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Working Paper 144

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

Nathanael Tilahun and Abebe Gebrehiwot Yihdego

August 2022

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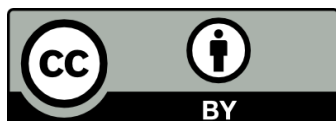
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Summary

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 obtain more revenue from the transnational economic transactions of multinational enterprises. The outcome, although varied, has been disappointing. Constraints of material capability are considered the main explanations for low-income countries' failure to implement transfer pricing rules in practice. By taking Ethiopia as a case study, this paper builds on the capacity explanation and shows that capacity is only a generic explanation that needs to be accompanied by context-specific explanations that are not bound to material capability. Despite more than a decade of efforts, 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. The paper identifies three country-specific factors that help explain the abysmal record of implementation of transfer pricing rules in Ethiopia: the inability of tax officers to depart from long-standing practices that run counter to OECD rules, institutional ambiguity and rivalry among tax policy and enforcement organs, and the possibility of 'mock complying' with international standards without in practice doing so. In combination, these factors show that procedures recommended by the OECD for dealing with transfer pricing issues are so far removed from the existing practices and capacities of the Ethiopian national tax administration that their formal adoption has resulted in little more than organisational re-labelling.

Keywords: transfer pricing; low-income countries; OECD Guidelines; Ethiopia; local institutions; customary tax practice; mock compliance.

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Contents

	Summary	3
	Acknowledgements	5
	Acronyms	5
	Introduction	6
1	The Catch 22: neither resisting nor implementing the OECD Guidelines	7
	1.1 Ethiopia as a case study	8
	1.2 Methodology	9
2	Overview of the Ethiopian transfer pricing regime	9
	2.1 Legal framework: Transfer Pricing Directive	9
	2.2 Institutional framework	10
3	Beyond the capacity problem	11
	3.1. Long-standing practices: the case of abuse of PE rules	13
	3.2. Institutional ambiguity and rivalry	14
	3.2.1. The TP Unit v. General Tax Audit	15
	3.2.2. Tax administration v. tax policy	15
	3.2.3. General Tax Audit/TP Unit v. Customs Commission	16
	3.3. Mock compliance	17
	3.3.1 Haphazard double taxation avoidance treaties	17
	3.3.2 Ritual observation of documentation and information exchange	19
4	Conclusion	19
	References	21

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Acronyms

ALP	Arms-length principle
DTA	Double taxation avoidance agreement
ITP	Income Tax Proclamation
MNE	Multinational enterprise
OECD	Organization for Economic Cooperation and Development
PE	Permanent establishment
TPGs	OECD Transfer Pricing Guidelines

Introduction

The globally predominant rules on transfer pricing (and tax in general) are those developed by the Organization for Economic Cooperation and Development (OECD), encapsulated in its Transfer Pricing Guidelines (TPGs) (OECD 2017a) and Model Tax Convention (OECD 2017b). The debate on the OECD transfer pricing regime and low-income countries is polarised. On one side, the mainstream of technical assistance endorses the OECD's approach to transfer pricing as useful for low-income countries. This camp frames the challenges such countries face as primarily due to deficits in implementation capacity, such as sufficient personnel in proportion to the number of cases and the ability to motivate and retain staff. For sure, tax administrations and MNEs in low-income countries, particularly in Africa, are faced with problems of 'availability and quality of financial data' on comparable transactions and on the financial performance of comparable non-related enterprises (ATAF 2014: 11). Nonetheless, according to this 'capacity thesis', the OECD standards could be made to work in low-income countries if sufficient technical assistance were provided.

On the other side, a critical camp questions the fit between OECD standards and the realities of low-income countries, in terms of both process and substance. This camp argues the process of norm-development at the OECD is skewed against the meaningful participation of developing countries due to deeper structural factors, even after major inclusivity reforms were undertaken in recent years, such as the creation of the Inclusive Framework (Christensen, Hearson and Randriamanalina 2020). Substantively, this view holds, the OECD rules on transfer pricing, in particular the transactional approach to the arms-length principle and accompanying methods of its application, are too complex to implement (Durst 2019; Eden 2016; Ezenagu 2019: 6–10; Picciotto 2018; Hearson 2021: 4). Proponents of this 'complexity thesis' consider that the OECD transfer pricing rules are too cumbersome and complicated to be effectively implemented by even the tax administrations of developed countries (Andrus and Collier 2017). The rules are, therefore, even more difficult to implement for low-income countries that lack transfer pricing expertise and capacity (Hearson, Ndubai and Randriamanalina 2020; United Nations 2017: B.1.3.11). Therefore, in this view, low-income countries, particularly least-developing African countries, are bound by an unfavourable global transfer pricing regime that they have little influence over.

This paper intervenes in this debate by showcasing the practical realities in low-income countries that do not easily lend themselves to one or the other camp. It shows that the OECD transfer pricing regime's fundamental problem of fit with low-income countries (the complexity thesis) is compounded by country-specific institutional problems that cannot also be resolved by simply increasing capacity assistance. The explanation of capacity would lead us to presume that with enough international technical assistance, low-income countries should be able to run an effective transfer pricing system. Granted, this would not be a quick process as setting up an effective transfer pricing audit system takes a minimum of three to five years (Cooper, Fox, Loeprick and Mohindra 2016). But ultimately, the presumption would be, technical input should translate to capacity output. The Ethiopian case complicates this picture. Despite more than a decade of activity and international technical assistance, the country has not undertaken a single complete transfer pricing audit following any of the globally accepted methods.

The Ethiopian experience shows, as this paper will bring to light, that the lack-of-capacity thesis is not a sufficiently specific explanation of why low-income countries fail to implement transfer pricing rules. Instead, unpacking the 'capacity' issue by investigating the specific country context is important to understand why a particular low-income country fails to realise TPGs on transfer pricing. In other words, yes, capacity matters but the capacity question could have varying components in specific low-income countries. This investigation needs to be driven with the premise that governmental actors within a particular low-income country

have active agency, informed by their own needs and possibilities, in serving as interlocutors that translate the (globally endorsed) formal transfer pricing policy into practice.

