

# Ethiopia's Transfer Pricing Rules

September 06, 2016

## *In brief*

Ethiopia, one of Africa's fastest growing economies, The Ethiopian Ministry of Finance and Economic Development (MoFED) issued transfer pricing rules effective 12 October 2015 through the Ethiopian Ministry of Finance and Economic Development (MoFED).

Whereas Ethiopia has always had a provision within its Income Tax Proclamation ("ITP") requiring transactions between related persons to be conducted at arm's length, no guidance had been provided by the Ethiopia Tax Authority ("ETA") on how this arm's length standard was to be implemented.

The recently issued transfer pricing rules mark a significant milestone for multinational enterprises (MNEs) seeking to do business in Ethiopia by providing them with clarity on how to arrange their business operations to comply with the arm's length principle.

We provide in this insight the key features of these transfer pricing guidelines which MNEs would need to consider as they carry out business in Ethiopia.

## *In detail*

### *Application of these rules*

These rules are to be implemented in the application of Article 29 (1) of the ITP which requires transactions between resident taxpayers and their related non-resident entities ("international transactions"), and transactions between two related resident persons having an annual turnover of more than 500,000 Ethiopian birr/USD 22,380 ("domestic transactions") to be conducted at arm's length.

The ITP and these rules will take precedence over the OECD guidelines in cases of conflict.

### *Documentation requirements*

The rules require a taxpayer to have in place transfer pricing documentation at the filing date of its statutory tax return that verifies that its related party transactions for the relevant tax year were conducted at arm's length.

Taxpayers are required to prepare the documentation in either Amharic or English and submit the same to the ETA within 45 days of a written request from them.

Taxpayers involved in international transactions with their related parties where the aggregate value

of such transactions for a particular fiscal period exceeds 500,000 Ethiopian birr (USD 22,380) are required to fill a 'transfer pricing declaration' form to disclose such transactions for the relevant fiscal period. In computing the aggregate value, the loan balances and capital transactions should be included while income and expenses may not be offset.

In addition to the transfer pricing documentation, the ETA may request additional supporting information which it deems necessary in the course of the audit procedures to carry out its functions.

### **Approved transfer pricing methods**

The rules provide for five approved transfer pricing methods to test the arm's length nature of related party transactions, similar to the ones provided by the OECD. However, the ITP states that the Comparable Uncontrolled Price Method ("CUP") will be considered to be the most preferred method.

In applying the Transactional Profit Split Method ("PSM"), the rules recommend the use of a residual profit analysis in instances where the arm's length price for some of the functions performed by one or more of the parties to the controlled transaction can be determined using any of the other four approved methods.

Taxpayers can also use the other method ("OTH") to test their transactions in cases where none of the five approved methods can be reasonably applied, and the use of the OTH to test the controlled transaction provides an arm's length return.

### **Use of the median of the arm's length range to make transfer pricing adjustments**

The rules provide that a transfer pricing adjustment by the ETA shall be based on the median of the arm's length range and shall only be made where the results of the tested transactions fall outside the arm's length range.

However, it is not given that every adjustment will be made to the median if either the taxpayer or the ETA demonstrates that an adjustment to a point other than the median is more appropriate.

In addition, the rules indicate that the ETA shall only make the adjustment where the net effect is an increase in a taxpayer's taxable income.

### **Comparables and disclosure of comparable information**

The rules provide that a taxpayer is required to disclose information on the comparables used in demonstrating the arm's length nature of its domestic and international transactions where such is requested by the ETA. Similarly, where the ETA makes an adjustment on the taxpayer, the ETA should disclose to the taxpayer the comparable information relied upon to make the adjustment. Whereas this eliminates the risk of the ETA making an adjustment on the taxpayer's data without disclosing such information to them, the onus lies on businesses to make sure that they have in place all comparable data which they have relied on in demonstrating the arm's length nature of their controlled transactions.

Based on the rules, the ETA favours the use of local and regional comparables but will accept the use of comparables from other geographic markets if appropriate adjustments are made to account for geographic differences and other factors that affect price and profitability.

### **Advance pricing arrangements**

The rules provide that a taxpayer may request to enter into an advance pricing arrangement ("APA") with the ETA to determine the arm's length conditions for its future transactions over a fixed period of time. The APA mechanism seeks to eliminate uncertainty for businesses through enhancing the

predictability of the tax treatment of their related party transactions. A description of the taxpayer's business, its controlled transactions, the proposed scope and duration for determination by the APA should accompany the taxpayer's request to the ETA. The rules allow the taxpayer to enter into either unilateral, bilateral or multilateral APAs.

In as much as they have been included in the rules, these APA provisions are not yet effective pending a letter of confirmation from the MoFED Minister.

Once approved by the ETA, the APA formalises the taxpayer's request and is binding to the ETA as long as the taxpayer complies with the terms of the APA. The rules are however silent on the expected time from request to approval of the APAs.

The APA applies to any transaction carried out subsequent to the date in which it is approved and is valid during the tax periods indicated in the arrangement itself. However, the validity may not extend beyond five tax periods beginning after the date of approval of the APA. Though not expressly stated, the rules can be drawn to specify that a taxpayer cannot enter into an APA with the ETA for a period exceeding 5 years.

The ETA seeks to win the taxpayers' confidence to enter into APAs by assuring taxpayers of the confidentiality of trade secrets and other sensitive information and documentation submitted to it in the course of the APA proceedings.

### **Costs incurred in raising funds to acquire participation interests**

Where a holding company incurs shareholder costs in raising funds to acquire participation interests in its related members, the rules provide that the holding company may apply a service charge (mark-up) on these costs if the members are directly or indirectly acquired by it and the resultant acquisition is expected to provide it with benefit.

### **Transfer pricing adjustments**

The transfer pricing rules provide relief from double taxation for both domestic and international transactions where a transfer pricing adjustment has the effect of subjecting the same income to double taxation.

In domestic transactions, where a transfer pricing adjustment is made on the taxable income of one entity, a corresponding adjustment shall be

made on the taxable income of the other party to the transaction.

In international transactions, relief from double taxation will only be available where the non-resident related party is resident in a country which has a Double Tax Treaty (“DTT”) with Ethiopia. Some of the countries which have DTTs with Ethiopia include China, Czech Republic, France, India, Israel, Italy, Romania, South Africa, Turkey and the United Kingdom.

In the presence of a DTT and upon request, the ETA shall grant relief to an Ethiopian taxpayer where a transfer pricing adjustment results in taxation in Ethiopia of income already taxed in the other country.

Where the relevant authorities cannot agree on the relief from double taxation, the rules specify that the matter should be resolved through mutual agreement procedure within the timelines provided under the relevant Double Tax Treaty.

### **The takeaway**

As one of the African countries attracting significant foreign direct investment, it is expected that the introduction of these transfer pricing rules will reduce the instances of transfer pricing conflicts and provide greater certainty for MNEs intending to or currently carrying out business in Ethiopia.

The clarity provided on the implementation of the arm’s length principle seeks to improve Ethiopia competitiveness as a preferred investment destination for MNEs seeking to carry out business in Africa.

Businesses in Ethiopia should therefore relook into their domestic and international business arrangements to ensure compliance with the arm’s length principle in light of the recently provided guidelines.

### **Let’s talk**

PwC Tax is ready to help you monitor the developments around the introduced transfer pricing rules and assess the impact of the rules on your business operations.

#### **Titus Mukora**

+254 20 2855 395

titus.mukora@ke.pwc.com

#### **Steve Okello**

+254 20 2855 116

steve.x.okello@ke.pwc.com