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MEMORANDUM FOR

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cc: Dr. Adam Elhiraika
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From: Bob Conrad

Subject: Comments on Ethiopian Transfer Pricing Documents

You asked me to review potential gaps in the Ethiopian tax law related to transfer pricing. Some initial comments are supplied below.

Second, I reviewed the three documents you supplied to me. These documents are:

1. Terms of Reference for Benchmarking Visit,
2. Transfer Pricing Best Practices, and
3. Checklist for Benchmarking Visit.

Finally, I supply some initial comments about alternative methods to address transfer pricing. My preference for one method has developed over time based on my concern that the traditional approach to transfer pricing, using the theoretical approach of the arm's-length standard, cannot be administered reasonably in OECD countries much less in emerging economies where tax administration is severely constrained in numbers, access to resources, and technical capacity.

I. Gaps in Ethiopian Law

Transfer pricing is covered in Article 79 of the Income Tax Proclamation 979 of 2016. Specific guidance on transfer pricing is provided by Directive 43 of 2015.[1] The provisions in the tax proclamation and the directive are generally in accord with international norms. It should be noted that the transfer pricing provision in Section 79 applies to both domestic and international transactions: a point that is well taken.[2]

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[1] Directive 43 and commentary on the Directive such as Price Waterhouse Coopers "Tax Insights from Transfer Pricing: Ethiopia Issues Transfer Pricing Rules" dated September 15, 2016 note the reference to Article 29 of the Income Tax Proclamation of 2002. I believe the relevant provision is Article 79 of the Income Tax Proclamation of 2016.

[2] While reasonable relative to the stated standard, I note that my view is that no one, including the best analysts in the private sector, knows the true value of a transfer price relative to the arm's-length standard. Thus, it is reasonable for the taxpayer to take an aggressive stance and to justify that stance with documentation according to the standard, and the tax administration to take the opposite view. The transfer pricing section is contained in Part 8 on Anti-Avoidance. Thus, what is avoidance is really in the eye of the beholder. For example, Directive 43 provides that the tax administration will accept a "median" estimate in some cases as a means of splitting the difference with respect to a common lack of knowledge.

There are other provisions relevant to transfer pricing that are also in accord with international norms. For example, "Tax Sources of Income" defined in Section 6 of the Income Tax Proclamation, the definition of a Permanent Establishment (PE),[3] and the thin capitalization rule based on a measured debt-to-asset ratio are all commonly accepted rules.[4]

I could not find a definition of related party. There is a 50% direct and indirect ownership rule in the thin capitalization provisions (Art. 47) and in one other place. I did not find a formal definition of related party, however. I might have missed it, but the definition should be checked to determine if there is a formal definition in either law or regulation.

In sum, there appears to be reasonable coverage in law and regulation for the tax authorities to implement transfer pricing rules according to norms such as the OECD standards.

II. Documents Related to Site Visits

The three documents, taken together, provide the justification and plan for site visits to four countries (China, Brazil, South Africa, and Canada) to learn more about transfer pricing applications in those countries. There is a transfer pricing program, or unit, within the Large Taxpayer Unit (LTU), I believe, and the activity is designed as a step in the further development of that group. South Africa is well chosen because of recent developments there and the link with the African Tax Administration Forum. Canada is also well chosen because of the inherent problems of addressing transfer pricing issues related to significant cross-border transactions with the United States (both by US investors and Canadian investors in the US). Brazil, I understand, is seeking membership in the OECD and thus is beginning to align their transfer pricing rules with OECD standards. This exercise may be informative in learning about how Brazil is attempting to accommodate OECD standards in the context of both the tax administration's experience and institutional development. It appears that China and Ethiopia have developed a relationship with regard to tax administration, and so it appears reasonable for the authorities to afford themselves of such an opportunity given the significant Chinese investment in Ethiopia and the region more generally.

