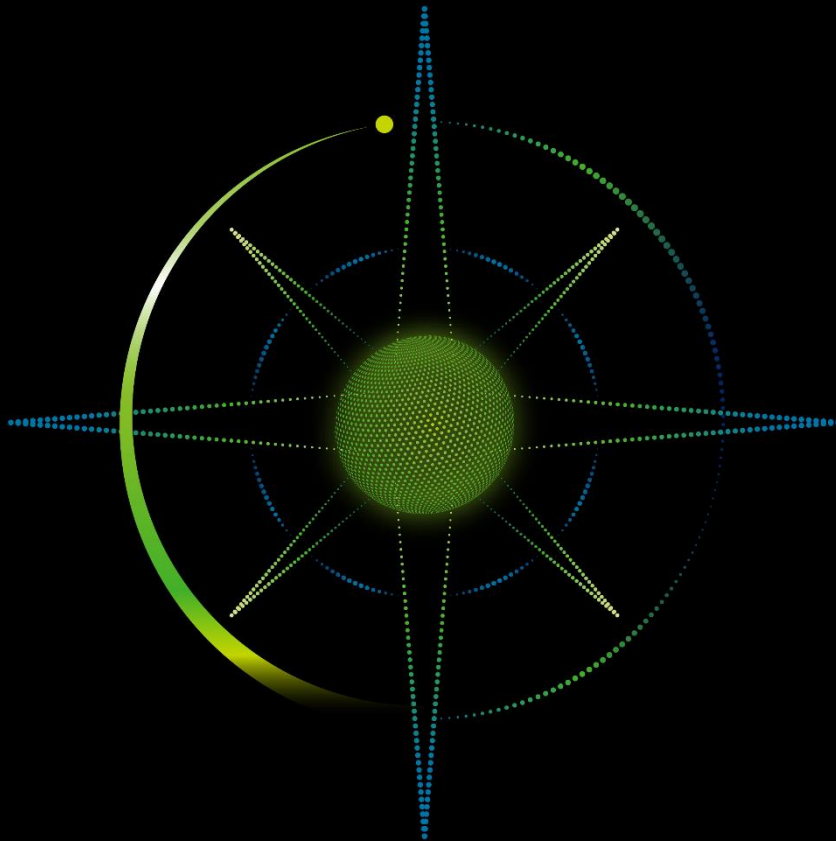


Tax & Legal Alert
February 2024



Ethiopia Transfer Pricing Directive, 2024

A summary of the key aspects

Pursuant to the power granted to the Ministry of Finance by way of Art. 79 (2) and (4) of the Federal Income Tax Proclamation (“ITP”), the Ministry of Finance and Economic Cooperation (“MoF”) has issued a Directive to provide Rules on Transfer Pricing (“2024 TP Rules, “Rules”). The preamble of the Directive No. 981/2024 is to facilitate proper implementation of the arm’s length principle as stated under Art. 79 of the ITP. The 2024 TP Rules are effective as from January 2024.

The rules are largely consistent with the Organization for Economic Cooperation and Development (OECD)’s Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (“OECD Guidelines”). In this alert, we summarise the key highlights of the 2024 TP Rules. You are advised to read this alert together with [the MoF Directive](#) for more details.

Background – Legislation on transfer pricing

Ethiopia issued the first TP rules in October 2015 through Directive No. 43/2015. This was revised through a Directive No. 231/2021 issued in 2021 which has now been repealed by Directive No. 981/2024 (“2024 TP Rules”) effective January 2024.

The 2024 TP Rules apply to transactions between resident taxpayers and their resident and non-resident related entities. These Rules largely mirror the guidance provided by the previous directives with additional provisions for non-compliance penalty.

We provide a summary of the key aspects below:

Scope of application of the TP Rules

The 2024 TP Rules are applicable to taxpayers with an annual turnover of more than ETB 500,000. The Rules cover both domestic and international transactions involving related persons.

Under Article 4 of the Tax Administration Proclamation No.983/2016 (“TAP”), two persons are considered related when the relationship between them is such that one person may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of the other person, or both persons may reasonably be expected to act in accordance with the directions, requests, suggestions, or wishes of a third person. Direct or indirect shareholding of 25% or more also makes a person to be related to another person for purposes of the TP Rules.