The structure of the paper is as follows. Section 1 considers the ambivalent position most low-income countries are found in as they are unable to successfully implement or resist OECD standards on transfer pricing. Section 2 provides an overview of the legal and institutional framework governing transfer pricing in Ethiopia. It shows that the normative framework draws heavily on the OECD template. Section 3 is the core discussion that presents the findings of the study. The discussion in this section is divided into the three main findings of the paper, i.e. factors related to existing practices (3.1), institutional issues (3.2), and mock compliance (3.3). Concluding remarks are offered under the final section, section 4.

1 The Catch 22: neither resisting nor implementing the OECD standards

Low-income countries are often able to neither pivot away from nor effectively emulate the OECD orthodoxy in transfer pricing. Simplified transfer pricing methods that pivot away from the OECD TPGs in light of the constraints of low-income countries are proposed by scholars (Picciotto 2018; Ezenagu 2019; Hearson and Prichard 2018). There is also some practice of devising alternative methods and practices in a few developing countries, notably in Latin America and Asia. Notable examples include Brazil's adoption of fixed profit and markup margins when using cost-plus and resale price methods (Illarraz 2014: 218–235; OECD/Receita Federal do Brasil 2019) and other instances where partial adjustments to the application of the OECD methods were made, such as use of a referential profit margin, whereby tax authorities rely on pre-defined profitability margins approximate to those found in the open market, and geographical market adjustments that capture the difference between jurisdictions/economies of varying characters (Hearson *et al.* 2020; Hearson and Prichard 2018; Gómez Serrano, Bolado Muñoz and Arias Esteban 2019). The development of alternative methods, however, has not gained significant traction in Africa. Instead, the prevalent trend is recognition of the OECD rules in the domestic legal system, either by law or by *fait accompli*. In the limited jurisprudence in Africa on transfer pricing we see that some judiciaries endorse the OECD TPGs as applicable rules de facto, even in the absence of recognition by local law (Unilever [case] 2005 and Picciotto 2018: 21). International technical assistance in setting up transfer pricing administration capacity in developing states is also concentrated on emulating the OECD template in those countries.

Although critical work in political economy has shed light on the misfit between the OECD TPGs and the needs and capabilities of developing countries, adherence to the OECD standards continues to be the norm (Picciotto 2018: 19). The ability of developing states to depart from the OECD template is constrained due to deep structural factors. The key structural factors include political path dependency by developing countries, the consolidation and institutionalisation of an epistemic community committed to OECD orthodoxy, competitive risks of regulatory divergence, and the difficulty of devising alternative systems (Picciotto 2018). The path dependency in particular arises from the fact that the OECD TPGs occupy a 'hegemonic' (Hearson *et al.* 2020: 10) or 'canonical' (Picciotto 2018: 19) position in global tax governance. The TPGs are accepted as a *de facto* legal standard, without technically being a binding instrument (Hearson 2021; Picciotto 2015; Brugger and Engebretsen 2020).

In low-income countries where adopting the OECD methodology is accepted as the only option, actually implementing it is also a problem. In such countries, setting up transfer pricing regimes requires ensuring sufficient capacity to effectively implement the OECD TPGs and at the same time reforming broader tax regimes to mitigate the disadvantages source countries face under the OECD approach. African states face key capacity constraints such as building and sustaining expertise, accessing resources such as databases, and information exchange mechanisms (IMF, OECD, United Nations and World Bank 2011). The capacity problem is compounded by the fact that the OECD-led regime undergoes constant updates, which makes keeping pace an even greater challenge (ATAF 2019). In addition to the question of capacity, a key aspect of countries' broader tax regime that impacts their ability to generate revenue through transfer pricing is the role of double taxation agreements.

Taxation of services rendered between related parties is a particularly thorny issue for tax administrations in low-income countries, and an area perceived to be of high revenue loss. The existence of double taxation agreements often implies that when a service is provided by a non-resident entity, business profits from the services rendered are not taxable in the country where the service took place (i.e. the source country). In other words, profits from services are usually excluded from source country taxation, unless the service provider has permanent establishment in that country. The payment for services rendered, however, is normally deductible from the business profits of the service recipient in the source country. This means that the source state does not lose revenue in terms of tax not withheld from payment for services and the reduction of taxable profit of the service recipient.

1.1 Ethiopia as a case study

Ethiopia is relatively new to transfer pricing. The legislative instrument that nominally introduced transfer pricing was the Income Tax Proclamation (ITP) 286/2002.¹ The detailed rules on transfer pricing were adopted 13 years later in 2015,² and a transfer pricing unit (TP Unit) was established under the Large Taxpayers Office of the Ministry of Revenue in 2016. The Ministry of Revenue has since restructured the organisation and set up the TP Unit under the General Tax Audit Directorate.

Ethiopia is a case study of interest as it is one of the largest economies in Africa, with fast economic growth and recent market liberalisation reforms that have dramatically increased its openness for MNEs. The country is the second most populous in Africa with close to 115 million people. It has one of the fastest growing economies in Africa, having registered an average 9.5 per cent growth per year for about 15 years until 2019/20.³ Following governmental reform in 2018, the country has embarked on a so-called 'Homegrown Economic Reform', an ambitious market liberalisation and opening agenda supported by international financial institutions.⁴ This means the country is poised for a significant influx of MNEs and exposure to attendant transfer pricing issues.

As a newly established transfer pricing administration system within a large developing country, the Ethiopian regime is a practical and intellectual case study on how actors within such systems translate formal policy to action. The study refines our understanding of the broad administrative and legislative constraints of low-income countries identified in existing literature by bringing to light distinctive issues arising from the peculiarities of the administrative system and regulatory culture of the country. In this light, the paper reveals

¹ Article 29 of Proclamation 286/2002.

² Transfer Pricing Directive (TP Directive) 43/2015.

³ World Bank country overview, available at <https://www.worldbank.org/en/country/ethiopia/overview#1>.

