite the process of input tax crediting, banks should make it their business to require borrowers to surrender input VAT invoices along with the collateral or the title to the collateral. Otherwise, banks risk delays in their bid to obtain input tax credits upon the properties they sell in foreclosure proceedings. Or even worse, borrowers may manage to obtain input tax credits while the collateral is in the possession of banks. Once tax credits have already been claimed by borrowers, the Tax Authorities will be hard put to grant tax credits to banks upon sale of collaterals by banks.

Now that banks are aware of the VAT consequences of foreclosure sales, they should insist on surrender of VAT invoices showing evidence of payment of VAT upon collaterals now held as security.¹⁴⁹ Where the property involved has a separate VAT invoice when it was acquired or purchased by the borrower, the computation of VAT is a simple affair of calculating VAT upon output and deducting the input tax from the VAT due on the output. In the *Abyssinia Bank* case, for example, the input VAT invoices consisted of the input VAT paid on tires when they were imported by Tana International (the borrower). All that Abyssinia Bank could have done was to deduct the input VATs paid on the importation of tires from the output VATs due on the sale of the tires in foreclosure proceedings.

However, it is not often that separate invoices are issued for acquisition of goods. What if, for example, the borrower manufactured the collaterals, not purchased or imported them? Ordinarily, we should not be concerned about this issue in other sales because the taxpayer who sells the goods is also the taxpayer who requests the tax credits in respect of the goods. In the case of sale of goods

¹⁴⁸ Sometimes, a bank may sell a business as a going concern. In VAT, the sale of a business as a going concern is zero-rated. A transaction which is zero-rated when a debtor sells his business directly is also zero-rated when the bank sells the business as a going concern. When that happens, the bank is entitled to a full refund of the input tax paid on the business being sold as a going concern. Of course, the bank charges zero on the output of the sale of the business as a going concern; see VAT Proclamation 2002, *supra* note 4, Article 7(2)(d).

¹⁴⁹ Of course, the sale of the collateral may be exempt because the property in question is exempted from VAT even when it is sold directly by the borrowers. In that case, banks need not worry about VAT invoices as the foreclosure sales of such collateral would also be exempted from VAT.

in foreclosure proceedings, however, we have a situation where the bank and the borrower may concurrently request input tax credits.

The difficulty of allocation should not lead to denial of the input tax credits altogether. Instead, some solutions must be sought – solutions that are acceptable to all parties involved: the Tax Authorities, borrowers and banks. One solution is the application of allocation formula that is applicable in cases where taxpayers make mixed supplies of taxable and exempt goods.¹⁵⁰ To the extent practicable, this solution should be pursued as it entails little or no additional administrative requirements upon the parties.

Another solution is to impose some administrative duties upon borrowers and banks to ensure that no double tax credits are obtained. Borrowers that give merchandise or any other property as security may be required to furnish the Tax Authorities with information regarding the granting of property as security so that input tax credits in respect of the collaterals are suspended until such time the collaterals are sold in bank foreclosures or redeemed to borrowers upon payment of the loan. This solution prevents the taking of input tax credits by borrowers prior to the sale of the collaterals. It also ensures that banks and not borrowers take input tax credits in respect of properties sold through foreclosure proceedings.

14. Priority Issues in Bank Foreclosure Sales

Even after taxation of foreclosure sales is settled, banks may claim priority of payment over the collaterals sold in foreclosure sales. One of the arguments the counsel for Abyssinia Bank raised was that the Bank had priority of payment even if it were conceded that foreclosure sales carried VAT. The claim of priority of payment is strictly speaking not an argument against taxation of foreclosure sales. As shown in the *Abyssinia Bank* case, banks may raise ‘priority’ of secured creditors in the event that the argument against taxation of foreclosure sales fails. Since the claim of priority is likely to persist in future cases, it is appropriate to address the question of priority in the context of foreclosure sales. Once the government has made a case for taxation of foreclosure sales, it is still confronted with the burden of overcoming issues of priority of tax claims vis-à-vis the claims of other creditors, particularly creditors secured by the collateral.