The checklist and topics include country-by-country reporting, application of transfer pricing rules, organization of transfer pricing units, thin capitalization rules, dispute resolution, and related matters. Again, it is apparent that the working group and the tax administration have given considerable thought about how to how to take advantage of the opportunity in order to further enhance the capabilities and organization of the transfer pricing group in Ethiopia.

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[3] I am aware of efforts by the OECD, the World Bank, and other international organizations to assist emerging economies, including Ethiopia, with adopting what are assumed to be international norms. That effort may be reflected in the directives and legislation regarding transfer pricing.

[4] My view is that this rule, as generally applied, is flawed and should be replaced with an asset-stripping rule. See my memorandum dated September 20, 2019 on this topic. I note that one of the topics to be covered in the proposed site visits is the use of an asset-stripping rule similar to the one I proposed in the September 20, 2019 memorandum.

III. A Note of Caution

a. The Problem

My view is that the OECD transfer pricing rules, as well as most of the Base Erosion Initiative, cannot be effectively administered even by the wealthiest OECD countries, and that an alternative, other than formulary apportionment, might be developed, particularly for emerging economies that, individually and collectively, can lead in the evolution of approaches that can be administered. My reasons for this conclusion include, but are not limited to:

- There are many more taxpayers than tax administrators. All taxpayers, many of whom have trained tax advisers, have an incentive to reduce taxes to a minimum (holding constant before-tax profits). It is not possible to monitor, audit, and assess each transaction or set of transactions between related parties, as defined.

- The deterrent effect of audits and publication of settlements is minimal. It is not possible to examine all transfer prices of even one large international firm. Investors know that the probability of audit may be insignificant, at least for particular transactions. Accordingly, even risk-averse investors may have a strong incentive to take aggressive, albeit non-fraudulent, positions.

- Any taxpayer, particularly a foreign investor, has a number of degrees of freedom that can be used collectively to reduce taxes to a reasonable minimum within a country and globally. These degrees of freedom include:

    - The choice of corporate (or other) organization to employ for any investment in a particular country;

    - The choice of the tier structure of related parties (that is, the ability to create a subsidiary in one country and to have that subsidiary owned by another subsidiary incorporated in another jurisdiction);

    - The choice of transactions between related parties (for example, the establishment of a marketing subsidiary in another country to purchase the exports from the domestic subsidiary where production takes place);

    - The number and types of transactions (revolving credit agreements, intellectual property, contractual structures to allocate risk, provision of technical services, loan guarantees, rules to allocate overheads, in-kind capital contributions supplied by related parties, and charges for services among others); and

    - The choice about where to source particular types of income and costs given the source and other rules

- Transfer pricing rules generally relate to one particular set of transactions (payments for intellectual property, for instance) that might limit only one or a few of the potential degrees of freedom. But even limiting the range of prices does not reduce the potential to reduce or to eliminate taxes in a particular jurisdiction.

- There is significant asymmetry of information because tax administrators do not have full information about both sides of a transaction, much less how the transaction affects the profitability of the overall international enterprise. (Exchange of information, joint audits, and programs such as country-by-country reporting may be helpful but are resource intensive as well as incomplete.)

To illustrate, suppose a subsidiary of a foreign enterprise is organized in Ethiopia. This enterprise is capitalized with inter-firm debt, independent bank financing, some cash, some intangible property owned by another subsidiary, and used property. The parent enterprise guarantees the bank financing in order for the subsidiary to receive a lower interest rate. The parent charges the subsidiary for the loan guarantee. Suppose further that the subsidiary sells output on the local market to distributors at the current market price and sells to a related marketing firm located in the Isle of Man under a long-term contract. There is a futures market for some of the goods used in the production of the subsidiary's output from the Ethiopian subsidiary and another subsidiary incorporated in Switzerland operates a hedging operation on behalf of the global enterprise. The subsidiary receives services on a fee-for-services basis, receives royalties from the intangible property, pays royalties for the use of a trademark, and obtains inputs manufactured by another subsidiary. Finally, the parent charges the subsidiary an allocated portion of corporate overhead based on a proportion of costs attributed to the subsidiary.[5]