Compliance with the arm’s length principle

The 2024 TP Rules require taxpayers engaged in covered transactions to comply with the arm’s length principle. In establishing the arm’s length principle, the 2024 TP Rules require a taxpayer to:

A. Carry out a comparability analysis

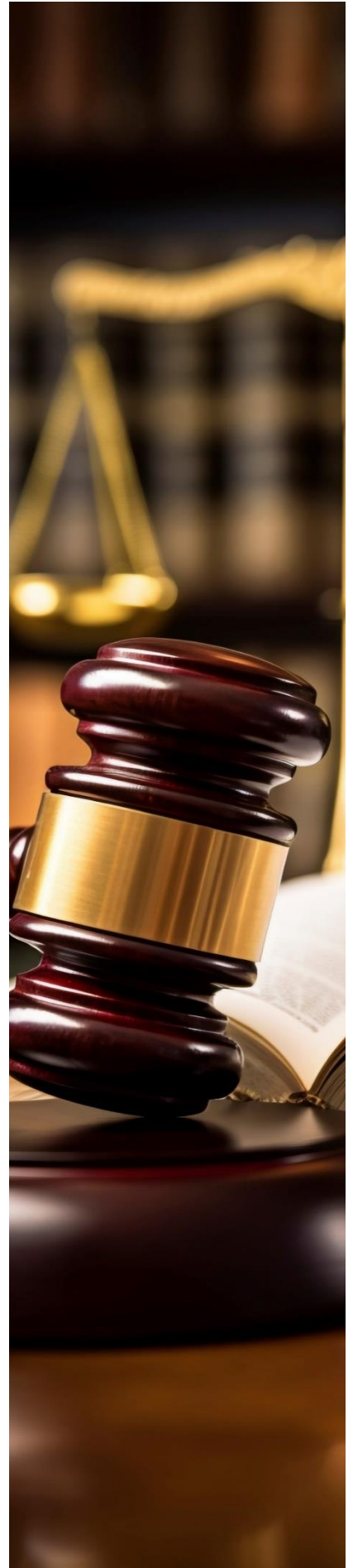
Comparability between controlled and uncontrolled transactions should be based on factors that are economically relevant to facts and circumstances of the transactions. Some of the comparability factors include:

- Characteristics of property or services,
- Functions undertaken, assets utilized, and risks assumed,
- Contractual terms and conditions,
- Economic conditions and market circumstances, and
- Business strategies.

Comparability adjustments should be undertaken if they are expected to increase the reliability of the results.

Internal or external sources of information on the uncontrolled comparable transactions can be applied if available to both the tax authority and the taxpayer.

Where comparable uncontrolled transactions are accepted from other geographic markets, an assessment of the expected impact of geographic differences and other factors on the price and profitability of the transaction should be performed.



B. Select the most appropriate TP method

In line with the OECD Guidelines, the 2024 TP Rules adopt the application of the ‘most appropriate’ TP method based on the facts and circumstances of the case and considering the method’s strengths and weaknesses, appropriateness to the functional analysis, availability of reliable data, and the degree of comparability of the controlled and uncontrolled transaction.

The approved transfer pricing (“TP”) methods include:

- a) Comparable uncontrolled price method (“CUP”);
- b) Resale price method (“RP”);
- c) Cost-plus method (“CP”);
- d) Transactional net margin method (“TNMM”); and
- e) Transactional profit split method (“TPSM”)

If it is not possible to determine an arm’s length price for some of the functions performed by the related party, the transactional profit split method can be applied to allocate the common residual profit (or loss) from the transaction once the routine functions are remunerated.

The Rules permit a taxpayer to apply any other pricing methodology where it can be demonstrated that (i) none of the above approved TP methods can reasonably be applied and (ii) the alternative method yields results consistent with the arm’s length principle.

C. Determine the arm’s length range

The arms’ length range is defined as a range of relevant financial indicator figures (price, margin or profit) produced by the application of the most appropriate TP method. The median of the arm’s length range is the 50th percentile of the financial indicator figures.

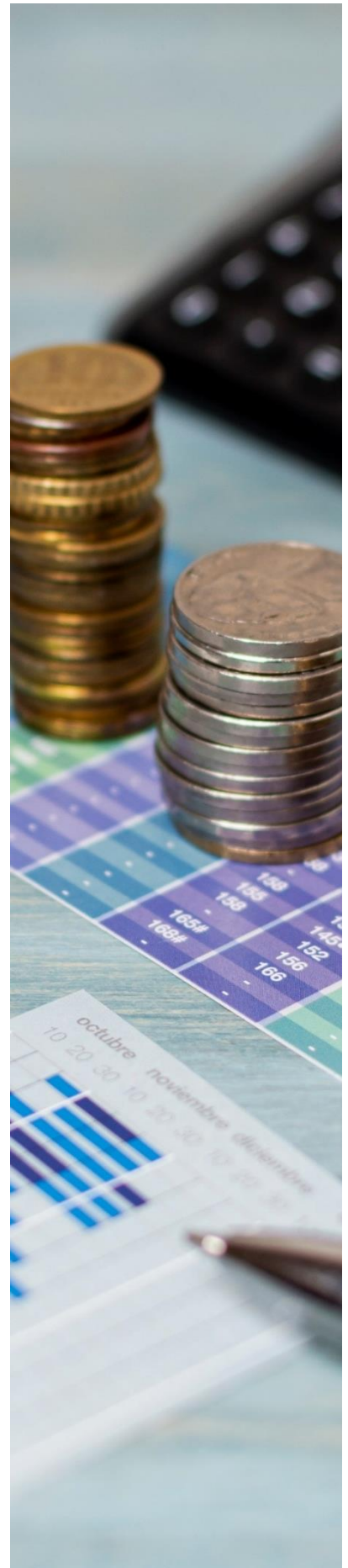
Where the results of the controlled transaction fall outside the arm’s length range, an adjustment can be made by the Tax Authority to the median of the arm’s length range unless either the taxpayer or the tax authority demonstrates that adjustment to another point in the range is more appropriate. Such adjustments are allowed only when the net effect of the adjustments is an increase in the taxpayer’s taxable income.