Before we address the issue of priorities in the context of foreclosure sales, we shall review briefly the issue of priorities of tax claims under Ethiopian laws. The priority of tax claims vis-à-vis other claims (including the claims of secured creditors) was a staple of controversy in a number of court cases pitting

¹⁵⁰ See VAT Proclamation 2002, *supra* note 4, Article 21(2)(c).

especially secured creditors (e.g., banks) and tax authorities.¹⁵¹ The tax laws of Ethiopia issued in 2002 partly put the controversies to rest by clarifying the position of tax claims vis-à-vis secured creditors.¹⁵²

The tax laws of Ethiopia distinguish two types of taxes for purposes of priorities. There are, on the one hand, taxes which are required to wait in line in the order of priorities among competing claims of creditors. We may call these 'priority-prone' taxes. These are taxes which are directly claimed from taxpayers in which the taxpayers stand as debtors. These taxes are mostly the so-called direct taxes. Taxes like profit taxes claimed from the income of businesses are directly claimed from businesses as debtors. The taxpayers are at once taxpayers and debtors. The government in these instances is required to stand in line and wait until creditors with superior rank are paid. The tax laws of Ethiopia accord priority to tax claims but subordinate these claims to the claims of secured creditors over their collaterals.¹⁵³

There are, on the other hand, tax claims which taxpayers are assumed to collect from others and hold in trust for the account of the government. We may call these 'priority-immune' taxes. These are mostly indirect taxes and direct taxes collected through withholding schemes. These types of taxes are not subject to competition with the claims of other creditors of the taxpayer. In other words, the tax authorities enjoy absolute priority rights in respect of these taxes.

Ethiopian tax laws are not consistent in this regard, but at least in one respect, there is a specific reference to some of these taxes and the language of the law is emphatically for exception of 'priority-immune' taxes from the rules of priorities. The Income Tax Proclamation (of 2002) provides that taxes withheld for the account of the government by taxpayers are not subject to the rules of competition and must be paid to the government no matter how many other creditors the taxpayer might have.¹⁵⁴ In these instances, it is as if the tax authorities have already appropriated the tax proceeds, the only thing remaining

¹⁵¹ See Taddese Lencho, *Ethiopian Bankruptcy Law: Commentary*, Part II, J. Eth. L., vol. 24, No. 2, at 61-72; see also *Inland Revenue Authority vs. Fissehaye W/Gebriel, Housing and Thrift Bank and Addis Ababa Abattoirs*, (Supreme Court, Civ/App. No. 13/1984), in *Supreme Court Cases*, Vol. 3, in Amharic, at 595-598; *Commercial Bank of Ethiopia vs. Inland Revenue Authority*, (Supreme Court, Civ./App. No. 562/69), in *Supreme Court Cases*, Vol. 1, in Amharic), at 17-18.

¹⁵² See VAT Proclamation 2002, *supra* note 4, Article 32(1); the Turnover Tax Proclamation, *supra* note 3, Article 14, and the Excise Tax Proclamation No. 307/2002, *Federal Negarit Gazeta*, 9th year, No. 20, Article 11(1).

¹⁵³ See *ibid.*

¹⁵⁴ See Income Tax Proclamation No. 286/2002, *Federal Negarit Gazeta*, 8th year, No. 34, Article 82.

being the collection of these taxes from the taxpayer. Different organizations or institutions (e.g., government bodies, NGOs, etc) are required by income tax laws to withhold taxes from payments these organizations or institutions make for purchase of goods and services.¹⁵⁵ Similarly, most employers are required to withhold income taxes from salaries, wages and other emoluments of employees.¹⁵⁶ These withholding agents hold the taxes withheld in trust and for the account of the government. The taxes are neither theirs to keep nor for other creditors to claim. They are, in other words, not subject to competition of priority by other creditors of employers or other withholding organizations.

The tax laws only make specific mention of withholding taxes, but an equally strong case can be made for indirect taxes like VAT, which are after all collected from consumers by businesses in trust and for the account of the government. Particularly with respect to VAT, there are a number of provisions which support the idea that the taxpayers in VAT are mere collection/withholding agents.¹⁵⁷

The businesses that charge VAT whenever they make supplies are withholding the VAT from purchasers on behalf of and for the account of the government. In that sense, it may be argued that the VAT collected in foreclosure sales (or for that matter of any sales) should never be subject to the rules of priority no matter how anxious banks are to cast these taxes as such to obtain superior advantage over the tax claims of the government over foreclosure sales.