⁴ IMF Press Release No. 19/486, available at <https://www.imf.org/en/News/Articles/2019/12/20/pr19486-ethiopia-imf-executive-board-approves-ecf-and-eff-arrangements>.

that while the general capacity constraint thesis remains valid, the Ethiopian case study qualifies that thesis by showing three distinct factors that explain why the country has failed to follow the TPGs. The first concerns the inertia of existing customary tax practices that contradict the TPGs; the second relates to peculiar institutional ambiguity and contradiction within the broader tax governance architecture that hinder bringing transfer pricing rules to the ground; and the third is the possibility of shadow playing or ‘mock complying’ with international standards that has siphoned off attention from actually implementing transfer pricing rules.

1.2 Methodology

The study is conducted through a desktop review of literature, legal analysis of Ethiopian legislation, semi-structured qualitative interviews with key informants in Ethiopia, and a focus group discussion. The literature review covered an assessment of transfer pricing experiences and broader trends in the developing world. Ethiopian legislation is juxtaposed against OECD instruments to highlight the influence of the latter on the design of the Ethiopian transfer pricing regime. The semi-structured interviews were essential to understanding the functioning of the Ethiopian transfer pricing administration.

Interviews were undertaken between the last week of August and the end of September 2021 with officials (heads of units) from the Ethiopian Ministry of Revenue (the Transfer Pricing Audit Unit), the Ministry of Finance (Legal Service and Tax Policy Directorates), and the Customs Commission Valuation Office; current and former legal and audit staffers of select MNEs operating in Ethiopia; and a senior private consultant who was formerly involved in the initial work of setting up the Ethiopian transfer pricing regime. The interviews were an in-depth qualitative exploration of the issues surrounding the implementation of the Ethiopian transfer pricing legislation, and were semi-structured with guiding themes and questions. The focus group brought together representatives of the above-mentioned government organs for an interactive discussion based on initial input they had provided during interviews.

2 Overview of the Ethiopian transfer pricing regime

2.1. Legal framework: Transfer Pricing Directive

Transfer pricing was nominally introduced into the Ethiopian tax regime in 2002,⁵ but detailed rules on the subject were adopted only in 2015, in the form of the Transfer Pricing Directive (TP Directive) issued by the Ministry of Finance.⁶ Although the Ministry of Finance has consulted stakeholders during the drafting process, the Directive is little known by tax administrators and the private sector. It also has some inconsistencies with the general income tax legislation of the country, as the latter was revised subsequent to the adoption of the transfer pricing Directive. Work on reconciling the Directive and the general income tax legislation is currently frozen due to COVID-19 disruptions.

The Ethiopian transfer pricing regime accepts the established arm’s length principle to assess and adjust prices for transactions between related enterprises,⁷ and is largely aligned

⁵ Income Tax Proclamation 286/2002, later on replaced by Proclamation 979/2016.

⁶ TP Directive 43/2015.

⁷ ‘Transaction between related parties’ is understood in Ethiopian tax law as transactions between resident taxpayers and their related non-resident entities (international transactions), or those between two related resident taxpayers having an

with the OECD TPGs. It recognises the five transfer pricing methods adopted under the OECD TPGs: (i) comparable uncontrolled price method; (ii) resale price method; (iii) cost-plus method; (iv) transactional net margin method; and (v) transactional profit split method. The Directive also provides taxpayers with the option to use a method other than the five approved methods, provided that none of the five methods can be reasonably applied and the other method's result is consistent with the arm's length principle.⁸ With respect to services, the Directive provides standard guidance largely consistent with the OECD TPGs, and specifically provides for the possibility of applying indirect methods for determining service charges.⁹ In selecting the method most appropriate to specific cases, the Directive replicates criteria for consideration provided under the OECD TPGs.¹⁰ The Directive also stipulates standard factors determining comparability,¹¹ which are consistent with the TPGs.

Taxpayers are required to present transactions made with related enterprises when reporting to the tax authority for tax purposes. The transfer pricing Directive further sets out certain elements to be included in documentation requirements,¹² to be fulfilled either in English or in the local language (Amharic), but does not require taxpayers to report such documents automatically within a specific time period. It simply bestows the tax authorities with the power to request the disclosure of such documents – and any other documents – but does not stipulate a penalty for failure to comply.

2.2. Institutional framework

The Ethiopian Ministry of Finance is mandated with formulating policy and laws on taxes, while the Ministry of Revenue administers taxes and custom duties. The Customs Commission is situated within the Ministry of Revenue. The Ministry of Revenue is mandated with both tax and customs and other non-tax revenue streams administration. The Ministry was formerly a special agency, known as the Revenue and Customs Authority, accountable to the Prime Minister.¹³ After a governmental restructuring in 2018,¹⁴ it has become an independent ministry within the Prime Minister's cabinet. This restructuring has ostensibly given the Ministry more political power as it now has a say in policymaking deliberations at the cabinet. However, the Ministry still does not enjoy full political power within its remit as ultimate policymaking on tax and revenue matters belongs to the Ministry of Finance. The Ministry of Revenue can only initiate policy, and issue directives for the implementation and administration of policy.

A core branch within the Ministry of Revenue, known as the Domestic Tax Revenue stream, houses a General Tax Audit Directorate. The Ethiopian Transfer Pricing Unit (TP Unit), the chief audit unit responsible for administering the TP Directive, is a department under the

annual turnover of more than 500,000 Ethiopian Birr (ETB), which is around 10,000 USD (see, Transfer Pricing Directive, Article 3, read in tandem with Article 79 of Income Tax Proclamation 979/2016). On 5 December 2017, the Ministry of Finance and Economic Cooperation (MoFEC) issued a directive (No.T/C/5/161) that increased the mandatory value added tax (VAT) registration threshold from ETB 500,000 to ETB 1 million.

⁸ TP Directive, Article 6(2).

⁹ TP Directive, Article 13.

¹⁰ TP Directive, Article 5. These are: (i) strengths and weaknesses of the method; (ii) the nature of the controlled transaction; (iii) availability of reliable data needed to apply selected method; and (iv) degree of comparability between controlled and uncontrolled transactions.

¹¹ These are: characteristics of the goods or services, functional analysis, contractual terms, economic conditions and market circumstances, and business strategies. See TP Directive, Article 5.