Advance pricing arrangements (“APA”)

The 2024 TP Rules allow a taxpayer to request the Tax Authority to enter an APA to determine the appropriate set of criteria for the determination of the arm’s length conditions for certain future-controlled transactions over a fixed period not exceeding five years.

The taxpayer request must be accompanied by:

- A description of the taxpayer’s business activity, controlled transactions, proposed scope and duration of the transactions to be determined.
- Significant comparability factors, the TP method selected, and critical assumptions made regarding future events under the transaction(s) being determined.



- Country or countries, if any, that the taxpayer wishes to participate in the arrangement.
- Any other information the tax authority may prescribe.

Once approved, the APA is binding on the Tax Authority if the taxpayer follows the terms of the arrangement.

The APA may be revoked retrospectively by the Tax Authority where the taxpayer neglectfully or wilfully makes a misrepresentation, mistake or omission or fails to materially comply with fundamental terms and conditions of the arrangement.

The APA may be cancelled for the remainder of the period covered if it is established:

- that there was a misrepresentation, mistake or omission that was not attributable to the neglect or wilful default of the taxpayer, or
- that the taxpayer failed to materially comply with a fundamental term or condition of the arrangement, or
- that there was a material breach of one or more of the critical assumption, or
- that there was a change in tax law that is materially relevant to the arrangement.

The commencement date of the Directive on the APAs shall be fixed by a circular of the MoF.

Services transactions

A service charge is considered consistent with the arm's length principle if:

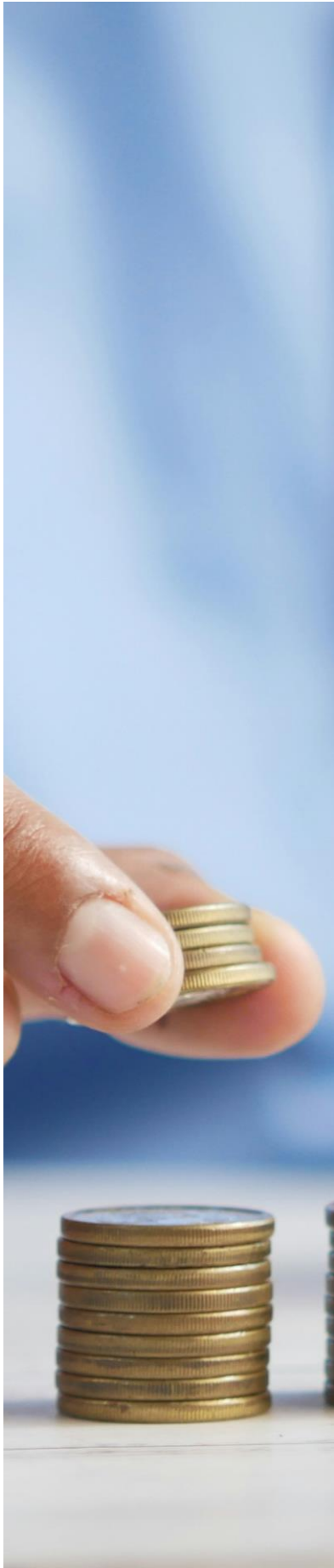
- the service is actually rendered;
- the service provides the recipient with economic or commercial value to enhance its commercial position;
- an unrelated person in comparable circumstances would have been willing to pay for such services or would have performed the services in-house, and
- The amount corresponds to that which would have been agreed between unrelated persons for comparable services in comparable circumstances

Such services charges should exclude shareholder activities including but not limited to:

- juridical structure, shareholder meetings, and costs for supervisory board.
- reporting requirements including consolidation of reports by parent entity.
- raising of funds for acquisitions not beneficial to the taxpayer.