Unfortunately, due to careless reproduction of certain rules of the income tax in other taxes like VAT, we have rules which lump VAT with direct income taxes in this regard, contrary to the real nature of VAT. The rules which assert the priority of secured claims against tax claims are reproduced verbatim in the VATP and other indirect tax Proclamations of Ethiopia.¹⁵⁸ If Banks raise these arguments of priority, therefore, they cannot be blamed for the laws actually support their arguments in this regard. The income tax rules of priority are reproduced in VAT and other indirect tax laws of Ethiopia without proper understanding of the real differences between these taxes. The collection of VAT by banks from foreclosure sales should never have become a subject of priority battles. Banks, like all other sellers, hold the VAT in trust and for the

¹⁵⁵ *Id.*, Articles 52, 53, and 54; see also Council of Ministers Income Tax Regulations No. 78/2002, *Federal Negarit Gazeta*, 8th year, No. 37, Articles 24 and 25.

¹⁵⁶ See Income Tax Proclamation, *supra* note 156, Articles 51 and 65.

¹⁵⁷ See VAT Proclamation 2002, *supra* note 4, the preamble which states that VAT is a consumption tax; see also Articles 21(5) and 22.

¹⁵⁸ *Id.*, Article 32; Excise Tax Proclamation, *supra* note 154, Article 11; Turnover Tax Proclamation, *supra* note 3, Article 14.

account of the government and should transmit what they collect without any question of priority.

15. Is Exemption a Good Thing for Financial Institutions?

Those who oppose taxation of foreclosure sales are convinced that the imposition of VAT upon these sales will depress the foreclosure market and even eat into the secured transactions currently protecting banks against risks of defaulting borrowers. In one newspaper article opposing the taxation of foreclosure sales, one writer suggested a number of 'negative' consequences of taxation of foreclosure sales.¹⁵⁹ He expressed fear that banks might not be able to recover loans from defaulting borrowers now that they have to share the proceeds (the spoils) with the government. He also feared that the taxation will force banks to let borrowers sell the property through private sale arrangements.

We submit that these fears are exaggerated and unfounded. The fears assume a static world in which banks remain indifferent to the changing situation around them. No one can or should underestimate the ability of banks to assess the risks of non-payment and default. Their core specialization consists of risk assessment and little else. It would be difficult to believe that banks will fail to assess the risk properly because some foreclosure sales are now slapped with VAT. It is likely that banks will factor the VAT into their pricing of the collaterals they accept in exchange for extension of loans to borrowers. They will probably cushion themselves against risks of under-security by requiring borrowers to give collateral with a value greater than the basic loan owed by borrowers so as to cover the additional costs of VAT. We can be certain that banks will adjust to the imposition of VAT upon foreclosure sales. Instead of VAT depressing and disrupting foreclosure markets, therefore, we must expect the markets to internalize new information and function as normally as ever before.

If banks understand the nature of VAT, they will not revert to requiring borrowers to sell collaterals through private sale arrangements, as some have suggested. This suggestion is based on a false premise that those private sale arrangements are beyond the reach of VAT. As we saw previously, regardless of how the sales are carried out – private sale or public sale, foreclosure sale or no foreclosure sale, the sales attract VAT. In fact the sales attract VAT precisely because they are carried out by borrowers, and not banks. The conclusion that private sales are beyond the reach of VAT arises from the misconception that the sales are carried out by banks.

¹⁵⁹ See Getahun Worku, *supra* note 8.

Since many of the negative reactions to VAT arise from the misconception about the nature of VAT exemptions, we shall examine the impact of VAT exemptions upon financial institutions in general to clear up some of the common misconceptions that persist in the debates about taxation or exemptions of financial services.