In order for the tax administration to comprehensively audit the firm, it is necessary to determine transfer prices for:

1. The interest rate on the related party loan,
2. The value of the intangible asset that will be subject to amortization in Ethiopia,
3. The value of the used property used to capitalize the subsidiary,
4. The value of the loan guarantee,
5. The risk-adjusted value of the contract price between the subsidiary and the marketing company,[6]
6. How to attribute hedging expenses or how to value the inputs used given the hedged positions,
7. The value of inputs from related parties used to produce output that is not hedged,
8. The value of the royalty received for the intangible property,
9. The value of the royalty paid for the trademark, and
10. A reasonable percentage charge for corporate overhead.

Even if there are established rules and methods required by Ethiopian regulations for each general type of transaction, the facts and circumstances related to each computation are unique, data must be obtained, including comparables perhaps, and audited. In addition, the values, and perhaps methods, may change through time in response to economic events.[7] Given the tax administration's access to data such as country-by-country reporting and other information and exchange of information,

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[5] I believe that such a fact pattern is not unusual.

[6] The local spot price, if there is such a price, may be used as a starting point, but management will argue that there will be, at the minimum, a risk-sharing component in the long-term contract and may supply arm's-length comparable contracts as evidence of the difference.

[7] For instance, the long-term contract might be renegotiated in light of changes in risk perceptions or overall enterprise profitability.

the tax administration will always be at an informational disadvantage because there will never be full access to all the internal accounts that might use an entirely different set of prices for management purposes. In summary, determining the transfer price for each of the profit elements imposes a significant burden on a tax administration that is constrained by resources, skills, and information. Ultimately the prices, if agreed and audited, will be negotiated.

I believe the problem can be traced, at least in part, to traditional efforts to impose taxation on a source basis combined with the legal, and I believe necessary, definition of a legal entity as a taxable person. Source taxation needs source rules, and the ease of creating unique taxable persons under the laws of different jurisdictions creates the need to allocate or attribute net income to jurisdictions for tax purposes where such allocations and attributions may not be necessary for economic or decision-making purposes. The evolution of the arm's-length standard and transfer pricing rules may have been a natural result because of the intuitive appeal to independent actors acting in their own self-interest to negotiate prices. A subsidiary of a multinational firm is not an independent decision maker, however, and the efficient (even tax-inclusive) price to charge for related parties operating in different jurisdictions will not be the same, in general, as the arm's-length price between two independent parties (even if an established arms-length price that is publicly observable exists), if firm managers even develop such prices for internal decision-making purposes.[8] Accordingly, a series of rules and conventions have evolved that, while not completely arbitrary, are intended to counter the clear incentive for any taxpayer to use every tool at their disposal to reduce their tax bills to a minimum and maximize profit consistent with their risk preferences.

These rules will always lag the ability of tax managers to develop new, and more complex, methods to legally avoid the rules via the use of new instruments and the exploitation of ambiguity in the rules because the private sector has an incentive to reduce taxes, holding other things constant, and has more resources to develop new options. In short, using the arms-length standard implies that tax administrations are always catching-up because tax administrations are not in a position to determine the next effective method to legally use the rules, and rule changes, in favor of further reducing taxes.[9]

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[8] I do not want to imply that enterprises do not use transfer prices for the purposes of internal coordination and to enhance the efficiency of the enterprise. Tax administrators will probably never know these prices because there is no necessary relationship between the transfer prices set relative to profit maximization and the transfer prices used for tax purposes holding profits fixed. In addition, the transfer prices used by the firm may not be to attribute or allocate income on a geographical basis. For example, an integrated oil company may define divisions (or subsidiaries) into exploration, refining, and marketing. The internal prices charged between divisions is then based on the need to coordinate the activities of the integrated enterprise, regardless of where particular activities take place within each division. Furthermore, it is not clear that tax administrations would want to use the internal prices that maximize the overall profits of the enterprise. The use of such prices may result in losses in one or more divisions, assuming management's objective is to maximize the overall profits. That is, it is not necessary, or perhaps even efficient, for managers to use internal signals that result in the reporting of positive profits for each division when the profits of the overall enterprise are at a maximum adjusted for risk. This would imply that losses would be reported in some countries with profits in others. This is not base shifting in order to avoid tax but efficient signaling.

