

## Policy Brief

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# Unsuccessful Implementation of the OECD Transfer Pricing Guidelines in Low-Income Countries: The Case of Ethiopia

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This policy brief is extracted from a full-fledged research report financed by the International Centre for Tax and Development through the Ethiopian Tax Research Network and published in the British Tax Review, Issue 2, 2023. Much international technical assistance is directed towards increasing the capacity of tax authorities in low-income countries to understand and effectively implement the OECD Transfer Pricing Guidelines and thus retain their fair share of revenue from the transnational economic transactions of multinational enterprises. The outcome of such assistance in the case of Ethiopia has been generally disappointing. Despite more than a decade of effort and nearly two decades since the initial introduction of transfer pricing rules in the tax system, the Ethiopian tax administration has not successfully completed a single transfer pricing audit. Three country-specific factors explain the poor implementation of transfer pricing rules in Ethiopia: the inability of tax officers to adapt from long-standing practices that run counter to OECD Guidelines, institutional ambiguity and rivalry among tax policy and enforcement organs, and the possibility of mock compliance with international standards without there being any such compliance in practice. Resolving some of the critical changes requires external technical assistance and decisive internal political and technocratic leadership, among other things.

## Introduction

Transfer pricing refers to the technique of ascertaining the value or price of business transactions between related parties for tax purposes. The price of business transactions between related business entities (for example, a subsidiary and a parent company) is subject to a special assessment regime (that is, transfer pricing) because such a price is susceptible to being artificially set and, therefore, at variance with the tax that would have been obtained in the case of comparable transactions between unrelated parties.

Multinational enterprises (MNEs) operating in multiple jurisdictions artificially price transactions between entities within their group to shift taxable profits out of jurisdictions where tax liabilities are higher. In response, international tax rules allow national tax authorities to reassess whether transactions between related parties are undertaken on the basis of the so-called arm's length principle (which resembles transactions between unrelated parties) and to make tax adjustments where necessary.

The globally predominant guidelines on transfer pricing (and tax in general) are those developed by the Organisation for Economic Cooperation and Development (OECD) and are encapsulated in its Transfer Pricing Guidelines (OECD 2017b) and the Model Tax Convention (OECD 2017a). There is polarised debate on the role of the OECD Guidelines in low-income countries.

On the one hand, mainstream international technical assistance programmes, championed by intergovernmental financial and development organisations, endorse the OECD Guidelines as useful for low-income countries. On the other side of the debate, a critical camp questions whether the Guidelines fit the realities that face low-income countries, both in terms of process and substance. This camp argues that the process of norm development at the OECD is skewed against the meaningful participation of developing countries due to deeper structural factors, even after the inclusivity reforms undertaken in recent years. Proponents of the camp in question argue that the Guidelines are too cumbersome and complicated to be effectively implemented by tax administrations, even by those of developed countries.

## Study methodology

The research in question intervenes in the above debates by showing the practical realities in low-income countries that do not easily fall into one or other of the camps. The case of implementing transfer pricing in Ethiopia shows that the OECD Guidelines' fundamental problem of fit with low-income countries is compounded by country-specific institutional problems that cannot be resolved by simply increasing assistance to build capacity. Ethiopia is a case study of interest due to its large economic size in Africa, its fast economic growth and recent market liberalisation reforms in the country, which have dramatically increased its openness to MNEs. Despite more than a decade of activity and international assistance, Ethiopia has not undertaken a single complete transfer pricing audit following the methods adopted by the OECD Guidelines.

The study is conducted through a desktop review of literature and legal analysis of Ethiopian legislation, as well as semi-structured qualitative interviews and focus group sessions with elite informants in Ethiopia.

## Results and discussion

Ethiopia is relatively new to transfer pricing. The legislative instrument that nominally introduced it was the Income Tax Proclamation No. 286/2002 (Government of Ethiopia 2002). Thirteen years later, in 2015, a Transfer Pricing Directive (TP Directive) with detailed rules on transfer pricing was adopted, and a transfer pricing unit (TP Unit) was established under the Larger Taxpayers Office of the Ministry of Revenue in 2016 (Government of Ethiopia 2015; 2016). The Ministry of Revenue has since restructured the organisation and set up the TP Unit under the General Tax Audit Directorate.