The TP Rules endorse both direct charge for specific services to a related person, and indirect charge method for services provided jointly to various related persons in determining the service recharges. This allows for use of one or more reasonable cost allocation keys depending on the nature of the services provided.





Transactions involving intangible property

Transactions involving intangibles include, but not limited to, licenses, sales and any other transfer, arrangement concerning or provision of intangible property such as patents, copyright, formula, process, design, model, plan, trade secret, know-how, trademark and the like.

When applying the arm's length principle to transactions involving intangible property, the perspective of both parties need to be considered as well as the expected benefits, geographical limitations, exclusivity, and transferee role in the future developments of the intangible.

Transfer pricing documentation

The affected taxpayer must prepare/ maintain a contemporaneous TP documentation for the relevant tax year in Amharic or English. This documentation should be ready before the statutory tax return filing date.

The Rules prescribe the information to be included in the TP documentation such as the business overview, organizational chart, group organizational and operational structure, controlled transaction(s), comparability analysis, functional analysis, industry analysis, economic analysis, details of APAs, conclusion on compliance with the arm's length principle, and any other material information.

The documentation should be submitted within 45 days upon request by the Tax Authority.

Corresponding adjustments

The 2024 TP Rules allow for corresponding adjustments to taxable income in relation to domestic and international transactions as follows:

- Where an adjustment is made by the Tax Authority in relation to a domestic transaction, the Tax Authority shall make an appropriate adjustment to the taxable income of the other party to the transaction.
- Corresponding adjustments on international transactions are allowed only where there is a treaty between Ethiopia and the country raising the primary adjustments that provides for the relief of economic double taxation. In this case, the affected taxpayer must make an application and provide all the information necessary for the Tax Authority to examine the consistency of the adjustment made by the tax administration of the other country. The application must be within the timeframe for making such requests as per the mutual agreement procedures under the respective treaty.

Relevance of the OECD TP guidelines

Although Ethiopia is not a member of the OECD, the 2024 TP Rules recognize the OECD Guidelines as a relevant source of interpretation. However, the ITP and the 2024 TP Rules take precedence in case of any differences or conflicts.

Administrative penalties for non-compliance

The Rules introduce penalties under the TAP No. 983 of 2016 for failure to maintain TP documentation and failure to submit the documentation when requested by the Tax Authority.

The penalty for non-compliance is Twenty Thousand Birr (ETB 20,000) per tax year. This penalty, previously applied to other tax matters, now extends to TP documentation and related party disclosures.

Our view

This 2024 TP Rules provide clarity on the TP compliance requirements in Ethiopia. A key aspect of the Rules is the provision for Advance Pricing Agreements (“APAs”) that allows taxpayers to enter into binding agreements with the Tax Authority on the determination of transfer prices for future controlled transactions. APAs are becoming increasingly popular as they provide taxpayers with some level of certainty regarding their TP arrangements. The provision will however only become operational upon issuance of a circular by the MoF.

Rule 10 on transfer pricing adjustments is an important provision since it provides greater certainty to taxpayers that they will not be subject to TP adjustments if their results fall within the arm’s length range. In line with the OECD Guidelines, the definition of arm’s length range provided in the 2024 TP Rules could be interpreted by the Tax Authority to mean the inter-quartile range (lower and upper quartile), rather than the full range, of results of comparable uncontrolled transactions. Notably, only upward TP adjustments to increase the taxpayer’s taxable income are allowed.

Rule 16 on corresponding adjustments is a positive measure as it mitigates the risk of double taxation where a TP adjustment is made on a domestic or international transactions. Notably, the Federal Democratic Republic of Ethiopia has double tax treaties with countries such as Cyprus, Egypt, France, Great Britain and North Ireland, India, Ireland, Israel, Italy, Netherlands, Poland, Portugal, Romania, Singapore, South Africa, South Korea, and Turkey.

The TP Rules do not contain guidelines or rules on country-by-country reporting (CbCR). Hence, there is no CbCR compliance requirement in Ethiopia as yet. CbCR is a global initiative spearheaded by the OECD that has been adopted by many jurisdictions both members and non-members of the OECD. The aim of the initiative is to enhance transparency and information sharing on the activities of MNEs in different jurisdictions. Ethiopia is yet to join the OECD’s Inclusive Framework under which members are expected to implement the minimum standards, including CbCR, covered under Base Erosion and Profit Shifting initiative.

With the revision of the TP Rules, it is expected that the Tax Authority may intensify their focus on transfer pricing audits. MNEs with presence in Ethiopia should take necessary measures to ensure compliance by putting in place appropriate TP documentation before the due date for their statutory tax return.



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