¹² TP Directive, Article 15(3). The elements are: (i) the taxpayer's business operations and organisational chart; (ii) the group's structure; (iii) the controlled transaction; (iv) explanation of selected method; (v) comparability analysis; (vi) industry and economic analysis; (vii) details of any APA or other agreements; (viii) justification of consistency with ALP; and (ix) any other relevant information.

¹³ Article, 3, Proclamation 587/2008 – Ethiopian Revenue and Customs Authority Establishment Proclamation.

¹⁴ Proclamation 1097/2018 – Powers and Duties of the Executive Organs of the Federal Democratic Republic of Ethiopia.

General Tax Audit Directorate. The Directorate is well consolidated in terms of human resources, while the TP Unit, as will be discussed later, is a highly under-staffed unit.

Although the TP Unit and the General Tax Audit seem designed to deal with transfer pricing and general tax auditing respectively, there is some confusion as to which unit deals with transfer pricing cases, as will be elaborated later on. The TP Unit perceives its mandate as including undertaking transfer pricing audits, but it has so far not been able to undertake one due to factors to be explained later. Partly because the TP Unit is not undertaking audit work so far, and partly out of mandate ambiguity, the General Tax Audit deals with multinational taxpayers with potential transfer pricing issues, but relies on general tax provisions in rejecting and accepting expenses incurred in transactions between related parties as deductible expenses. As such, it does not apply the arm's length principle assessment, nor the 'fair market value'¹⁵ principle which gives the tax authority the power to adjust prices for transactions between unrelated parties.¹⁶

In terms of the settlement of disputes between taxpayers and the tax administration, the following layers of dispute settlement mechanisms are in place. When a taxpayer disputes the tax authority's audit report-based tax decision, they may file a Notice of Objection to a Tax Decision in a written form within 21 days after the decision¹⁷ is delivered. There is a Tax Review unit, which is placed within the Ministry of Revenue to provide recommendations to the tax authority or the taxpayer.¹⁸ A notice of decision on an objection contains a statement of findings on the material facts, the reasons for the decision and the right to appeal to the Tax Appeal Commission.¹⁹ The taxpayer may appeal to the Tax Appeal Commission within 30 days after the end of the 180-day period. The Commission is accountable to the Prime Minister. The judiciary (Federal High Court and Supreme Court)²⁰ serves as a last recourse to tax disputes settlement. So far, the researchers have not found any transfer pricing-related case pending in court.²¹

3 Beyond the capacity problem

This paper principally reveals the non-material dimensions of capacity as the constraints that hinder the implementation of transfer pricing rules. However, this does not mean material capability is not a relevant or important factor. To the contrary: the Ethiopian tax system has a severe material capacity problem. The country's TP system is, in terms of expertise and resources, at a near non-existent level. Currently the TP Unit of the Ministry of Revenue is staffed by a handful of auditors (at the time of interview in September 2021, only three auditors), who are in charge of all aspects of transfer pricing in the country, from conducting risk analysis to undertaking audit into specific multinational enterprises. This small team has mostly been busy investigating and compiling data on the type and number of multinational enterprises functioning in Ethiopia (about 179 MNEs identified) and has not yet undertaken a

¹⁵ The Tax Authority applies 'fair market value' to determine the cost of an asset under Article 68 of the ITP, the disposal of an asset under Article 70, and the valuation of amounts derived in-kind under Article 75.

¹⁶ Tax Administration Proclamation 983/2016, Article 3.

¹⁷ Article 54 of the Tax Administration Proclamation 983/2016 provides the first step in the procedure for disputing tax decisions. It should be done by the filing of a notice of objection to the decision.

¹⁸ Tax Administration Proclamation 983/2016, Article 55.

¹⁹ *Ibid.*, articles 55 and 56.

²⁰ Appeal to the Federal High Court and the Supreme Court can be made on a question of law only, and the notice of appeal has to state the question of law that will be raised on the appeal (see articles 57 and 58 of the Tax Administration Proclamation 983/2016).

²¹ Since its establishment in 2018, the Tax Appeal Commission has received and dealt with 2215 customs and 1654 tax appeals. It currently has 358 pending cases. None of the completed and pending cases directly identify transfer pricing as a disputed issue.

full transfer pricing audit.²² Although trainings were provided by OECD experts when the Unit was established, staffers admit they do not have sufficient knowledge to perform the ALP assessment using any of the standard methods. The last substantive training provided was about ten years ago, and those that had taken the trainings have since left the Ministry of Revenue.²³ Since then, there have been some capacity building projects run by the OECD, the IMF and the International Bureau of Fiscal Documentation (IBFD),²⁴ but those were mainly targeted towards policymakers at the Ministry of Finance (the Legal Directorate and the Tax Policy Directorate). Demands by unit staff for subsequent trainings by international experts are met with non-response by policymakers, due to, among other things, suspicion that foreign experts will exploit the legal gaps in the system if given intimate access.²⁵

The TP Unit also does not have a well-organised structure, nor access to any 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 a rudimentary organogram internally prepared by the TP Unit.²⁶ Moreover, all research and investigation, including information on the nature and activities of taxpayers, is undertaken using open-source materials and regular internet search.²⁷ Furthermore, databases necessary for comparability assessment are not in use. There have been discussions about purchasing a subscription to certain databases (e.g. Orbis) that can be shared by other units of the Ministry of Revenue, but a decision has not been made, mainly due to the databases' high cost and poor fit with the Ethiopian context.²⁸ In the absence of such formal sources of information and data, the TP Unit is not in a position to manage transaction audits for multinational enterprises.

The capacity problem is compounded by practical obstacles. One example is the issue of language. The TP Directive is heavily influenced by the principles elaborated in the TPGs. Article 18 of the Directive specifies that the TPGs are a source of interpretation for the Directive. The TPGs are, however, too complex for local experts. The TP Unit staffers state that much of the English vocabulary and concepts in the TPG are simply too difficult to grasp and implement. Some of the tax accountants interviewed also stated that this is a serious challenge not only for the regulator, but even for private consultants who in general possess better expertise than the TP Unit staffers. Not only the TPGs, but also the TP Directive prepared in the Amharic language, is described as not easy to understand. It is noteworthy that in the preparation of the Directive, undertaken by OECD consultants with World Bank funding, a first draft was rejected as too complex, and the final text of the Directive is a second version that was presumed to further simplify the TPGs. Reference to the TPGs would, however, still be necessary to interpret the Directive. In this light, there have been local efforts to translate the TPGs itself into the local language (Amharic). That effort, however, has not materialised as the task proved too difficult, requiring significant investment, and at any rate likely unhelpful as translation into unfamiliar local terms would not reduce the complexity problem.²⁹

The above-mentioned dire capacity constraints, however, are not particularly unique to Ethiopia. Low-income countries face largely similar material challenges. A closer study of the working practices of Ethiopian tax officers reveals that other context-specific non-material

²² Interview with TP Unit staffers.