[9] I also do not want to imply that tax managers of large enterprises are omniscient. Like all agents, they operate with uncertainty and with limited resource constraints. It is true that the evolution of the arms-length standard has increased the cost of profit shifting, at least to some extent. In addition, tax managers should only engage in tax reduction strategies to the point as long as the expected benefit is greater than the costs adjusted for risk.

In summary, the objective of a multinational, or domestic, enterprise that operates in more than one line of business or in more than one geographical location is to maximize the present value of owner returns adjusted for risk. Thus, by definition, any set of internal prices, if used for management purposes, will not be comparable to arm's-length prices of independent actors.

b. Ways to Approach the Problem

There are currently some methods used to provide simple tools to a tax administration to counter the competitive advantages of a large enterprise other than formulary apportionment.

1. Change Policy

One option is to simplify the income tax by eliminating the distinction between types of firms (there are three types in Ethiopia that are subject to different rates), move to flat-rate taxation of the income from both labor and capital, and limit, or perhaps eliminate, the double taxation of corporate income (Ethiopia imposes a corporate tax, a tax on retained earnings, and a tax on dividends). At a minimum, taxing activities at the same marginal rates will reduce the incentive for domestic firms and their owners to engage in transfer pricing and to re-characterize income into tax-favored forms.

2. Use Asset-Stripping Rules

The emergence of asset-stripping rules such as the interest limitation as a proportion of taxable income is one method to simplify the system without the use of transfer pricing. The use of this rule could be expanded to include all transfer-priced inputs. There is no reason why the limitation as a proportion of taxable income could not extend to the total of all related party charges. That is, the summation of all charges (interest, purchased inputs, services charges, and other charges) could be subject to a limitation on the proportion of taxable income before the deduction of any related party charge. At a minimum, such a rule would limit the ability of the firm to shift related party interest costs to other related party charges in order to reduce taxes and still satisfy the thin capitalization rule.

The use of such limitations is allowed under international rules for mining contracts, which have tax provisions that are harsher than the limitation on transfer prices. Some mining contracts impose a limitation on all costs as a proportion of total revenue attributable to the operation. Such an approach enables the country to collect some income tax, as well as contractual payments, regardless of the transfer prices used by the firm. Mining, in my view, is no different from other activities as a matter of taxation. Acceptance of such rules for mining thus could imply acceptance of a rule with regard to the limitation on all related party charges.

3. Set Arbitrary Maximums

Another tool used is to simply set an arbitrary maximum for any particular charge. For example, I have argued that head office expenses should be limited to a specified dollar amount with annual adjustments for inflation instead of using a proportion of cost or revenue. The tax administration knows the revenue loss from such a limitation and is spared the cost of determining a proportion and further monitoring costs. This method could be extended to other inter-firm charges. At the extreme, the maximum could be zero, an action that is equivalent to a disallowance of the related party cost.