The exemption of some financial services is not as positive as it is sometimes supposed. The exemption means that banks and other financial institutions are not entitled to tax credits on their inputs (purchases of computers, etc),¹⁶⁰ something they could have claimed as a matter of right if their supplies were taxable supplies. As result, financial institutions provide most of their financial services loaded with un-creditable input taxes, which puts the recipients of these services at a competitive disadvantage. Businesses that purchase financial services are not entitled to tax credits for VAT embedded in financial services, as these taxes are not even allowed to be shown in the transactions. Businesses which receive their inputs from taxable sectors are entitled full tax credits for VAT paid on their inputs. That puts those businesses which use financial services as inputs at a competitive disadvantage. Banks and other financial institutions may vociferously object to applications of VAT to their services, but they should realize that exemption is not necessarily to their advantage.

The current VAT treatment of financial institutions forces financial institutions to be excluded from the benefits of VAT (input credits) while requiring them to register for VAT on their taxable supplies. The fact that some of their services are exempted from VAT has not exempted them from the requirement of registration. Financial institutions are required to register and account for VAT on their taxable supplies. Financial institutions are required to maintain detailed records on their taxable supplies. Because financial institutions are exempted on some of their supplies, they are required to maintain more detailed records than otherwise in order to be able to distinguish their taxable supplies from exempted supplies.¹⁶¹ Input taxes related to the production of regularly taxed financial services are creditable while input taxes paid on exempt financial supplies are not creditable.¹⁶² This is administratively burdensome to financial institutions. They have to determine which inputs are used for what – track the actual use of inputs in their production processes. Since most inputs are used to produce both exempt and taxable supplies, it is difficult to track them separately, making the VAT regime more of an onerous requirement to financial institutions than is normally the case.¹⁶³

¹⁶⁰ See Harry Huizinga, *supra* note 41, at 499.

¹⁶¹ *Ibid.*

¹⁶² *Id.*, at 509; see also VAT Proclamation 2002, *supra* note 4, Article 21(2).

¹⁶³ See Harry Huizinga, *supra* note 41, at 509.

Another negative consequence of exemption of financial services in VAT has been litigation. The extent of the exemption has already generated considerable litigation in EU member states.¹⁶⁴ Some of the disputes relate to the status of services outsourced by financial institutions while others are about the proper allocation of a business input tax between taxable and exempt supplies.¹⁶⁵ We shall look no farther than some of the controversies outlined in this article to demonstrate that exemption of financial services and taxation of some other services of financial institutions leads to controversies. The controversies so far generated in Ethiopia regarding the scope of VAT exemption are indicative of the level of disputes that might arise in the future.

Exemption of some financial services (with the denial of input tax credits) has also been said to encourage vertical integration of operations.¹⁶⁶ A financial institution is denied input tax credits for taxes paid on its purchases from other businesses (including importers). If the financial institution is able to supply these purchases from its in-house operations (in other words, self-supply some of its inputs), it will not be subject to tax on its inputs. A bank may, for example, choose to hire its own security staff, instead of outsourcing (which brings with it the danger of VAT, if we can regard VAT as a danger) from the firm that provides security services. The Bank may also choose to create its own 'IT services unit' instead of outsourcing the service to an outside IT firm which will then charge VAT on its IT supplies. If the bank is able to self-supply these services, it will escape taxation of some of its inputs. This is of course not desirable as it will distract banks and other financial institutions from their core operations and force them to engage in some tax planning activities which are not productive to the economy.

Conclusion and Recommendations

Foreclosure sale constitutes a continuum of actions that a bank takes to enforce the terms of a financial contract. As a bank takes action to collect the debt directly, a bank also takes action to foreclose on collaterals. In both cases, a bank is simply enforcing the terms of the financial contract and remains within the confines of intermediation. The intermediation nature of the transaction is not changed because a bank has resorted to or has been forced to sell property in order to enforce the payment of the loan along with the interest.

All the arguments marshaled so far to find exception for taxation of foreclosure sales constitute varying levels of misunderstanding regarding the real nature of the transactions involved and their relationship with the

¹⁶⁴ Schenk, *supra* note 47, at 37.