The Ethiopian Income Tax Proclamation (Government of Ethiopia 2016) requires that transactions between related persons be conducted in accordance with the established arm's length principle, which is largely aligned with the OECD Guidelines. The Ethiopian

TP Directive (Government of Ethiopia 2015) provides guidance on how the arm's length principle is to be implemented in assessing and adjusting prices for transactions between related enterprises. It recognises the transfer pricing methods adopted under the OECD Guidelines. Taxpayers are required to present transactions made with related enterprises in documentary form when requested to do so by the tax authority.

The study principally reveals that intangible, non-material (that is, non-economic) dimensions of capacity are the constraints that hinder the implementation of the OECD Transfer Pricing Guidelines. However, this does not mean that material capability is an irrelevant or unimportant factor. On the contrary, the Ethiopian tax system has a severe material capacity problem.

### **Lack of material capacity**

The country's transfer pricing system is near non-existent in terms of expertise and resources. The TP Unit of the Ministry of Revenue is staffed by a handful of auditors (at the time of the interview in September 2021, there were only three auditors), who are in charge of all aspects of transfer pricing in the country, from conducting risk analyses to undertaking audits of specific multilateral enterprises.

The small TP Unit has mostly been busy investigating and compiling data on the type and number of MNEs functioning in Ethiopia (about 179 MNEs have been identified) and has not yet undertaken a full transfer pricing audit. Although training was provided by the OECD when the TP Unit was established, staffers admit they do not have sufficient knowledge to perform the arm's length assessment using any of the standard methods. The last substantive training was provided about ten years ago, and those who were trained have since left the Ministry of Revenue. However, there have since been some capacity-building projects run by the OECD, the International Monetary Fund (IMF), and the International Bureau of Fiscal Documentation.

The TP Unit also lacks a well-organised structure and access to a database or advanced information-processing technology. Foundational steps, such as developing a structure, manuals, and procedures for undertaking transfer pricing, have not been carried out except for a rudimentary organogram internally prepared by the TP Unit. All research and investigation, including information on the nature and activities of taxpayers, is undertaken using open-source material and regular internet searches.

### **Non-material factors**

However, a closer study of the working practices of Ethiopian tax officers reveals that other context-specific non-material factors are also at play in blocking the translation into action of transfer pricing rules as they appear on the books. The study identified the following three major factors.

#### **Long-standing practices: the case of permanent establishment rules**

Departing from long-established working practices and embracing transfer pricing rules is a critical challenge for Ethiopian tax officers. The challenge of inertia arising from the long-standing tax practice is most visible in the context of the taxation of payments for technical and management services rendered by foreign entities without a local permanent establishment (PE). When the service provider is a related party to the local service recipient, the tax treatment of the payment is, in practice, ambiguous. The tax authorities' practice, borne out of the desire to prevent PE abuse, runs contrary to the OECD rules that allow such payments to be tax deductible as long as they keep the arm's length principle. The existing practice is to largely dismiss headquarters' expenses as non-deductible, which makes the application of transfer pricing rules redundant.

### **Institutional ambiguity and rivalry**

Certain tensions in the operation of the various entities and organisations involved in transfer pricing policy-making and administration also contribute to the overall paralysis in Ethiopia's transfer pricing regime. The ambiguity and rivalry between relevant tax authorities result in confusion for taxpayers. There is a disconnect between the administrative level (TP Unit) and the policy level (the Ministry of Finance). Within the administrative level, there is an overlap between the mandates of the Transfer Pricing Audit Unit and the General Tax Audit Department of the Ministry of Revenue and a disconnect between the mandates of the Ministry of Revenue and the Customs Commission.

The TP unit is positioned under the Ministry of Revenue's General Tax Audit Department, which has a general remit. There is a certain mandate ambiguity and rivalry between the TP Unit and the General Tax Audit Department. The TP unit is mandated to undertake TP audits as a supplement to the general audit and is driven by its own risk analysis. There is a tendency among higher management of the Ministry of Revenue to perceive the mandate of the TP Unit as being only for data processing and analysis that feeds investigation reports on transactions between related parties in the General Tax Audit.