²³ Interview with TP Unit staffers and a consultant to the Ministry of Revenue involved in the initial setting up process.

²⁴ Interview with Ministry of Finance staffers; see also the database of Platform for Collaboration on Tax, available at <https://www.tax-platform.org/country/ethiopia>

²⁵ Interview with a consultant to the Ministry of Revenue.

²⁶ Interview with TP Unit staffers.

²⁷ Interview with TP Unit staffers.

²⁸ Interview with TP Unit staffers.

²⁹ Interview with TP Unit staffers and a consultant to the Ministry of Revenue involved in the initial setting up process.

factors are also at play in blocking the translation of transfer pricing rules in the books into action. This paper identifies three major factors along these lines: (i) long-standing tax practices that contradict transfer pricing rules, (ii) institutional ambiguity and rivalry, and (iii) mock compliance. The following sections elaborate each factor.

3.1. Long-standing practices: the case of abuse of PE rules

Departing from a long-established working practice and embracing transfer pricing rules is a critical challenge for Ethiopian tax officers. The challenge of inertia from long-standing tax practice is most visible in the context of 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. Tax authorities' practice, borne out of the desire to prevent PE abuse, runs contrary to the OECD rules that allow for such payments to be tax deductible as long as they are in keeping with the ALP. Existing practice is to largely dismiss headquarters expenses as non-deductible, and this makes it difficult to apply transfer pricing rules.

Interviews with revenue and tax authority personnel reveal that the artificial avoidance of PE is a critical point of potential loss of revenue. Technical and management services provided by a parent or related company to their PE in Ethiopia are a very common point of dispute between taxpayers and the tax authority. There is a general belief among tax policymakers and administrators that such services are key vulnerabilities through which significant tax base erosion occurs in the country.

Permanent establishment for the furnishing of services, including consultancy services, is defined under the ITP as requiring the continuation of activities of that nature for the same or a connected project for a period or periods aggregating 183 days in a year.³⁰ This timeframe (183 days) is relatively long compared to, for example, the Kenyan regime that limits the time period to 91 days in case of services. This provides a gap, particularly for management services companies that are often engaged in activities lasting less than the stated duration, or those structuring their activities in such a way that their parent company consultants stay in the country for less than the threshold amount. However, the Ethiopian ITP requires a resident or PE of a non-resident establishment to effect a 15 per cent withholding tax on payments for technical and management services provided by a non-resident.³¹ As such, tax authorities can mitigate the challenge of taxation when the threshold for the establishment of a PE is not met by simply enforcing withholding tax on payments made by residents.

The PE-related problem is not only one of artificial avoidance by taxpayers, but also the unjustified refusal to recognise legitimate PE expenses as tax deductible by tax administrators, particularly expenses for technical and management services rendered by headquarters. The ITP provides a generic recognition of all expenses 'incurred for the purpose of earning, securing and maintaining' a business income and does not include a PE's payments for technical and management services under non-deductible items.³² The legal interpretation is, therefore, that expenses incurred by PEs for such services are tax deductible, subject to the normal transfer pricing condition that the transaction must have been undertaken at an arm's length.³³ In practice, however, the General Tax Audit summarily rejects such expense items in its tax assessment. Interviews with experts representing

³⁰ Income Tax Proclamation 979/2016, Article 15(2).

³¹ ITP, Article 89; Also, Council of Ministers Regulation No. 410/2017.

³² ITP, articles 20 and 21.

³³ If there is a tax treaty the provisions of such a treaty apply. Treatment of the taxes interchangeably applies on the type of provisions adopted in each treaty. In this respect as well, a problem identified during the authors' interviews is that the tax authorities do not qualify or categorise expenses so as to consider deductible expenses.

agricultural exporters and manufacturers have also shown a similar pattern. Tax administrators do not apply transfer pricing rules and instead simply reject expense deductions on the grounds of general tax law, or on the basis that the particular expense item is not recognised under the general tax rules.³⁴ The common justification provided is a customary view that services provided by parent companies cannot be regarded as expenses to the PE.³⁵ In other instances, the rejection arises from the belief that such deductibles cannot be granted in the absence of a tax regime regulating those specific expense items by way of setting limits or thresholds. By the 'tax regime', the reference is to the ITP, not the TP Directive. In other words, the General Tax Audit puts aside the TP Directive entirely and seeks to evaluate these expenses in light of the general income tax regime.

In one illustrative case, following such a rejection from tax authorities, a dispute between taxpayers and the Ministry of Revenue was brought to the policymaking body (Ministry of Finance) for a ruling. Company X was withholding a 15 per cent technical services fee for payments made to its parent company. However, all the technical services fees were rejected following a general tax audit. The taxpayer claimed that if technical and management services are not recognised as independent transactions with the parent or related company, then the 15 per cent withholding tax originally paid on that transaction should be refunded to them. The Ministry of Revenue brought a request for an advance ruling at the level of policy to the Ministry of Finance, which ruled that the withholding tax should indeed be refunded to the taxpayer. An interview with the pertinent Ministry of Finance officials revealed that the policymakers appreciate that the matter should have been assessed according to the TP Directive stipulations and that the technical and management services fees should have been recognised as tax deductible expenses, subject to the usual arm's length precondition. However, the policymakers reason that they cannot overrule the Ministry of Revenue's individual tax assessments as they do not have an administrative mandate, and that their advance ruling only clarifies the policy that withholding tax cannot be imposed on a transaction that is not recognised as occurring between two separate entities. But what this ruling creates is a general precedent where the tax administrator simply puts aside transfer pricing rules in rejecting technical services fees as expenses, in which case taxpayers would request a refund for the withholding tax collected. This example shows the kind of challenge both the tax administration and taxpayers are facing.