¹⁶⁵ *Ibid.*

¹⁶⁶ *Id.*, at 43.

underlying financial services provided by banks. The disputes, however, point to the possible escape routes by debtors from VAT when collaterals are sold through foreclosures: judicial or contractual. The Tax Authorities should watch out for these escape routes, for it is not often that people think of these transactions as supplies taxable under the VAT regimes. Many of the bank foreclosures probably involve the sale of business assets by debtors who are registered taxpayers. These must be pursued vigorously. If the businesses themselves sell these assets, they are subject to VAT. There is no reason why they should escape taxation simply because the business assets are sold through bank foreclosure.

At the same time, bank foreclosures may also involve sale of assets which are not subject to VAT under normal circumstances. Borrowers give all kinds of property as security for payment of loans, including their personal property. A bank that sells a residential property is not selling a property that is subject to VAT if the sales were made by the owner directly. There is no reason why a sale that is exempted when made by the owner should be taxable when it is made by the intermediary (the bank). A bank may also sell business assets of a borrower who is not registered or who ought not to have been registered for VAT. The sale would not have attracted VAT had the borrower herself sold the assets, and there is no reason why the mere sale of the same assets by the intermediary should attract VAT. As the Tax Authority should watch out for the possible avoidance of tax in foreclosure sales, it should also be careful not to slap a transaction with VAT otherwise non-taxable or exempted under ordinary circumstances.

In general, we must cast foreclosure sales as transactions between borrowers and winning bidders, with banks acting merely as agents. Placing the locus of the supply in that of borrowers sets the stage for whether VAT attaches at all and how VAT is to be chargeable upon foreclosure sales. If a transaction is chargeable with VAT when borrowers supply the goods, banks should ensure that VAT is charged upon foreclosure sales. The obverse is also true. If the transaction is not chargeable with VAT when borrowers supply the good (e.g., where the supply pertains to collateral by a borrower who is not or should not be registered for VAT), banks that sell the good in foreclosure sale need not charge the transactions with VAT.

As agents, banks are required to discharge certain obligations under Ethiopian VAT laws. They are required to issue VAT invoices for the foreclosure sales chargeable with VAT. Their identity as agents persists when banks perform certain obligations on behalf of borrowers in foreclosure sales. As agents, banks should issue VAT invoices in the name and on behalf of borrowers. If they are not in possession of the requisite invoices, it is incumbent upon them to get those invoices from borrowers, preferably at the time of taking possession of the collaterals as security.

Their identity as agents persists also for purposes of registration. In spite of all the clamors for registration, it must be clear by now that banks should not be required to register for VAT in order to collect VAT on foreclosure sales. Banks should use the registration identity of borrowers in the course of charging foreclosure sales with VAT. While registration is the gateway to obligating suppliers to charge their supplies with VAT, it is unnecessary for foreclosure sales. The tax authorities are understandably wary of any prescription that dispenses with registration – their way of keeping track of what registered taxpayers do. In lieu of registration of banks (which is clearly not a solution for foreclosure sales), the tax authorities may use other schemes. One solution suggested in the body of this article is requiring banks to report their foreclosure sales – including those that do not attract VAT. The tax authorities may use these reports to keep track of the activities of banks in this regard and hold them to account for VAT whenever they fail to do so.

It is, however, important to caution against reading too much into this exemption from registration. As a general matter, banks and other financial institutions should be required to register for VAT (regardless of the volume of their annual taxable transactions), but this is quite a different matter from requiring them to register for VAT in order for them to account for VAT on foreclosure sales. As suggested in the body of this article, financial institutions make a number of taxable transactions for which registration for VAT is absolutely necessary. Given the size of financial institutions in this country, it is not even necessary to establish the minimum threshold of registration in the case of financial institutions.

As the tax authorities eye foreclosure sales as objects of VAT, they should remember that all aspects of VAT are applied with full force, not just the selective arguments so far made in this regard. The full force of VAT means that banks are entitled to tax credits as are borrowers. The full force of VAT also means that for some types of supplies, the conventional VAT exclusive method of computation is a distortion of the notion of VAT. For foreclosure sales that have already occurred and for those sales in which bidders are not informed in advance about VAT, the proper method of computation of VAT is the VAT inclusive method of computation. _____■