4. Set Output Prices as a Proportion of the Market Price of Final Output

Zambia imposes a royalty on copper concentrate that is a proportion of the LME price of refined copper, eliminating the need to compute the transfer price for copper concentrate under long-term contracts. This value is also used for income tax purposes. Care must be exercised in using this method, because the f.o.b. value of an input (concentrate) will always be less than the f.o.b. price of the final product in a different location. Such an approach has potential, however, in situations where the transfer price of output used as an input by a related party for tax purposes can be a proportion of the independently-observable price of final output.[10]

5. Impose Withholding Taxes on Related Party Charges

I believe that emerging economies should begin to develop their own rules as an alternative to standards such as the OECD transfer pricing rules. Rules such as the OECD rules reflect a negotiated compromise position of the tax administrations of capital-exporting countries and their investors. At a minimum, the rules reflect the interests of the countries and investors that are exporters of significant foreign investment. The rules are complicated, and I have noted above that the rules cannot be reasonably administered in OECD countries much less in emerging economies where the challenges are significantly greater.

One option I have been asking governments to consider is to eliminate source rules and treat the corporate tax as a withholding tax on the income of the individual owners regardless of their residence.[11] Such a change can be achieved by exempting dividends from taxation regardless of the tax residence of the shareholder. If the corporate rate is the same as the maximum rate on labor income, then there is no incentive to re-characterize income and the income from corporate capital will be taxed once in the taxing jurisdiction.[12] In addition, the absence of source rules will enable a country to impose withholding taxes on all related party transactions (both domestic and foreign) at the corporate rate. There will be no discrimination[13] because the withholding tax is imposed on both domestic and nonresident related party payments and the net-of-tax income can be exempt to domestic individual residents or subject to the gross-up and credit as stipulated in the policy.[14] The tax administration will not have to monitor any transfer prices on inputs because the total tax payment would be independent of such charges. Revenue lost by increasing the transfer price is gained by the withholding tax.

[10] Netback pricing is really a means of computing what proportion of the final output price is attributable to a particular input, such as concentrate.

[11] I have also proposed using this approach in the United States. The tradition basis of taxation has been to tax the worldwide income of residents and the domestic source of income of nonresidents. Elimination of source rules, it might be argued, would eliminate the legal basis for taxing nonresidents. This point is well taken, but I believe the basis for taxation could be that tax is imposed on nonresidents to the extent that they have an economic interest either a withholding agent (or taxpayer) in the taxing jurisdiction. For labor income this would imply that tax on nonresidents will be impose to the extent that they supply labor services to a domestic resident charged with withholding. For the income form capital, the basis for taxation would an equity interest in a domestic entity or permanent establishment.

[12] There may be an issue about capital gains taxes; I will be happy to discuss that issue in detail should there be interest.

[13] In effect, transfer-priced inputs can be described as a type of disguised dividend. Dividends, however, should be paid out of fully taxed income. Thus, the withholding tax on related party charges combined with a zero tax on dividends will help ensure that dividends are paid out of income that is fully taxed.

[14] The gross-up and credit would be identical to the method used for the foreign tax credit in Ethiopia.

Significant administrative resources will be freed to address more revenue and compliance-enhancing activities such as fraud, evasion, and general compliance activities. Finally, I believe that concerns about double taxation can be addressed.[15] Briefly, double taxation is not an issue if the costs used to produce the good or service that is supplied to the local entity are deducted somewhere, with the "somewhere" being determine by the management of the global enterprise.

IV. Summary

In summary, I appreciate the efforts and the approach taken by Ethiopian authorities in developing a transfer pricing unit and the desire to have a transfer pricing system that is compatible with international standards. That said, I believe Ethiopia, or any country, should place transfer pricing in the context of the overall tax policies and develop rules that can be administered in a cost-effective manner while providing reasonable incentives for investment.

I hope these comments are helpful and I will be happy to supply additional detail as desired.

Thank you.

[15] Claims of double taxation should be suspect for two reasons in my view. First, there needs to be a commonly-accepted definition of income that is subject to double taxation. Second, it is not clear that double taxation is inefficient. For example, an enterprise could be subject to taxation only once and pay $10.00 in tax or be taxed twice and pay $8.00 in tax. The issue is the overall tax burden of the enterprise and the marginal effective tax rate faced when investing in any particular country, not the number of times the income is taxed.