In circumstances where the related party in the transaction is a resident of a jurisdiction with which Ethiopia has a double taxation avoidance agreement (DTA) in place, the local receiver of the service/or the payer asserts their right to not pay withholding tax at all. The anxiety Ethiopian tax administrators describe is that when expenses for transactions with parent or related companies are taken as expenses, in accordance with the TP Directive, and the withholding tax on such transactions is also waived due to a DTA, the country would be losing revenue double-fold. The customary impulse to reject such transactions as expenses also arises from this anxiety.

3.2. Institutional ambiguity and rivalry

Certain tensions in the operation of the various entities and organs involved in transfer pricing policymaking and administration also contribute to the overall paralysis in Ethiopia's transfer pricing regime. There is ambiguity and rivalry between relevant tax authorities that results in confusion and challenge for taxpayers. There is a gap or disconnect between the TP Unit (the administrative level) and the Ministry of Finance (the policy level). Within the administrative level, there is an overlap between the mandates of the Transfer Pricing Audit

³⁴ Interview with expert representatives of flower growers and exporters, and pharmaceutical manufacturers.

³⁵ Interview with private auditors, representatives of large taxpayers, and officials at the Legal Directorate of the Ministry of Finance.

Unit and the General Tax Audit departments of the Ministry of Revenue, and a disconnect between the mandates of the Ministry of Revenue and the Customs Commission.

3.2.1 The TP Unit v. General Tax Audit

The TP Unit is an independent audit unit established under the Large Taxpayers Office of the Ministry of Revenue. As mentioned earlier, the TP Unit is positioned under the Ministry of Revenue's General Tax Audit Directorate which, as the name implies, has a general tax audit remit. There is a certain mandate ambiguity and rivalry between the TP Unit and the General Tax Audit unit. The TP Unit is mandated to undertake TP audit, as a supplement to the general audit, driven by its own risk analysis. However, interviews with key informants from the General Tax Audit revealed that there is a tendency among higher management within the ministry of perceiving the mandate of the TP Unit as only a data processing and analysis unit, feeding investigation reports on transactions between related parties to the General Tax Audit, and not as an audit unit in itself – despite the naming of the TP Unit as an 'audit process unit'. The TP Unit, on the other hand, assert its role as an audit unit.

The fact that the TP Unit so far is not implementing the TP Directive, but is instead applying general tax legislations, complicates the demarcation between the Unit and the General Tax Audit functions. The General Tax Audit Directorate is facing confusion because it believes that the auditing task cannot be detached from the department. The respondents from the Directorate do also believe that the TP Unit's role should only be confined to investigation of taxpayers' involvement in transfer pricing and supplying inputs for the General Tax Audit's auditing tasks which include TP related issues. The TP Unit is expected to undertake comprehensive tax audit on select taxpayers, i.e. multinational corporations, and on the transactions of related enterprises. As such, the TP Unit is designed to engage in the same activity as the General Tax Audit, except specifically focusing on taxpayers that are deemed to be likely to engage in transaction with related parties. Given this similarity of roles and the lack of progress in operationalising the TP Directive, some within the Ministry of Revenue suggest the TP Unit needs to be dismantled and/or merged with the General Tax Audit.³⁶

A practical issue that stands in the way of such proposals for merger is the disparity in the length of time general audit and TP audit require. Within the General Tax Audit unit there is a general performance standard requiring comprehensive tax audit to be completed within 50 days for large taxpayers, within 25 days for medium taxpayers, and within 15 days for small taxpayers. As transfer pricing is a far more complex process, this timeframe would not be realistic. This, of course, is not an unsurmountable problem. The point here is not to endorse the proposal, but to show the need to rethink the relationship between the two units so that their mandates would *in reality* not overlap and that the aspects they share in common should be repurposed into useful synergy, instead of competition, for example by sharing the use of databases.

3.2.2. Tax administration v. tax policy

A disconnect between the policymaking and administration levels of transfer pricing is also observable. At the policymaking level, particularly within the Ministry of Finance's Legal and Tax Policy Directorates, there is expectation that the administrative unit, i.e. the TP Unit, should simply take up and operationalise the TP Directive. The TP Unit, however, does not apply the TP Directive completely and, to the extent it undertakes any tax analysis, resorts to regular income tax rules. The TP Unit staffers claim they are hindered from applying the TP Directive by the absence of further guidance from the policymaking level. In particular, they claim, there is lack of guidance as to how to assess technical and management service fees and in such circumstances they resort to customary tax practices. The ITP does not have

³⁶ Focus group discussion with officials at the Ministry of Revenue.

specific regulations regarding such expenses, nor are there particular thresholds or limitations. When taxpayers declare large sums of money as technical or management service fees paid to a related or parent company abroad, the TP Unit, similar to the General Tax Audit, simply rejects such expenses as tax deductible.

The TP Unit does not apply the arm's length principle assessment under the TP Directive, nor the 'fair market value' assessment customary under general income tax law. It is unable to apply the arm's length principle due to the complexity of the regime, and the fair market value assessment because it is not legally applicable for transfer pricing. The current practice of the TP Unit is, therefore, to reject such expenses either automatically as non-deductible expenses or, in a few instances, after making a vague fair market value determination of such expenses as 'exaggerated.' This practice is rationalised by a partial reading of the TP Directive which states that in cases of ambiguity or a clash between the TPGs and the ITP, the later takes precedence.³⁷ While this provision is applicable in the course of interpreting and applying the TP Directive, it is instead invoked to disapply the Directive and fall back on the ITP.

