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## ***Ethiopia's Rules on Transfer Pricing***

by: Thomas Mulugeta





# Ethiopia's Rules on Transfer Pricing

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In a recent discussion made between The Ministry of Revenue and stakeholders, the issue of transfer pricing was brought up to create more awareness on the rules and their applicability. This session has clearly indicated that more focus is needed on transfer pricing, arm's length principles and taxpayers' role in this respect.

Back in 2015, Ethiopia enacted its first rule on transfer pricing through the issue of Directive 43/2015. This marked the beginning of a regulated transfer pricing policy which for long has been a mere principle on income tax proclamations of the land with regards to Arm's Length transactions between related parties. Transfer pricing Directive 43/2015, which provided guidance on both Article 29 of the old income tax proclamation 286/94 also serves as a guidance to article 79 of the income tax proclamation no. 979/2016. This is clearly indicated in the article 101/6 of the 2016 proclamation.

This directive follows the comparability principles of the Organisation for Economic

Co-operation and Development (OECD) guidelines as stated in Article 18 of the Directive. The guidelines consider circumstances of comparability of controlled transaction (transactions with related parties) and uncontrolled transactions (those with unrelated parties) These circumstances are:

- i. If there is no significant difference between them that could have any substantial impact on the financial indicator under the appropriate transfer pricing method or
- ii. If any such difference exists, it can be eliminated by adjusting the financial indicator of the uncontrolled transaction to eliminate the effect of the difference on comparability.



Although Directive 43/2015 allows five different methods as 'approved transfer pricing methods', it also allows taxpayers to adopt other methods, as long as the taxpayer can establish that none of the approved methods can be applied under the circumstances and as far as the results of the adopted method are consistent with arm's length principle.

These five 'approved transfer pricing' methods are:

- i. Comparable uncontrolled price method
- ii. Resale price method
- iii. Cost plus method
- iv. Transactional net margin Method
- v. Transactional profit split method

Selection of appropriate methods, as specified in Article 7 of the Directive, first and foremost should be consistent with the Arm's length principles. This is followed by four criteria to evaluate the appropriate methods for the selection. These criteria are:

- strength and weaknesses of the transfer pricing method.
- appropriateness of the approved transfer pricing method in view of the nature of the controlled transaction.
- availability of reliable data needed to apply selected transfer pricing method(s) and
- degree of comparability between controlled and uncontrolled transactions.

Internal comparable price is a common method of comparison, defined by the directive as uncontrolled transactions that are made between the taxpayer and an unrelated party, for the purpose of determining an arm's length range to compare with a controlled or related party transaction.

### Documentation

Taxpayers are required to maintain adequate documentation to substantiate conditions and circumstances of controlled transactions (transactions with related parties) that are consistent with the arm's length principles. These documentations should ensure that the taxpayer discloses the nature of the operations, history and general overview of the relevant market.

They should also include the organizational structure of the business. In this situation members of a group company if any, or operations and business relationships of any related companies should be included in the documentation.

One other significant aspect of the documentation requirement is with respect to list of controlled transactions along with an analysis on the comparability factors with uncontrolled transactions. The analysis to be documented should include comparability adjustments taking into account the materiality of the difference for which the adjustment is being considered, the quality of the data subject to adjustment, the purpose of the adjustment and the reliability of the approach used to make the adjustments.

The taxpayer is also required to document an explanation on the appropriateness of the selected methods including specific financial indicators and the party on which the methods are tested where relevant.

As comparability is the key aspect of the TP and Arm's length principles, the analysis thereto and the descriptions of the comparable uncontrolled transactions should also be part of the taxpayer's files and documentation.

Other documentations to consider are detailed adjustments made after the comparability analysis, budgets and projections used, sector analysis done and any other relevant information.

### Advance pricing arrangement

Article 12 of the directive provides an opportunity for taxpayers to enter into an agreement with the tax authority to determine appropriate criteria to set arm's length conditions for related party transactions. This arrangement is agreed for a fixed period of time. Such practices are also exercised in other countries as a tool to eliminate uncertainty and with a view of ensuring the confidentiality of information during the process. This also enhances the relationship with the tax authorities.

The Directive guides the taxpayer to file a formal request for the pricing arrangements if need be. This advance pricing request should be filed along with description of controlled transactions, proposed scope and duration of the arrangement, TP method selected, the comparability factors considered, and countries to be included in the arrangement.

## Application of the law and recent developments

Currently, more emphasis is given to controlled or related party transactions between businesses operating in Ethiopia and their international related partners even though the Directive also covers related companies in Ethiopia without any international affiliations. This means transfer pricing is also a key issue regarding transactions between two or more domestic related businesses as clearly required by Article 79/4 of the income tax proclamation 979/2016.

However, the authority is now paying more attention to controlled transactions that are entirely between resident companies in Ethiopia. These companies are required to declare such transactions along with their annual income tax filing. Therefore, companies need to set their house in order to organize and furnish all information, analysis and documentation on transfer pricing in time. One other issue to be put into consideration in case of controlled transactions between two domestic companies is, any adjustment on the related party transactions should affect both parties.

If one looks at the transfer pricing declaration document or form, it primarily describes transactions to be filed as 'Internationally Controlled'. The Ministry of revenue has recently acknowledged this in its deliberations to stakeholders.

The Ministry has also decided to increase filing requirement of the minimum threshold of aggregate controlled transactions of ETB 500,000 to ETB 1,000,000. The annual declaration also prohibits offsetting of income and expenses to avoid non detection of controlled transactions.

The bottom line is taxpayers with controlled transactions need to continuously be alerted to the need for filing transfer pricing declarations. And those with adequate documentations and a robust transfer pricing policy do not find it difficult to file TP requirements in time. ■



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