At the policy-making level, particularly within the Ministry of Finance's Legal and Tax Policy Directorates, there is an expectation that the TP Unit should simply take up and operationalise the TP Directive. In interviews, the TP Unit staffers claim they are hindered from applying the TP Directive by the absence of further guidance from the policy-making level. In particular, they state, there is a lack of guidance as to how to assess technical and management service fees, and in such circumstances, they resort to customary tax practice of 'fair market value' assessment, that is, accepting or rejecting deductibles based on the tax officer's assessment of whether an expense appears to be suspiciously inflated or not.

There is also an apparent tension between the priorities of customs and tax authorities. Customs authorities, tasked with the function of raising revenue from goods imports, focus on tackling the undervaluation of imports. Higher valuation means more customs revenue, so customs authorities are incentivised to be less vigilant regarding over-invoicing. On the other hand, the tax authorities' focus is to ensure imports are not over-invoiced, as they ultimately become expenses that reduce in-country business profit tax liability. The scheme of over-invoicing imports to reduce ultimate tax liability is a critical area of revenue loss for low-income countries, as industrial development-driven incentive regimes offering minimum or no customs liability for exporters are common practices. In Ethiopia, for example, importing raw materials for re-export purposes is free from customs duty. Most multinational enterprises, for example, in the pharmaceutical and horticultural sectors, import products or industry inputs from a related company abroad, and some also re-export their products to a related party. In such cases, the importers would pay minimal or no customs duty on the over-invoiced import and, after exporting their final product, benefit from significant deductibles in their business profit tax liability due to the inflated price of the relevant import.

The seeming clash between the priorities of the customs and tax administrators is exacerbated by the fact that the two sides do not have a direct working relationship. The tax administration sometimes asks for clarification of price valuation from the Customs Commission when there are suspicious cases. However, in most cases, the tax administration simply assumes that the prices accepted by the Customs Commission upon declaration by the taxpayer are final.

### **Mock compliance**

Another factor compounding Ethiopia's delay in implementing transfer pricing rules is the possibility of mock compliance without decisive implementation of the rules. The tax authority's lack of ability and lacklustre political commitment to implementing transfer pricing rules exist side by side with the need to appear compliant with internationally accepted taxation practices. This can be illustrated by the country's haphazard approach to the signing of tax treaties, in particular, Double Taxation Avoidance Agreements (DTAs), in the absence of a cohesive tax treaty policy. The country has entered into various DTAs with inconsistent motivations, lacking institutional anchorage and, at times, having no intention of actually implementing the DTAs or with countries with which it has no significant trading relations. A similar institutional culture could be said to have driven the adoption of transfer pricing rules, as it lacks clear institutional ownership and decisive political commitment to implementing such rules. This is further illustrated by the lack of enforcement of the procedural steps necessary for transfer pricing audit, in particular in relation to documentation and information exchange. While the transfer pricing rules empower tax authorities to demand documentation from taxpayers and taxation treaties provide facilities for information exchange with foreign tax authorities, these mechanisms are hardly utilised by Ethiopian tax authorities.

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### **Conclusion and recommendations**

The implementation of the OECD Transfer Pricing Guidelines by low-income countries is generally constrained by their capacity limitations. However, by focusing on the law and practice of Ethiopia, this study showed that while the material capacity constraint is a serious factor, it is not the only one. The study identified three other factors of a social and institutional nature.

The first factor is the inability of tax officers to depart decisively from long-established tax practices that run counter to the OECD transfer pricing rules.

The second factor is the institutional mandate ambiguities and rivalries that exist within tax administration organisations and between them and tax policy organisations.

The third factor is the possibility that countries engage in the appearance of compliance with international guidelines (mock compliance) without seriously applying the relevant stipulations on the ground.

These findings imply that improving Ethiopia's compliance with the OECD Guidelines requires increasing technical assistance to resolve the material constraints and resolving questions of habit, clarity and commitment at the levels of working processes, institutional organisation and policy-making. The findings also suggest that improving the ability of low-income countries to administer transfer pricing effectively needs to be a local process that involves the relevant tax-policy makers and administrators in the design of the transfer pricing regime. They also show that overcoming some of the critical challenges, particularly institutional ambiguities and rivalries requires external technical assistance and decisive internal political and technocratic leadership. Furthermore, the challenge of path dependency in the working processes of tax administrations means that building an effective transfer pricing regime might require setting up an entirely new team or institutional framework that would not be beholden to customary tax practices.

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## Credits

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