This approach is also compounded by the fact that the TP Unit harbours a general distrust of taxpayers and a tendency to avoid risk, traits common across tax audit units in general. There is a general suspicion that large amounts of funds are being declared as expenses without necessary control. This suspicion is only strengthened by the fact that oftentimes large taxpayers do not present well-documented invoices for expenses. For example, for management service fees between related parties, internal receipts and correspondence between the companies are presented as invoices. Auditors also often use their judgement to determine valid expenses, and in ambiguous cases they prefer to get a case out of their hands instead of approving an expense and taking the responsibility. This results in a tendency to summarily reject expenses deemed unjustified and let the dispute settlement process take care of them. To assess whether an expense is justified, auditors rely on the general tax provision allowing expenses incurred specifically for 'earning', 'securing', and 'maintaining' the business income of an establishment.³⁸

At the policymaking level there is an appreciation that implementing the TP Directive as it stands is beyond the technical capability of the TP Unit. Accordingly, there is ongoing study to further simplify the Directive, although that work is disrupted by ongoing Covid-19 challenges.

3.2.3. General Tax Audit/TP Unit v. Customs Commission

The Ethiopian Customs Commission is an organ of the Ministry of Revenue, the same ministry which the tax administrators General Tax Audit and the TP Unit belong to. The Customs Commission functions independently of the tax administrators, and there is minimal interaction between these organs.³⁹ The primary concern of the Customs Commission is tackling import under-invoicing as this results in less customs duty liability on the importer. Under-invoicing of imports is a common occurrence aimed at evading or reducing import tariffs. Over-invoicing, on the other hand, has the reverse effect (i.e. boosts import tariffs), and therefore the Commission does not actively monitor it. Taxpayers engaged in re-export business in particular have reason to over-invoice their imports in order to ultimately pay less taxes on their exports or make their business profit appear reduced. The tax administrators assume prices/invoices that are accepted by the Customs Commission to be final or not subject to adjustment when applying transfer pricing rules. Consequently, reliance on over-

³⁷ TP Directive 43/2015, Article 18.

³⁸ Income Tax Proclamation 979/2016, Article 20.

³⁹ Interview with Customs Commission officials.

invoiced prices for tax assessment leads to artificially reduced tax liability. As such, the focuses of the customs and tax administrators are at odds with each other.

The scheme of over-invoicing imports to reduce ultimate tax liability is a critical area of revenue loss for the country as there are incentive regimes offering minimum or no customs liability for exporters. For example, the import of raw materials for re-export purposes is free from customs duty. Most multinational enterprises import products or industry inputs from a related (parent or subsidiary) company abroad.⁴⁰ 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 deductible in their business profit tax liability due to the inflated price of import. Even in cases where taxpayers are not exempt from customs duty, over-invoicing is still a source of revenue loss for the tax administration as the customs fee will be ultimately recouped by the taxpayer by declaring it as a cost for the purposes of custom duty.

The Customs Commission does investigate transactions between related parties, although not as systematically as is the case with the tax administration units. However, this investigation is triggered only when there are suspicious cases of under-valuation.⁴¹

The seeming clash between the priorities of the customs and the 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 from the Customs Commission for price valuation when there are suspicious cases. But in most cases the tax administration simply assumes the prices accepted by the Customs Commission upon the taxpayer's declaration as final. Resort to Customs Commission valuation, which is effectively placing the Commission as a control mechanism, is also ultimately not an efficient solution as the Commission is positioned at the end of the import process. Furthermore, the Commission undertakes adjustments to increase prices, but it does not have a practice of adjustment to decrease prices – it is also legally unclear if the Commission can undertake decrease adjustments. In fact, the Commission considers higher prices as a source of greater customs duty, and hence over-invoicing as a welcome opportunity. In addition to the potential harm on taxable income, the over-invoicing of items and the Commission's lax approach to tackling it enables multinational enterprises to repatriate dividend as deductible expense made to parent company or subsidiaries.

3.3. Mock compliance

Another factor compounding Ethiopia's lag in implementing transfer pricing rules is the possibility of doing mock compliance (Dafe and Engebretsen 2021) without taking decisive measures to implement the rules. The lack of ability and lacklustre political commitment to implement transfer pricing rules exist side-by-side with the need to appear to be implementing the rules by enacting legislative frameworks and rudimentary institutional practice. We see this in two aspects. The first is with respect to Ethiopia's haphazard approach to DTAs that have direct impact on transfer pricing application. The second illustration is the lack of enforcement of necessary procedures for transfer pricing audit, in particular relating to documentation and information exchange. The following sections elaborate both illustrations.

3.3.1. Haphazard double taxation avoidance treaties

Ethiopian DTAs are not entered into in pursuit of deliberate tax policy, but rather for a host of haphazard reasons, including political symbolism. More recently, when realisation of the tax

⁴⁰ Proclamation 768/2012 – Export Trade Duty Incentive Schemes Proclamation.

⁴¹ *Ibid.*

and transfer pricing implications of DTAs started to sink in among Ethiopian policymakers, serious conversation on the need to review the terms of DTAs has emerged.

As of December 2021, Ethiopia has signed 33 (23 in force) DTAs with both developed and developing countries.⁴² All the DTAs contain a provision that addresses the Associated Enterprises article or Article 9 of the OECD Model Tax Convention. Various factors are behind the signing of DTAs, except a deliberate tax-conscious policy on DTA signing. A prominent factor is a request from the national airline to reduce the tax liability in countries it flies to. There are currently several pending requests from the airline for the signing of DTAs, with, among others, Nigeria, Mali, Philippines, and Djibouti.⁴³ However, a request from the airline is not the exclusive or even the most decisive factor in the signing of DTAs. The DTAs serve the airline in limited aspect only; there is a separate set of treaties, known as air service agreements, that Ethiopia has signed with several countries covering certain taxation aspects in aviation activities.⁴⁴

Ethiopia has also signed DTAs with countries where the airline does not fly to, and does not have a commercial interest, such as Palestine and Malta. This goes to show the existence of non-aviation related factors for the signing of DTAs. Political consideration is a prominent factor, as observed in the case of other African countries as well. Often, DTAs are signed as manifestations of political solidarity with another state. When the highest political leadership of the country visits a friendly nation, or vice versa, DTA signing can follow as a political statement, sometimes without much deliberation as to the content of such treaties.⁴⁵ In other instances, the political push comes from the other country; for example, in the case of Ethiopia's DTA with Palestine, the latter had an interest in using the treaty as a sign of state recognition under international law. The initiative for DTAs, therefore, could be led by the Ministry of Finance (in economic cases) or the Ministry of Foreign Affairs (in political cases).

In yet other cases, capital-exporting states (e.g. United Kingdom) and tax haven jurisdictions (e.g. Mauritius) push for the signing of DTAs with Ethiopia.⁴⁶ In such cases, the problem of technical and management services highlighted above becomes relevant. In the likely scenario that the country's transfer pricing administration remains dormant or weak for the foreseeable future, DTAs with such countries become key vehicles of revenue loss as technical and management services are grounds for reducing business profit tax liability and are often not subject to withholding tax.

The tax implications of DTAs are lately increasingly being recognised by Ethiopian policymakers. A recent DTA signed with Switzerland on 29 July 2021 allows the country to retain withholding taxes for technical and management services rendered by a related party. The treaty's definition of business profits excludes 'profits derived from the rendering of any service of a managerial, professional, technical or consultancy nature'. Instead, echoing Article 12A(5) of the UN Model, Article 21(4) of the DTA provides that such service fees shall be deemed to arise in the source state if the payer for the service is a resident of that state. There is also now discussion at the level of policy within the Ministry of Finance on the need to revise and renegotiate all DTAs, and on whether future DTAs must include a similar treatment of technical services as a matter of principle.⁴⁷

⁴² The DTAs are signed with: China, Cyprus, Czech Republic, Egypt, France, India, Iran, Ireland, Israel, Italy, Kuwait, Malta, Mozambique, Netherlands, North Korea, Palestine, Poland, Portugal, Qatar, Republic of Korea, Romania, Russia, Saudi Arabia, Seychelles, Slovakia, South Africa, Sudan, Switzerland, Tunisia, Turkey, United Kingdom, United Arab Emirates, Yemen. See, KPMG, *Ethiopia Fiscal Guide 2019*, March 2020 available at <https://assets.kpmg/content/dam/kpmg/za/pdf/pdf2020/ethiopia-fiscal-guide-2019.pdf>

⁴³ Interview with officials at the legal directorate of the Ministry of Finance.

⁴⁴ As of 2020, 41 air service agreements are signed and 56 more initialed.

⁴⁵ Interview with officials at the legal directorate of the Ministry of Finance.

⁴⁶ On capital exporting and developing states' tax treaty relationships generally, see Hearson 2021.

⁴⁷ Interview with officials at the legal directorate of the Ministry of Finance.

3.3.2. Ritual observation of documentation and information exchange

Ethiopian tax officers have a practice of undertaking purely ritual performance of some transfer pricing procedures. Although the TP Directive requires taxpayers to document and disclose information on transactions with related parties, in practice this requirement is not observed by taxpayers. Obtaining information on international controlled transactions through exchange of information with foreign tax authorities and through documentation required from taxpayers is a major gap in Ethiopia's transfer pricing system. Ethiopia is not a member of relevant multilateral conventions that facilitate information exchange between tax authorities, such as the OECD Convention on Mutual Administrative Assistance in Tax Matters (MAC). However, non-membership of such mechanisms is not the real obstacle. Instead, interviews with tax officials and policymakers revealed that there is no desire to utilise such mechanisms even if they were available. The proof for this is also the fact that the numerous bilateral DTAs that contain information exchange clauses are hardly utilised.⁴⁸ Both General Tax Audit and the TP Unit admit that they have never utilised exchange of information processes based on DTAs to investigate or obtain more information on related multinational enterprises. The limited instances of DTA-based information exchange practices are only limited to issues such as certification of tax residence, tax records, and financial status, most of which are only incoming requests for information.

Documentation requirements are stipulated by law as a matter of ticking the standard practice box. However, these are not enforced in reality. In addition to the documentation requirement described in section 2.1. above, the Ministry of Revenue also requires taxpayers to complete and submit an annual TP Declaration form. Taxpayers with an annual aggregate international controlled transaction exceeding 500,000 ETB are required to complete the form, which collects details such as the taxpayer's principal business activities, their international controlled transactions, and the transfer pricing method used (Raya 2019: 50). Both the general documentation requirements and the additional TP Declaration are not observed in practice by taxpayers, and the requirements are also not enforced by the Ministry of Revenue, partly for fear of arbitrariness as there is no comprehensive data on multinational enterprises engaged in international controlled transaction. Crucially, TP Unit personnel state that the enforcement mechanism for the documentation requirements is not clearly set under the TP Directive. What measures or penalties the tax authority can take in case of a taxpayer's failure to keep or provide such documentation is unclear. The ITP generally stipulates a penalty of 100,000 ETB for such enforcement measures; this penalty amount is, however, too small to have any impact on multinationals and vague as to its accrual period – it is not clear if it is per month, per year or any other period.

4 Conclusion

Low-income countries' implementation of the OECD's transfer pricing rules is constrained by their capacity limitations. This study, by focusing on the law and practice of Ethiopia, provides a context-specific and more qualified exposition of the capacity thesis in explaining unsuccessful implementation of OECD rules in low-income countries. While showing that the capacity constraint is a serious factor, the paper illustrates that material capacity is not the only explanation. Instead, it identifies three other explanations of an institutional nature. The first is a tax officer's inability to decisively depart from long-established tax practices that run counter to the OECD transfer pricing rules. The second factor is a myriad of institutional mandate ambiguity and rivalry within tax administration organs, and also between the tax administration and tax policy organs. The third factor is the possibility of countries engaging in the appearance of compliance with international standards (mock compliance) without in

⁴⁸ Ethiopia has signed 33 DTAs, of which 23 are in effect.

fact seriously applying the rules in the book on the ground. These findings imply that improving Ethiopia's compliance with the OECD transfer pricing rules requires not merely increasing capacity assistance to resolve the material constraints, but also resolving questions of habit, clarity, commitment to the working practices, institutional organisation, and policymaking.

The above findings imply that improving the ability of low-income countries to effectively administer transfer pricing needs to be as much a local process that involves relevant tax policymakers and administrators in designing the transfer pricing regime as it is an international technical intervention. They also show that resolving some of the critical challenges, in particular the institutional ambiguities and rivalries, requires not external technical assistance, but 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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